Cross border taxation of Islamic finance in the MENA region

Phase One

1. Contents

2. Disclaimer

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

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

Accordingly, none of the authors or organisations involved with this paper accepts any legal responsibility to any person who acts, or refrains from acting, as a result of anything written in this paper.

The views expressed in this paper are purely the views of the three named authors in their personal capacity, and should not be attributed to any organisation involved with the preparation of this paper, or attributed to any organisation with which the authors may be affiliated.

3. Executive summary

The taxation systems of almost all countries were developed in an environment of conventional finance.

Most transactions that are undertaken in Islamic finance seek to achieve economic outcomes which are similar to the economic outcomes achieved by conventional finance. However to achieve these economic outcomes the Islamic finance transactions typically require more component steps than do the equivalent conventional financial transactions.

For example a conventional loan of money for a 12 month period at a fixed rate of interest with a single bullet repayment requires only one transaction, namely the transfer of money from the lender to the borrower along with the execution of a loan agreement specifying the interest rate and the date of payment. Achieving the same result by using a commodity murabaha transaction requires three transactions in the underlying commodity: its purchase by a bank, the sale of the commodity by the bank to the customer, and finally the sale of the commodity by the customer to another purchaser, typically a commodity market participant.

The additional transactions required by Islamic finance are at risk of being subject to transfer taxes or to taxes on income or gains. This can be seen most clearly by considering the sukuk transactions reviewed in this paper where in many cases a transaction which is economic equivalent to the issue of a conventional bond secured on real estate gives rise to transfer tax and capital gains tax liabilities which make the sukuk transaction prohibitively expensive to carry out.

This work for this report was sponsored by the Qatar Financial Centre Authority, and assisted by two professional services firms, but its contents are the sole responsibility of the authors. We have reviewed the tax treatment of four common Islamic finance structures, commodity murabaha, sukuk, salaam and istisna in eight MENA region countries: Egypt, Jordan, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Turkey and also in the Qatar Financial Centre.

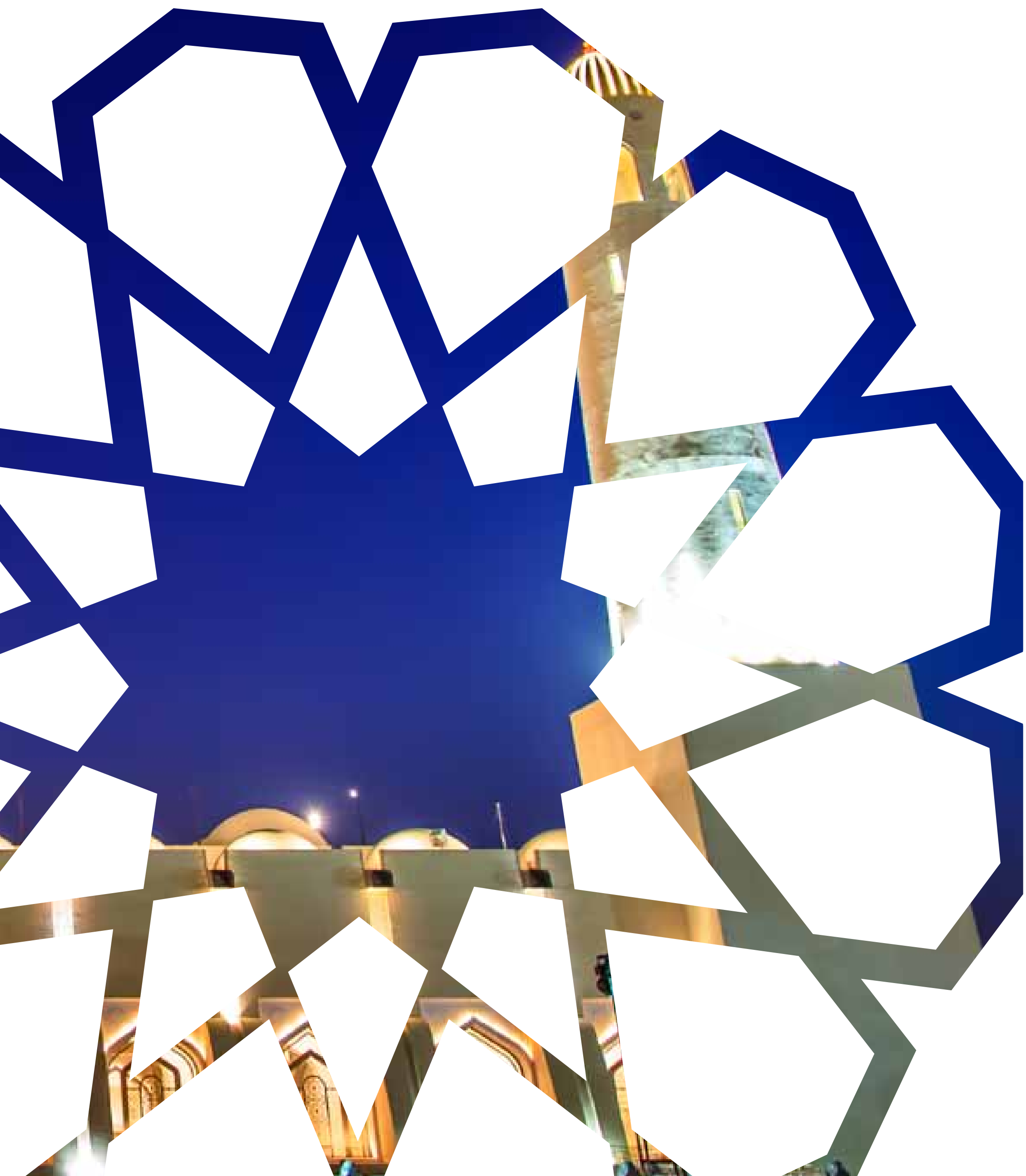
The survey shows that while simpler Islamic finance transactions can be carried out in some of these countries without prohibitive tax costs, only Turkey and the QFC have a tax system that enables sukuk transactions to be carried out without excessive tax costs.

We then consider two alternative approaches to the modification of tax law to facilitate Islamic finance. For simplicity we term these the Malaysian approach and the United Kingdom approach.

The Malaysian approach is based upon the regulatory authorities putting in place a process for advance determination of whether a transaction does or does not constitute Islamic finance. For those transactions which are certified as being Islamic finance transactions, tax law can be modified relatively easily to give these Islamic finance transactions the same taxation outcome as the equivalent conventional transactions. Where intermediate transactions are necessary to effect the Islamic finance structure, the intermediate transactions can be readily be disregarded for tax purposes.

The United Kingdom approach is based upon the philosophical objective of separating religious matters from tax law. Accordingly, the United Kingdom does not want the tax treatment of a transaction to depend upon whether or not it is Shariah compliant. Indeed, the United Kingdom wishes to keep all religious references out of tax law. Accordingly, the United Kingdom has proceeded by defining certain kinds of transactions using purely secular free-standing language which makes no reference to Islam or to Islamic finance. Once the transactions have been defined, their tax treatment can be specified in a manner that results in the same tax treatment that will be given to equivalent conventional finance transactions. The United Kingdom approach requires much more complex drafting of tax law since no reference can be made to external Islamic finance sources; conversely, it has the merit of keeping religion out of tax law.

In the case of Muslim majority countries such as the countries in the MENA region, we recommend the Malaysian approach as being quicker and simpler to implement.



4. The preparation of this report

Sponsor

This report was made possible by the sponsorship of the Qatar Financial Centre Authority (website **www.qfc.com.qa**).

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 thought leaders in this area.

Research project management

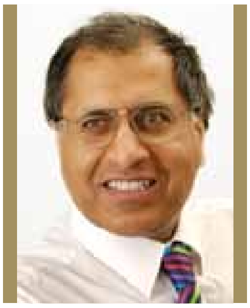
This research project was initiated during the Second Middle East/North Africa Tax Forum held in Istanbul, Turkey, in October 2011, and has been managed by the International Tax and Investment Center (ITIC). A consensus was reached at the end of the Forum by participating countries on the need for further research on cross border tax issues related to Islamic finance transactions. ITIC has organized the Forum since 2010 with a view to creating a structure for dialogue and communication on tax and investment issues in the region. The Forum was founded with the enthusiastic support of the Public Revenue and Department, Qatar Ministry of Finance, and the leadership of the QFC Authority as one of the founding financial sponsors.

Founded in 1993, ITIC serves as a clearinghouse for information on best practices in taxation and investment policy, and as a training center to transfer such know how to improve the investment climates of transition and developing countries, thereby spurring formation and development of business and economic prosperity. ITIC is an independent nonprofit research and education foundation with offices in Russia, Azerbaijan, Kazakhstan, Jordan, the Philippines, Ukraine, the United Kingdom, and the United States.

Report authors

The research for and the preparation of this report have been carried out jointly by three people: Mohammed Amin, Salah Gueydi and Hafiz Choudhury, with the majority of the writing being done by Mohammed Amin.

Mohammed Amin



Mohammed Amin is an Islamic finance consultant. Previously he was a partner in Pricewaterhouse Coopers LLP and led their Islamic finance practice in the UK. He is a chartered accountant, a chartered tax adviser and a qualified corporate treasurer. Amin serves as a Council member of the Chartered Institute of Taxation and as a member of the Policy & Technical Committee of the Association of Corporate Treasurers.

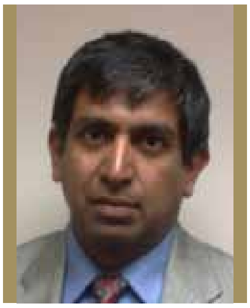
Amin has spoken on Islamic finance in over 20 cities covering every continent except Antarctica. Many of his articles and presentations on Islamic finance can be found on his website www.mohammedamin.com.

Salah Gueydi

Salah Gueydi is a senior tax adviser in the Qatari Ministry of Economy and Finance. He joined the Ministry in 2005 following a technical assistance project for the Qatari Government concerning tax reform in which he was actively involved as a senior consultant. His duties include mainly drafting tax laws and regulations, negotiating tax treaties and giving legal opinions to taxpayers and other government bodies.
He also participates as a representative of the State of Qatar to international tax-related events such as the annual meetings of the UN Committee of Experts in International Cooperation on Tax Matters where he worked on the update of the UN model convention. His main contribution was focused on the treatment of Islamic financial instruments under the model.

Mr. Gueydi worked also as a senior consultant and senior researcher in the International Bureau of Fiscal Documentation (IBFD) in the Netherlands and as a Counsellor in the Tunisian Ministry of Finance.
Mr.Gueydi graduated in Corporate Finance, Public Finance and Taxation from the IHEC, ENA (Tunisia) and ENI (France).

Hafiz Choudhury



Hafiz Choudhury is a Senior Advisor to the International Tax and Investment Center, Washington D.C. His focus is to manage the technical programs of the organization in the Asia Pacific and the Middle East/North Africa regions. He is a Principal with The M Group, a consulting firm that provides strategy consulting and subject matter expertise directly to tax, customs and revenue administrations (www.mgroupglobal.com.). He has worked in locations as diverse as India, Qatar, Myanmar, Thailand, Malaysia, Seychelles, Mongolia, Latvia and China. He has a strong interest in the international tax aspects of transactions in Islamic finance, and has been involved in commissioning and managing several research tasks in this area.

He is also involved with software companies that build international tax and trade decision support, modelling and analysis tools. (www.orbitax.com&www.reganalytics.com). Prior to these roles, he was with IBFD, in Amsterdam, the Netherlands (www.ibfd.org), where he held a variety of roles including as head of the Asia-Pacific/Middle East team, director of business development, and director of the Americas business. He graduated from London University with a Masters degree in International Relations, and joined HM Board of Inland Revenue in the UK (now HMRC), where he received his professional tax training. He is currently based in Washington D.C.

Professional services firms

The preparation of this report has received invaluable assistance from two leading professional services firms.

Ernst & Young

Ernst & Young's office in Qatar coordinated the issue of blank questionnaires to their offices in each country in the MENA region. Each office was responsible for completing the questionnaire, seeking the approval of its country tax authority and then returning the completed questionnaire to Ernst & Young in Qatar for delivery to the research team.

This survey would not have been feasible without that support.

PricewaterhouseCoopers

PricewaterhouseCoopers' office in Malaysia completed a questionnaire for Malaysia. This provided an invaluable comparator in the form of a Muslim majority country from outside the MENA region that has been involved in promoting Islamic finance for several decades.

The comments about Malaysia in this report would not have been possible without that support.

Copyright

5. Why Islamic finance gives rise to tax policy challenges

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. They also contain rules for determining when an overseas person is liable for taxation within the jurisdiction, and for determining when withholding taxes must be deducted from payments made to overseas persons.

Islamic finance presents a challenge for such tax systems, as they have generally been developed within a framework of conventional financial transactions.

Islamic finance transactions in most cases are designed to give a similar economic outcome to a conventional finance transaction, while meeting Islamic religious requirements which include avoiding any charging of interest, avoidance of excessive uncertainty, avoidance of selling assets that are not yet owned, etc. [1] To achieve this result, a greater number of steps is typically involved. This can be illustrated by the example of a fixed rate mortgage.

Conventional fixed rate mortgage

With a fixed rate mortgage, the interest rate is fixed for the entire duration of the mortgage. For example a property costing $500,000 may be financed under the following terms.

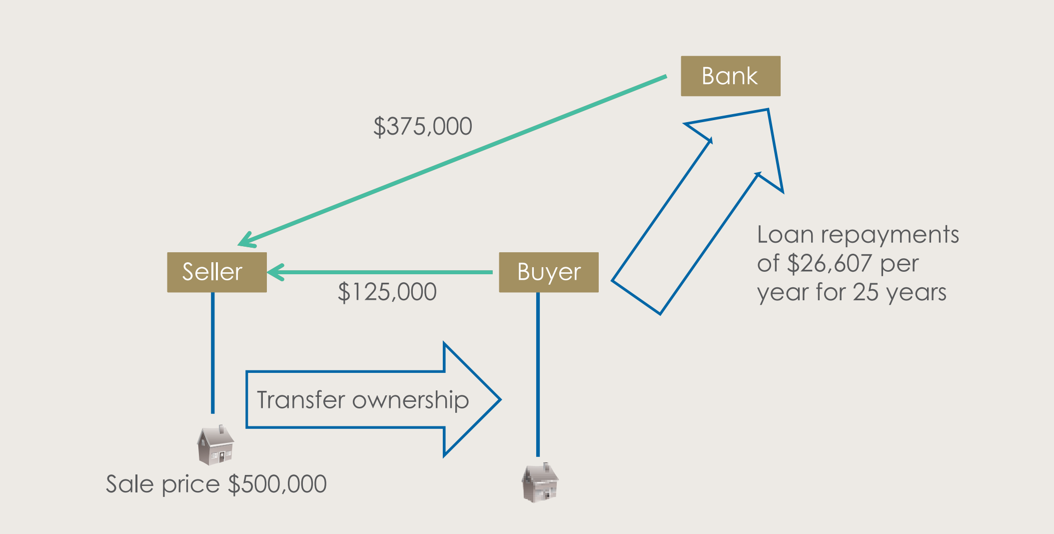
Cost of property from third party	$500,000
Term of finance	25 years
Customer deposit required	25% which is $125,000
Amount of loan	$375,000
Interest rate	5% pa fixed
Frequency of customer payments	Once a year on the anniversary of the making of the loan.
Customer to make equal annual payments	Payments can be computed as $26,607 per year.

Note: The payment frequency would normally be monthly. Annual payments are used purely for illustration to simplify the calculations.

This conventional mortgage transaction is illustrated in the diagram below.

1) For brevity, this report does not elaborate further on the religious requirements of Islamic finance. There are many sources where such information can be obtained, for example the websites of the Islamic Research and Training Institute and of the International Centre for Education in Islamic Finance. **(http://www.inceif.org/)**

Conventional fixed rate mortgage



Islamic equivalent of a fixed rate mortgage

Under Islamic finance, the equivalent of a fixed rate mortgage can be achieved by the following transaction.

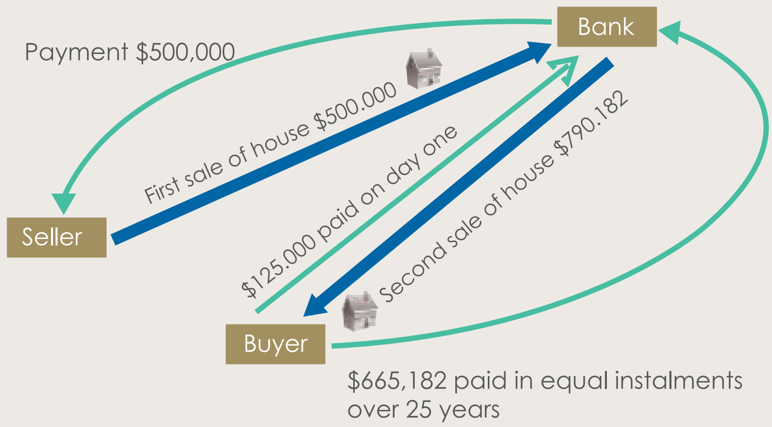
The Islamic bank will buy the property from the third party seller for $500,000 having pre-agreed with the customer that the customer will then buy the property from the Islamic bank at a pre-agreed price, on pre-agreed payment terms.

The Islamic bank may offer finance to the customer on the following terms:

Cost of property from third party	$500,000
Term of finance	25 years
Islamic bank will purchase the property and immediately resell it to the customer for a fixed price:	$790,182
Part of price payable by customer on day one	$125,000
Balance of price to be paid in 25 equal instalments	$665,182
Frequency of customer instalments	Once a year on the anniversary of the initial purchase
Amount of each customer instalment	$26,607

The contract is illustrated in the following diagram.

Islamic equivalent of fixed rate mortgage with effective 25% deposit



Possible taxation issues to consider

Assume that the bank is in a foreign jurisdiction and not in the customer's jurisdiction. Some of the taxation issues that may arise with the Islamic transaction above are:

- In the case of the conventional mortgage, the bank is assumed to have no taxable presence in the customer's jurisdiction. Accordingly, it is unlikely to be taxable apart from the possible charge to withholding tax on the interest element of the mortgage payments that the customer makes to the foreign bank. There is widespread agreement on how the mortgage payments are to be dissected between capital and interest for the purposes of computing withholding tax.

- If the jurisdiction charges tax on real estate transfers, this will be payable once on the transfer from the seller to the buyer. Most jurisdictions do not charge real estate transfer tax on mortgage transactions, although other types of tax may sometimes be charged on mortgage transactions.

- In the case of the Islamic mortgage, there are two sales of the property:

    1. From the seller to the bank, for a price of $500,000.
    2. From the bank to the customer, for a price of $790,182.

Potentially both of these sales are chargeable to real estate transfer tax, unless there are special reliefs applicable.

- The bank has bought the property for $500,000 and sold it for $790,182. Many jurisdictions charge tax on foreign persons who make gains from the sale of real estate located within the jurisdiction.

- In the absence of specific legislation, there may be no mechanism for dissecting the payments of $26,607 that the customer is paying to the bank each year. Legally, they are instalments of that part of the purchase price of $790,182 which is still outstanding. Absence of dissection may mean that the bank is not chargeable to any withholding tax; it may also mean that the customer has no mechanism for claiming a tax deduction for the economic finance cost involved in the transaction. Since the Islamic transaction cash flows are of the same amounts as the conventional transaction, the implied cost of finance over the 25 years is a fixed rate of 5%.

- Therefore, without a tax policy specifically designed to achieve neutrality of treatment with conventional finance, Islamic financial transactions will bear a higher(or possibly lower) tax cost than their equivalents in conventional finance.

6. Overview of taxation issues

Taxation issues potentially arise because Islamic finance uses different, and usually more complex, forms of transaction to achieve the same economic results as conventional finance. This can be seen from the fixed rate mortgage transaction illustrated above, and is explored further with the transactions considered in the research survey.

The potential issues fall into several conceptual categories.

Domestic characterisation of the transactions

If the jurisdiction bases its taxation treatment on the legal form of the transaction, then it is likely to arrive at a different tax treatment from the tax treatment given to an economically equivalent conventional transaction.

For example in the conventional fixed rate mortgage transaction above, the customer is paying an explicit interest charge which, depending upon domestic tax law, may be deductible for tax purposes. In the case of the equivalent Islamic transaction, the legal documentation does not identify any interest charge; the customer is merely buying a property for a higher price payable over an extended period but without any interest explicitly being charged. The tax treatment of the transaction will be determined on this basis.

Cross border characterisation of the transactions

When the transactions are cross border, one needs to consider the way that they are treated for tax purposes in both jurisdictions. This may give rise to an overall tax burden that is too high or possibly too low (if the two countries both tax the transaction but in different ways). Furthermore, the two countries may reach different decisions on whether or not one party (here assumed to be the foreign bank) has a taxable presence in the other country. This issue will need to be re-examined in the light of the treaty provisions in the case where the two jurisdictions have a double taxation agreement.

Taxation of intermediate transactions

As seen from the fixed rate mortgage above, Islamic finance typically involves more transactions than does conventional finance. In the fixed rate mortgage example, the Islamic transaction involves the building being sold twice, which may give rise to two charges to real estate transfer tax.

7. The MENA survey

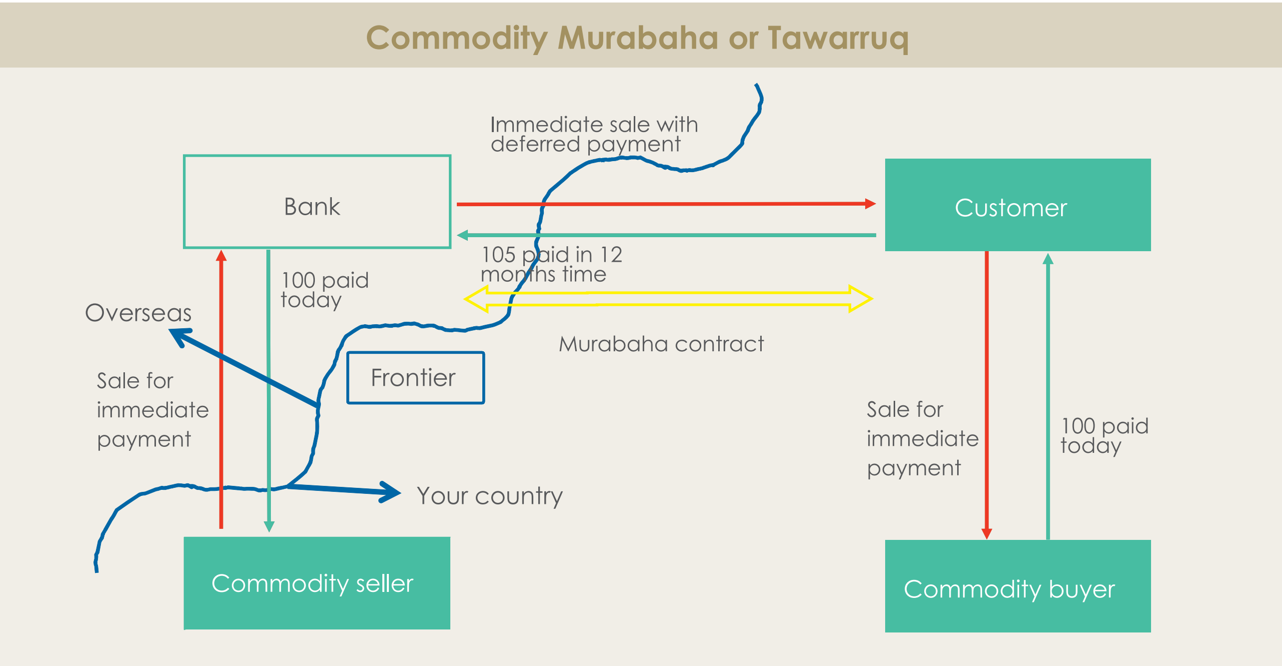
Through Ernst & Young's Qatar office, a standard questionnaire (reproduced in the Appendix) was issued to a number of countries for completion by the E & Ytax team in that jurisdiction with review by the tax authorities of that country, and then returned via E&Y to the research team.

The questionnaire gave details of four hypothetical transactions and asked a number of tax questions about them (the ijarah sukuk is divided into two sections, one with an onshore SPV and one with an offshore SPV.).They are summarised below.

Commodity murabaha or tawarruq

The purpose of this transaction is for a bank to supply an amount of money to its customer, and for the customer to be liable to pay a fixed larger amount of money back to the bank on a fixed future date. This is to be accomplished without having an interest bearing loan which would be prohibited under the rules of Islamic finance.

Accordingly, the bank sells its customer a commodity on deferred payment terms, with the customer selling the commodity to obtain cash. This is illustrated by the diagram below.



Transaction summary

The bank is located overseas and the commodity is copper. The bank purchases copper from a commodity seller for immediate delivery and payment. The bank then sells the copper to the customer for a higher price which is deferred, but delivers the copper immediately. The customer then sells the copper for cash.

In cash terms, Customer receives cash of $100 now, and pays cash of $105 to Bank in 12 months' time.

Taxation questions

The taxation questions are grouped into categories for ease of analysis.

Loss suffered by Customer

Customer receives $100 today from selling the copper, but is obliged to pay Bank $105 in 12 months' time, so it suffers a net loss of $5.If Customer is in business and can claim a tax deduction for other costs, is it able to claim a tax deduction for this cost of $5?

If a tax deduction is given, is the deduction given on the date that Customer pays the $105 to Bank, or is the deduction spread on a time basis over the 12 month period of the commodity murabaha contract?

For example if the Customer's accounting year end takes place six months after today, will the $5 loss be split $2.5 for this accounting period and the next accounting period, or will the entire $5 deduction be given in the second accounting period?

Tax position of Bank

Assume that Bank has no branch presence in the country and no employees based in the country. Instead it has entered into the murabaha transaction using electronic communications or faxes.Will the transactions themselves cause Bank to have a taxable presence (permanent establishment) in your country causing its $5 profit to be taxable in the country?

Is there any withholding tax suffered by Bank when it receives the $105 payment from Customer?

Impact of double taxation treaties

Are the answers to any of the above questions different when Bank is located in a MENA country with a comprehensive double taxation treaty?

Transfer taxes

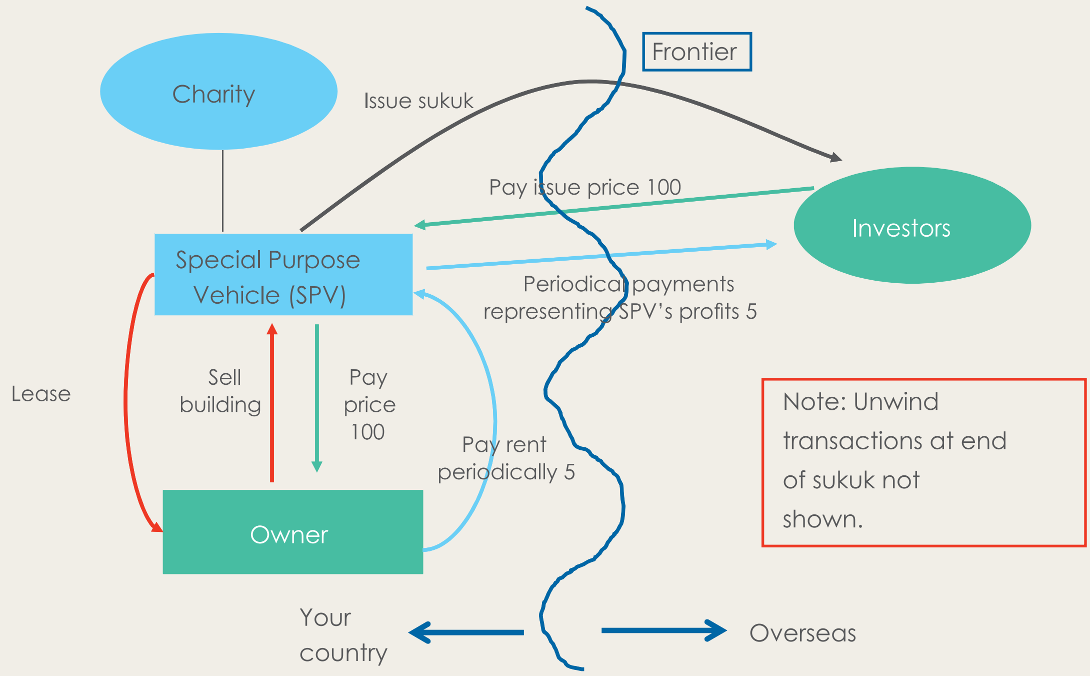
Would any transfer taxes that would apply to this murabaha transaction using copper?
If other assets are used instead of copper, and the transfer of those assets normally gives rise to transfer taxes, are there any reliefs given by the country due to this transaction being a murabaha transaction?

Ijarah sukuk with onshore SPV

The purpose of the sukuk structure is to create an instrument that can be freely bought and sold between investors. Under the terms of the instrument, the investors will receive a fixed cash payment each year, and they will receive a fixed cash payment when the specified period of the sukuk ends.

These fixed cash payments are achieved by the owner of a building selling the building to a special purpose vehicle and then leasing the building paying rent. At the end of the fixed period, the original owner will buy back the building.

Ijarah sukuk with onshore SPV



Guide to the sukuk structure diagram

Red arrows are used to illustrate the sale or leasing of land

Green arrows are used to illustrate payments of cash which take place at the commencement of the sukuk structure

The black arrow illustrates the issue of the sukuk

Turquoise arrows are used to illustrate payments of cash which take place during the life of the sukuk structure

Transaction summary

Owner owns a building which it purchased many years ago for $20 million. After the SPV has been formed, Owner sells that building to SPV for a price of $100 million. Owner also 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, while 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.

Accordingly it is very likely that the building will be sold by the SPV back to the original owner for a price of $110 million in five years' time.

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.

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. These are sold to investors, located overseas, for a total price of $100 million and the cash is used to pay Owner for the property.

All of the rental payments and the buyback payments take place as planned. Accordingly, at the end of year 5, Owner pays $110 million to SPV and SPV transfers ownership of the building to Owner. SPV passes the $110 million sale price of the building on to the investors in proportion to their ownership of the sukuk certificates and the sukuk certificates are cancelled.

Taxation questions

The purpose of the sukuk structure is to create an instrument that can be freely bought and sold between investors. Under the terms of the instrument, the investors will receive a fixed cash payment

The taxation questions are grouped into categories for ease of analysis.

Creation of the sukuk structure

Is there a charge to transfer tax on the sale of the building by Owner to SPV?

Owner purchased the building many years ago for $20 million and is now selling it to SPV for $100 million. Is this gain of $80 million taxed when Owner sells the building to SPV as part of this sukuk transaction?

Are there any reliefs from taxation of the $80 million gain due to this being a sukuk structure with Owner intending to repurchase the building in five years' time?
Are there any taxes charged on the creation of the lease between SPV and Owner?

Are there any taxes charged when SPV issues sukuk to the investors?

Events during the five year period of the Sukuk

When Owner pays $5 million rent each year to SPV, is this rent a deductible expense for tax purposes?

Is SPV taxable on the $5 million rental receipt?

Does SPV receive a tax deduction for the $5 million payment it makes to the investors when it passes the rent on to them?

Is any withholding tax chargeable on the $5 million payment to the investors?

If a foreign investor who paid $10 million to acquire 10% of the sukuk holdings sells that holding to another foreign person for a price of $12 million, is any withholding tax charged on this transaction?

In the previous question, the foreign investor has made a profit of $2 million. Is this profit taxable in your country, assuming that the foreign investor has no other connection with your country?

Events on the termination of the sukuk structure

At the end of year five, SPV sells the building back to Owner for a price of $110 million. Is any transfer tax charged on this building sale?

Owner sold the building for $100 million but pays $110 million to repurchase it.
Does Owner receive any tax relief for the extra $10 million it pays?

Prior to the first sale of the building by Owner to SPV, Owner's tax basis (the base figure used to compute tax depreciation or when computing a capital gain) in the building was $20 million, being the original amount that Owner had paid for the building. What is Owner's tax basis in the building after it has been repurchased?

SPV has made a gain of $10 million as it paid Owner $100 million for the building but sells it back for $110 million. Is this gain taxable?

SPV originally received $100 million from the sukuk investors, but pays them $110 million on termination of the sukuk as it is obliged to pay the investors all of the sale proceeds of the building. Does SPV receive a tax deduction for this $10 million extra payment?

The investors originally subscribed $100 million for the sukuk, but receive $110 million on its termination. Assuming that the investors are all foreign and have no other connection with your country, is this $10 million gain taxable by your country?

Does the country charge any withholding tax on the $110 million termination payment to the foreign investors?

Impact of double taxation treaties

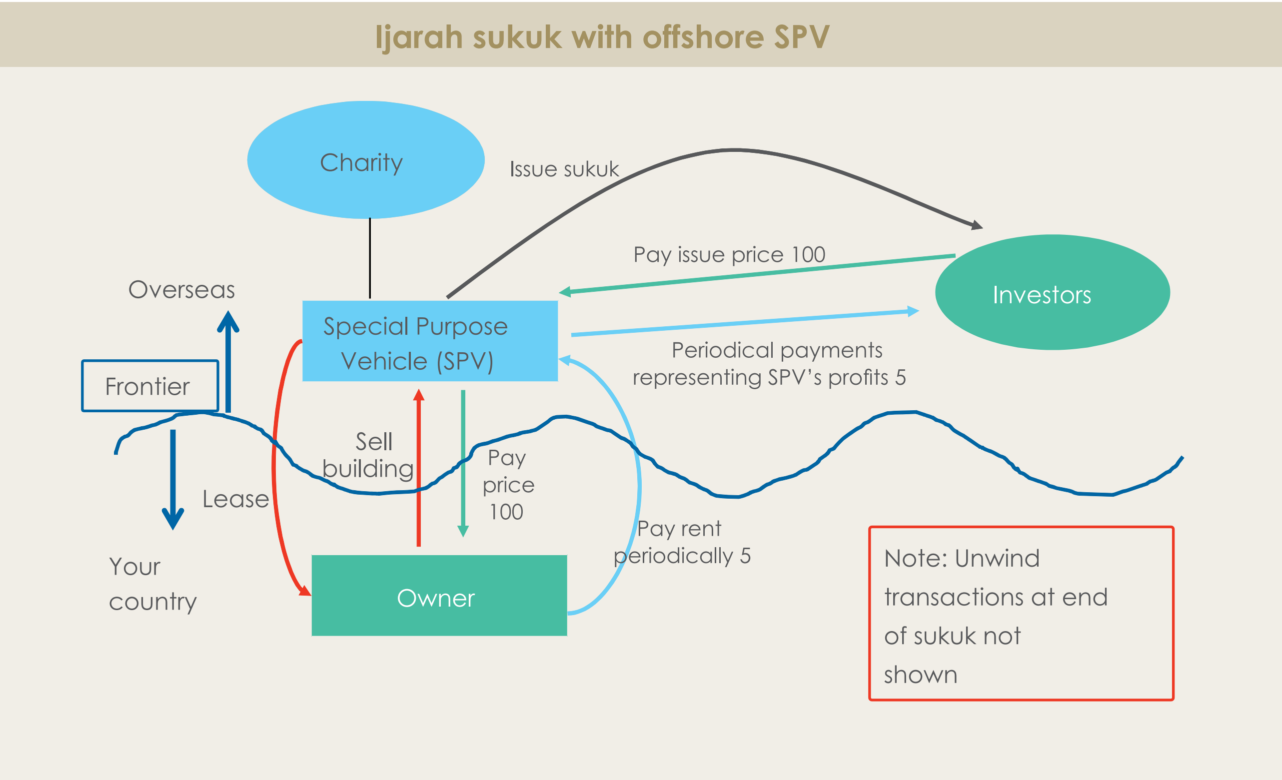
Are the answers to any of the above questions changed when SPV or the Investors are located in a MENA country with which your country has a double taxation atreaty?

Ijarah sukuk with offshore SPV

The purpose of the sukuk structure is to create an instrument that can be freely bought and sold between investors. Under the terms of the instrument, the investors will receive a fixed cash payment each year, and they will receive a fixed cash payment when the specified period of the sukuk ends.

These fixed cash payments are achieved by the owner of a building selling the building to a special purpose vehicle and then leasing the building paying rent. At the end of the fixed period, the original owner will buy back the building.

The difference from the previous structure is that the SPV is now offshore. This may (or may not) enable the structure to be established and operated with lower tax costs than the case when the SPV is onshore.



Transaction details

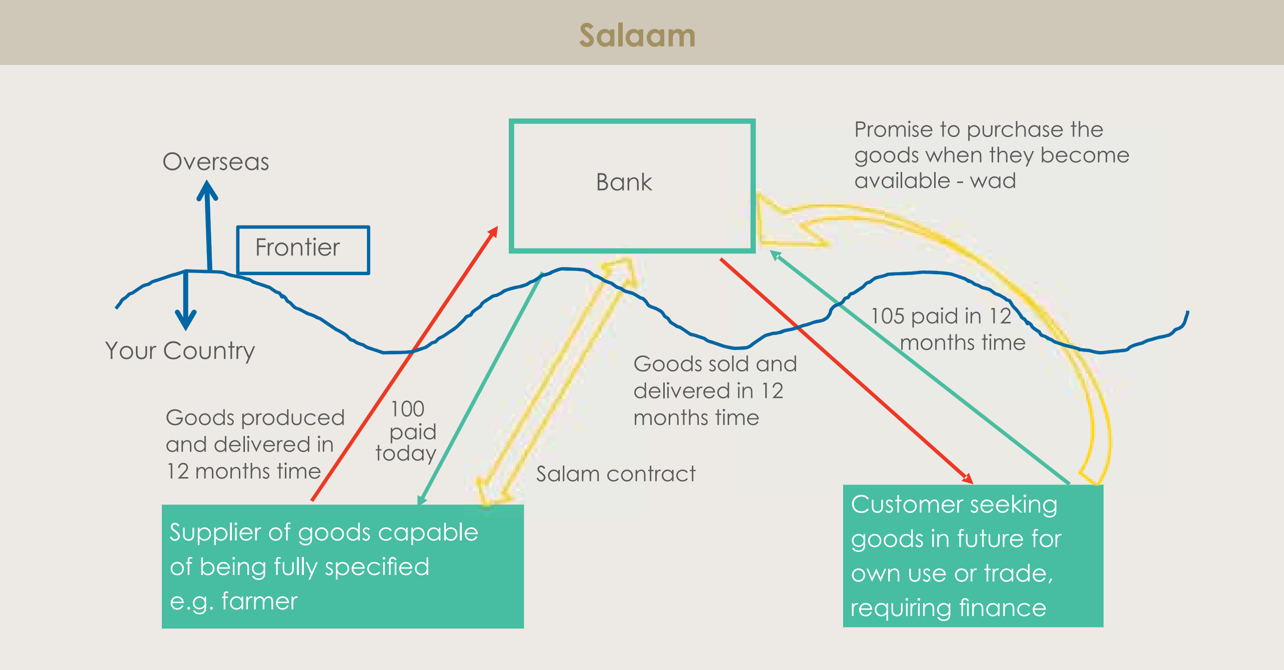
The transaction details are identical to the previous case where the SPV was onshore, i.e. located in the same jurisdiction as the Owner.

In this version, the SPV is outside the jurisdiction, as the goal was to consider what differences in taxation treatment arise when the international frontier is located at a different part of the overall structure.
Essentially the same taxation questions were asked as for the situation where the SPV was onshore.

Salaam

The purpose of the salaam structure is to enable the bank to provide finance to a producer of goods, for example a farmer. The farmer requires cash now, possibly to purchase seeds or fertiliser, while the output will only be produced in the future.

The bank wishes to avoid having an economic exposure to the price of the goods, so it enters into an agreement with a customer who wishes to obtain those goods in the future at a price which is fixed today.



Transaction details

The Bank is located overseas.
A Customer located in the country being reviewed wishes to receive 300kg of wheat in 12 months' time, and is willing to commit to paying $105 for that wheat. Accordingly today Customer gives a promise to Bank that if in 12 months' time Bank offers to sell 300kg of wheat to Customer for a price of $105, Customer will purchase it.

Supplier is a farmer located in the same country. Today Bank enters into a salaam contract with Supplier under which Bank will pay Supplier $100 immediately and Supplier will agree to deliver 300kg of wheat to Bank in 12 months' time.
The contracts are completed in due course in accordance with their terms.

Taxation questions

The taxation questions can be considered in the following categories.

Tax position of Bank

Assume that Bank has no branch presence in the country and no employees based in the country. Instead it has entered into the salaam transaction using electronic communications or faxes.
Will the transactions themselves cause Bank to have a taxable presence (permanent establishment) in your country causing its $5 profit to be taxable in the country?

Transfer taxes

If the country has transfer taxes, would transfer taxes be charged on both the sale by Supplier to Bank and on the sale by Bank to Customer?

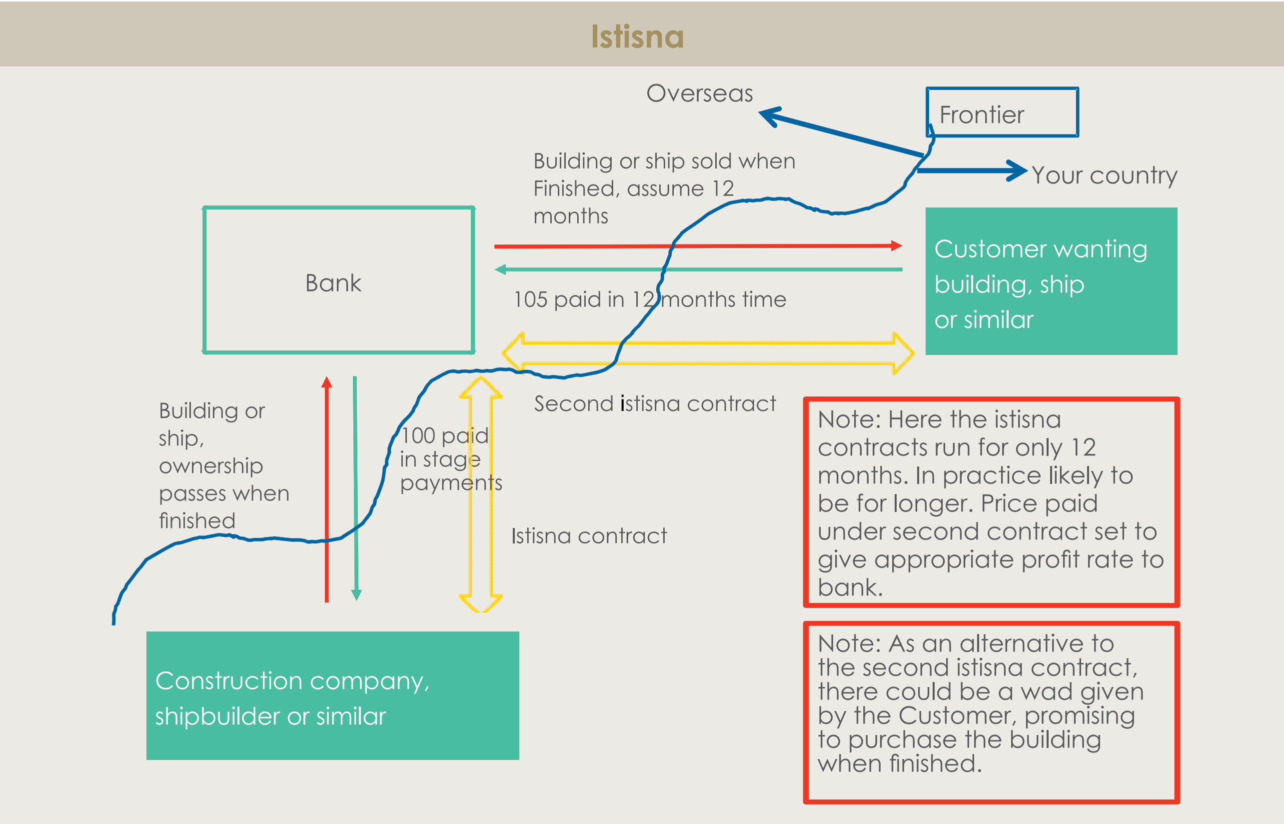
Impact of double taxation treaties

Are the answers to any of the above questions changed when Bank is located in a MENA country with which the country has a double taxation treaty?

Istisna

The purpose of the istisna contract is to enable the bank to provide finance which is required by a customer purchasing goods which are to be manufactured to the customer's specifications. Normally the manufacturer would require the customer to make stage payments, both to reduce the manufacturer's credit risk against the customer and also to enable the manufacturer to finance the inventory while the goods are being manufactured.

However the customer does not have the funds needed to make stage payments to the manufacturer, and therefore seeks finance from the bank. The bank is willing to take on the customer's credit risk, but does not want any economic exposure to the value of the goods being manufactured.



Transaction details

Customer is located in the country being reviewed and wishes to have a purpose designed ship constructed by a shipyard which is located in the same country. The ship will take 12 months to construct, and customer is willing to pay $105 for the newly completed ship in 12 months' time. However customer does not have the funds available to make instalment payments as the ship is constructed.

Bank is located overseas.

Customer and Bank agree that Bank will construct the ship (or procure its construction) over the next 12 months and that once the ship is finished customer will pay $105 to Bank for the completed ship.

Shipbuilder is located in the same country as the customer and has a shipyard which is also located in the same country.

Bank enters into an istisna contract with Shipbuilder. Under that contract Shipbuilder will construct a ship for Bank while Bank will make specified stage payments to Shipbuilder totalling $100.In 12 months' time the ship is finished. Bank takes ownership of the ship from Shipbuilder and sells the ship to Customer for a price of $105. Customer pays Bank $105.

Taxation questions

The taxation questions are again considered in the following categories.

Tax position of Bank

Assume that Bank has no branch presence in the country and no employees based there. Instead it has entered into the istisna transaction using electronic communications or faxes.

Will the transactions themselves cause Bank to have a taxable presence (permanent establishment) in the country causing its $5 profit to be taxable there?

Customer is located in the country being reviewed and is making a payment to a foreign bank. Will any withholding taxes be due on this payment?

Transfer taxes

If your country has transfer taxes, assume that the goods covered by this istisna contract would be of the type that is subject to transfer taxes.

Would transfer taxes be charged on both the sale by Supplier to Bank and on the sale by Bank to Customer?

Impact of double taxation treaties

Are the answers to any of the above questions changed when Bank is located in a MENA country with which your country has a double taxation treaty? If so, please give details.

Respondent countries

Completed questionnaires were received from the following countries, listed in alphabetical order:

1. Egypt
2. Jordan
3. Kuwait
4. Libya
5. Oman
6. Qatar. As a distinct tax regime applies in the Qatar Financial Centre, a separate response was also obtained from the QFC.
7. Saudi Arabia
8. Turkey

In order to provide a comparison with other regions, a questionnaire was also completed by PricewaterhouseCoopers for Malaysia. The report authors are familiar with the taxation system of the United Kingdom, which has also served as an external comparator region.

Survey responses on the overall development of tax law for Islamic finance

All respondents were asked:

"Has your country enacted any tax laws specifically to facilitate Islamic finance? If so, please give details and also send an English language translation of the law if one is available."

To avoid the risk of the authors of this paper misunderstanding the questionnaires' respondents, the responses in the section below (only) have been reproduced verbatim. When the individual structures are reviewed later, the responses given in the questionnaires have been converted by the report authors into their own words for ease of comparability.

Egypt

In Egypt, the Islamic financial institutions is not mature enough leading to different interpretations and variations around compliance and tax issues as they are quite limited and usually asset backed. The Egyptian income tax law no. 91 of 2005 introduced very brief to Musharka, Mudarba and Murabha. However, specific guidelines were issued.

The tax treatment of the Islamic Finance structures is not defined in the Egyptian income tax law. However, the Egyptian tax authority's main object is to ensure that Sharia compliant financial products are taxed in a way that is that is neither more nor less advantageous than equivalent banking products.

There is no specific tax law enacted in Egypt specifically to facilitate Islamic finance

Jordan

The Islamic banks taxation in Jordan has no separate law treating it. Islamic banks are taxed like other banks based on the Jordanian income tax law.

Kuwait

There is no specific tax law enacted by the Kuwait tax authorities which makes reference to Islamic finance transactions.

Libya

Libyan Tax Law 7/2010 does not include any provisions on Islamic Finance. Islamic Finance transactions will therefore be treated as any conventional, non-Islamic, financial transaction.

Libya issued Islamic Finance Regulations in March 2012 as an addendum to existing Banking Law and three banks have been designated as Islamic banks, but these Regulations have not yet been adopted. Neither Commercial Laws nor Tax Law has been amended to reflect the principles of Islamic Finance or to facilitate it.

Oman

Oman is gearing up for Islamic Finance for which banking regulations are undergoing changes as well as few banks are being incorporated to facilitate provide customers with Islamic Finance products.

However, there are no provisions in the tax law relating to Islamic Finance. Even executive regulations, issued during the year 2012, governing the new tax law, do not make a mention on treatment of Islamic Finance products.

The Oman tax authority is in the process of amending the existing Income Tax Law to incorporate Islamic finance. There are discussions underway on how the tax law will consider taxability issues arising on account of Islamic products being offered by the banks in Oman.

Currently, the treatment of Islamic finance products would be seen from the perspective of conventional banking transactions and decision taken on its taxability.

The tax authority, in the transition until Income tax provisions related to Islamic finance are enacted, has promised to ensure that Islamic finance institutions are at level playing field with conventional institutions.

Qatar

No.

Qatar Financial Centre (QFC)

The QFC introduced tax regulations, effective from 1 January 2010, covering firms licensed with the QFC which ensure that the tax treatment of Islamic Financial Institutions and Islamic Finance Transactions is, as far as possible, not less advantageous than that of conventional finance alternatives. This is achieved by way of a tax equalization adjustment in the tax return. An advance ruling regime also facilitates taxpayers obtaining certainty of treatment, if the statutory treatment is unclear.

QFC entities are required to prepare accounts under IFRS, but by agreement may also use accounts prepared in accordance with standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) or other acceptable GAAP.

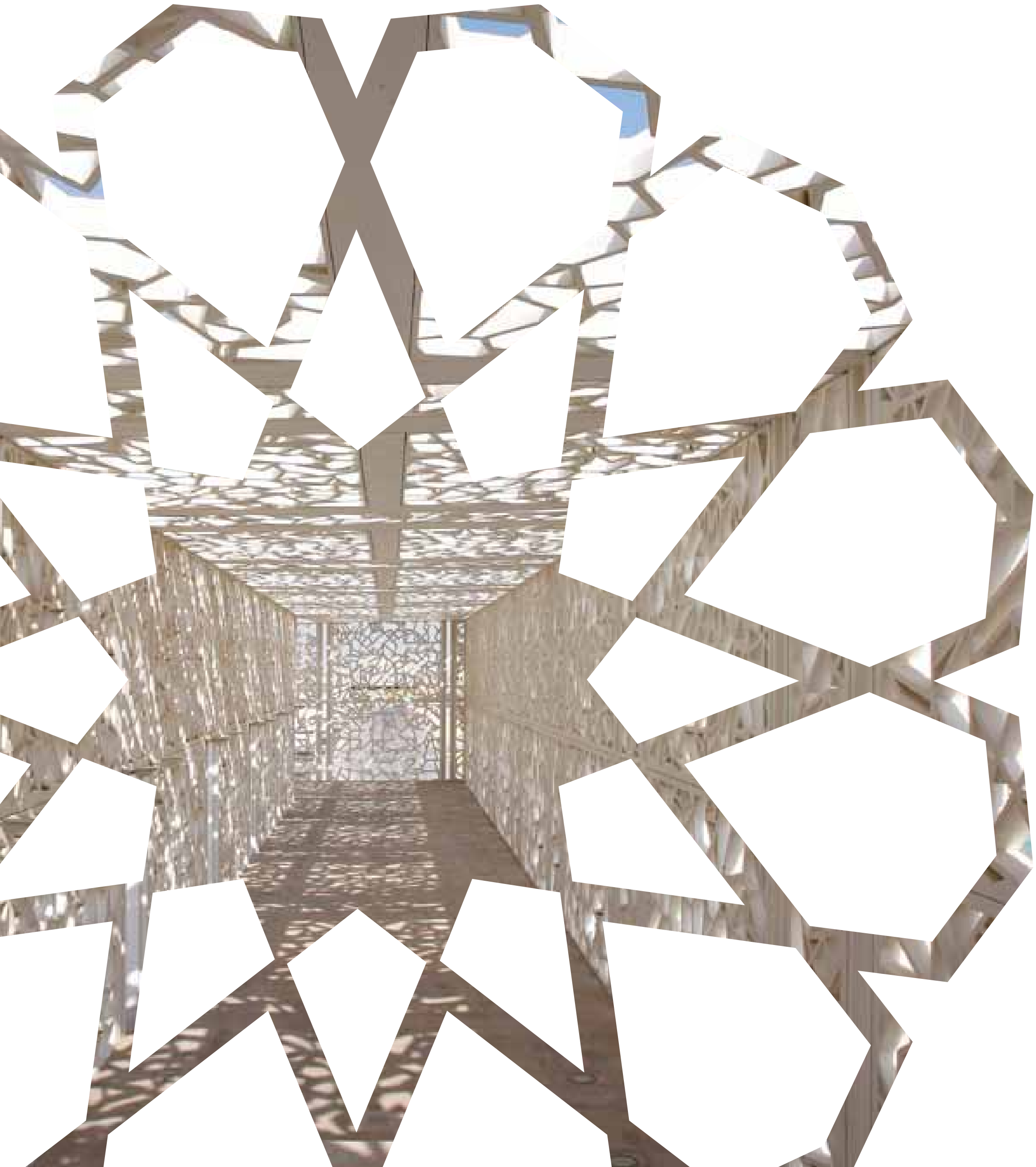
The Islamic finance provisions in the QFC tax regulations are reproduced in Appendix 2.

Saudi Arabia

KSA has not enacted any tax law specifically to facilitate Islamic finance.

Turkey

There is no specific tax law enacted by Turkish tax authorities. Turkish Tax Laws have only provisions regarding taxation of onshore sukuk transactions.



8. Our findings, organised by transaction

Commodity murabaha or tawarruq

Egypt

The response from Egypt can be summarised as follows.

- The customer's loss of $5 should be tax deductible, provided that it meets other criteria which are common to conventional and Islamic finance such as the rate of interest not being above specified limits.
- The customer's $5 loss appears to be fully deductible in the first year if the murabaha contract straddles a year end.
- Having the transactions take place within Egypt would not of itself cause the foreign bank to have a taxable presence in Egypt.
- Subject to the application of tax treaties, Egyptian withholding tax at 20% would apply to the payment to the foreign bank. The response does not specify whether the 20% would apply to the full $105 terminal payment to the foreign bank, or only to the foreign bank's $5 profit which is equivalent to the interest on a conventional loan. However the response states *"The tax treatment of the Islamic Finance structures is not defined in the Egyptian income tax law. However, the Egyptian tax authority's main object is to ensure that Sharia compliant financial products are taxed in a way that is that is neither more nor less advantageous than equivalent banking products."* Accordingly this report assumes that the 20% withholding tax would be applicable only to the $5 profit.
- Egypt has a large number of tax treaties, 51 being named in the response, including both countries within the MENA region and elsewhere. Treaty benefits would be applicable to this transaction.
- Egypt does not impose transfer taxes on this transaction.

The responses from other countries are summarised below. In each case, if there is no other comment the Egyptian treatment can be taken to apply.

Jordan

- The customer's loss of $5 must be allocated to the relevant accounting periods under the IFRS accruals basis.
- Jordanian law does not contain a definition of permanent establishment, and no permanent establishment is considered to arise.
- Withholding tax on imported services at 7% would be applied to the foreign bank's $5 profit, (as well as sales tax at 8%).
- Jordan has tax treaties with many MENA countries. Only the Kuwaiti treaty appears to reduce the WHT to a lower rate which is 5%.
- Jordan has stamp duty (similar to a transfer tax) on the value of contracts, with the rate varying by type of contracting party.
- The response suggested using shares as the underlying subject matter of the murabaha agreement, as they would not be subject to sales tax, only to stamp duty at a low rate.

Kuwait

- Kuwait has a corporate income tax, but this is not charged on corporate bodies incorporated in any GCC country which are wholly owned by GCC citizens. Deductibility for corporate income tax isonly relevant when the ownership conditions are not satisfied. From the response's comments about NLST and Zakat, it appears that the loss of $5 would also be deductible for corporate income tax purposes for companies subject to that tax.
- The $5 loss should be deductible for computing Kuwaiti NLST (National Labour Support Tax) and Zakat. The $5 needs to be spread between accounting periods on a time basis.
- The bank would be considered to have income of $5 subject to Kuwaiti tax at a flat rate of 15%.
- WHT at 5% would be applicable to the bank's $5 profit, but would be cancelled if the bank provides a valid tax clearance certificate issued by the tax authority covering compliance with the 15% flat rate tax.
- Only six tax treaties with MENA countries were listed, none of which are in the GCC. That may indicate that Kuwait applies other arrangements to GCC countries, such as the exemption from corporate income tax in the cases of GCC incorporated companies which are wholly owned by GCC nationals mentioned above.
- Tax treaties may reduce the tax rate of 15% mentioned above.
- Kuwait has no transfer taxes.

Libya

- Libya has issued draft Islamic finance regulations, but these have not yet been adopted. Libyan commercial law has yet to be adapted for Islamic finance, and the commodity murabaha would be illegal since foreign banks would not be permitted to buy and sell a commodity within Libya. However it would be permitted to export the commodity and then sell it into Libya from offshore.
- The customer's loss of $5 would be recognised immediately.
- No tax would be due on the bank, assuming it was selling the commodity into Libya from offshore (as mentioned above) and Libya has no WHT.
- Libya has six tax treaties with MENA countries. These would not affect the tax treatment stated above.
- Stamp duty at just over 1% would be chargeable on each of the three contracts for the purchase and sale of the commodity

Oman

- Oman is currently considering how to modify its tax laws for Islamic finance. Pending legislation, the tax authorities have indicated that they will seek to tax Islamic financial institutions so that they receive comparable treatment to conventional institutions.
- The customer's $5 loss should be deductible in the periods when it is recognised in the financial statements.
- Transfer of title to the commodity within Oman may create a permanent establishment for the bank.
- Oman has no transfer taxes or WHT on commodity sales. If real estate is used, 3% transfer tax is payable by the seller.
- Oman has seven tax treaties with MENA countries.

Qatar

- The customer's $5 loss would be deductible in the first year as the response assumes that it would be fully recognised in the first year's financial statements. However if the customer is accounting on a cash basis, the $5 deduction will fall in the second year.
- No permanent establishment arises.
- Qatar has tax treaties with most MENA countries.
- There are no transfer taxes.

Qatar Financial Centre (QFC)

- QFC entities normally prepare accounts under IFRS which would entail spreading the customer's loss of $5 over the duration of the transaction. The tax treatment would follow the accounting treatment.
- The QFC tax regime only applies to banks licensed in the QFC. Accordingly the tax postion of the foreign bank would be governed by genaral Qatari tax law.
- The QFC has no transfer taxes and no withholding taxes.
- Qatar's tax treaties apply to QFC entities.

Saudi Arabia

- Substance over form would apply to treat the customer's $5 loss as a financing expense to be spread over the period that it relates to.
- While a murabaha contract is for a fixed sale price, not dependent upon the customer's business performance, the response points out that since Islamic finance is meant to be profit and loss sharing, the Bank's profit may be considered by the tax authorities to be a share of the customer's profit.
- If that treatment was applied, the bank would be liable to 20% corporate income tax and 5% distribution withholding tax.
- Unless the tax authorities argue for the profit sharing point mentioned above, the transactions should not of themselves cause the Bank to have a taxable presence in Saudi Arabia.
- 5% WHT is charged on financing costs paid to non-residents.
- There are no transfer taxes except for properties transferred by foreign individuals.
- Saudi Arabia has tax treaties with only two MENA countries, Syria and Tunisia (not yet in force.)

Turkey

- As far as the Customer is concerned, the murabaha transaction may be treated as a commodity trade giving rise to a $5 loss, or treated as a financing transaction giving rise to a $5 financing expense. Islamic banks tend to treat murabaha transactions as loan transactions, which is likely to cause the tax authorities to regard the Customer to also be party to a financing transaction. A substance over form approach is likely to lead to the same conclusion. Accordingly the $5 expense would be spread over the period of the murabaha contract.
- Turkey has recently introduced thin capitalisation regulations which can limit the deductibility of a financing expense.
- The transactions should not cause the Bank to have a taxable presence in Turkey.
- The Customer will be regarded as paying a financing charge of $5 to the foreign bank. This is subject to WHT, but as the recipient is a foreign bank the WHT rate is zero.

- Turkey has 13 tax treaties with MENA countries.
- The WHT conclusion above is not affected by the treaties. However the definition of a permanent establishment may differ from treaty to treaty.
- There are no applicable transfer taxes. Turkey has VAT, but VAT is not within the scope of this study.

Ijarah sukuk with onshore SPV and with an offshore SPV

Egypt – onshore SPV

- Egypt has no transfer taxes.
- The sale of the property by the Owner to the SPV will be viewed as a normal sale of assets achieving taxable capital gains[2].
- No taxes are payable on the creation of the lease or the issue of the sukuk.
- The rent of $5 million per year should be a deductible expense for Owner.
- The payments to sukuk holders will be treated as interest paid to non-residents and 20% WHT will be charged, subject to tax treaties and other Egyptian rules which can reduce or eliminate the WHT for long duration agreements.
- No WHT would be charged where one non-resident sukuk holder sells the sukuk to another non-resident. The $2 million profit would not be taxed in Egypt as the transactions are outside Egypt.
- WHT will not be charged on the $110 million termination payment to the sukuk holders.
- On the end of the sukuk, SPV's $10 million gain on the sale of the building back to Owner will be subject to tax.
- SPV will not receive any relief for the payment of the $10 million to sukuk holders on termination of the sukuk. The sukuk holders will not be taxable on their $10 million gain if they are non-resident.
- WHT will not be charged on the $110 million termination payment to the sukuk holders.

Egypt – offshore SPV

- The same tax treatment applies as with an onshore SPV except as indicated below.
- The transaction is likely to be treated as a finance lease transaction, with Owner capitalising the finance lease, depreciating the newly capitalised building and also charging a finance expense in its financial statements. If so, Owner will deduct the finance expense and depreciation on the capitalised building in accordance with Egyptian tax rules. This finance lease treatment was explained in the Egypt response in the section with an offshore SPV, but it is unclear why it should not also be applicable to Owner where the SPV is onshore.
- Payment of the annual $5 million rent by Owner to the offshore SPV will be treated as a payment of interest to a non-resident with WHT at 20% or a lower rate if a tax treaty or an exemption applies.
- Payments from the offshore SPV to overseas sukuk holders have no Egyptian tax consequences.
- It appears that SPV's offshore status would not protect it from Egyptian tax on its $10 million gain on selling the building back to Owner.

2) The possible application of Egyptian sales tax at 25% has not been considered, as VAT and similar taxes are outside the scope of this report.

Jordan – onshore SPV

- Transfer tax on buildings is payable at 6% by the purchaser (SPV) and at 4% by the seller (Owner). This would apply both to Owner sale to SPV on commencement of the sukuk and to SPV's sale back to Owner at the end of the sukuk period.
- The Owner's $80 million capital gain will be taxed on sale to the SPV.
- Stamp duty at 0.6% or 0.3% (depending on the types of entity involved) is payable on the creation of the lease.
- The issue of the sukuk is subject to 7% WHT.
- The leaseback is likely to be treated as a finance lease and capitalised by Owner under IFRS. Tax depreciation at 2% straight line is given on the capitalised building. The response is not explicit on whether the finance cost element of the lease would be deductible for Owner.
- SPV would be taxed on the annual $5 million rental receipt, but able to deduct the $5 million it pays each year to sukuk holders. However Jordan's thin capitalisation rules will apply to restrict tax relief for the payments to sukuk holders, leaving the SPV with some amount of profit being taxed each year. 7% WHT will apply on payments to the sukuk holders.[3] The sale of sukuk by one non-resident investor to another does not give rise to any Jordanian withholding taxes, and appears not to suffer Jordanian income or gains tax.
- SPV would be taxed on its $10 million gain when it sells the building back to Owner.
- SPV would receive a tax deduction when it pays the $10 million to the sukuk holders, subject to the other rules governing tax deductible expenditures. While the response does not mention thin capitalisation again at this point, the mention earlier in the response indicates that part of the $10 million payment to sukuk holders would be denied a tax deduction due to SPV being thinly capitalised. Withholding tax would be applicable to this $10 million payment.
- Some of Jordan's double tax treaties reduce the maximum rate of withholding tax.

Jordan – offshore SPV

- The same tax treatment applies as with the onshore SPV, except as indicated below.
- Foreign persons, such as the offshore SPV, may acquire property in Jordan but there are specific conditions and limitations.
- The payment of rent by Owner to SPV will be subject to WHT at 7%.
- No WHT would apply to payments by SPV to investors outside Jordan, as the parties would all be outside Jordan.

Kuwait – onshore SPV

- Kuwait would not charge transfer taxes on the sale of the building by Owner to SPV.
- Kuwait has a corporate income tax that applies only to companies owned wholly or partly by non GCC nationals. Accordingly, the gain of $80 million on the sale from Owner to SPV will be taxable, unless Owner is wholly owned by GCC nationals.
- NLST and Zakat at 2.5% and 1% respectively would be charged on the capital gain if the Owner is subject to them.
- The creation of the lease between SPV and Owner does not give rise to any taxes.

3) Jordanian sales tax has not been considered in this report as being outside of the scope.

- Once the foreign investors own sukuk issued by SPV, the Kuwaiti authorities will consider them to be earning income from the ownership / lease of a building in Kuwait and will consider them subject to tax in Kuwait, unless they are companies incorporated in the GCC and wholly owned by GCC nationals since they are exempt from Kuwaiti corporate income tax.
- The $5 million rent paid each year to SPV should be deductible for corporate income tax purposes (if Owner is not exempted from corporate income tax by virtue of GCC incorporation and ownership) and deductible for NLST and Zakat.
- SPV would be subject to corporate income tax on the annual $5 million receipt (unless exempted from corporate income tax by virtue of GCC incorporation and ownership) and if applicable would be subject to NLST and Zakat. The $5 million payment to investors would not be deducible when computing SPV's liability to NLST and Zakat.
- The Kuwaiti tax authorities may also consider that the rental income earned by the overseas investor indirectly as a result of the sukuk certificate should be subject to tax in Kuwait under the domestic tax law.
- No withholding taxes would be applicable on the $5 million payment to the investors. However, the payments would be subject to 5% retention requirements. The domestic tax law provides that every contract owner must: submit a copy of the contract to the tax authority and retain 5% from the payments due to the contractor until the contractor provides a valid tax clearance certificate (TCC) issued by the tax authority in Kuwait. The TCC is issued once the tax payer has completed all of its tax obligations in Kuwait by complying with the regulations and settlement of tax, if any, as per tax assessment issued by the tax authority. Accordingly, if the foreign investors are taxable in Kuwait, they would need to comply with the requirements of Kuwait tax law and obtain a tax clearance certificate to have the 5% retention released from the SPV. In case the investors are not subject to tax in Kuwait, they would still need to approach the DIT and obtain a TCC from the DIT in order to claim the 5% amount retained by the SPV.
- When a foreign investor makes a gain by selling sukuk at a profit to another foreign investor, the capital gain would be taxed at a flat rate of 15% unless the exemption for GCC companies wholly owned by GCC nationals applies.
- When SPV makes a gain of $10 million by selling the building back to Owner, the gain would be taxable unless the exemption for GCC companies wholly owned by GCC nationals applies. Similarly if the SPV is subject to NLST and Zakat then, NLST and Zakat at 2.5% and 1% respectively would be payable on the capital gain.As the $10 million extra payment to the investors would be considered a distribution of profit to the investors, the SPV may not be able to obtain a deduction for the payment for the purpose of computing profit under the NLST/Zakat regulations.
- The capital gain of $10 million on redemption of the sukuk earned by overseas investors may be considered by the tax authorities to be taxable in Kuwait as arising from the underlying property in Kuwait, and if so it would be subject to corporate tax at a flat rate of 15% unless the exemption for GCC companies wholly owned by GCC nationals applies.
- While there would be no withholding tax on the $110 million termination payment to the foreign investors, the payments to the foreign investors for the extra payment of $10 million would require compliance with the 5% tax retention regulations.
- The position is not changed by Kuwait's tax treaties.

Kuwait – offshore SPV

- The same tax treatment applies as with the onshore SPV, except as indicated below.
- It is not possible for an overseas investor/SPV to own buildings/real estate in Kuwait. Accordingly, analysing the tax consequences of the structure risks becoming a hypothetical exercise.

Libya – onshore SPV

- On transfer of the building by Owner to SPV, stamp duty would be payable. The rate of Duty is 1% of the value of the sale agreement plus 5/1000 of the duty payable by the buyer.
- The profit on sale of $80 million will be subject to tax. If the building has been depreciated for tax purposes, the gain is computed by comparing the sale price of $100 million with the depreciated book value.
- The lease agreement between SPV and Owner is subject to stamp duty at the rate given above.
- On creation, the sukuk will be regarded as shares, and stamp duty at the above rate will be payable to register the ownership of these 'shares'.
- Libya does not require IFRS accounting. Accordingly, Owner would not be expected to capitalise the lease with SPV as a finance lease. Owner would instead deduct the annual $5 million rent.
- The SPV would be taxable on the $5 million annual rental income. The annual $5 million payment to investors would be treated as a dividend and would not be tax deductible to SPV. No WHT would be charged.
- When a foreign investor makes a gain by selling sukuk to another foreign investor, the gain would be treated as the transfer of a share in a Libyan company and the gain would be taxable.
- On termination, the transfer of the building by SPV to Owner would be subject to stamp duty at the above rate.
- The $10 million gain that SPV makes on selling the building back to owner would be taxable. No deduction would be given to SPV for the $10 million payment to investors.
- The gain to sukuk investors from the sukuk being redeemed for $110 million when only $100 million was originally subscribed would not be taxed. (This answer appears inconsistent with taxing a foreign investor who makes a gain from selling sukuk to another foreign investor. The answer appears to be that the $10 million profit here is treated as a dividend which is exempt from Libyan tax.)
- Tax treaties do not change the above outcomes.

Libya – offshore SPV

- The same tax treatment applies as with the onshore SPV, except as indicated below.
- A foreign SPV is not allowed to own property in Libya. This transaction would therefore be in breach of commercial law.Accordingly, analysing the tax consequences of the structure risks becoming a hypothetical exercise.

Oman – onshore SPV

- Owner would have to pay transfer tax at 3% of the sale price before the building can be transferred to SPV.
- Owner's $80 million gain on selling the building to SPV would be taxable.
- No taxes are payable on the creation of SPV's lease back to Owner.
- Oman does not yet have specific tax laws for Islamic finance. Under the conventional banking regulations, whenever bonds are issued there is certain bonds issue charges i.e. 1 baisa per bond of Rial Omani 1. These charges may also apply to the issue of sukuk.
- The tax deduction to Owner for the rental payments of $5 million per year depend upon the accounting treatment. If the leaseback is accounted for as a finance lease, Owner can deduct tax depreciation computed at 5% per annum straight line. The response does not mention any deduction for the implicit finance charge. If Owner accounts for the leaseback as an operating lease, the lease rental payments of $ 5 million should be considered as a deductible expense.
- SPV would be taxable on the annual $5 million rent received, but should be able to deduct the payment of $5 million to the sukuk holders.
- As far as the taxation of the sukuk investors is concerned, there is a likelihood that the tax authorities may consider the amounts paid to investors to be in the nature of equipment rentals (buildings) as the building is the only underlying asset in the SPV which has issued the sukuk. Further the SPV holds the building, the lease and the benefit of Owner's purchase undertaking as trustee for the owners of the sukuk certificates. Accordingly, withholding tax at the rate of 10% is likely to be applicable.
- Gains made by one foreign investor on selling sukuk to another foreign investor should not suffer any Omani WHT or income tax if the foreign investor has no other taxable presence in Oman.
- SPV would have to pay transfer tax at 3% of the $110 million sale price before the building can be transferred back to Owner.
- The sale of building under the tax law would result in capital gains of $10 million for the SPV in Oman and would be subject to tax as business income. The SPV should be able to deduct the $10 million it has to pay the sukuk investors.
- The investors' $10 million gain arising on termination of the sukuk should not be taxable in Oman if the investors do not otherwise have a taxable presence in Oman.
- Tax treaties do not change the above outcomes.

Oman – Offshore SPV

- The same tax treatment applies as with the onshore SPV, except as indicated below.
- As the sukuk will be issued overseas, the bond issue charge of 1 baisa per bond of Rial Omani 1 would not be applicable.
- As the SPV is offshore, when Owner pays rent of $5 million per year, 10% Omani WHT is payable.
- The SPV has no liability to Omani tax on its rental income beyond the 10% WHT.
- On termination of the sukuk, SPV makes a gain of $10 million. As the building is in Oman and any transfer back from the SPV to Owner would require registration with the Ministry of Housing in Oman, the transaction is likely to result in a taxable event for the SPV in Oman. However SPV should be able to deduct the $10 million it has to pay the sukuk investors.
- The investors should not be taxable on their gain on redemption of the sukuk provided they have no other taxable presence in Oman.

- The WHT may be reduced if the SPV is located in a country which has a double tax treaty with Oman providing for a lower WHT rate.

Qatar – onshore SPV

- Qatar has no transfer taxes.
- Owner's $80 million gain on sale of the property to SPV would be taxable.
- No taxes would arise on creation of the leaseback or the issue of the sukuk.
- Owner should be able to deduct the rent of $5 million per year paid to SPV.
- SPV would be taxable on the $5 million rental receipt. No deduction would be allowed for the $5 million payment to sukuk holders as that is regarded as a form of distribution or dividend.
- No WHT applies to payments to the sukuk holders.
- No WHT applies when a foreign investor sells sukuk to another foreign investor. However the investor who has made the $2 million gain is supposed to file a return reporting the profit realized and the tax due.
- When Owner repurchases the building for $110 million upon termination of the sukuk, Owner's new tax base will be $110 million. This will be treated as a new acquisition by Owner and not related back to the previous ownership or to the sale to SPV.Accordingly Owner will not receive tax relief for the extra $10 million that it pays upon termination of the sukuk, compared with the selling price it received five years prior.
- SPV is taxable on its $10 million gain when it sells the building back to Owner. SPV cannot deduct the $10 million payment it makes to sukuk investors as it is regarded as a form of distribution or dividend.
- The investors are not taxed on their $10 million gain as that was taxed at the level of the SPV. No WHT is charged on the redemption payment to them.
- Tax treaties do not change the above answers due to the property being in Qatar.

Qatar – offshore SPV

- The same tax treatment applies as with the onshore SPV, except as indicated below.
- No WHT is charged on payment of the $5 million rent to the offshore SPV.
- The SPV will be taxable on the $5 million rent received from Owner. It is regarded as an entity carrying on an activity in Qatar since leasing a building is a taxable activity.

QFC – onshore SPV

- Under IFRS the Owner would not reflect the $80 million gain on sale of the building to the SPV in its accounts. Accordingly the gain on sale would not be taxed.
- If the Owner is accounting under AAOIFI, it may reflect the $80 million gain in its financial statements. In that case, the Islamic finance provisions in the QFC tax regulations would have the effect of excluding the gain from taxation.
- There are no transfer taxes in the QFC, so no charges would arise on the transfer of the building from Owner to SPV or its subsequent transfer back at the end of the lease.
- If the owner accounts under IFRS, then for accounting purposes it will record a financial expense during the duration of the lease comprising the rent of $5 million per year and the $10 million additional repurchase price, spread rateably. This expense will be deductible for tax purposes.
- If the Owner accounts under AAOIFI, which may entail recognising only the $5 million annual rent as an expense, the QFC tax regulations may allow the $10 million uplift in the repurchase price to be deducted on a straight line basis over the five year life of the lease.

- An onshore SPV may be licensed with the QFC and may therefore be able to take advantage of the tax regime which exempts it from taxation, as long as it has not been set up for the sole or main purpose of avoiding QFC tax. In this example the cumulative profit of the SPV over the 5 year period of the transaction is zero so tax avoidance is unlikely to be an issue.Accordingly SPV will not be taxed on the rental receipts or on the $10 gain it makes when selling the building back to Owner.
- There would be no withholding taxes on the payment of rent by Owner to SPV or on the periodical payments by SPV to sukuk investors.
- As Owner is not taxed on the $80 million gain on selling the building to SPV, and can deduct the $10 million uplift on the repurchase price, after all of the transactions are completed its tax basis in the building will be the original figure of $20 million.

QFC – offshore SPV

- The above tax analysis should also apply with an offshore SPV.

Saudi Arabia – onshore SPV

- No transfer taxes would arise as the property is not being transferred by a foreign individual.
- Owner's $80 million gain prima facie appears liable to tax and zakat. The financial accounting for the sale to the SPV and the leaseback with a buyback commitment may spread the gain over the life of the leaseback or not recognise it at all using substance over form principles. However, it is possible that the tax authorities may not accept substance over form accounting, and may charge the $80 million gain to tax and zakat in the year when the sale to the SPV takes place. It would be desirable to seek advance clearance for the transaction.
- The creation of the leaseback should have no tax consequences.
- Owner is likely to have to account for the leaseback as a finance lease. Accordingly, instead of simply deducting the $5 million annual rent, Owner will need to compute the finance charge cost of the leaseback and will receive a tax deduction for that subject to the general Saudi tax rule that interest deductions are limited to 50% of the profit before interest.
- SPV is also likely to account for the leaseback as a financial transaction, and would be taxable on the financial income computed for each year. The tax authorities may disregard the substance over form accounting, and simply tax the $5 million the SPV receives each year.
- SPV may not be able to deduct the $5 million it pays to the sukuk holders if it is treated as a share of profit taxable at 20% with 5% WHT also applicable.
- Although foreign investors trading shares on the Saudi stock exchange are not taxed, the gain made by a foreign investor selling a large holding of sukuk (10% in the case study) may possibly be taxed in Saudi Arabia depending upon the detailed facts.
- SPV's gain of $10 million on selling the building back to Owner at the end of the five years will be subject to tax and zakat.
- SPV's payment of $10 million to the sukuk investors is unlikely to be tax deductible. The gain made by the investors may be subject to 20% tax and 5% WHT.
- Tax treaties do not change the position unless the treaty provides for extraordinary benefits such as exemption from capital gains tax or WHT on such payments.

Saudi Arabia – offshore SPV

- The same tax treatment applies as with the onshore SPV, except as indicated below.
- As SPV is overseas, Owner will be required to deduct WHT on that part of the $5 million rent which is treated as income in the hands of the lessor SPV. If the SPV is considered to be carrying on a business in Saudi Arabia, it will need to file a tax return and pay taxes accordingly.

Turkey – onshore SPV

- No transfer tax would arise on sale of the building to the SPV.
- Under the Article 5/e of Corporate Income Tax Code, it is stipulated that the incomes derived from transferring of the building from owner to SPV as part of a sukuk transaction is wholly exempt from corporate income tax. Accordingly Owner would not be taxed on the $80 million gain from transferring the property to the SPV.
- No taxes would be payable on the creation of the lease or the creation of the sukuk.
- The annual $5 million rent would be deductible by Owner.
- SPV would be taxable on the $5 million rent received, but would be able to deduct the $5 million that it pays the investors.
- The WHT position of foreign investors in the sukuk is complex. Sukuk certificates issued and registered in Turkey and/or traded in the stock exchange and derivatives exchanges established in Turkey are within the scope of Temporary Article 67. This has the following consequences:
    - When there is intermediation by a bank or brokerage house (presumably in Turkey), foreign natural persons suffer 10% WHT. In the case of foreign corporations, gains derived by foreign corporations in the nature of joint stock companies, companies limited by shares and limited companies and limited liability partnerships, country funds, funds owned by administrations and establishments, investment companies and all the other foreign corporate investors are subject to 0% withholding.Gains derived by other corporations are subject to 10% withholding.

    - When there is no intermediation by a bank or brokerage house, all foreign recipients suffer 10% WHT.
- The tax position of a foreign investor who makes a gain from selling sukuk is also complex.
    - If the transaction is conducted with intermediation of Turkish banks or brokerage houses, capital gains derived by foreign investors would be subject to withholding. Gains derived by foreign corporations in the nature of joint stock companies, companies limited by shares and limited companies and limited liability partnerships, country funds, funds owned by administrations and establishments, investment companies and all the other foreign corporate investors are subject to 0% withholding. Gains derived by other corporations and real persons are subject to 10% withholding.

    - If there is no intermediation of Turkish banks or brokerage houses, capital gains derived by foreign investors should be declared. Please also note that double tax treaty provisions should also be considered separately.

- Upon termination of the sukuk, no transfer tax would be charged when the building is transferred back to Owner.
- SPV is not taxed on its gain of $10 million. Under the Article 5/e of Corporate Income Tax Code, it is stipulated that the incomes derived from transferring of the building from SPV to owner as part of a sukuk transaction is wholly exemptfrom corporate income tax.
- The response states that SPV's payment of $10 million will be deductible for SPV, but SPV appears to have no taxable income to set this against, as it is not taxed on the $10 million profit it makes from selling the building back to Owner.
- The $10 million gain that the investors make is subject to the same WHT principles as outlined above.
- Double taxation treaty provisions might affect the taxation of capital gains derived by sukuk investors on the sale of sukuk certificates to the SPV or to other investors.

Turkey – offshore SPV

- The same tax treatment applies as with the onshore SPV, except as indicated below.
- There are certain limitations on sale of buildings in Turkey to non-Turkish residents.
- The special tax regime for sukuk mentioned above only applies where the SPV is onshore. If SPV is established outside Turkey, the proposed transaction would not be treated as sukuk.
    - The sale of the building by Owner to SPV would be subject to 18% VAT and 1.65% title deed charge.
    - The agreement signed between Owner and SPV would be subject to 0.825% stamp tax for all signed copies (TL 1,379,775.30 is the cap amount for stamp tax to be paid for agreements in 2012.)
    - The $80 million gain of Owner would be subject to corporate income tax.
- If there is a signed lease contract between SPV and Owner, this contract would be subject to 0.165% stamp tax.
- Rent payments made to offshore SPV would be subject to 20% withholding tax under Turkish tax legislation. As the SPV is offshore, this WHT will be the final tax borne by the SPV; no deduction will be available for SPV's payments to investors.
- The gain derived by foreign investor from the sale of the sukuk certificates would not be taxable in Turkey.
- The offshore SPV would be taxable in Turkey on the $10 million gain when it sells the building back to Owner. Offshore SPV.
- Double tax treaties may give the offshore SPV relief from Turkish taxation of the capital gain, depending upon the language of the treaty.

Salaam

Egypt

- The transactions outlined should not cause the bank to have a taxable presence in Egypt.
- Egypt has no transfer taxes.

Jordan

- Jordanian tax law does not contain a definition of a permanent establishment. However, the non-resident party in Jordan have no tax responsibilities, as the responsibility of deducting due taxes fall on the resident/Jordanian party.
- Jordan does not apply transfer taxes to these types of asset. However, sales tax exists in Jordan[4].

Kuwait

- In general, a foreign person who, while remaining abroad, buys and sells good within Kuwait should not have a taxable presence there. However as the salaam transaction is structured to replicate a conventional loan, the Kuwait tax authority may treat the revenue earned on the Salaam transaction in a similar way to conventional lending arrangements. In Kuwait the definition of taxable income has been extended to include income from money lending in the State of Kuwait. Accordingly, the $5 profit may be considered subject to tax at a flat rate of 15% by the tax authorities in Kuwait should they treat the salaam transaction in the same manner as a conventional financing arrangement.
- Kuwait has no transfer taxes.
- Tax treaties may allow the Bank to claim a lower rate of tax if the treaty specifies a lower tax rate for interest.

Libya

- This transaction is in breach of Libyan commercial law. The bank is buying and selling a commodity within the Libyan jurisdiction and commercial law restricts retail and wholesale trading to Libyan nationals. A foreign bank could not buy and ‘own’ a commodity and subsequently sell it within the Libyan jurisdiction.
- Stamp duty would be applicable as one party to the transaction is resident in Libya. The duty would apply to both the purchase by the bank and the sale by the bank.
- Tax treaties would not change the position.

Oman

- As the commodity is in Oman and is transferred by the supplier to the customer, on behalf of the bank, the supplier may be treated as an agent for the bank. Accordingly, the transaction is likely to be taxable in Oman for the bank.
- Oman has no transfer taxes.
- Tax treaties would not change the position.

Qatar

- The transactions should not cause the bank to have a taxable presence in Qatar.
- Qatar has no transfer taxes.
- Tax treaties would not change the position.

4) Jordanian sales tax is ignored for this report as being out of scope.

QFC

- As the bank is foreign, it is unlikely to be licensed in the QFC, especially if its only activities there comprise the sale and purchase of goods under the salam contract.

Saudi Arabia

- The transactions should not cause the bank to have a taxable presence in Saudi Arabia.
- No transfer taxes should arise on these goods.
- Tax treaties should not change the position.

Turkey

- Turkey has no special provisions for salaam transactions. The response received analyses the transaction as a purchase and sale of wheat by the Bank, but does not consider the alternative analysis of regarding it as a financing transaction.

Istisna

Egypt

- The transactions should not cause the foreign bank to have a taxable presence in Egypt.
- Egypt does not impose any transfer taxes.

Jordan

- Jordanian tax law does not contain a definition of a permanent establishment. However, the non-resident party in Jordan have no tax responsibilities, as the responsibility of deducting due taxes fall on the resident/Jordanian party.
- Jordan does not apply transfer taxes to these types of assets[5].

Kuwait

- In general, a foreign person who, while remaining abroad, buys and sells good within Kuwait should not have a taxable presence there. However as the istisna transaction is structured to replicate a conventional loan, the Kuwait tax authority may treat the revenue earned on the istisna transaction in a similar way to conventional lending arrangements. In Kuwait the definition of taxable income has been extended to include income from money lending in the State of Kuwait. Accordingly, the $5 profit may be considered subject to tax at a flat rate of 15% by the tax authorities in Kuwait should they treat the istisna transaction in the same manner as a conventional financing arrangement.
- Kuwait has no transfer taxes.
- Tax treaties may allow the Bank to claim a lower rate of tax if the treaty specifies a lower tax rate for interest.

5) Jordanian sales tax has been ignored as being out of scope.

Libya

- This transaction is in breach of Libyan commercial law. The bank is buying and selling a commodity within the Libyan jurisdiction and commercial law restricts retail and wholesale trading to Libyan nationals. A foreign bank could not buy and 'own' a commodity and subsequently sell it within the Libyan jurisdiction.
- Stamp duty would be applicable as one party to the transaction is resident in Libya. The duty would apply to both the purchase by the bank and the sale by the bank.
- Tax treaties would not change the position.

Oman

- As the commodity is in Oman and is transferred by the ship builder to the bank who will transfer it to the customer in Oman, the bank is likely to be taxable in Oman for the profit earned on this transaction.
- Oman has no transfer taxes.
- Tax treaties would not change the position.

Qatar

- The transactions should not cause the bank to have a taxable presence in Qatar.
- Qatar has no transfer taxes.
- Tax treaties would not change the position.

QFC

- The tax position in the QFC should be the same as in Qatar.

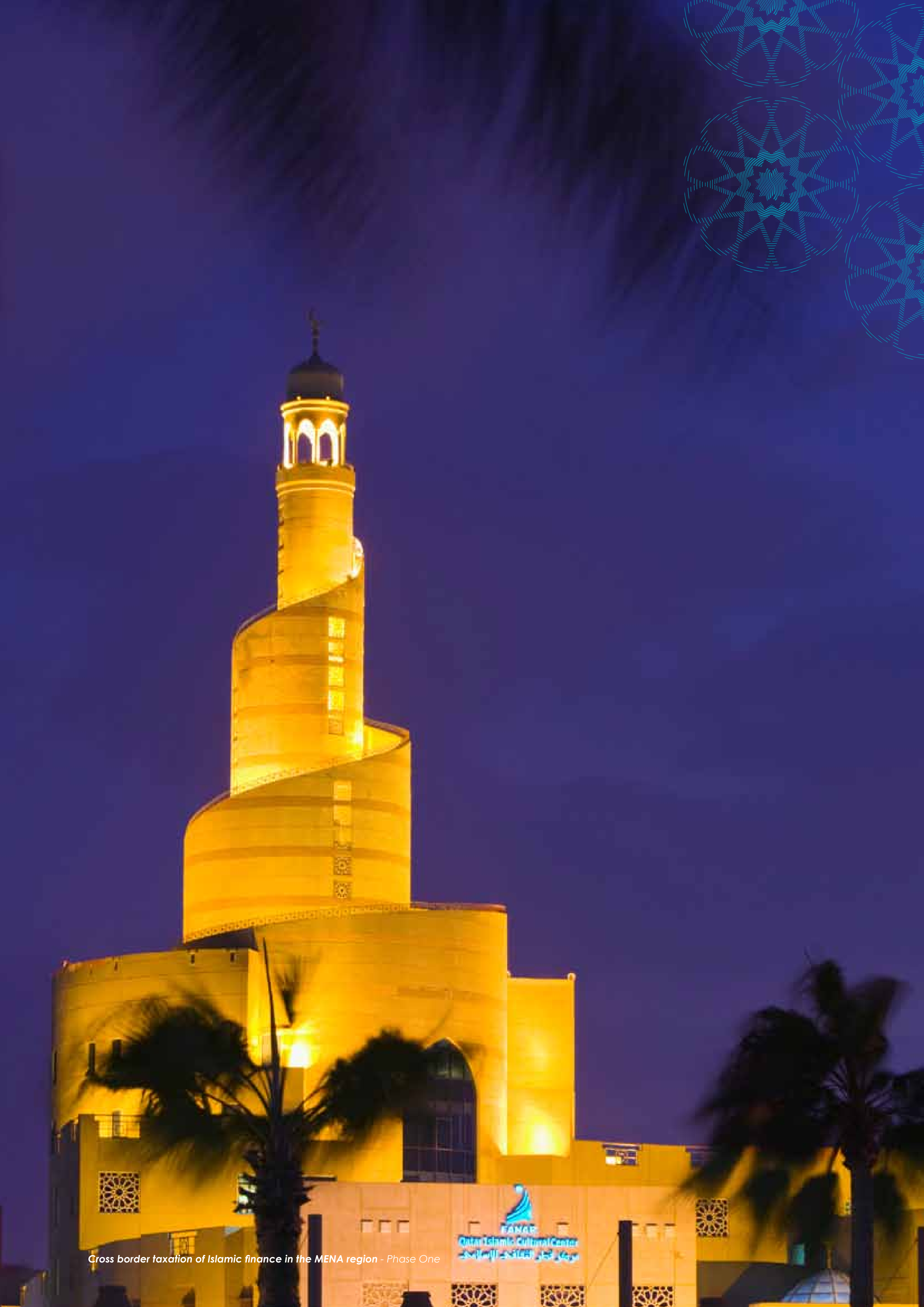
Saudi Arabia

- The transactions should not cause the bank to have a taxable presence in Saudi Arabia.
- Saudi Arabia does not impose any transfer taxes on goods.
- Tax treaties would not change the position.

Turkey

- The transactions should not cause the bank to have a taxable presence in Turkey.
- Turkey charges special consumption tax on sales of particular goods[6]. The transfer tax questions would not be affected by double tax treaties, but the definition of a permanent establishment can differ between treaties.

6) Turkish consumption taxes have been ignored as being out of scope.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9. Summary of findings from the survey

None of the countries covered have modified their tax laws to facilitate Islamic finance, apart from Turkey which has introduced limited changes to facilitate the issue of sukuk and Qatar with its special tax regime in the QFC.

For relatively simple Islamic finance transactions such as commodity murabaha, salaam or istisna, the application of the general tax laws of the countries concerned, unmodified for Islamic finance, appear to give results for the taxable income of the parties which broadly correspond with the results expected from an analysis of the transaction economics. However, depending on the details of the jurisdiction concerned, transaction taxes can arise which would not be payable in the case of a conventional finance transaction which had similar economic consequences.

In the case of more complex transactions such as sukuk, the application of the general tax laws of the countries concerned, unmodified for Islamic finance, leads to prohibitive tax costs which can make the transaction wholly uneconomic to carry out. (Turkey is excluded from these comments as it has brought in special tax provisions to facilitate sukuk transactions.) These prohibitive tax costs arise from taxing the asset transactions associated with the issue of sukuk, even though these asset transactions ultimately reverse themselves leaving the asset with its original owner.

The countries covered need to modify their tax laws if they wish to facilitate Islamic finance. Before deciding how the tax laws should be modified, it is helpful to look at examples of how other countries have modified their tax laws to facilitate Islamic finance.


qatar FINANCIAL CENTRE

10. Alternative approaches to Islamic finance tax policy

The survey above shows that the countries from which responses were received have so far done little to adapt their tax law for Islamic finance.

In the case of simpler transactions such as commodity murabaha, it is possible to arrive at a reasonable taxable outcome by application of the existing tax law to the Islamic finance transaction. However in the case of more complex Islamic finance structures such as sukuk, where there are a large number of associated transactions, the application of existing tax law to the Islamic finance transaction leads to an unsatisfactory outcome. In the example is considered above the taxation charges that arise would make the sukuk transaction impossible to execute in practice due to excessive tax costs.

Accordingly if more complex Islamic finance transactions such as sukuk are to be implemented within these jurisdictions, tax law must be modified to accommodate Islamic finance.

Conceptually there are two different approaches to modifying tax law for Islamic finance. These different approaches are best understood by looking at how two countries which have a leading role in Islamic finance have adapted their tax laws to enable Islamic finance transactions to take place.

Malaysia

Malaysia is a country roughly 60% of whose citizens are Muslims. Accordingly Islam has a special place in Malaysian society. For example while Malaysian commercial law is secular and owes much to English law, the personal law applicable to Malaysian Muslim citizens governing matters such as marriage, divorce and inheritance is Shariah as applied by Shariah qualified judges.

The approach that Malaysia has taken to the regulation of Islamic finance has been to enact specific legislation for Islamic finance such as:

- Islamic Banking Act 1983 (IBA) - this governs the operations of Malaysian Islamic banks.
- Takaful Act 1984 - to allow for the licensing and operation of Islamic insurance (Takaful) companies in Malaysia.

Most importantly, subsection 16B(1) of the Central Bank of Malaysia Act 1958 creates a “Syariah[Shariah] Advisory Council” for the Malaysian Central Bank (Bank Negara Malaysia). The Shariah Advisory Boards of all Islamic banks in Malaysia are required to follow any rulings laid down by the Shariah Advisory Council of the Malaysian Central Bank. The Malaysian Stock Exchange similarly has its own Shariah Advisory Council.

Furthermore Islamic financial institutions in Malaysia are not permitted to offer Islamic financial products without first having that product approved by the appropriate regulatory body (such as the Central Bank or the Stock Exchange) which will follow the guidance of its Shariah Advisory Council. Accordingly in Malaysia there is never any doubt as to whether a product being offered is an Islamic financial product, since all Islamic financial products must be approved in advance.

That in turn made it practical to make relatively simple changes to tax law to provide equal treatment for Islamic finance. This is illustrated by the Malaysian response to our questionnaire from which extracts are reproduced below. Where emphasis has been added, that has been done by the report writers.

The key point is that, because the Malaysian tax authorities can always be certain whether a transaction qualifies as Islamic finance, it has been relatively straightforward to amend tax law to give equal tax treatment.

For example, the transactions in the underlying asset that are needed to enable sukuk to be issued can simply be disregarded for tax purposes, and the payments to the sukuk investors treated as effectively being made by the company which caused the sukuk to be issued, namely the original Owner of the property. The comments below in italics are taken verbatim from the Malaysian response.

Commodity Murabaha or Tawarruq

Such a transaction described above, where approved by an appropriate regulatory body, would be seen and treated as an ordinary conventional loan.

The relevant provisions are as follows:

a) 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."*

b) Stamp Act, 1949 – Schedule II, Para (6) [Giving an exemption]

*"****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"*

Sukuk

Sukuk issuance based on the Ijarah principle is common in Malaysia. However, usually in practice, it is noted that the SPV is usually owned and established by the Owner instead of a separate/ independent party/charity. Please refer to Q19 **[response reproduced below]** *for further information on SPV treatment.*

However, under S60I of the Income Tax Act, 1967 where an SPV is specifically established for the issuance of Islamic securities.

S60I states that:

*"... **where a company establishes a special purpose vehicle** solely for the issuance of Islamic securities, **any source of the special purpose vehicle** and any income from that source **shall be treated as a source** and income **of that company** and such company shall have the right to receive and utilise any proceeds derived from the issuance of such Islamic securities"*

"The SPV is exempt from the responsibility of doing all acts and things required to be done under the Act"

"Islamic securities" means Islamic securities which adopt the principles of mudharabah, musyarakah, ijarah or istisna' approved by the Securities Commission or Labuan Offshore Financial Services Authority"

Salaam

Such Islamic financing structures are not common in Malaysia.
Where the financing structure is seen as an approved loan, repayment of the capital portion is not taxable. The $5 would be treated as interest payment and subject to 15% withholding tax.

Istisna

Strictly speaking, there are no specific tax provisions for Istisna financing transactions. In Malaysia however, financing structures which are based on Syariah principles (e.g.mudharabah, musyarakah, ijarah or istisna) 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.

The United Kingdom

Muslims are a small minority in the UK, being about 4% of the population. Despite having an established church, the UK generally maintains separation between church and state which leads to the following policy requirements:

- The same law applies to all citizens, irrespective of their religion.
- The state is not an arbiter on religious issues. For example, it has no interest in determining conflicting claims about what is Shariah compliant.
- The legal enforceability of a contract should not depend on whether it is Shariah compliant.
- Individuals and companies should be entitled to organise any form of business enterprises, provided they do not conflict with the law.

Without the enactment of special tax law for Islamic finance, the transactions studied in this paper would encounter the same kind of prohibitive tax costs that they encounter in the MENA countries which responded to the study questionnaire. However any legislation that the UK introduced needed to be responsive to the policy considerations outlined above.

Accordingly the UK has taken a radically different approach to that taken in Malaysia. It began by analysing what transactions were carried out in common Islamic finance transactions. This research involved activities such as discussions with Islamic bankers and reading prospectuses from actual sukuk issues, many of which were supplied to the UK tax authorities by one the report writers.

After this research, it was possible to draft tax law which enabled transactions of the type carried out in Islamic finance, but using free-standing definitions which did not reference Islamic finance in any way.

This is best illustrated by two examples.

Purchase and resale

Finance Act (FA) 2005 section 47 introduced legislation for something called "Purchase and Resale." As part of the UK's tax law rewrite project, FA 2005 s.47 has been repealed, and the corporation tax version of the rewritten legislation is found in Corporation Tax Act (CTA) 2009 s.503 which is reproduced below:

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.

(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).

Looking at the legislation above, it is easy to see that it is defining a murabaha transaction. However the definition does not require the transaction to be Shariah compliant. For example the definition would apply perfectly well even if a haram commodity such as whisky were the subject matter of the purchase and resale. Other parts of the tax law go on to specify what tax consequences arise for the two parties to the transaction; very briefly the difference between the purchase price and the sale price is treated for tax purposes as if it were interest.

Investment Bond

This structure was first legislated in Finance Act 2007, and the rewritten version for corporation tax can now be found as CTA 2009 s.507 reproduced below.

507 Investment bond arrangements

(1) This section applies to arrangements if—

(a) they provide for one person ("the bond-holder") to pay a sum of money ("the capital") to another ("the bond-issuer"),

(b) they identify assets, or a class of assets, which the bond-issuer will acquire for the purpose of generating income or gains directly or indirectly ("the bond assets"),

(c) they specify a period at the end of which they cease to have effect ("the bond term"),

(d) the bond-issuer undertakes under the arrangements—
(i) to dispose at the end of the bond term of any bond assets which are still in the bond-issuer's possession,
(ii) to make a repayment of the capital ("the redemption payment") to the bond-holder during or at the end of the bond-term (whether or not in instalments), and
(iii) to pay to the bond-holder other payments on one or more occasions during or at the end of the bond term ("additional payments"),

(e) the amount of the additional payments does not exceed an amount which would be a reasonable commercial return on a loan of the capital,

(f) under the arrangements the bond-issuer undertakes to arrange for the management of the bond assets with a view to generating income sufficient to pay the redemption payment and additional payments,

(g) the bond-holder is able to transfer the rights under the arrangements to another person (who becomes the bond-holder because of the transfer),

(h) the arrangements are a listed security on a recognised stock exchange, and

(i) the arrangements are wholly or partly treated in accordance with international accounting standards as a financial liability of the bond-issuer, or would be if the bond-issuer applied those standards

(2) For the purposes of subsection (1)—

(a) the bond-issuer may acquire bond assets before or after the arrangements take effect,

(b) the bond assets may be property of any kind, including rights in relation to property owned by someone other than the bond-issuer,

(c) the identification of the bond assets mentioned in subsection (1)(b) and the undertakings mentioned in subsection (1)(d) and (f) may (but need not) be described as, or accompanied by a document described as, a declaration of trust,

(d) a reference to the management of assets includes a reference to disposal,

(e) the bond-holder may (but need not) be entitled under the arrangements to terminate them, or participate in terminating them, before the end of the bond term,

(f) the amount of the additional payments may be—

(i) fixed at the beginning of the bond term,
(ii) determined wholly or partly by reference to the value of or income generated by the bond assets, or
(iii) determined in some other way,

(g) if the amount of the additional payments is not fixed at the beginning of the bond term, the reference in subsection (1)(e) to the amount of the additional payments is a reference to the maximum amount of the additional payments,

(h) the amount of the redemption payment may (but need not) be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income generated by them, and

(i) entitlement to the redemption payment may (but need not) be capable of being satisfied (whether or not at the option of the bond-issuer or the bond-holder) by the issue or transfer of shares or other securities.

(3) This section is subject to section 508.

It can be seen that the above section contemplates a sukuk transaction, with the following roles:

Bond-holder = investor in the sukuk

Bond-issuer = the SPV which issues the sukuk

Bond asset = the asset which is purchased by the SPV; in this paper's example the property.

Other parts of the legislation, not reproduced here, have the effect that, provided the structure will not last longer than 10 years and various other specified conditions are met, the sale of the property from the Owner to the SPV and from the SPV back to the Owner is effectively disregarded for the purposes of corporation tax, stamp duty land tax (the UK's real estate transfer tax) and capital allowances (the UK's rules for computing tax depreciation.)

The UK's approach requires the writing of far more legislation than the Malaysian approach, because the transactions have to be defined in meticulous free-standing detail, without being able to reference any definitions from elsewhere, and without being able to rely upon any form of advance certification of the structures by the regulatory authorities.

The philosophical approach in the UK is that private sector participants are free to enter into any contracts that they wish, apart from special cases where some contracts are prohibited by law or rendered unenforceable by law due to violating public policy as set out in English common law or occasionally due to violating specific legislative prohibitions.

11. Recommendations

Adaptation of tax law is essential

As seen above, in many cases the tax law of the countries studied, by not dealing specifically with Islamic finance transactions, makes it prohibitively expensive in tax terms to use certain Islamic finance structures such as sukuk. If countries wish to allow their citizens to use such structures, modifying their tax law becomes essential.

Non-Muslim majority countries should follow the UK model

Religious issues can often cause difficulties in societies.

For example in the USA, during the global financial crisis, the insurance company AIG was bailed out by the US Government injecting emergency funds. Some of AIG's subsidiaries had businesses, outside the USA, selling takaful products. In the case Murray v. United States Department of Treasury, an individual filed suit against the US Government alleging that its injection of funds into AIG violated the First Amendment to the US Constitution since AIG was promoting a religion (Islam) through its takaful activities. The case was eventually thrown out by the courts on the grounds that the plaintiff lacked standing to bring the case although as of June 2012 the plaintiff was still seeking to appeal that decision.

The UK approach does not require any recognition of Islam within tax law, as the definitions of the transactions is entirely free-standing, and the desired tax treatment is given to all transactions that fall within the definition, regardless of whether they are Shariah compliant or not.

The principal drawback from following the UK model is that the legal drafting can take significant effort, since all aspects of the transaction must be described in meticulous detail without any reference to sources external to statute law.

Muslim majority countries should follow the Malaysian model

As Malaysia has shown, amendment of the tax law to facilitate Islamic finance can be done relatively simply, if it is possible to be certain what is an approved Islamic finance transaction and what is not. Malaysia achieves such certainty by having a Shariah Advisory Council attached to each relevant regulatory authority such as the Central Bank and the Stock Exchange.

This approach requires far less complex drafting than does the UK approach. Accordingly, it will be much quicker to amend tax law to facilitate Islamic finance. This can be seen from the way that the QFC has been able to achieve the objective of tax neutrality with the relatively short section in its tax regulations devoted to Islamic finance which is reproduced in Appendix 2.

Central certification of Islamic financial products may at times slow down product development, but there should be advantages to customers from knowing that the product concerned has been approved as being Shariah compliant by the central regulatory authorities.

12. Next steps

This report is described as "Phase One" because it represents only the first stage of what may become a much larger project, the aim of which is to understand tax and regulatory policies adopted by all (or, at least, most) MENA countries in dealing with Islamic financial transactions and to make appropriate recommendations based upon the findings.

Outlined below is a tentative programme for future work.

Complete geographical coverage

We intend to complete our coverage of the MENA region (subject to resources), since at present only eight countries have provided responses to the questionnaire.

Cover additional structures

We would also like to extend the range of structures which are reviewed to ensure that the full range of products needed by users of Islamic finance have been considered.

Cover additional taxes and levies

Consumption taxes

To complete the analysis of tax policy issues one needs to consider consumption taxes such as sales tax, VAT, etc.

Zakat

Some countries require corporate entities (and individuals) to pay Zakat. Accordingly, it is desirable to research the practices and consider the policy issues arising from the application of Zakat to Islamic finance.

Double taxation treaties

We would like to review the way that countries take account of Islamic finance when negotiating double taxation treaties, and the input they give to multilateral institutions such as the OECD and the UN.

Consider regulatory and governance issues

Prudential regulation

It is desirable to consider how the evolving governance framework for conventional finance (especially the Basel II and III guidelines) is adapted to the needs of Islamic finance.

Shariah governance

It would be desirable to review country practices regarding the Shariah governance of Islamic financial institutions, including consideration of how it takes into account the diversity of schools of thought.

13. Appendix 1 – Full text of the survey questionnaire

Introduction

In order to facilitate the development of Islamic finance in the Middle East and North Africa (MENA) region, the Qatar Financial Centre Authority (QFC) has commissioned a study on the existing tax treatment of Islamic finance transactions in selected MENA countries. The detailed work is being conducted by the International Tax and Investment Center (ITIC), Ernst & Young (E&Y) and Mr Mohammed Amin.

For the purposes of this paper, the MENA region is taken to comprise the following countries which are listed in alphabetical order

1. Algeria
2. Bahrain
3. Egypt
4. Iran
5. Iraq
6. Jordan
7. Kuwait
8. Lebanon
9. Libya
10. Morocco
11. Oman
12. Palestinian Territories
13. Qatar
14. Saudi Arabia
15. Syria
16. Tunisia
17. Turkey
18. United Arab Emirates
19. Yemen

Technical scope of the study

This study is restricted to the following types of tax:

- 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

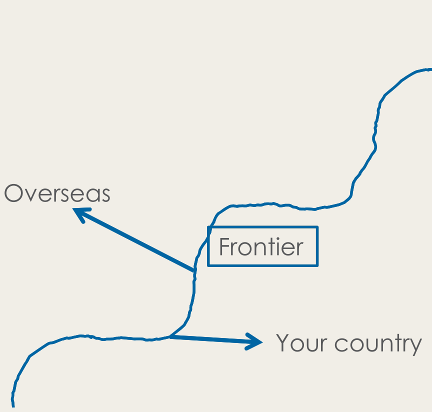
Value Added Tax operates in a different way from transfer taxes such as real estate transfer tax, because a business which pays VAT when buying goods is normally able to offset such VAT against VAT that it collects from customers. For simplicity, at this stage VAT is excluded from the study. We may conduct in the future a separate study of the way that MENA countries implement VAT on Islamic finance.

Structure of this paper

This paper sets out four Islamic finance structures which are relatively common. In each case the structure is introduced with a diagram, and then the detailed transaction steps are set out, using hypothetical numbers. Assumptions are given for the jurisdiction of the parties to the transaction.

Various questions are then asked regarding how the tax law of your country would deal with this hypothetical transaction.

Guide to the Structure Diagrams (1)



On each diagram a frontier is drawn to make it clear which parties to the transaction are located in your country, and which parties are located overseas.

Guide to the Structure Diagrams (2)

Red arrows are used to illustrate the sale of commodities or tangible assets

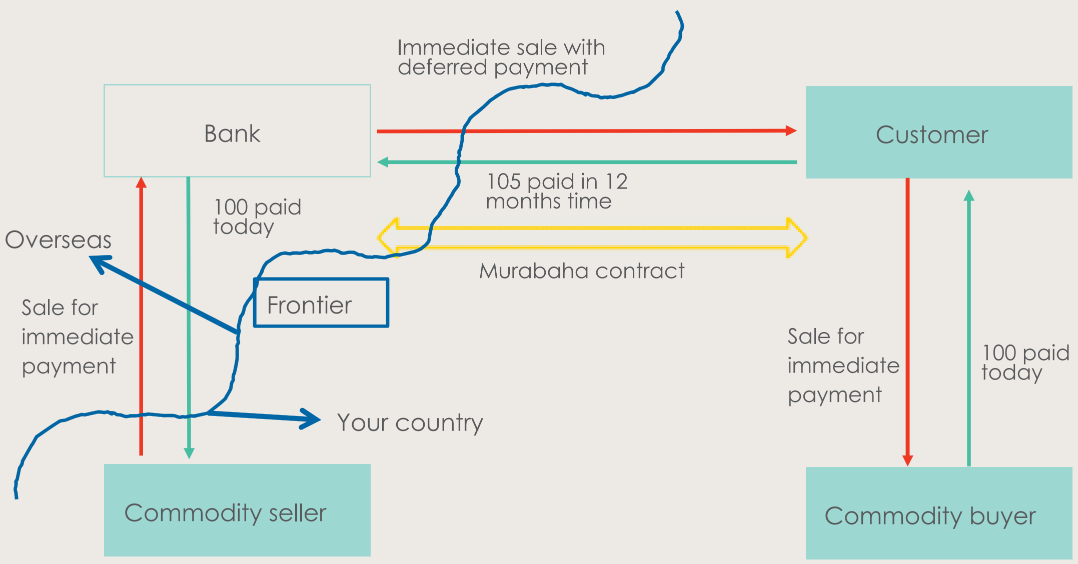
Green arrows are used to illustrate the payment of cash

Commodity murabaha or tawarruq

The purpose of this transaction is for a bank to supply an amount of money to its customer, and for the customer to be liable to pay a fixed larger amount of money back to the bank on a fixed future date. This is to be accomplished without having an interest bearing loan which would be prohibited under the rules of Islamic finance.

Accordingly the bank sells its customer a commodity on deferred payment terms, with the customer selling the commodity to obtain cash. This is illustrated by the diagram below.

Commodity murabaha or tawarruq



Transaction details

1.Bank is located overseas.

2. Customer, Commodity seller and Commodity buyer are companies located in your country.
3. The commodity consists of bars of refined copper which are physically located in your country.
4. Today at time 1300 Bank purchases 13kg of copper from Commodity seller for immediate delivery and payment. Bank pays $100 to Commodity seller.
5. Today at time 1301 Bank sells 13kg of copper to Customer for immediate delivery but payment being deferred by 12 months. The price which Customer only has to pay in 12 months' time is $105.
6. Today at time 1302 Customer sells 13kg of copper to Commodity buyer for immediate delivery and immediate payment at a price of $100. Commodity buyer pays customer $100.
7. In 12 months' time, Customer pays to the bank the deferred price of $105.

In cash terms, Customer receives cash of $100 at time 1302 today, and pays cash of $105 to Bank in 12 months' time.

Would the transaction as described above be legally valid in your country? If not, please explain why in the answer box below. When dealing with the taxation questions below, please assume that the transaction is legally valid.

Please type your answer in this box which will expand to accommodate it:

Taxation questions

In many jurisdictions, different rates of tax apply to transactions depending upon the size of the transaction. For simplicity, please assume that the transactions values are very large, instead of the illustrative amounts set out above. For example, instead of $100 and $105, they may be $100,000,000 and $105,000,000.

Are there any tax provisions in your country dealing specifically with this transaction? If so, please give details and if possible supply a copy of the tax provisions.

Please type your answer in this box which will expand to accommodate it:

Loss suffered by Customer

Customer receives $100 today from selling the copper, but is obliged to pay Bank $105 in 12 months' time, so it suffers a net loss of $5.

If Customer is in business and can claim a tax deduction for other costs, is it able to claim a tax deduction for this cost of $5?

Please type your answer in this box which will expand to accommodate it:

If a tax deduction is given, is the deduction given on the date that Customer pays the $105 to Bank, or is the deduction spread on a time basis over the 12 month period of the commodity murabaha contract?

For example if the Customer's accounting year end takes place six months after today, will the $5 loss be split $2.5 for this accounting period and the next accounting period, or will the entire $5 deduction be given in the second accounting period?

Please type your answer in this box which will expand to accommodate it:

Tax position of Bank

Assume that Bank has no branch presence in your country and no employees based in your country. Instead it has entered into the murabaha transaction using electronic communications or faxes.

Will the transactions themselves cause Bank to have a taxable presence (permanent establishment) in your country causing its $5 profit to be taxable in your country?

Please type your answer in this box which will expand to accommodate it:

Is there any withholding tax suffered by Bank when it receives the $105 payment from Customer?

Please type your answer in this box which will expand to accommodate it:

Impact of double taxation treaties

Please list the MENA countries with which your country has a comprehensive double taxation treaty.

Please type your answer in this box which will expand to accommodate it:

Are the answers to any of the above questions different when Bank is located in a MENA country with a comprehensive double taxation treaty? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

Transfer taxes

Please give details of any transfer taxes that would apply to this murabaha transaction using copper.

Please type your answer in this box which will expand to accommodate it:

If other assets are used instead of copper, and the transfer of those assets normally gives rise to transfer taxes, are there any reliefs given by your country due to this transaction being a murabaha transaction?

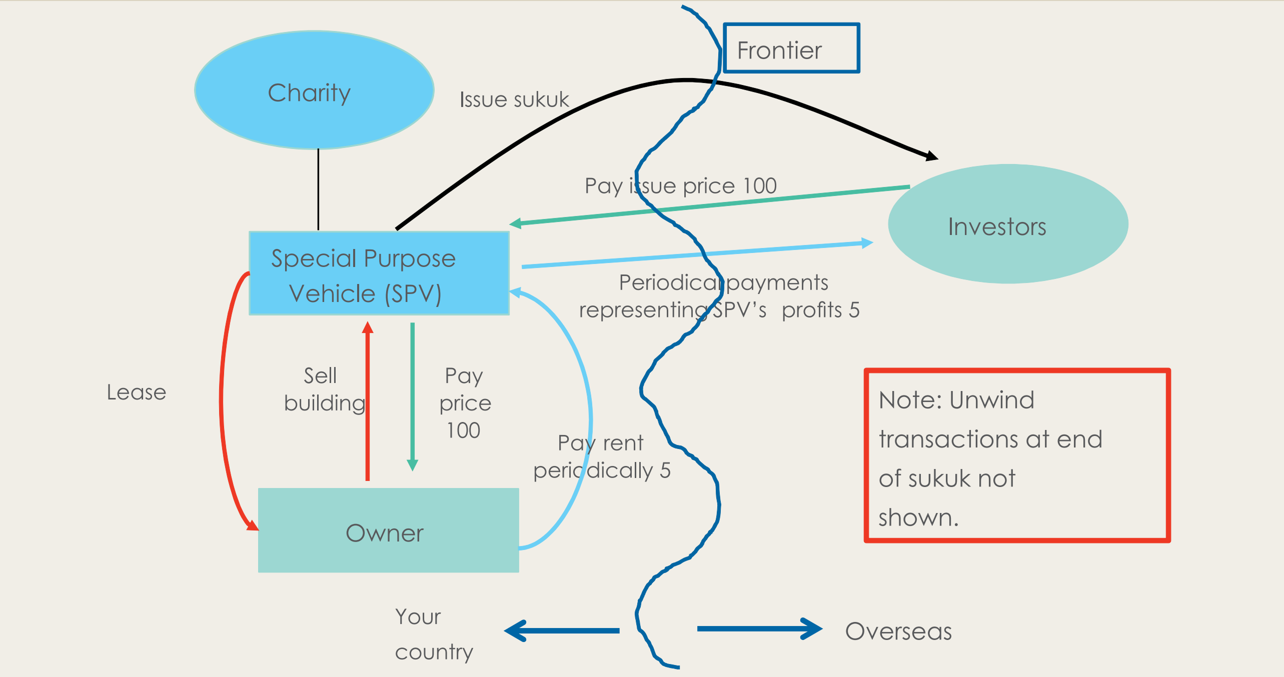
Please type your answer in this box which will expand to accommodate it:

Ijarah sukuk with onshore SPV

The purpose of the sukuk structure is to create an instrument that can be freely bought and sold between investors. Under the terms of the instrument, the investors will receive a fixed cash payment each year, and they will receive a fixed cash payment when the specified period of the sukuk ends.

These fixed cash payments are achieved by the owner of a building selling the building to a special purpose vehicle and then leasing the building paying rent. At the end of the fixed period, the original owner will buy back the building.

Ijarah sukuk with onshore SPV



Guide to the Sukuk structure diagram

Red arrows are used to illustrate the sale or leasing of land

Green arrows are used to illustrate payments of cash which take place at the commencement of the sukuk structure

The black arrow illustrates the issue of the sukuk

Turquoise arrows are used to illustrate payments of cash which take place during the life of the sukuk structure

Transaction details

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.

Would the transaction as described above be legally valid in your country? If not, please explain why in the answer box below. When dealing with the taxation questions below, please assume that the transaction is legally valid.

Please type your answer in this box which will expand to accommodate it:

Taxation questions

Are there any tax provisions in your country dealing specifically with this transaction? If so, please give details and if possible supply a copy of the tax provisions.

Please type your answer in this box which will expand to accommodate it:

Creation of the sukuk structure

Would your country charge a transfer tax on the sale of the building by Owner to SPV? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

Owner purchased the building many years ago for $20 million and is now selling it to SPV for $100 million. Is this gain of $80 million taxed when Owner sells the building to SPV as part of this sukuk transaction?

Please type your answer in this box which will expand to accommodate it:

Are there any reliefs from taxation of the $80 million gain due to this being a sukuk structure with Owner intending to repurchase the building in five years' time?

Please type your answer in this box which will expand to accommodate it:

Please type your answer in this box which will expand to accommodate it:

Are there any taxes charged on the creation of the lease between SPV and Owner? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

Are there any taxes charged when SPV issues sukuk to the investors? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

Events during the five year period of the sukuk

When Owner pays $5 million rent each year to SPV, is this rent a deductible expense for tax purposes?

Please type your answer in this box which will expand to accommodate it:

Is SPV taxable on the $5 million rental receipt?

Please type your answer in this box which will expand to accommodate it:

Does SPV receive a tax deduction for the $5 million payment it makes to the investors when it passes the rent on to them?

Please type your answer in this box which will expand to accommodate it:

Is any withholding tax chargeable on the $5 million payment to the investors?

Please type your answer in this box which will expand to accommodate it:

If a foreign investor who paid $10 million to acquire 10% of the sukuk holdings sells that holding to another foreign person for a price of $12 million, is any withholding tax charged on this transaction?

Please type your answer in this box which will expand to accommodate it:

In the previous question, the foreign investor has made a profit of $2 million. Is this profit taxable in your country, assuming that the foreign investor has no other connection with your country?

Please type your answer in this box which will expand to accommodate it:

Events on the termination of the sukuk structure

At the end of year five, SPV sells the building back to Owner for a price of $110 million. Is any transfer tax charged on this building sale?

Please type your answer in this box which will expand to accommodate it:

Owner sold the building for $100 million but pays $110 million to repurchase it.

Does Owner receive any tax relief for the extra $10 million it pays?

Please type your answer in this box which will expand to accommodate it:

Prior to the first sale of the building by Owner to SPV, Owner's tax basis (the base figure used to compute tax depreciation or when computing a capital gain) in the building was $20 million, being the original amount that Owner had paid for the building. What is Owner's tax basis in the building after it has been repurchased?

Please type your answer in this box which will expand to accommodate it:

SPV has made a gain of $10 million as it paid Owner $100 million for the building but sells it back for $110 million. Is this gain taxable?

Please type your answer in this box which will expand to accommodate it:

SPV originally received $100 million from the sukuk investors, but pays them $110 million on termination of the sukuk as it is obliged to pay the investors all of the sale proceeds of the building. Does SPV receive a tax deduction for this $10 million extra payment?

Please type your answer in this box which will expand to accommodate it:

The investors originally subscribed $100 million for the sukuk, but receive $110 million on its termination. Assuming that the investors are all foreign and have no other connection with your country, is this $10 million gain taxable by your country?

Please type your answer in this box which will expand to accommodate it:

Does your country charge any withholding tax on the $110 million termination payment to the foreign investors?

Please type your answer in this box which will expand to accommodate it:

Impact of double taxation treaties

Are the answers to any of the above questions changed when SPV or the Investors are located in a MENA country with which your country has a double taxation treaty? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

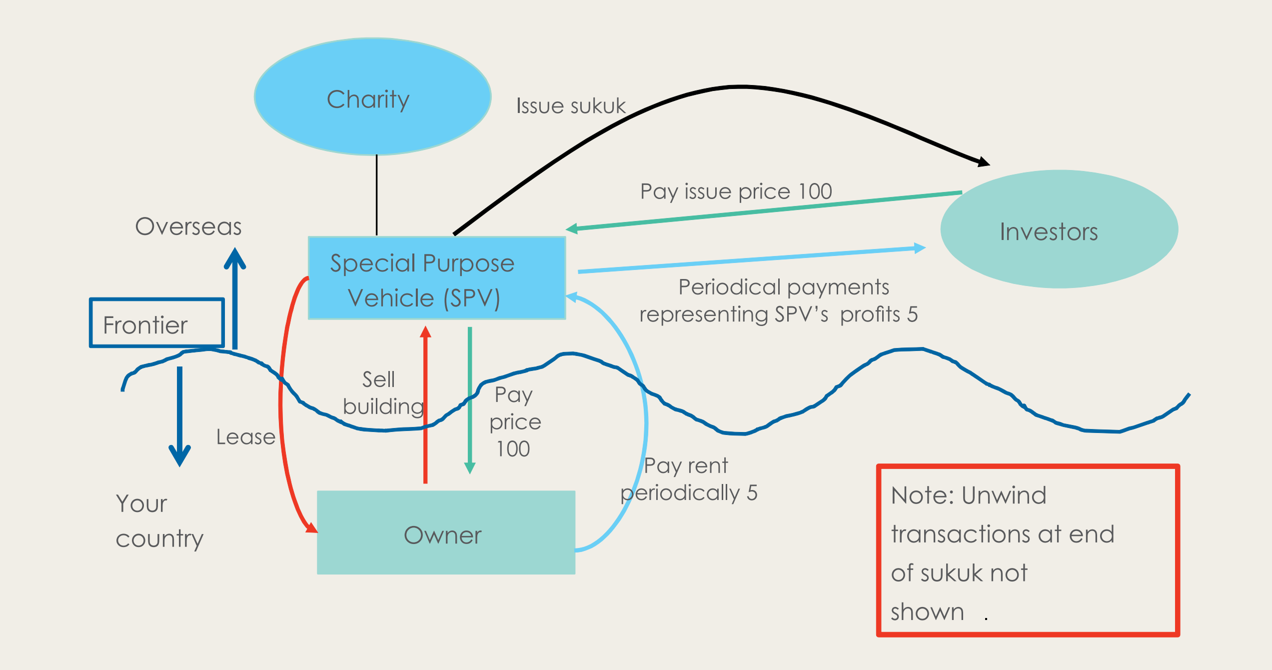
Ijarah sukuk with offshore SPV

The purpose of the sukuk structure is to create an instrument that can be freely bought and sold between investors. Under the terms of the instrument, the investors will receive a fixed cash payment each year, and they will receive a fixed cash payment when the specified period of the sukuk ends.

These fixed cash payments are achieved by the owner of a building selling the building to a special purpose vehicle and then leasing the building paying rent. At the end of the fixed period, the original owner will buy back the building.

The difference from the previous structure is that the SPV is now offshore. This may (or may not) enable the structure to be established and operated with lower tax costs than the case when the SPV is onshore.

Ijarah sukuk with offshore SPV



Guide to the sukuk structure diagram

Red arrows are used to illustrate the sale or leasing of land

Green arrows are used to illustrate payments of cash which take place at the commencement of the sukuk structure

The black arrow illustrates the issue of the sukuk

Turquoise arrows are used to illustrate payments of cash which take place during the life of the sukuk structure

Transaction details

1. Owner is a company located in your country.

2. Today Charity which is located overseas and is not connected with Owner creates a company called Special Purpose Vehicle (SPV) which is also located overseas.

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.

Would the transaction as described above be legally valid in your country? If not, please explain why in the answer box below. When dealing with the taxation questions below, please assume that the transaction is legally valid.

Please type your answer in this box which will expand to accommodate it:

Taxation questions

Are there any tax provisions in your country dealing specifically with this transaction? If so, please give details and if possible supply a copy of the tax provisions.

Please type your answer in this box which will expand to accommodate it:

Creation of the sukuk structure

Would your country charge a transfer tax on the sale of the building by Owner to SPV? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

Owner purchased the building many years ago for $20 million and is now selling it to SPV for $100 million. Is this gain of $80 million taxed when Owner sells the building to SPV as part of this sukuk transaction?

Please type your answer in this box which will expand to accommodate it:

Are there any reliefs from taxation of the $80 million gain due to this being a sukuk structure with Owner intending to repurchase the building in five years' time?

Please type your answer in this box which will expand to accommodate it:

Are there any taxes charged on the creation of the lease between SPV and Owner? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

SPV is an overseas company and the investors are all overseas. However the sukuk relate to rights to a building located in your country. Are there any taxes charged when SPV issues sukuk to the investors? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

Events during the five year period of the sukuk

When Owner pays $5 million rent each year to SPV, is this rent a deductible expense for tax purposes?

Please type your answer in this box which will expand to accommodate it:

Is any withholding tax charged when Owner pays the $5 million rent to the foreign SPV?

Please type your answer in this box which will expand to accommodate it:

Is the foreign SPV taxable on the $5 million rental receipt?

Please type your answer in this box which will expand to accommodate it:

If the foreign SPV is taxable on the rental receipt, would it SPV receive a tax deduction for the $5 million payment it makes to the investors when it passes the rent on to them?

Please type your answer in this box which will expand to accommodate it:

SPV is a foreign company making the $5 million payment to the investors who are also foreign. However the payment relates to rent on a building located in your country. Does that connection with your country cause any withholding tax to be payable on the payment to the investors?

Please type your answer in this box which will expand to accommodate it:

If a foreign investor who paid $10 million to acquire 10% of the sukuk holdings sells that holding to another foreign person for a price of $12 million, is any withholding tax charged on this transaction on the grounds that it relates to an entitlement over a building which is located in your country?

Please type your answer in this box which will expand to accommodate it:

In the previous question, the foreign investor has made a profit of $2 million. Is this profit taxable in your country, because the building is located in your country, assuming that the foreign investor has no other connection with your country?

Please type your answer in this box which will expand to accommodate it:

Events on the termination of the sukuk structure

At the end of year five, SPV sells the building back to Owner for a price of $110 million. Is any transfer tax charged on this building sale?

Please type your answer in this box which will expand to accommodate it:

Owner sold the building for $100 million but pays $110 million to repurchase it.
Does Owner receive any tax relief for the extra $10 million it pays?

Please type your answer in this box which will expand to accommodate it:

Prior to the first sale of the building by Owner to SPV, Owner's tax basis (the base figure used to compute tax depreciation or when computing a capital gain) in the building was $20 million, being the original amount that Owner had paid for the building. What is Owner's tax basis in the building after it has been repurchased?

Please type your answer in this box which will expand to accommodate it:

SPV has made a gain of $10 million as it paid Owner $100 million for the building but sells it back for $110 million. Does the building being located in your country make this gain taxable?

Please type your answer in this box which will expand to accommodate it:

SPV originally received $100 million from the sukuk investors, but pays them $110 million on termination of the sukuk as it is obliged to pay the investors all of the sale proceeds of the building. If SPV is taxed on its $10 million gain because the building is located in your country, would SPV receive a tax deduction for this $10 million extra payment?

Please type your answer in this box which will expand to accommodate it:

The investors originally subscribed $100 million for the sukuk, but receive $110 million on its termination. Assuming that the investors are all foreign and have no other connection with your country, is this $10 million gain taxable by your country on the grounds that the building is located in your country?

Please type your answer in this box which will expand to accommodate it:

Does your country charge any withholding tax on the $110 million termination payment to the foreign investors on the grounds that the building is located in your country?

Please type your answer in this box which will expand to accommodate it:

Impact of double taxation treaties

Are the answers to any of the above questions changed when SPV or the Investors are located in a MENA country with which your country has a double taxation treaty? If so, please give details.

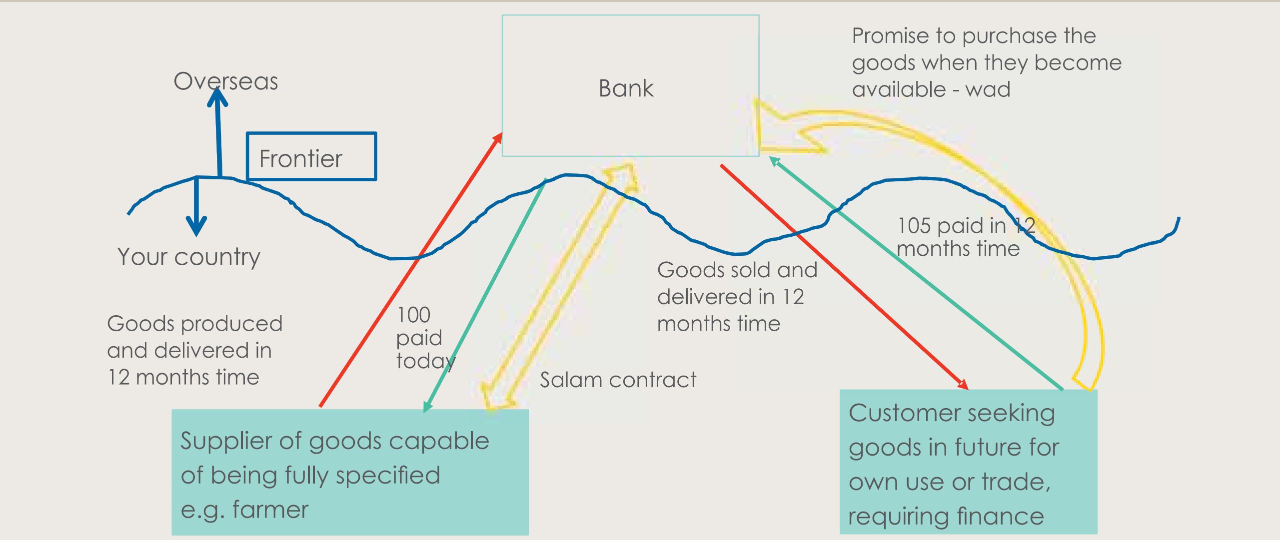
Please type your answer in this box which will expand to accommodate it:

Salaam

The purpose of the salaam structure is to enable the bank to provide finance to a producer of goods, for example a farmer. The farmer requires cash now, possibly to purchase seeds or fertiliser, while the output will only be produced in the future.

The bank wishes to avoid having an economic exposure to the price of the goods, so it enters into an agreement with a customer who wishes to obtain those goods in the future at a price which is fixed today.

Salaam



Transaction details

1. Bank is located overseas.
2. Customer is located in your country. Customer wishes to receive 300kg of wheat in 12 months' time, and is willing to commit to paying $105 for that wheat. Accordingly today Customer gives a promise to Bank that if in 12 months' time Bank offers to sell 300kg of wheat to Customer for a price of $105, Customer will purchase it.
3. Supplier is a farmer located in your country. Today Bank enters into a salaam contract with Supplier under which Bank will pay Supplier $100 immediately and Supplier will agree to deliver 300kg of wheat to Bank in 12 months' time.
4. In 12 months' time Supplier fulfils its obligation under the salaam contract by delivering 300kg of wheat at Bank's order. Bank instructs Supplier to deliver the wheat direct to Customer, instead of to Bank.

5. In 12 months' time, Customer takes delivery of 300kg of wheat (delivered by Supplier) and pays Bank $105.

Would the transaction as described above be legally valid in your country? If not, please explain why in the answer box below. When dealing with the taxation questions below, please assume that the transaction is legally valid.

Please type your answer in this box which will expand to accommodate it:

Taxation questions

Are there any tax provisions in your country dealing specifically with this transaction? If so, please give details and if possible supply a copy of the tax provisions.

Please type your answer in this box which will expand to accommodate it:

In many jurisdictions, different rates of tax apply to transactions depending upon the size of the transaction. For simplicity, please assume that the transactions values are very large, instead of the illustrative amounts set out above. For example, instead of $100 and $105, they may be $100,000,000 and $105,000,000.

Tax position of Bank

Assume that Bank has no branch presence in your country and no employees based in your country. Instead it has entered into the salaam transaction using electronic communications or faxes.

Will the transactions themselves cause Bank to have a taxable presence (permanent establishment) in your country causing its $5 profit to be taxable in your country?

Please type your answer in this box which will expand to accommodate it:

Does your country have transfer taxes on some categories of goods?

Please type your answer in this box which will expand to accommodate it:

If your country has transfer taxes, please assume that the goods covered by this salaam contract would be of the type that is subject to transfer taxes.

Would transfer taxes be charged on both the sale by Supplier to Bank and on t
he sale by Bank to Customer?

Please type your answer in this box which will expand to accommodate it:

Impact of double taxation treaties

Are the answers to any of the above questions changed when Bank is located in a MENA country with which your country has a double taxation treaty? If so, please give details.

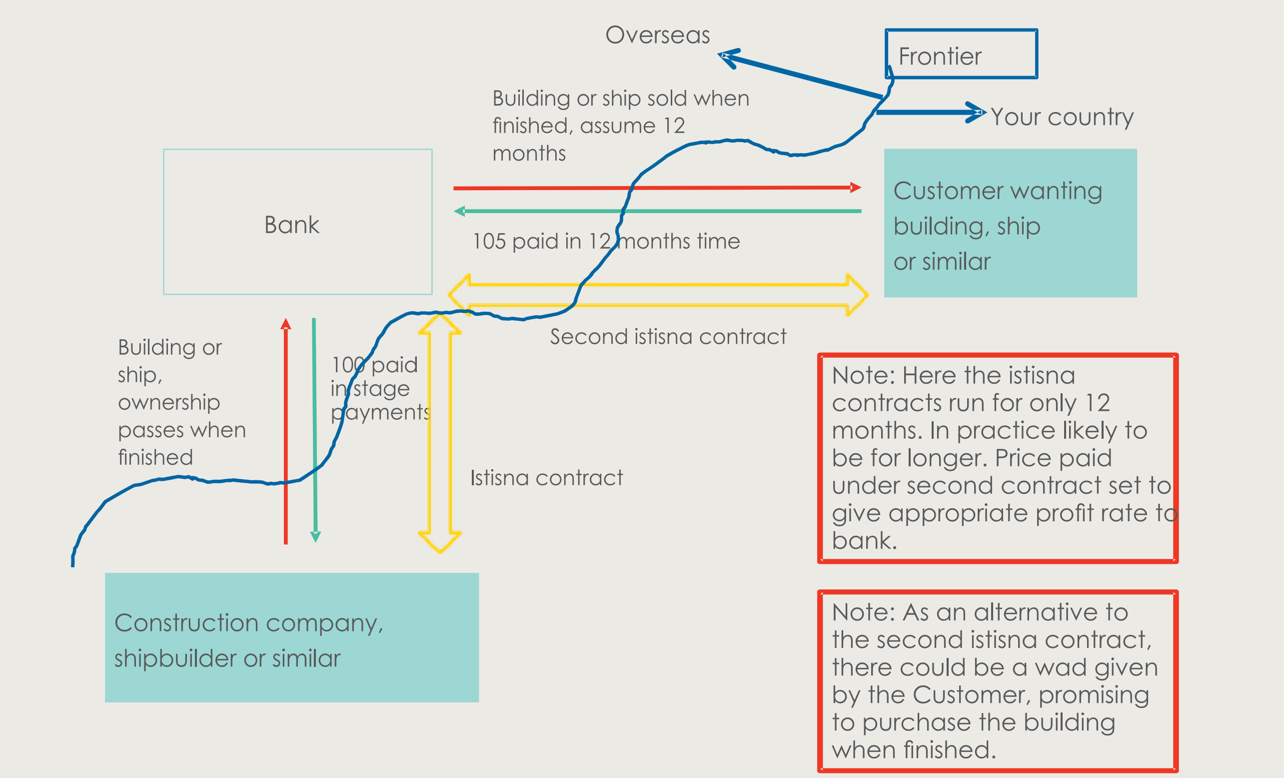
Please type your answer in this box which will expand to accommodate it:

Istisna

The purpose of the istisna contract is to enable the bank to provide finance which is required by a customer purchasing goods which are to be manufactured to the customer's specifications. Normally the manufacturer would require the customer to make stage payments, both to reduce the manufacturer's credit risk against the customer and also to enable the manufacturer to finance the inventory while the goods are being manufactured.

However the customer does not have the funds needed to make stage payments to the manufacturer, and therefore seeks finance from the bank. The bank is willing to take on the customer's credit risk, but does not want any economic exposure to the value of the goods being manufactured.

Istisna



Transaction details

1. Customer is located in your country.

2. Customer wishes to have a purpose designed ship constructed by a shipyard which is located in your country. The ship will take 12 months to construct, and customer is willing to pay $105 for the newly completed ship in 12 months' time. However customer does not have the funds available to make instalment payments as the ship is constructed.
3. Bank is located overseas.

4. Customer and Bank agree that Bank will construct the ship (or procure its construction) over the next 12 months and that once the ship is finished customer will pay $105 to Bank for the completed ship.

5. Shipbuilder is located in your country and has a shipyard which is also located in your country.

6. Bank enters into an istisna contract with Shipbuilder. Under that contract Shipbuilder will construct a ship for Bank while Bank will make specified stage payments to Shipbuilder totalling $100.

7. In 12 months' time the ship is finished. Bank takes ownership of the ship from Shipbuilder and sells the ship to Customer for a price of $105. Customer pays Bank $105.

Would the transaction as described above be legally valid in your country? If not, please explain why in the answer box below. When dealing with the taxation questions below, please assume that the transaction is legally valid.

Please type your answer in this box which will expand to accommodate it:

Taxation questions

Are there any tax provisions in your country dealing specifically with this transaction? If so, please give details and if possible supply a copy of the tax provisions.

Please type your answer in this box which will expand to accommodate it:

In many jurisdictions, different rates of tax apply to transactions depending upon the size of the transaction. For simplicity, please assume that the transactions values are very large, instead of the illustrative amounts set out above. For example, instead of $100 and $105, they may be $100,000,000 and $105,000,000.

Tax position of Bank

Assume that Bank has no branch presence in your country and no employees based in your country. Instead it has entered into the istisna transaction using electronic communications or faxes.

Will the transactions themselves cause Bank to have a taxable presence (permanent establishment) in your country causing its $5 profit to be taxable in your country?

Please type your answer in this box which will expand to accommodate it:

Transfer taxes

Does your country have transfer taxes on some categories of goods?

Please type your answer in this box which will expand to accommodate it:

If your country has transfer taxes, please assume that the goods covered by this istisna contract would be of the type that is subject to transfer taxes.
Would transfer taxes be charged on both the sale by Supplier to Bank and on the sale by Bank to Customer?

Please type your answer in this box which will expand to accommodate it:

Impact of double taxation treaties

Are the answers to any of the above questions changed when Bank is located in a MENA country with which your country has a double taxation treaty? If so, please give details.

Please type your answer in this box which will expand to accommodate it:

Other questions

Has your country enacted any tax laws specifically to facilitate Islamic finance? If so, please give details and also send an English language translation of the law if one is available.

Please type your answer in this box which will expand to accommodate it:

Please give the name and contact details of the person who has completed this questionnaire.

Please type your answer in this box which will expand to accommodate it:

Appendix 2 – The QFC's Islamic finance tax regulations

There is a section of the QFC tax regulations devoted to Islamic finance which is reproduced below. There are two key measures designed to achieve parity of treatment between Islamic finance and conventional finance:

1. Where an Islamic financial institution prepares its financial statements under AAOIFI, and its profits would have been materially lower if it had accounted under IFRS, it can claim for a tax adjustment.

2. If the profits of an Islamic financial institution are materially higher than would have been the case if it had entered into an equivalent conventional finance transaction, it can claim for a tax adjustment.

Part 11: Islamic Finance

Article 66 - Policy Statement on Islamic Finance

The QFC supports the development of Islamic financial services within Qatar through a tax regime which ensures that the tax treatment of Islamic Financial Institutions and Islamic Finance Transactions is certain and is, as far as possible, neither more nor less advantageous than that of conventional finance alternatives.

Article 67 - Taxation of Islamic Financial Institutions

(1) Subject to the provisions of this Part, the Chargeable Profits of an Islamic Financial Institution shall be computed in the same manner as those of a Conventional Financial Institution.

(2) Where any of the conditions of Article 67(4) are met an Islamic Financial Institution may make a claim, in respect of any Accounting Period, for a tax adjustment.

(3) In this Article a "tax adjustment" means a decrease in the Chargeable Profits, or an increase in the tax loss, of an Islamic Financial Institution, and can create a tax loss.

(4) The conditions required for a tax adjustment are-

(a) the profit declared in accounts prepared under standards issued by the Auditing and Accounting Organisation for Islamic Financial Institutions (AAOIFI) is materially higher, or in the case of a loss the loss is lower, than would have been declared under International Financial Reporting Standards (IFRS); or

(b) the Chargeable Profit, or tax loss, in respect of an Islamic Finance Transaction, or series of transactions, is materially higher or, in the case of a tax loss, lower, than would have arisen from an equivalent transaction, or series of transactions, structured as a Conventional Finance Transaction.

(5) For the purposes of Article 67(4) "materially" means more than 5%.

(6) The amount of a tax adjustment under this Article shall be such as is required to adjust the Chargeable Profits or, as the case may be, the tax loss for the Accounting Period of claim to the figure that would have arisen had the profit or loss been declared under IFRS or the transaction, or series of transactions, had been structured as a Conventional Finance Transaction.

(7) Where the whole or part of a tax adjustment arises from the timing of the recognition of income or expenditure, the Chargeable Profits or tax losses of subsequent Accounting Periods shall be adjusted to take into account the reversal of any such timing difference.

Article 68 - Funding Costs of Islamic Financial Institutions

(1) In computing Chargeable Profits or tax losses for an Accounting Period an Islamic Financial Institution is entitled to a deduction for the equivalent funding amount.

(2) The "equivalent funding amount" for an Accounting Period is the deduction for funding costs that would be allowable under Part 4 of these Regulations for that Accounting Period if the Islamic Financial Institution were a Conventional Financial Institution funding its operations using Conventional Finance Transactions, less the actual funding amount.

(3) The "actual funding amount" for an Accounting Period is the deduction for funding costs actually allowable for that Accounting Period under Part 4 of these Regulations.

(4) "Funding costs" means the cost of servicing debt obligations, excluding capital repayments.

(5) The transfer pricing provisions of Part 8 of these Regulations apply to the calculation of the equivalent funding amount in Article 68(2).

Article 69 - Taxation of Islamic Finance Transactions

(1) This Article applies to any QFC Entity entering into an Islamic Finance Transaction with an Islamic Financial Institution.

(2) If on making a claim a QFC Entity can show to the reasonable satisfaction of the Tax Department that by entering into an Islamic Finance Transaction it has either-

- (a) paid an amount of tax earlier; or
- (b) over the period of the transaction paid a greater amount of tax, than would have been the case if the transaction had been entered into as a Conventional Finance Transaction, then an adjustment may be made to the self-assessment of the QFC Entity for the Accounting Periods covering the period of the transaction.

(3) An adjustment under this Article shall be such as is required to put the QFC Entity in the same position, with respect to its liability to tax, that would have been the case if the Islamic Finance Transaction had been entered into as a Conventional Finance Transaction.

Article 70 - Islamic Finance and Special Purpose Vehicles

A special purpose vehicle (SPV) established for the purposes of supporting or facilitating an Islamic Finance Transaction may elect for special exempt status in accordance with Part 14 of these Regulations.

Qatar Financial Centre Authority

Tower 1, Diplomatic Area
P.O. Box 23245, Doha – Qatar
Tel: +974 4496 7777
Fax: +974 4496 7676
info@qfc.com.qa
www.qfc.com.qa

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