

UK TAXATION OF ISLAMIC FINANCE – WHERE ARE WE NOW?

This article is based upon the presentation given by Mohammed Amin on 25 July 2006.

Section 1 – Introduction and overview of conventional finance

In conventional finance, the key distinction is between debt and equity.

With debt there are fixed returns (or variable returns linked to market interest rates) to the person who is providing the finance but that person has no upside participation in the results of the commercial venture. The lender and borrower agree a price for the finance, e.g. 6% pa, and agree the repayment terms. After that, the lender is relatively indifferent to the commercial results of the business, provided that there is no risk of the business becoming insolvent so that the loan and related interest cannot be repaid. A typical contract for conventional debt finance would be a bank loan or a corporate bond that can be traded on the market.

With equity finance, the financier is essentially buying a stake in the business with unlimited upside participation. The better that business does, the greater is the return that the financier achieves. Conversely if the business does badly, the financier may make no returns and also be unable to recover the initial investment. Typical ways of providing equity finance are a share in a partnership or becoming an ordinary share holder in a company.

There are of course many hybrid financial arrangements that have some of the characteristics of debt and some of the characteristics of equity. However, it is easier to focus on the two logical extremes as a precursor to considering the tax treatment of finance costs.

Tax law has always treated equity finance and debt finance differently. The cost of debt finance is considered a cost to the business and is tax deductible. Conversely the rewards achieved by a provider of equity finance are not deductible to the paying business; they are the investor's participation in the profits of the business.

Accordingly, it would be attractive to disguise something that was economically equity finance in the form of debt, to obtain tax relief. There are a number of different tax rules designed to prevent this, of which probably the most important in this context is found in ICTA 1988 s.209(2)(e)(iii). This states that any interest paid on "securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company's business or any part of it" is a distribution, which means that it is not tax deductible. Instead it is treated as if it were a dividend payment to an equity provider.

In passing, ICTA 1988 s.212 stipulates that the above provision does not apply if the interest is paid to another company within the charge to corporation tax. This rule was brought in about 25 years ago to prevent loss-making companies that were unconcerned about tax deductions for finance

costs borrowing from UK banks under profit participating loans. Otherwise, interest on such loans treated as a dividend would be tax free to the bank. The need for both s.209 and s.212 indicates the commercial complexities that the tax system must cope with.

Section 2 – Islamic finance – typical structures

This section covers some specific structures that are used for Islamic finance, before considering how they are treated for tax purposes.

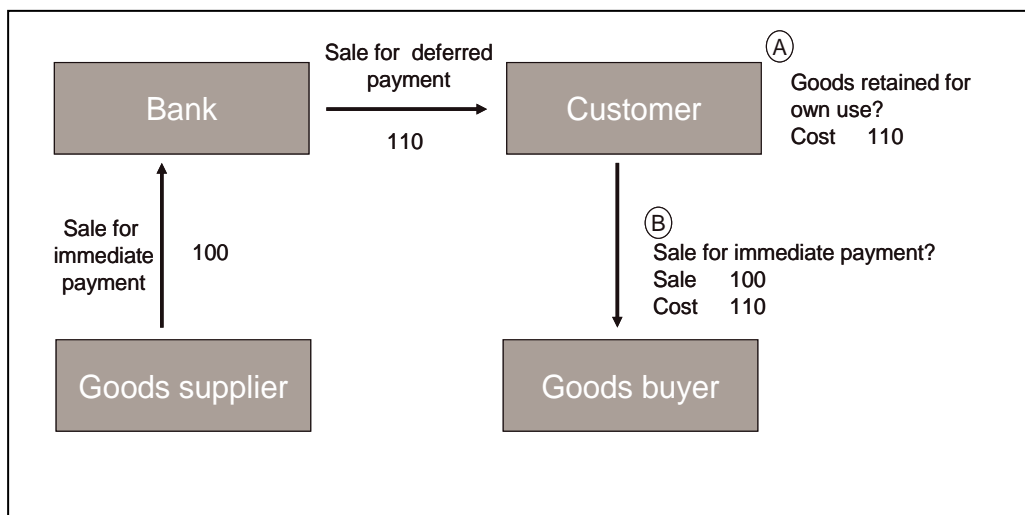
Murabaha

Murabaha is used for two basic purposes. It can be used where a customer wants to acquire something for use in its business, and needs finance to achieve that, or it can be used as a way of obtaining finance in the form of cash.

If the customer wants a machine, for example, the bank will buy that machine for, say, £100 and sell it to the customer for a price of £110, payable at some point in the future. The customer obtains immediate use of a machine worth £100, and has an obligation to pay £110 in, say, two years time. The extra £10 that the customer pays is clearly, in economic terms, the cost of the finance.

Conversely, if the customer actually wants cash, what the bank will do is buy something that can be sold very easily afterwards and with little difference between the bid/offer (buy/sell) prices. A typical example would be a quantity of copper bought in a commodity market. The bank buys the copper, immediately paying £100 for it, and transfers ownership to the customer at a price of £110 payable in, say, two years time. The customer can then immediately sell the copper for a price of about £100. This give the customer cash equal to what the bank has laid out, £100, and an obligation to pay the bank £110 in two years time. Again, the extra £10 is the cost of the finance.

Murabaha Diagram 1

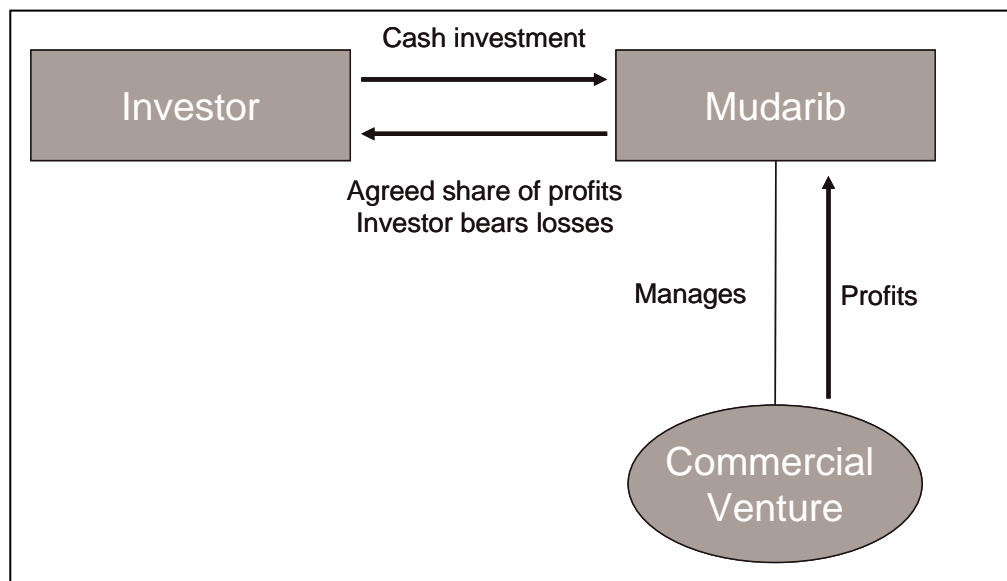


Mudaraba

Mudaraba essentially involves an investor providing cash to another person, called a Mudarib, who will invest that money in a commercial venture, with the Mudarib managing that commercial venture.

The deal is that if there are losses in the venture, the investor has to bear the losses. This is, I understand, one of the requirements for Shariah compliance. If there are profits in the venture, as expected, those profits are shared between the Mudarib and the investor on an agreed basis.

Mudaraba Diagram 2



Wakala

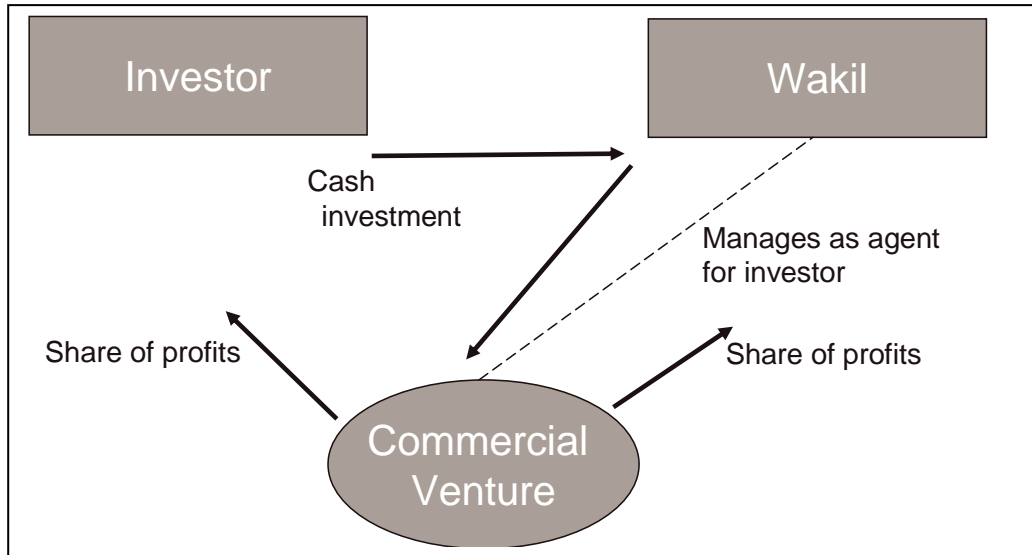
In Wakala, again cash is going from the investor and ending up in a commercial venture with the profits of the commercial venture being shared between the investor and the Wakil in agreed proportions.

The key difference between Wakala and Mudaraba is the legal relationship. When UK tax law (discussed below) was modified in 2005 to accommodate Islamic Finance, it was assumed that in Mudaraba the Mudarib actually receives the cash investment and becomes legally indebted to the investor so that the legal form of the contract is essentially that of a deposit. Conversely in Wakala, the UK tax law changes in 2006 (also discussed below) envisage that the Wakil is legally acting as an agent, so the money never becomes the Wakil's property.

That distinction will matter in the event of the intermediary Mudarib's or Wakil's insolvency. In a Mudaraba contract, if a bank has taken what is a deposit at law and then becomes insolvent, the investor is limited to claiming

in the bank's insolvency along with its other creditors. Conversely, with a Wakala contract, if the agent bank becomes insolvent, the investor has a direct legal claim on the underlying commercial venture.

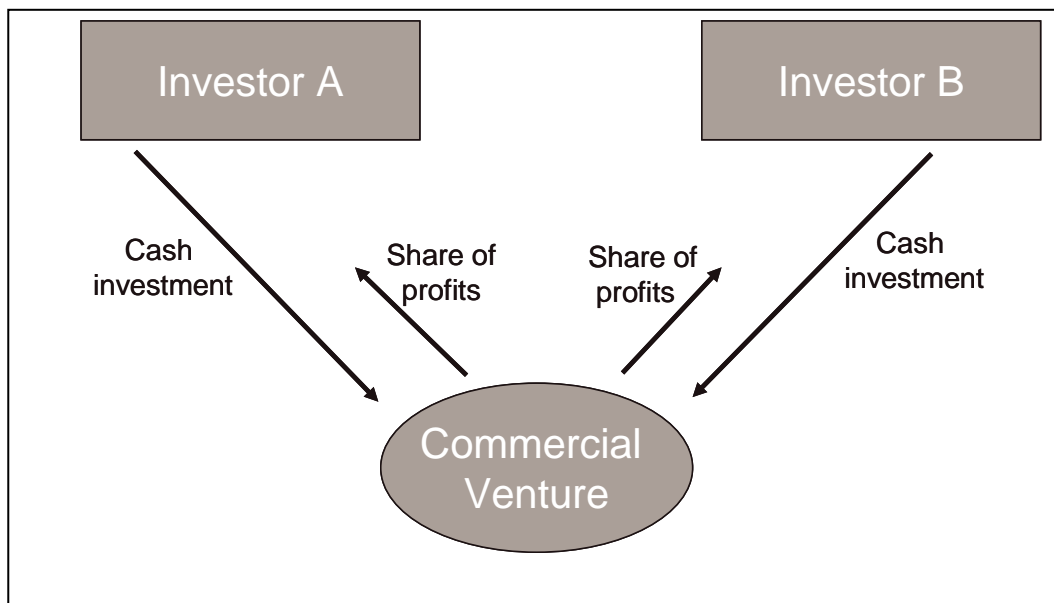
Wakala Diagram 3



Musharaka

In Musharaka, one has two or more investors, here A and B, contributing towards a commercial venture and agreeing to share profits and losses in particular proportions. This structure is almost exactly the same as a conventional Western partnership.

Musharaka Diagram 4

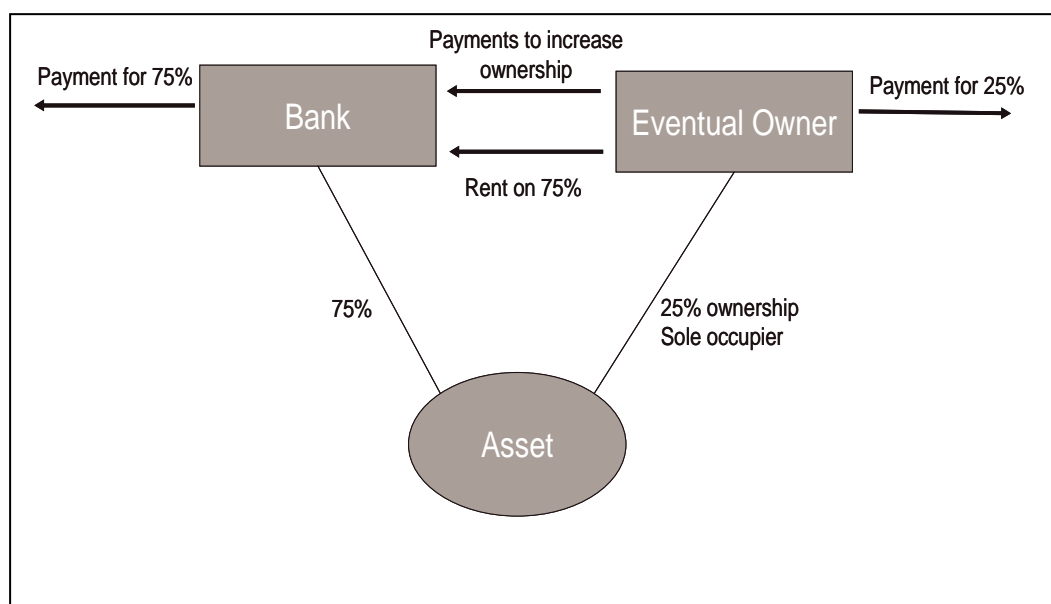


Diminishing Musharaka

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

The eventual owner pays rent to the bank on the 75% of the property that he doesn't own. Then, over the life of the arrangement, as well as paying the rent, the eventual owner will make additional payments to the bank to purchase additional slices of the asset. This is often used for people buying houses for owner occupation instead of a conventional mortgage.

Diminishing Musharaka Diagram 5



Sukuk

Sukuk is an arrangement that has been devised over the last decade or so as a way for Islamic organisations to issue an instrument similar to a tradable Western bond, while still being Shariah compliant.

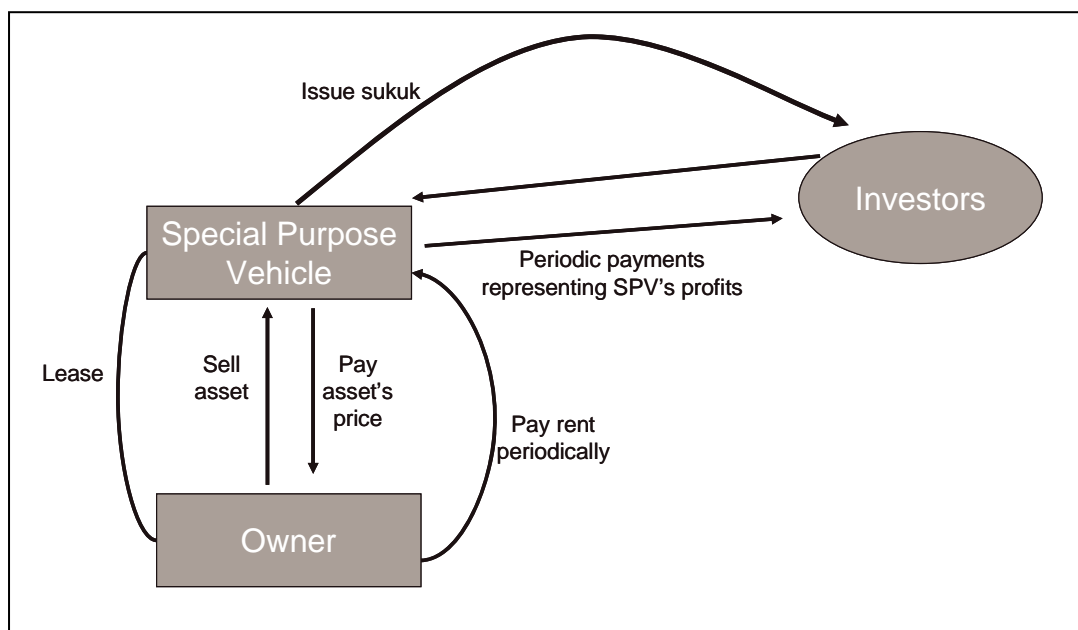
Typically the owner of an asset will want to use this asset to raise finance. As a first step, the owner sells this asset to a special purpose vehicle (SPV) set up specifically for this purpose – hence the name. The SPV could be a company which is part of the same group as the original owner, or a company owned by a bank or perhaps a company owned by a charity as is commonly the case in Western securitisation.

The SPV raises cash to pay for the asset by selling participation certificates, called Sukuk, to outside investors.

For the period set out in the Sukuk arrangements, the SPV rents the asset back to the original owner. The rent which the SPV receives is used to make periodical payments to the investors on the Sukuk bonds. Those payments to the investors are not interest. Instead what the Sukuk contract will specify that all of the commercial profits of the SPV will be paid out to the owners of these participation certificates.

Eventually, at the end, when the Sukuk certificates are due to be repaid, the owner will buy the asset back from the SPV. The SPV uses the proceeds to redeem the participation certificates.

Sukuk Diagram 6



Section 3 – UK tax treatment prior to new legislation

With each structure, the key tax question is: does the customer have a tax deductible cost?

In some cases, the customer may do. For example, in Diminishing Musharaka, the eventual owner is paying rent for the use of that part of the asset which he does not own. In other cases, the tax analysis is more problematical. For example, in the Mudaraba contract, the Mudarib is making payments to the investor which are actually a share of the profits of the commercial venture; that looks like a profit-linked distribution.

Similarly, with the Murabaha contract, does the customer have a financing cost, or a non-deductible loss on the purchase and sale of goods outside the course of a trade?

If a foreign investor is involved, does the structure create a taxable presence in the UK? For example does Wakala, with a UK-based Wakil carrying out a commercial venture on behalf of a foreign investor, give rise to a branch or

agency in the UK with the foreign investor being taxable? If so, the result would be very unfavourable compared with a foreign person simply lending money to a UK bank, since foreigners earning bank interest in the UK are generally not taxable.

Section 4 – New tax law: Finance Acts 2005 and 2006

New tax law was first introduced in Finance Act 2005 to facilitate Islamic finance, and amended in Finance Act 2006 to increase the range of Islamic finance structures covered.

One of the key principles underlying the legislation is that the Government cannot sensibly legislate for different religions: one cannot have one set of tax laws that apply to Muslims, a different tax law for Christians and a different tax law for Jews.

Instead, FA 2005 introduced some new tax law which applies to certain types of transactions if certain tests are met. It applies to all transactions of that type, regardless of who is carrying them out, and regardless if it is intended to fall within the Shariah or not. You don't have to look at Shariah; you just have to look at the tax law.

There are some key concepts in the tax law, with some new vocabulary describing "alternative finance arrangements" which give rise to two types of commercial return: "Alternative Finance Return" and "Profit Share Return." These are precisely designated in the statute.

The legislation only operates where one of the parties to the contract is a financial institution as defined. If neither party is a financial institution, these rules do not apply – even if one meets all the other tests. The definition of financial institution has five categories.

1. A bank, as defined by the Income and Corporation Taxes Act 1988 s.840A.
2. A building society, as defined by the Building Societies Act 1986.
3. A person licensed under Part 3, Consumer Credit Act 1974, to carry on consumer credit business or consumer hire business.
4. A person authorised outside of the UK to receive deposits from the public. UK taxpayers may find themselves engaging in Islamic Finance transactions with foreign Islamic Finance organisations. Unless the foreign organisation falls within this definition, the new tax law will not apply.
5. A wholly owned subsidiary of a bank or building society also counts as a financial institution. The legislation is very precise: the subsidiary has to be wholly owned. If there is even one share of that subsidiary owned outside the banking group, say by a private individual, that subsidiary will not count as a financial institution.

As a further qualification, the new tax treatment only applies to a commercial return which equates, in substance, to the return on an investment of money at interest. As it is designed to mirror the tax treatment of conventional finance, it is limited to transactions which are providing finance economically equivalent to debt, and does not apply to something which is economically in the nature of an equity participation.

If all of the definitions of the tax law are met, then the customer's expense is treated, for all tax purposes, in exactly the same way that interest would be treated. The law is very careful to avoid saying that the item is interest.

Similarly the financial institution is treated exactly as if it were paying or receiving interest.

In the case of foreign investors the activities of the financial institution, either as an agent, (Wakil), or as a borrower, (Mudarib), will not cause the foreign investor to have a UK taxable presence.

Section 5 – applying the new tax law to Islamic Finance structures

One can directly map some of the Islamic finance structures outlined above to the rules set out in the tax legislation. Alternative Finance Return, when legislated in FA 2005, only applied to contracts which followed the Murabaha model described above. In FA 2006, it has been extended to something called Diminishing Shared Ownership in the legislation. This is explained above as Diminishing Musharaka.

Profit Share Return when legislated in FA 2005 only applied to a Mudaraba contract with a deposit and payments on that deposit deriving from the profits of a commercial venture. In FA 2006 it has been extended to a Wakala contract with an agency arrangement.

Note that the tax law (unlike some of the explanatory materials published by the Government) never uses terms such as Mudaraba or Wakala. It only uses the definitions of the transactions as set out in the tax legislation.

(a) Murabaha – direct tax implications

The precision of the law can be illustrated by looking in more detail at the rules governing Murabaha set out in FA 2005.

The law refers to two parties, X and Y. Using the same language; assume that Y is a customer who wants some goods, either for use in its own business or to sell them immediately to raise cash. X sells those goods to Y. For the new rules to apply, one of X or Y must be a financial institution.

If Y is a financial institution, and X is not, then X has to sell these goods immediately on purchase. If X has owned these goods for a period of time, the contract falls outside this new tax law.

Conversely, if X is a financial institution, it doesn't have to sell immediately; it could have owned the goods for a period of time. However, in the case of a non-immediate sale, the law then requires that X must have bought the goods for the purposes of sale under a contract within these definitions.

The problem this can create is illustrated by considering a car dealer wholly owned by a bank so that it qualifies as a financial institution. If X is such a car dealership selling to Y under a Murabaha contract a car that X already has in its trading stock, does the contract fall within these new rules? Reading the legislation, it doesn't. The reason is that when the car dealership bought the car, it bought it to sell it to anybody – whether that buyer was a normal retail customer paying cash, or a person like Y, wanting to buy under a Murabaha contract.

(b) Murabaha – VAT implications

The UK hasn't changed VAT law to fit in with the Alternative Finance Arrangements legislation, because it is constrained by the European Union treaties, in particular the Sixth Directive that sets out how VAT is intended to operate throughout the EU.

There are discussions underway at EU level to see if the Sixth Directive can be modified for Islamic finance. Pending any change, one looks at a Murabaha contract for VAT purposes and analyses it in the same way as would have applied prior to FA 2005.

X starts by buying some goods. If those goods are in the UK and they are goods of a type subject to VAT; that gives rise to input VAT for X, which X may or may not be able to recover. The sale from X to Y again is a taxable sale, with VAT that Y may or may not be able to recover.

The application of VAT may not always be undesirable. For example, if Y is a fully-taxable person, then Y can recover the VAT. Conversely, if X is a bank buying these goods for the express purpose of reselling them, then it should be able to recover the VAT on the cost of the goods. Furthermore, the taxable activity that the bank is now carrying on might help it to recover some of the VAT on its other overheads.

(c) Diminishing Musharaka

Again, the legislation in the Finance Act 2006 is very precise. The financial institution can share in any losses on the asset. If the bank couldn't share in any losses on the asset, then this contract would probably fail to be Shariah compliant and nobody would ever use it.

However, FA 2006 states that the bank cannot participate in increases in the value of the asset. This could become a problem. While there are some Diminishing Musharaka contracts that are based upon the original purchase price, there is also a move by some organisations to have a contract which allows the financial institution to participate in the growth of the asset. This is

regarded by them as perhaps being slightly better from a Shariah perspective. Unfortunately such a contract does not satisfy these new tax rules.

One can do a sale and lease back. The law doesn't say that the asset has to be bought from a third party, it could be sold by the eventual owner to the bank with the eventual owner then paying rent and gradually buying back the property. That is economically equivalent to taking out a mortgage on a property one already owns.

(d) Wakala

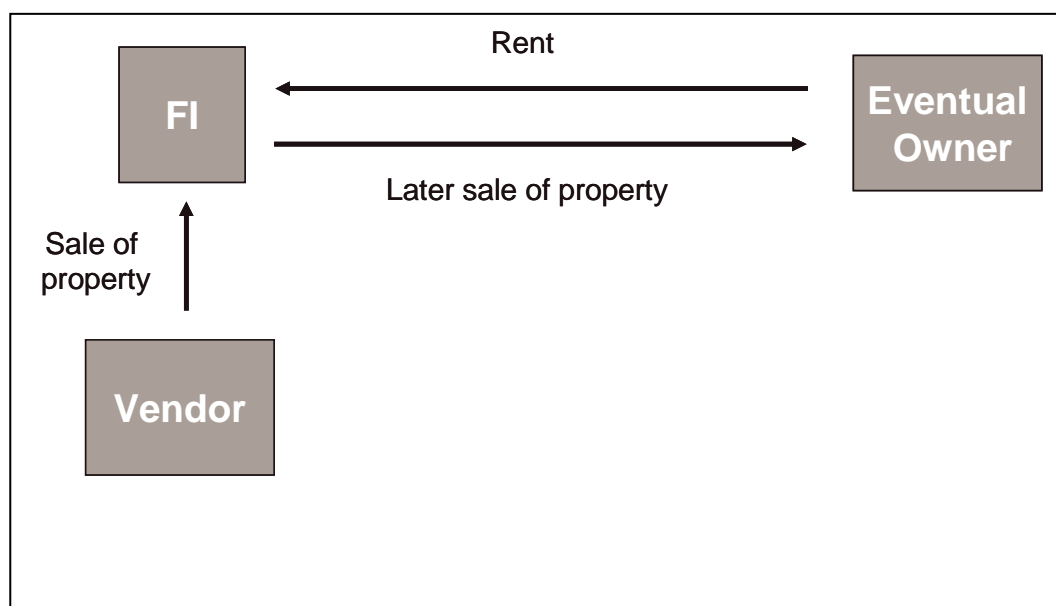
As previously mentioned, the tax law requires that the investor's profit share must equate in substance to the return on an investment of money at interest. If the commercial venture is actually one with higher risks and higher returns, for example cotton trading, then the payments from this commercial venture will not fall within the new rules, because they fail to equate to the investment money at interest.

Section 6 – Stamp duty land tax (SDLT)

The changes in FA 2005 and FA 2006 were needed to give certainty of treatment for income tax and corporation tax purposes. However, transaction taxes can also have a greater impact on Islamic Finance than on conventional finance. One example is SDLT, where a specific relief was therefore legislated in 2003 when SDLT itself came in.

Diagram 7 illustrates a Financial Institution (FI) financing a property purchase, perhaps using the Diminishing Musharaka contract discussed above. The vendor could be a third party or it could actually be the person renting that property and afterwards buying it in stages, the eventual owner.

Stamp duty land tax (SDLT) Diagram 7



Without special relief there would be two SDLT charges: one when the financial institution buys the property and another when the eventual owner buys the property from the financial institution. There could also be SDLT on the lease to occupy the property. Conversely, with a conventional mortgage, SDLT only gets paid once when the property is first acquired under the mortgage. There is no further SDLT when the mortgage is repaid.

This relief from SDLT was originally only available where the person renting or buying the property was an individual. In Finance Act 2006, the relief was widened because it was recognised that Muslims not only wanted to use this approach for the acquisition of personal residential property but also to acquire property for their businesses in a Shariah-compliant way and such a business might well be conducted by a company.

Now this relief is available for any person who is renting and buying, whether an individual, a partnership, or a company.

The definition of a financial institution for this SDLT relief is narrower than for the alternative finance arrangements in Finance Act 2005. The Consumer Credit Act licence qualification is absent in the SDLT legislation. Perhaps more importantly, the foreign authorised deposit taker qualification is also absent. This difference may not arise from deliberate policy, but simply from the SDLT legislation being older than the FA 2005 rules. However, unless the law is changed, a foreign institution that does not qualify as a bank under UK tax law cannot carry out Islamic mortgage transactions in the UK without a double SDLT charge.

Conversely, to illustrate the differences in the legislation, the SDLT rules permit the financial institution to participate in an increase in the value of the property, because there is no express prohibition, unlike the FA 2006 rules dealing with diminishing shared ownership.

Section 7 – Conclusion

When Gordon Brown spoke at the Muslim Council of Britain's Islamic Finance and Trade Conference earlier this year, he confirmed the Government's aspiration to have London as the pre-eminent centre for Islamic Finance outside the Muslim world. Accordingly, I expect UK legislation to continue to be adapted to facilitate Islamic Finance, both for the structures discussed above and for others that may be developed in future years.

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