

Demystifying Shariah Compliant Financing Structures

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- Structuring for leverage and tax efficiency
- Leverage using conventional debt
- Effect of UK tax reforms
- New models for leverage



Introducing leverage

- Maximises return to investors
- Has commonly been by way of conventional debt
- Lack of capacity in Islamic markets
- Difficulties in using Islamic instruments
- Objective: to create a Shariah compliant cashflow which can be used to service debt

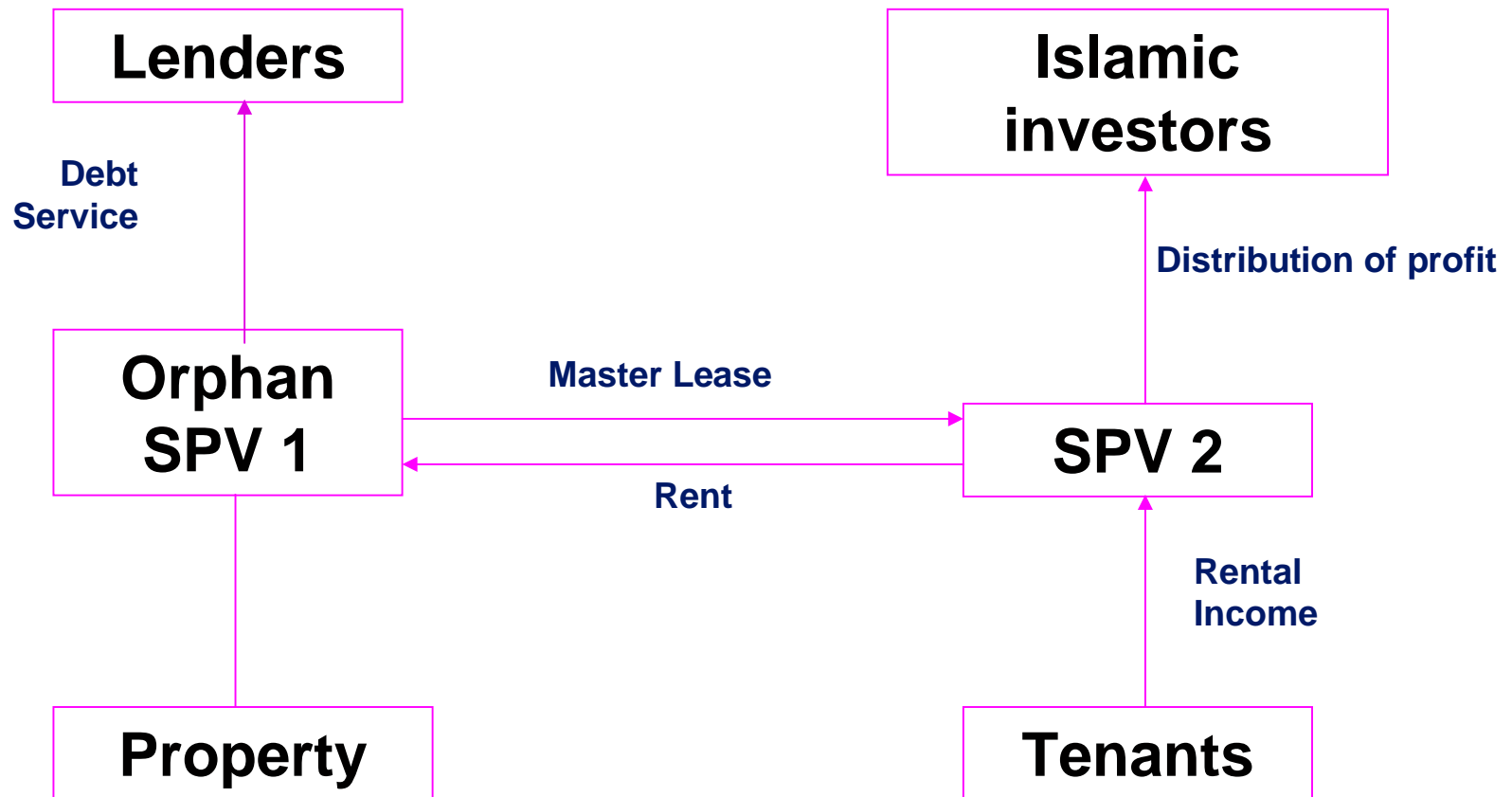


Tax efficiency

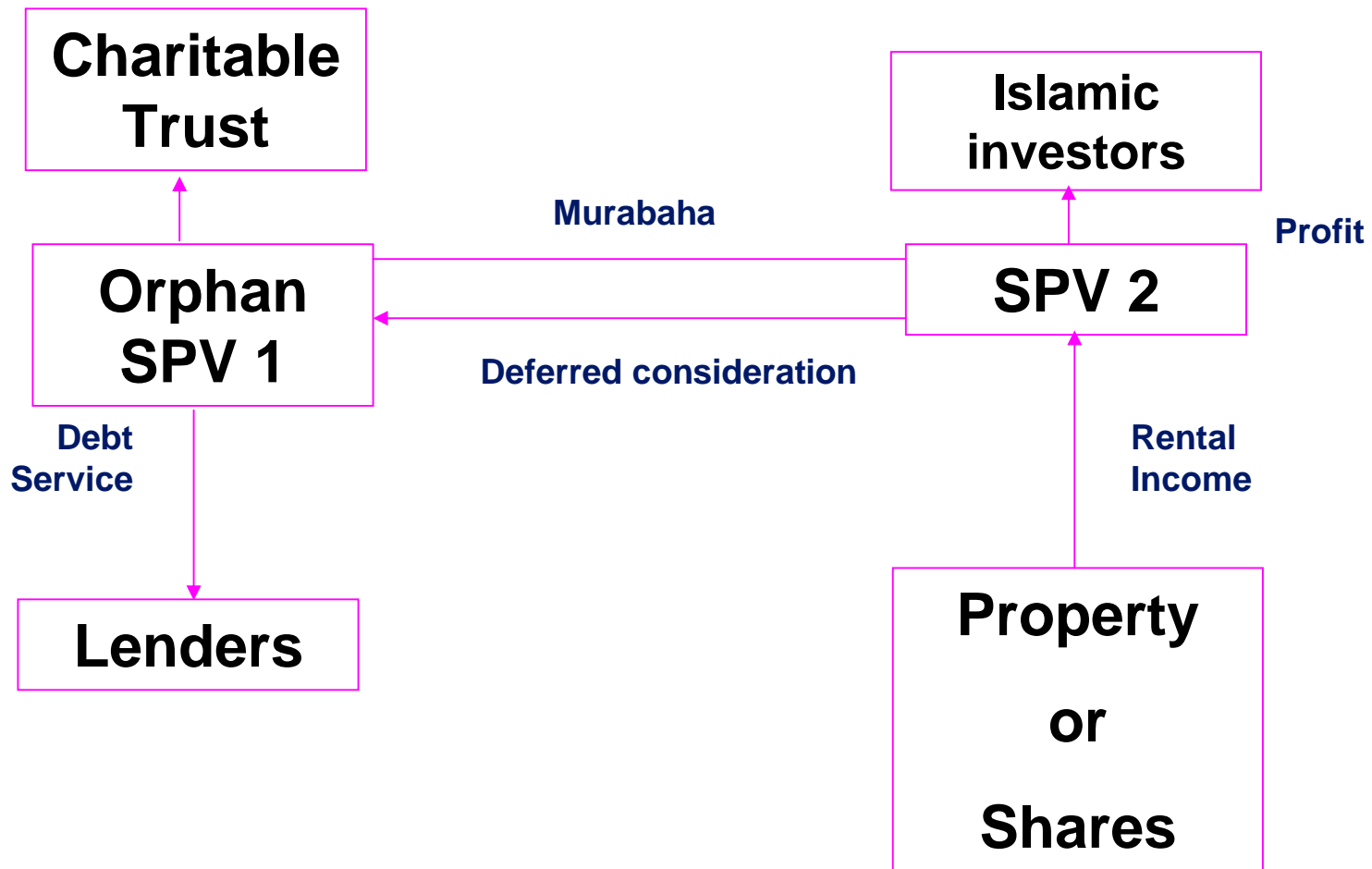
- Tax regime may not recognise Islamic structures
 - loan interest is deductible
 - payments under Islamic contracts are not interest
 - not deductible
 - may be taxed as profit share or distribution
- Transfer taxes – multiple charges
- Specific tax clearances may be available



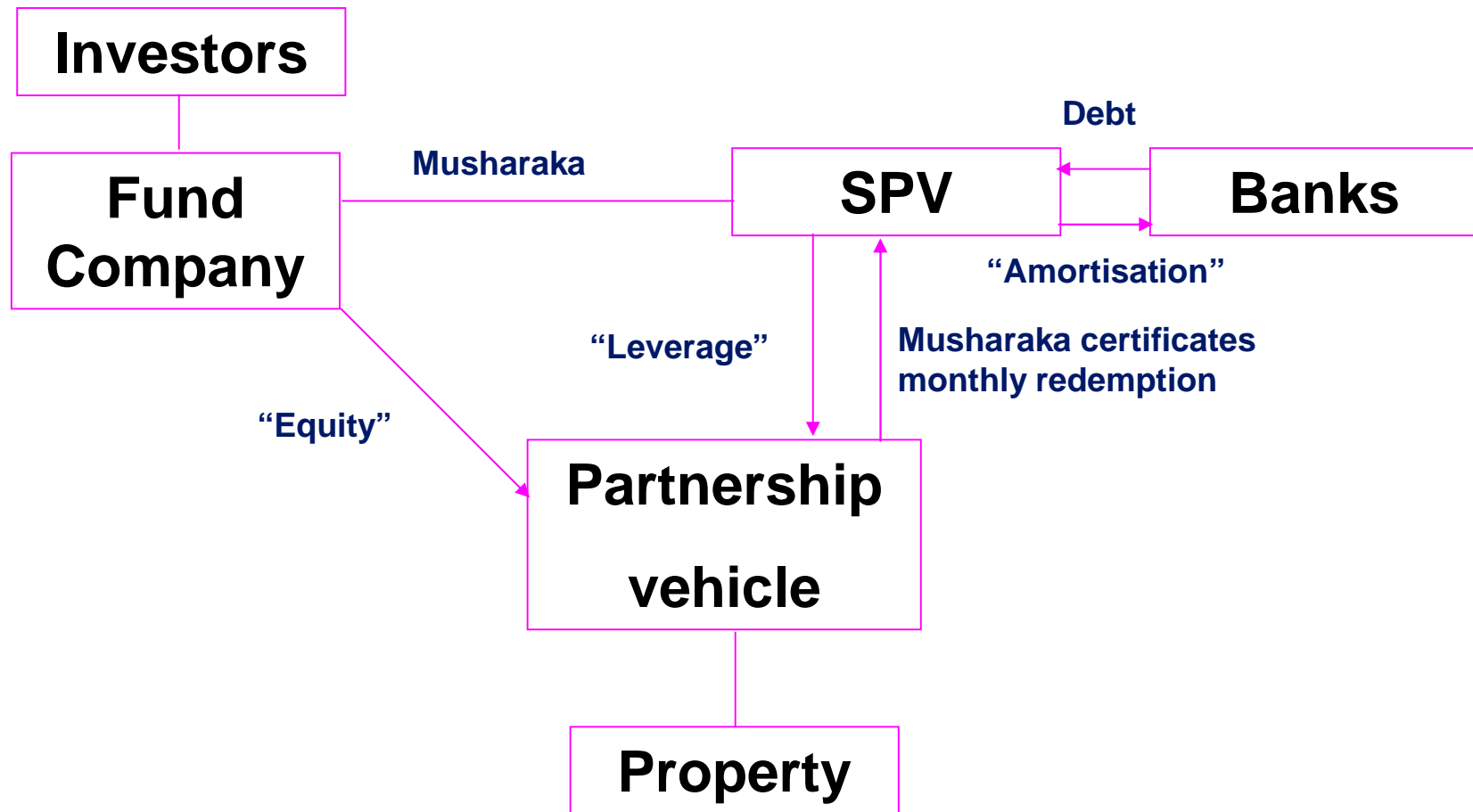
Leverage - ijara



Leverage - murabaha



Diminishing musharaka – structured solution



Diminishing musharaka

- This type of arrangement used to finance purchase of Sanctuary Buildings in London by TAIB Bank and Dominion Asset Management
- Equity funding was raised through the Sukuk issues
- Debt provided by Lloyds TSB Bank
- Structure allowed investors the benefits of a traditional financing
- Shariah issues
 - some boards would not allow partnership with a partner raising interest based debt
 - can bank take security over partnership assets?



Leverage – Islamic alternatives

- Use of conventional finance is pragmatic
- Shariah compliance issues
- Structures quite complex and costs higher than for a non-Islamic investor
- Preference for truly Islamic finance
 - Tawarruq
 - Murabaha
 - Sukuk
 - Diminishing musharaka



UK tax reforms

- Stamp duty land tax
 - double stamp duty was a major obstacle
 - reliefs introduced for “alternative property finance”
 - murabaha
 - ijara
 - diminishing musharaka
 - available for individual or corporate customers



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UK tax reforms

- Direct Taxes – corporation tax and income tax
- Alternative finance arrangements
 - alternative finance return - payments on a “purchase and re-sale” or “diminishing shared ownership” paid to a financial institution
 - payments must “equate, in substance, to the return on an investment of money at interest”
 - alternative finance investment bonds (sukuk)
 - bond issuer uses capital to acquire assets
 - at end of bond term bond issuer disposes of assets
 - redemption payment
 - additional payments not exceeding “a reasonable commercial return on a loan of the capital”



UK tax reforms

- Alternative finance arrangements are treated as a loan relationship as if payments were interest
 - payments are tax deductible
 - receipts taxed as interest
- Treasury has power to make further changes by order for arrangements which
 - equate in substance to a loan deposit or other transaction of a kind that generally involves the payment of interest
 - achieve a similar effect without providing for payment of interest

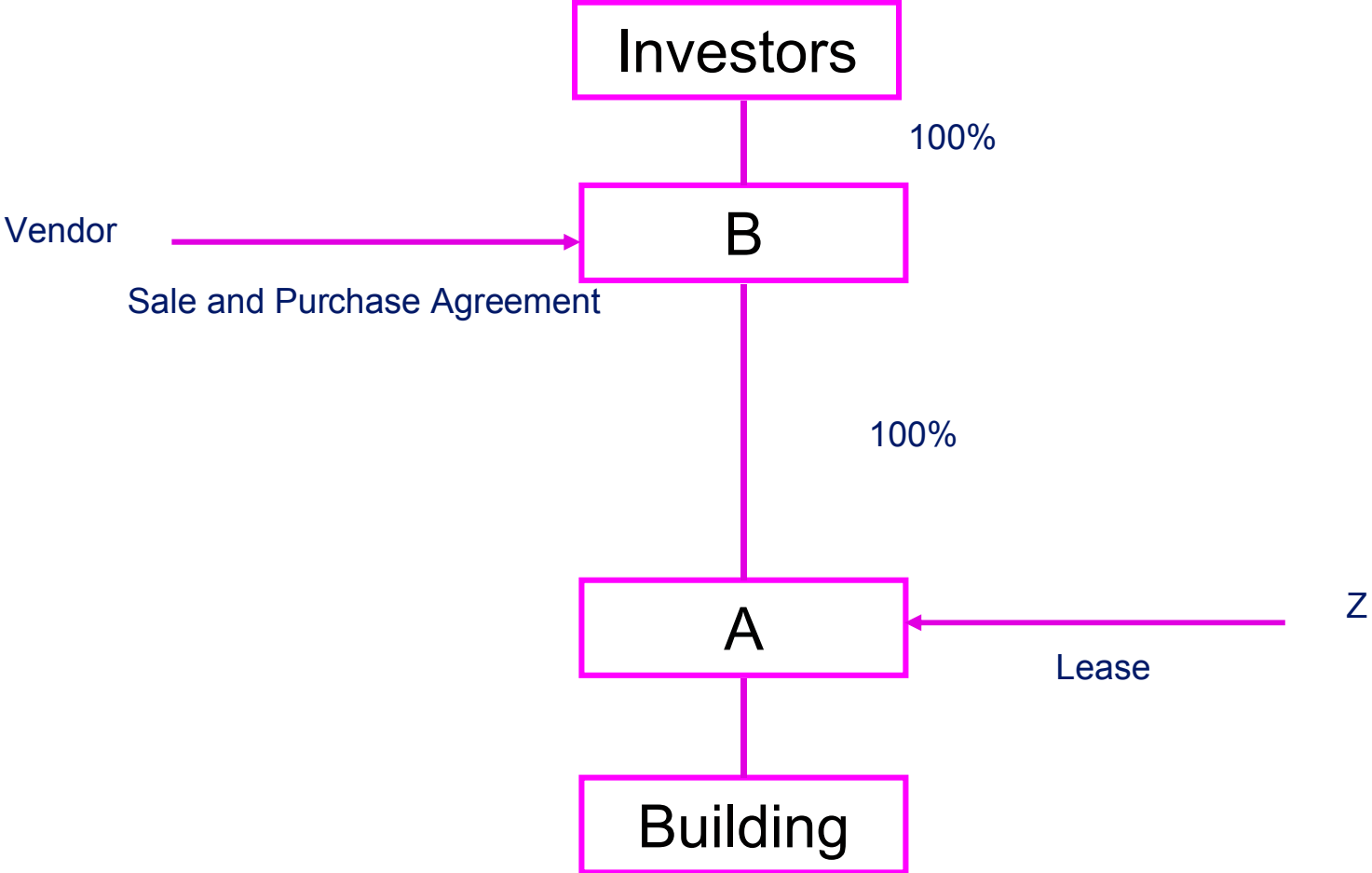


Case study - Tawarruq

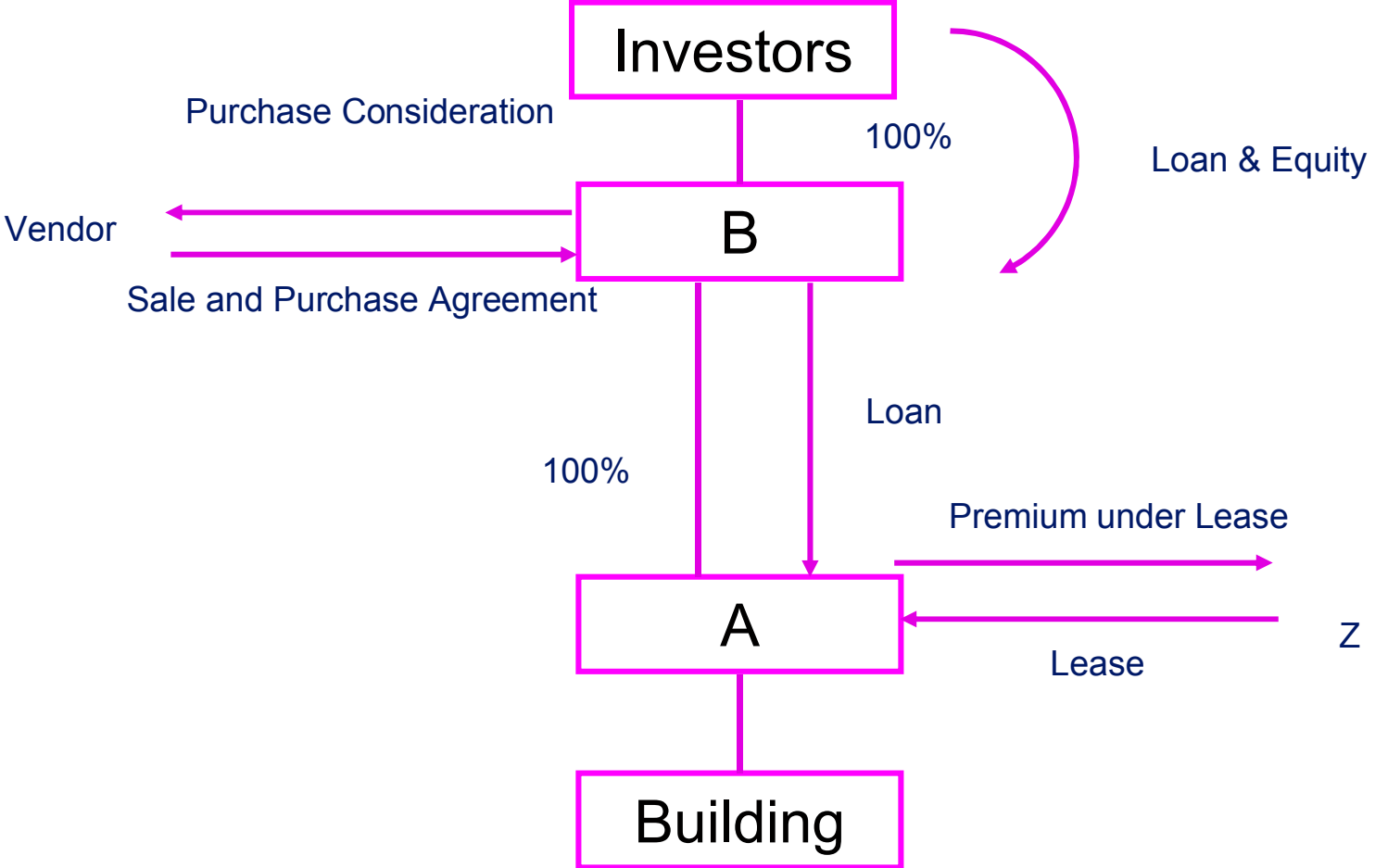
- Purchase of an investment property in London
- Owned by A (English company)
- Share purchase of A by B (Jersey company)



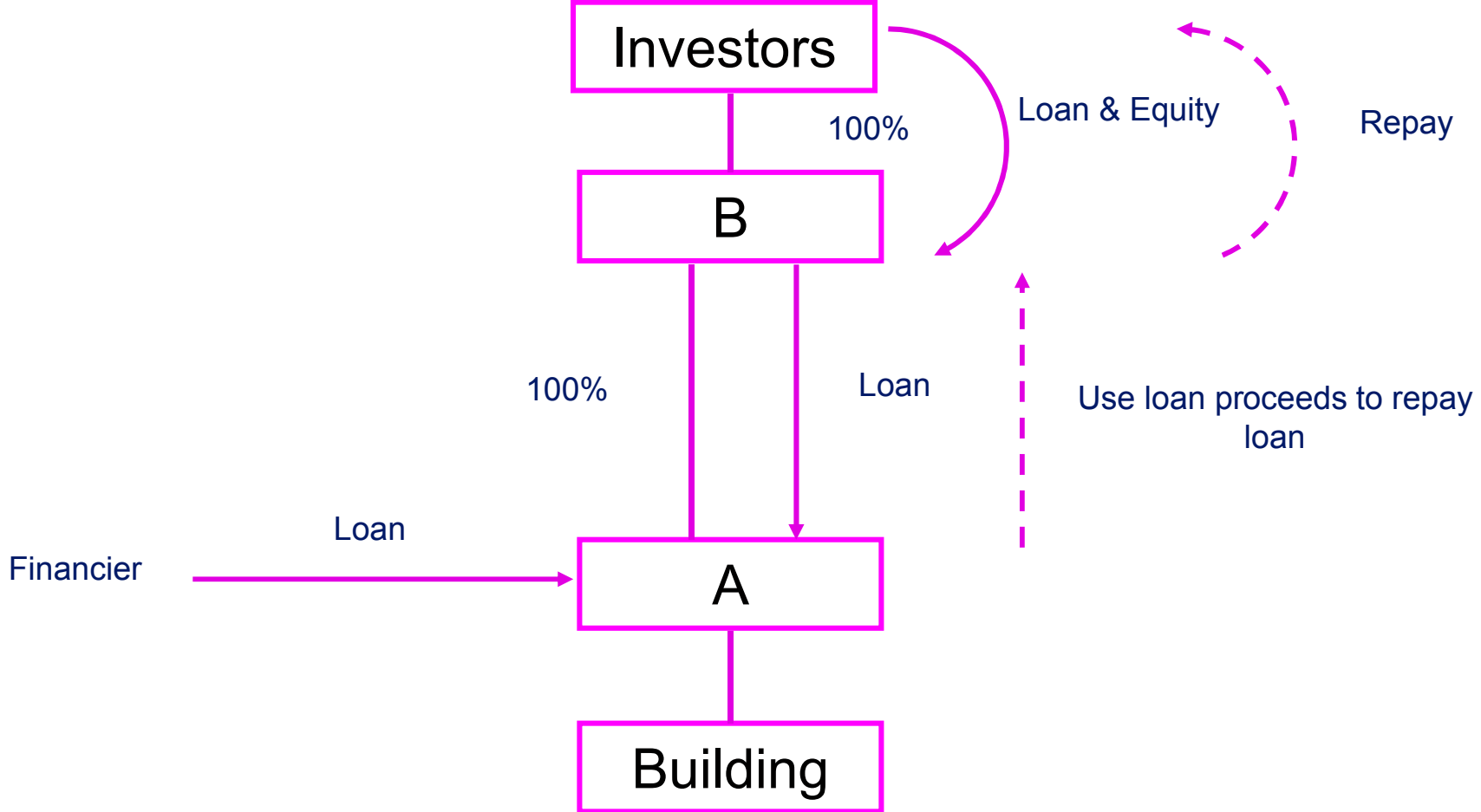
Ownership structure



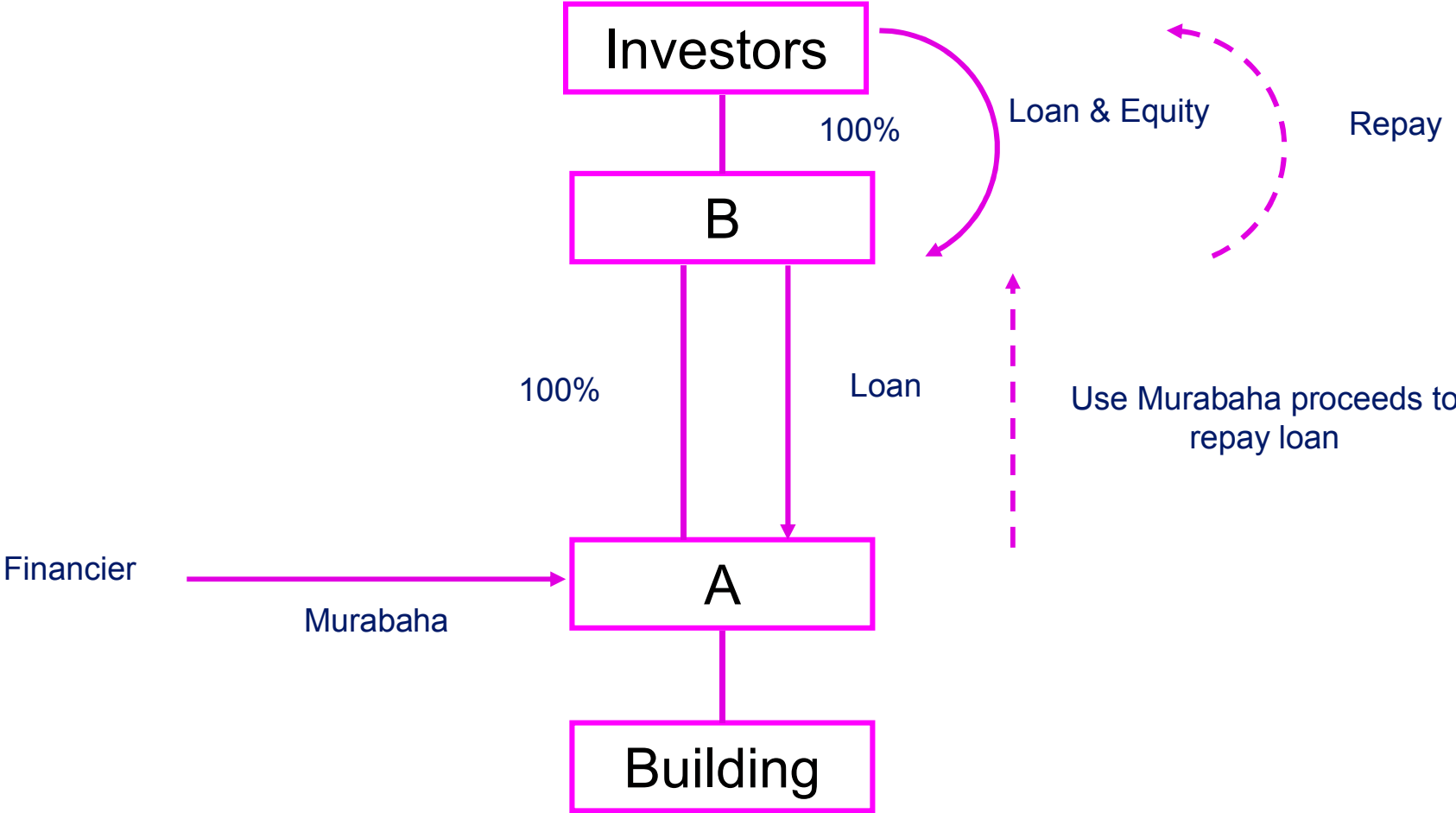
Shareholder financing



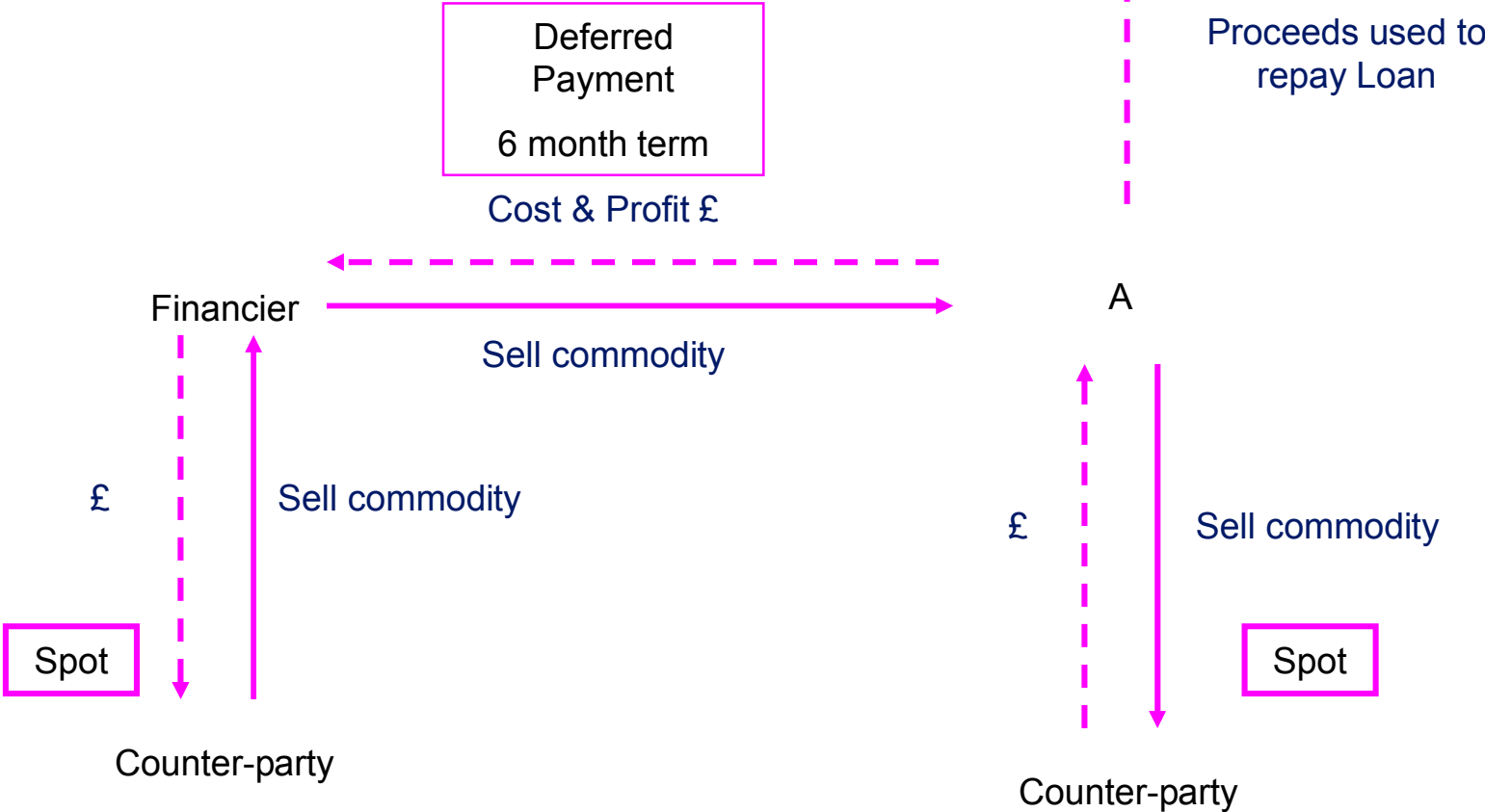
Refinancing – Option 1



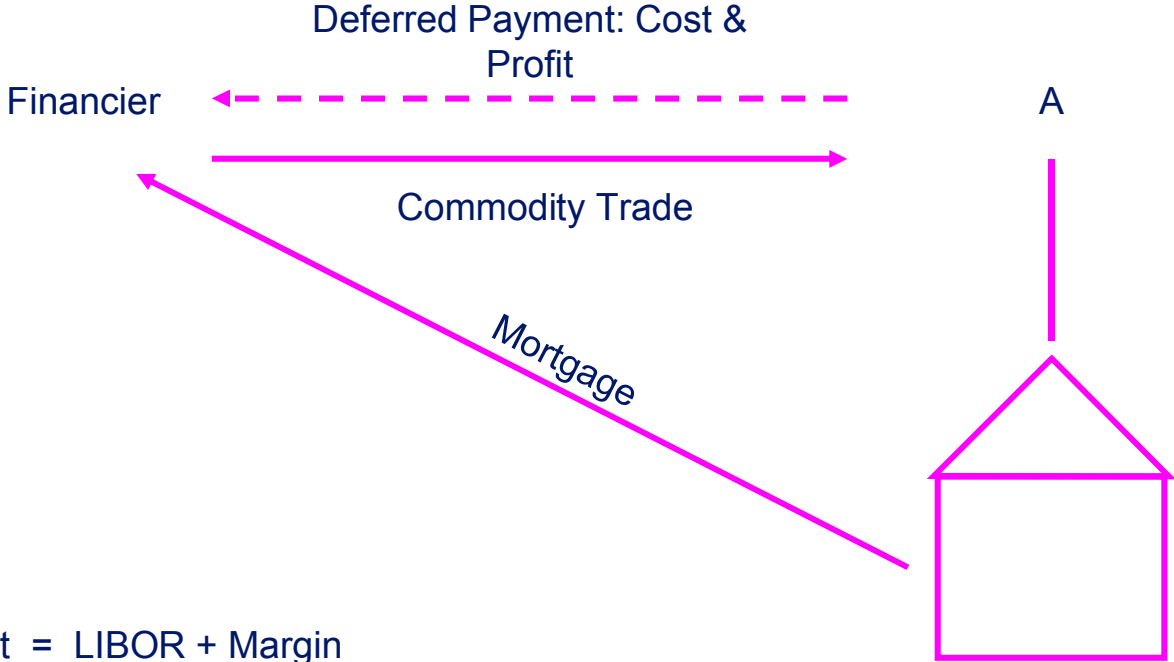
Refinancing – Option 2



Tawurraq - detail



Security



N.B. Profit = LIBOR + Margin



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Tax

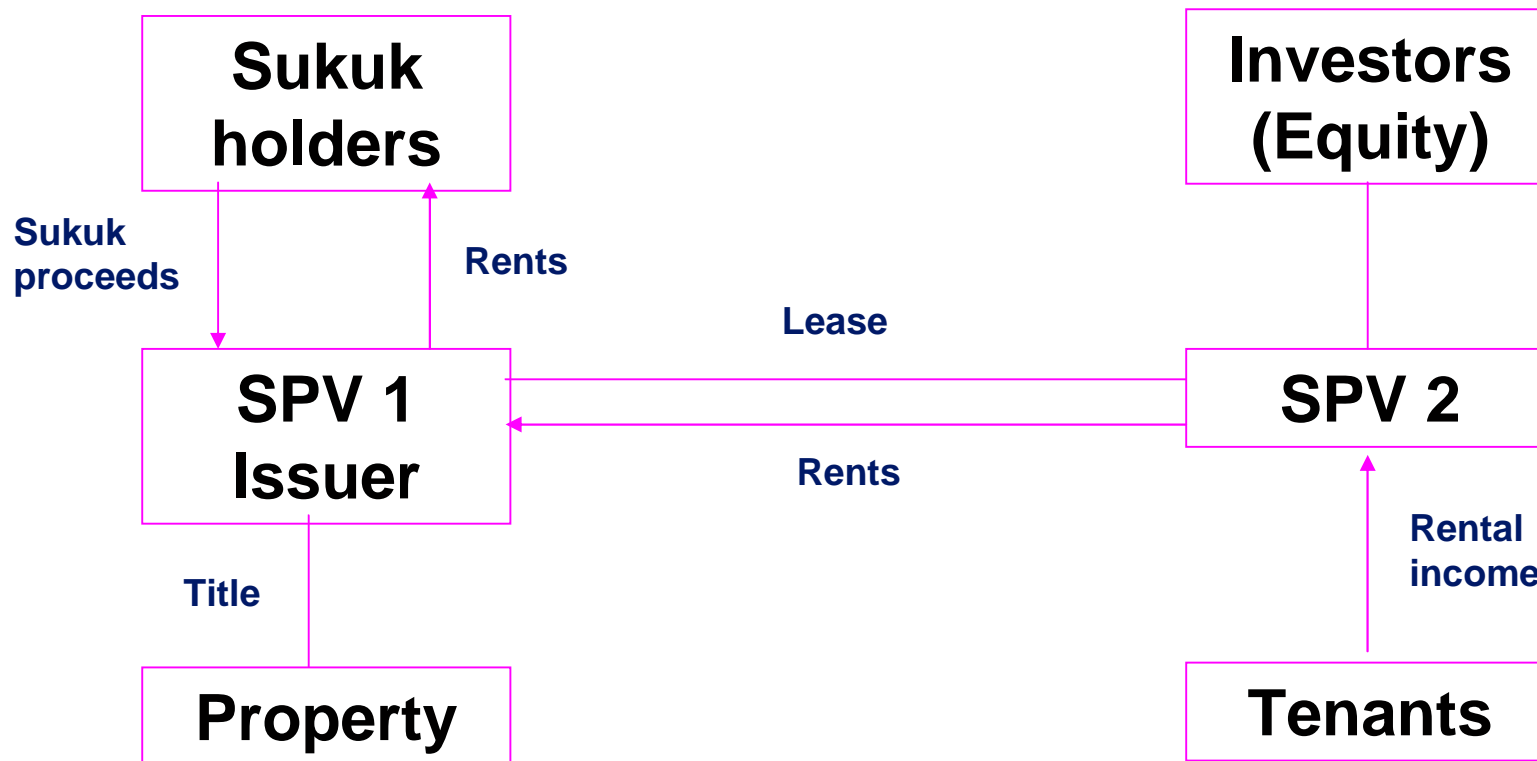
- Section 47 Finance Act 2005 – allows profit to be treated as interest (ie profit to be paid gross)

VAT

- Usually 17.5% (15%) added to commodity sale
- A suffers cashflow cost of funding 17.5% (15%)
- VAT zero-rated supplies



Leverage through Sukuk

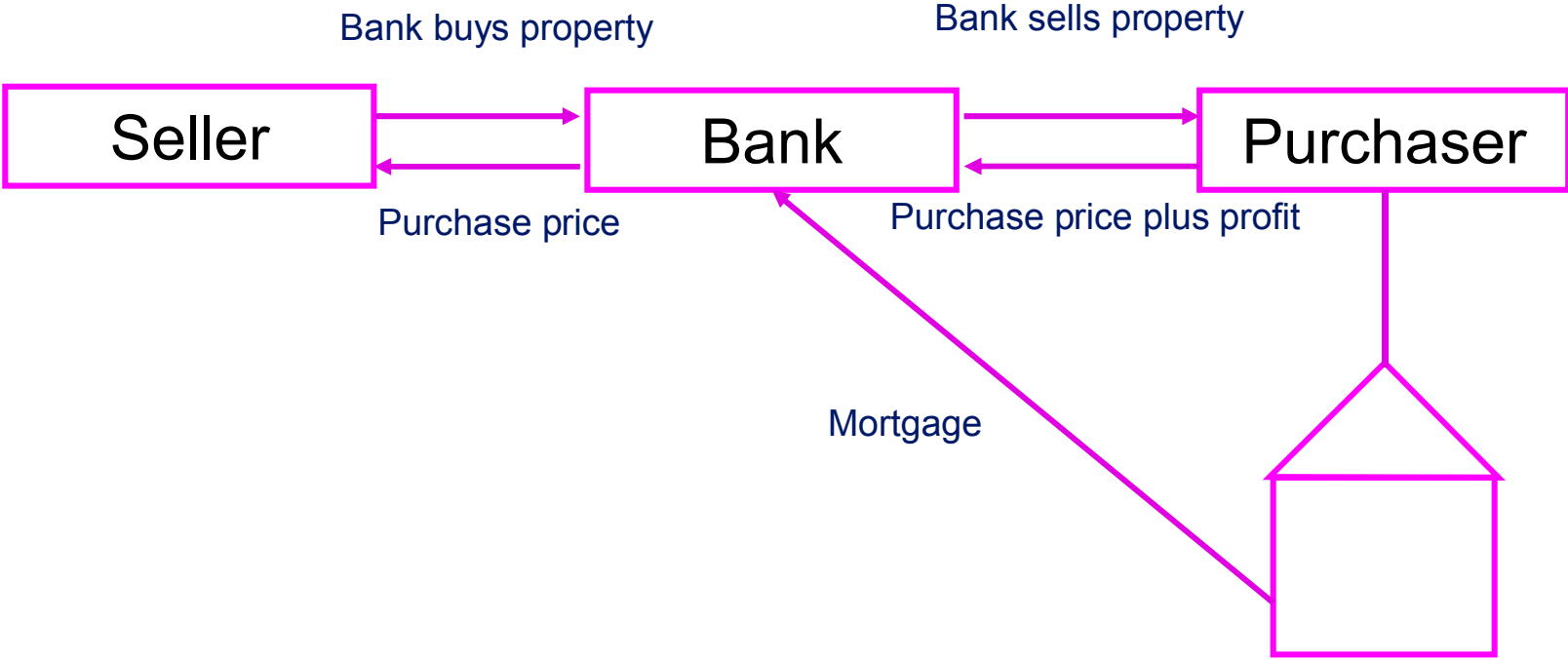


Diminishing musharaka/Ijara

- Under UK tax rules (section 47A Finance Act 2005) banks could provide finance on this basis
- Popular model for home finance
- Chelsea Barracks
- Do banks want to be co-owners? Is this an opportunity for Islamic banks?



Murabaha



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Murabaha

- Details – who exchanges contracts with Seller and pays deposit?
- Profit is fixed for term – how does Bank fund this?
- Opportunity for Islamic banks?



Final remarks

- Islamic investors and fund managers will need to continue to be pragmatic
- Leverage using Islamic contracts/sukuk will develop in the UK
- Further changes will be made to facilitate this
- Other European countries will follow

