



Shari'ah Structures: Preliminary Comparison

Frankfurt

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Shari'ah Structures



Shari'ah Structures

- **Ijara:**

- ▶ Can be used for acquisition financing

- **Tuwarruq/Murabaha**

- ▶ Can be used for acquisition financing and for working capital facilities including revolvers

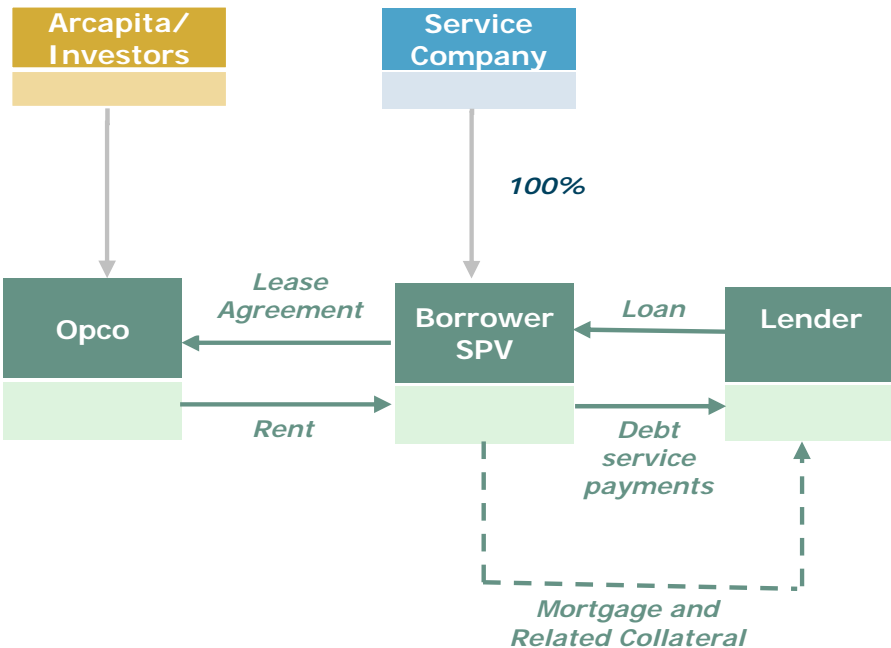
Shari'ah Structures

Ijara

STRUCTURE

OVERVIEW

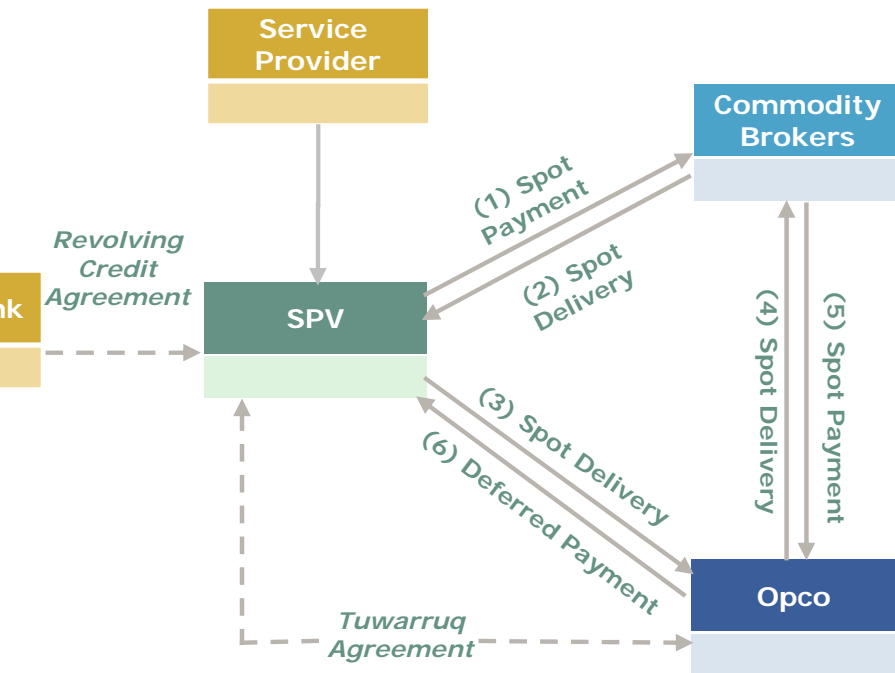
- SPV, owned by a 3rd party corporate services provider, obtains conventional acquisition financing from Lender
- SPV uses the loan amount to acquire the assets of Opco through an asset purchase agreement
- The funds raised by Opco, together with the Arcapita equity are used to pay the sellers.
- SPV then leases the assets back to Opco via a lease agreement in exchange for a predetermined rental payment stream which matches SPV's payment schedule under the credit agreement
- Lease incorporates all the customary covenants included in the credit agreement
- SPV and Opco also enter into a call option agreement, a put option agreement, a supplemental agreement and a tax matters agreement



Shari'ah Structures

Murabaha/Tuwarruq

STRUCTURE



OVERVIEW

- Bank enters into a conventional revolver or short-term loan with the SPV
- The SPV enters into a spot commodity purchase transaction with a commodity broker
- The SPV sells the commodities to the Opco, with immediate delivery but deferred payment
- Opco then resells the commodities to a commodity broker for immediate delivery and payment, which effectively provides Opco with liquidity
- Opco then pays the SPV on the date the deferred payment is due, which corresponds to the payment date under the working capital line
- Variation of this structure is the share purchase murabaha which could be used as an acquisition structure in some jurisdictions

Ijara - France



Ijara - FRANCE

■ Assets which can be sold and leased back

- ▶ Real property, equipment and machinery, intellectual property
- ▶ Risk of “going concern” characterization
- ▶ Strict public policy conditions must be met or will be voidable by the parties and 3rd party creditors
- ▶ Lease of a going concern (“*location-gérance*”) must also meet strict public policy conditions, otherwise the lease is voidable by the parties and 3rd party creditors. For e.g.:
 - Lessor must have been incorporated for at least 7 years
 - Lessor must have conducted the business for at least 2 years

■ Licensing Issues

- ▶ Risk that the sale–leaseback could be construed for banking law purposes as the provision of credit
- ▶ If SPV does this on a “regular basis”, this would be a violation of the banking monopoly
- ▶ Risk is reduced if a “one-off” transaction by the SPV

Ijara - FRANCE

■ Tax Treatment of Sale of Assets

- ▶ If asset sale, Opco's capital gain is subject to normal French corporate income tax at the rate of 34.43%
- ▶ If "going concern" sale, 5% registration tax applies on the price, or value if higher, of the assets, including real property (5.09% rate), equipment and machinery, intellectual property (other than patents) and goodwill ("clientele"), except for inventory which would be subject to VAT
- ▶ If no transfer of a "going concern" (e.g. if goodwill is not transferred), registration tax and VAT still applies to the assets above, except fixed assets
- ▶ Registration tax also potentially applies again on the foregoing bases when Opco re-acquired the assets pursuant to the put or call
- ▶ "Double" ad valorem taxation at 5% - not applicable if transactions could be structured as "credit-bail" under the French Commercial Code but SPV's "put" would be inconsistent with the *credit bail* regime
- ▶ Additional issues in any transaction in which more than 50% of the value of the assets owned by the SPV was French real estate, other than used in a hotel or other non-real estate business:
 - Neither SPV nor any companies in its chain of ownership should be incorporated in tax-havens, otherwise there would be potential exposure to a 3% annual tax on the gross value of the real estate

Ijara - FRANCE

■ Tax Treatment of Lease-Back

- ▶ French tax law: the form of the transaction as a lease is generally respected, and not recharacterized as a financing
- ▶ To be deductible by Opco for corporate income tax purposes, the “rent” paid to a foreign SPV should be justifiable as arm’s length:
 - French anti-abuse provisions shift to the taxpayer the burden of proving the arm’s length nature and hence deductibility of payments of rent, royalties, and service fees to payees subject to “privileged tax regimes”
 - Broadly, if the tax on the SPV tax were less than half of the comparable French tax
- ▶ “Rent” paid to a non-French SPV potentially subject to:
 - French corporate income tax of 34.43%, plus, under a few treaties such as the US, branch profits tax to the extent the “rent” is for real property, or
 - Withholding tax. Rates vary from 33 1/3% to 0%, depending on:
 - ▶ the tax treaty if any applicable to the SPV and
 - ▶ the nature of the assets leased

Ijara - FRANCE

▶ Royalties:

- Under some treaties, includes payments for the use of intellectual property and payments for the use of equipment and machinery, subject to a 33 1/3% withholding tax which may be reduced or eliminated by treaty

▶ Rent for French real property is potentially taxable in France under most treaties (the treaty with Denmark being one exception)

▶ VAT at 19.6% applies on the "rent" paid by Opco which would "self-charge" this "input VAT" and recover it against its output VAT, so the net result would be neutral to it

■ **Security Package: Bank Issues**

▶ Opco as lessee under the Lease agreement can grant a security interest over its assets to secure payment of the "rent" and the benefit of this security interest can be transferred from the SPV to Lender

▶ Issue for the Lender banks: their security interest is more remote from the real assets than in conventional financing

Ijara - Germany



Ijara - GERMANY

■ Assets which can be sold and leased back

- ▶ In principle, all types of assets (real property, personal property, intellectual property, i.e. patents) can be sold by way of a sale-and-lease-back transaction
- ▶ The following comments assume that relevant assets are located in Germany:
 - In case assets consist of real estate, OpCo has income under rental agreements
 - In case of IP, OpCo has income under license agreements etc
- ▶ Lease agreement provides that OpCo is entitled and obliged to:
 - acquire title in leased asset at the end of term of lease; or
 - acquire title upon exercise of one of the options

■ Tax Treatment of Sale of Assets

- ▶ German tax law: the "Ijara-structure" can qualify as a sale-and-lease-back transaction

Ijara - GERMANY

■ Tax Treatment of Sale of Assets

- ▶ Sale-and-lease-back transaction can be structured as:
 - a true sale or
 - a financing transaction:
 - ▶ The lease payments are composed of a tax neutral repayment of the principal and a tax deductible interest portion
 - ▶ For corporate tax purposes (corporate tax rate as of January 2008: 15%) the interest payments are fully deductible
 - ▶ For trade tax purposes (trade tax rate as of January 2008: on average 14%) 25% of the interest portion cannot be deducted from January 1, 2008
 - ▶ Initial sale is not subject to a capital gain taxation or VAT in Germany
 - ▶ If real property is sold, the initial sale would trigger German real estate transfer tax at a rate of 3.5% (4.5% in Berlin) of the purchase price, even though the sale-and-lease-back transaction is structured as a financing transaction

Ijara - GERMANY

- ▶ Sale-and-lease-back transaction can be treated as a financing transaction if OpCo qualifies (without any interruption) as the beneficial owner of the assets, i.e. any upside and downside potential lies consistently with OpCo
- ▶ Call and put option agreement: needs to be structured carefully in order to avoid a transfer of the beneficial ownership of the underlying asset

■ Security Package: Bank Issues

- ▶ OpCo to grant security to SPV to secure obligations under lease:
 - assignment of rental claims
 - assignment of receivables under license agreements
- ▶ Charge over assets of SPV in favor of bank:
 - land charge in case of real property
 - security transfer of tangible assets and receivables including:
 - ▶ rights under lease agreement with OpCo
 - ▶ pledge over bank account of SPV
- ▶ As OpCo's obligations under lease agreement are in turn secured by assignment of claims (see above), such claims will also have to be assigned to bank

Ijara - GERMANY

- ▶ Security package also includes assignment of claims of OpCo under APA with Seller – APA to permit assignment to SPV and security assignment to bank
- ▶ Subordination of rights of OpCo against SPV to rights of bank against SPV
- ▶ Inchoate right/contingent remainder (*Anwartschaftsrecht*) of OpCo re asset on the one hand and security assignment of tangible assets to SPV on the other hand
- ▶ Possible statutory termination rights of receiver (*Insolvenzverwalter*) in respect of lease agreement in event of insolvency of lessor, lessee and/or third party which whom lessee entered into agreement (rental agreement, license etc.). Consequences depend on which party becomes insolvent and on relevant asset leased
 - E.g. In case of tangible/movable asset and insolvency of SPV:
 - ▶ Receiver may not terminate lease due to security assignment of claims to bank
 - ▶ Bank may claim asset and has direct claim against lessee

Ijara – U.K.



Ijara – U.K.

■ Assets which can be sold and leased back

- ▶ Real estate
- ▶ Tangible personal property and intellectual property – could lead to disadvantageous accounting treatment

■ Tax Treatment of Sale of Assets

- ▶ Statutory regimes:
 - permit ijara structures to be taxed similarly to equivalent traditional lending transactions, in which case capital gain which would otherwise arise on the sale of the assets to SPV would not be taxed
 - aimed primarily at retail customers (as they relate primarily to real estate)
 - would not apply to the types of corporate transactions contemplated by institutional investors
 - can be relied on to finance a commercial real estate transaction
- ▶ Any profit arising (or deemed to arise) on any disposal would be subject to UK tax in the ordinary way
- ▶ Stamp duty land tax would apply to the sale of land or buildings in the UK

Ijara – U.K.

■ Tax Treatment of Lease-Back

▶ Statutory regimes:

- permit ijara structures to be taxed similarly to equivalent traditional lending transactions, in which case Opco would be entitled to a deduction for the “profit” element of its payments to the SPV
- aimed primarily at retail customers (as they primarily relate to real estate)
- would not apply to the types of corporate transactions contemplated by institutional investors

▶ Transaction taxed in accordance with its legal form

▶ Deduction would normally be allowed for lease payments following the debits and credits made in OpCos accounts in accordance with UK financial reporting standards (subject to certain modifications)

▶ Depending on the asset being leased and the location of the lessor, VAT may be chargeable on lease payments:

- Provided OpCo is not “partially exempt” for VAT purposes
- VAT would be recoverable by it against its own output tax, so the net result would be neutral

Ijara – U.K.

- ▶ Depending on the asset being leased and the location of the lessor, UK withholding and stamp duty tax may apply to lease payments
- ▶ The usual transfer pricing rules apply, which may restrict the deductibility of rental payments in certain cases where terms are not entirely arm's length

■ **Security Package: Bank Issues**

- ▶ In order to benefit from an advantageous tax treatment, the Ijara financing must be provided by a "Financial Institution." Financial Institution will have title to the assets which are being sold to it and leased back

Ijara – Poland



Ijara – Poland

■ Assets which can be sold and leased back

- ▶ Real and personal property
- ▶ Both tangible and intangible (e.g. intellectual property)
- ▶ Different types of leasebacks (financial and operational) will have different implications

■ Tax Treatment of Sale of Assets

- ▶ 19% capital gains rate on seller
- ▶ Transfer tax on purchase of assets at the rate of 2%% or 1%

Ijara – Poland

■ Tax Treatment of Lease-Back

- ▶ 20% withholding tax on lease fees paid by Polish Opco to non-Polish SPV: may be reduced under tax treaties and EC regulations depending on jurisdiction of incorporation of SPV and nature of assets leased

- ▶ VAT (basic rate of 22% or reduced rate for certain types of assets):
 - self-charged by Opco on lease payment
 - deductible as input tax and neutral
 - if lessor SPV is located in tax haven jurisdiction, self-charged VAT is not deductible as input tax by Opco and is out-of-pocket cost

- ▶ Polish SPV:
 - possible transfer tax on loan:
 - 19% c.i.t. on net income after offset of interest and costs
 - possible exemptions from withholding tax on interest to lender
 - VAT neutral

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