

# Moral Values and Financial Markets: Islamic Finance against the Financial Crisis

## Achieving equal tax treatment for Islamic finance

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- a Council member of the Chartered Institute of Taxation
- a member of the Policy & Technical Committee of the Association of Corporate Treasurers

Amin has spoken on Islamic finance on every continent except Antarctica. Many of his articles and presentations on Islamic finance can be found on his Islamic finance blog at:

[pwc.blogs.com/islamicfinance](http://pwc.blogs.com/islamicfinance)

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## **The challenge of achieving equal tax treatment and UK solutions**

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## Profits taxes: machine purchase example

### Conventional purchase

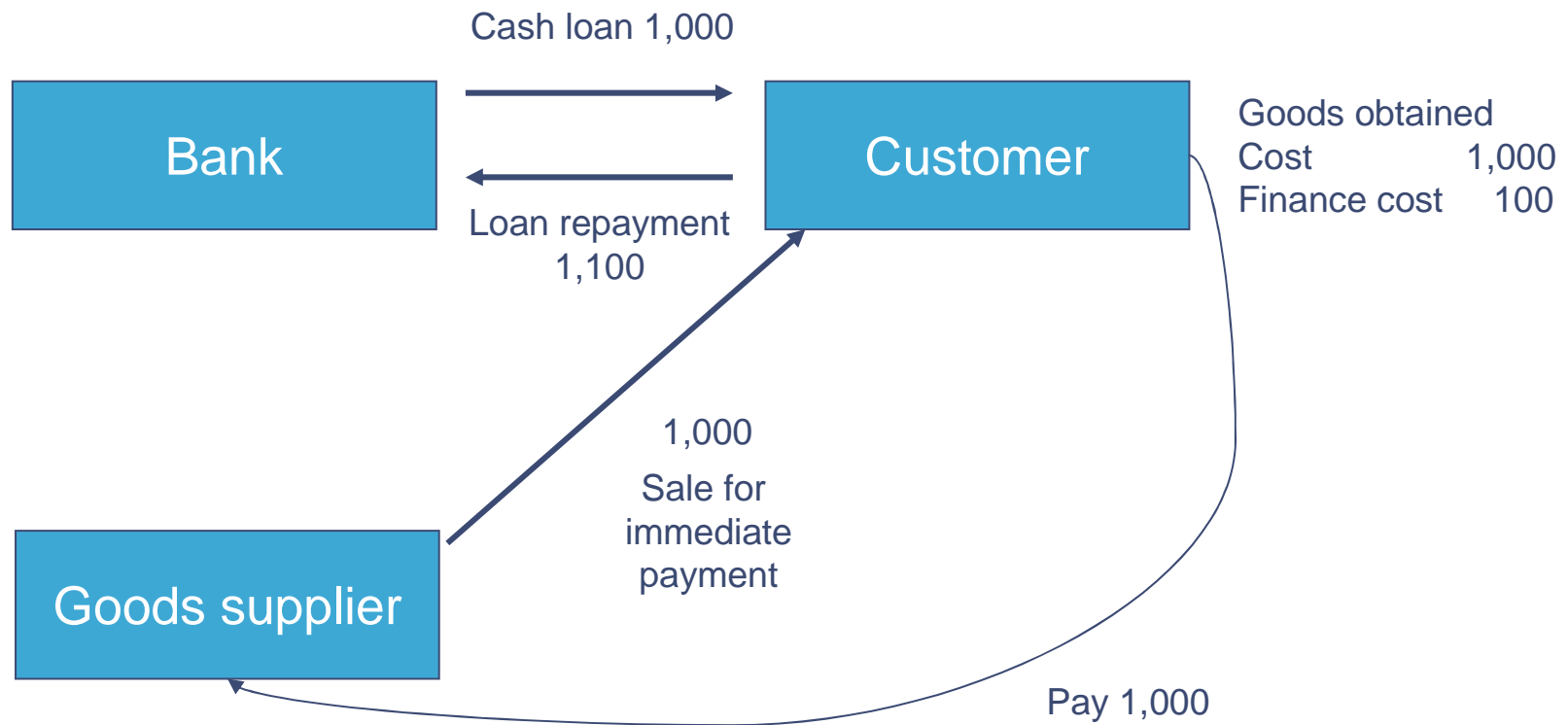
- Machine delivered, cost 1,000
- Pay immediately by borrowing bank loan
- Two year bank loan @ 5% simple interest payable on repayment
- Five year machine life

### Islamic purchase

- Machine delivered now
- Payment due after two years
- Machine price 1,100
- Five year machine life

**Identical cash flows**

# Conventional purchase



# Conventional analysis

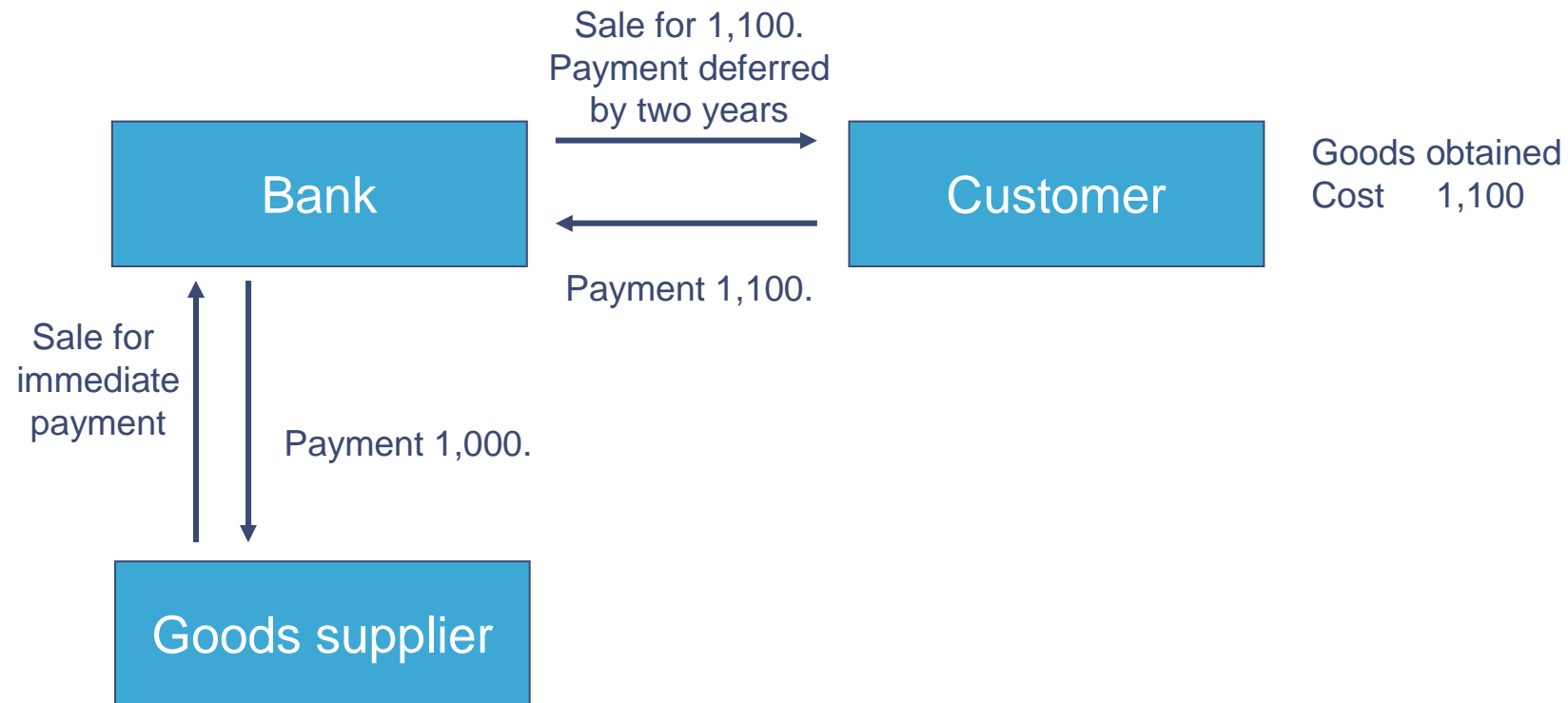
Machine costs 1,000 amortise over 5 years

Interest of 100 for 2 year period

## Conventional purchase tax deductions

Year	Amortisation	Interest	Total
1	200	50	250
2	200	50	250
3	200		200
4	200		200
5	200		200
<b>Total</b>	<b>1,000</b>		<b>1,100</b>

# Islamic purchase



## Legal evaluation of Islamic purchase

The machine cost 1,100 – amortise over 5 years

There is no cost of finance

## Islamic purchase tax deductions under legal approach

Year	Amortisation	Interest	Total
1	220	0	220
2	220	0	220
3	220		220
4	220		220
5	220		220
<b>Total</b>	<b>1,100</b>		<b>1,100</b>

## Economic evaluation of Islamic finance purchase

Machine value on delivery 1,000

Agreed price 1,100

Excess 100 price must be finance cost

Payment due after two years → 50 per year finance cost

## Islamic purchase tax deductions under economic approach

Year	Amortisation	Finance cost	Total
1	200	50	250
2	200	50	250
3	200		200
4	200		200
5	200		200
<b>Total</b>	<b>1,000</b>		<b>1,100</b>

UK Solution

Specific tax law

Makes tax result = economic approach given above

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### Profits taxes

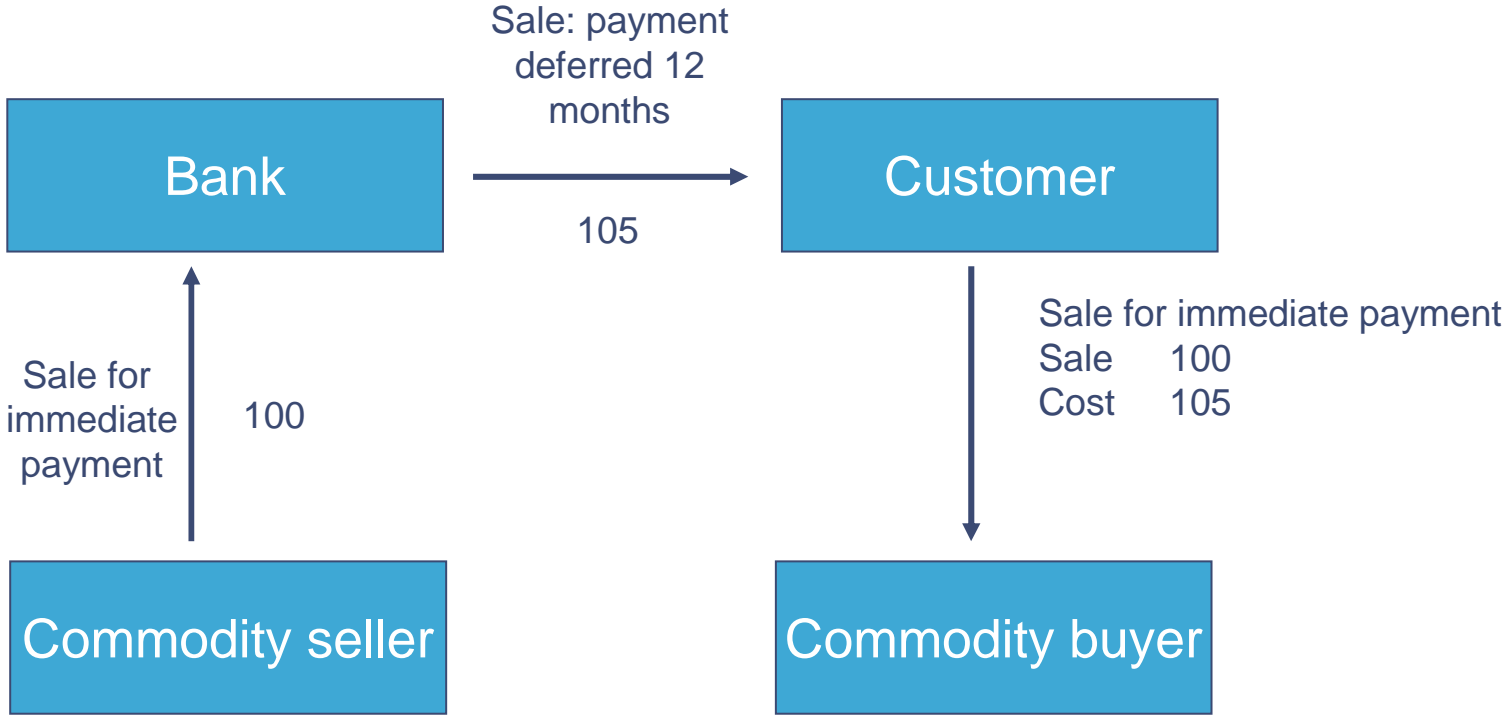
- Machine purchase example
- **Tawarruq example**

### Transaction Taxes

- Diminishing musharaka mortgage
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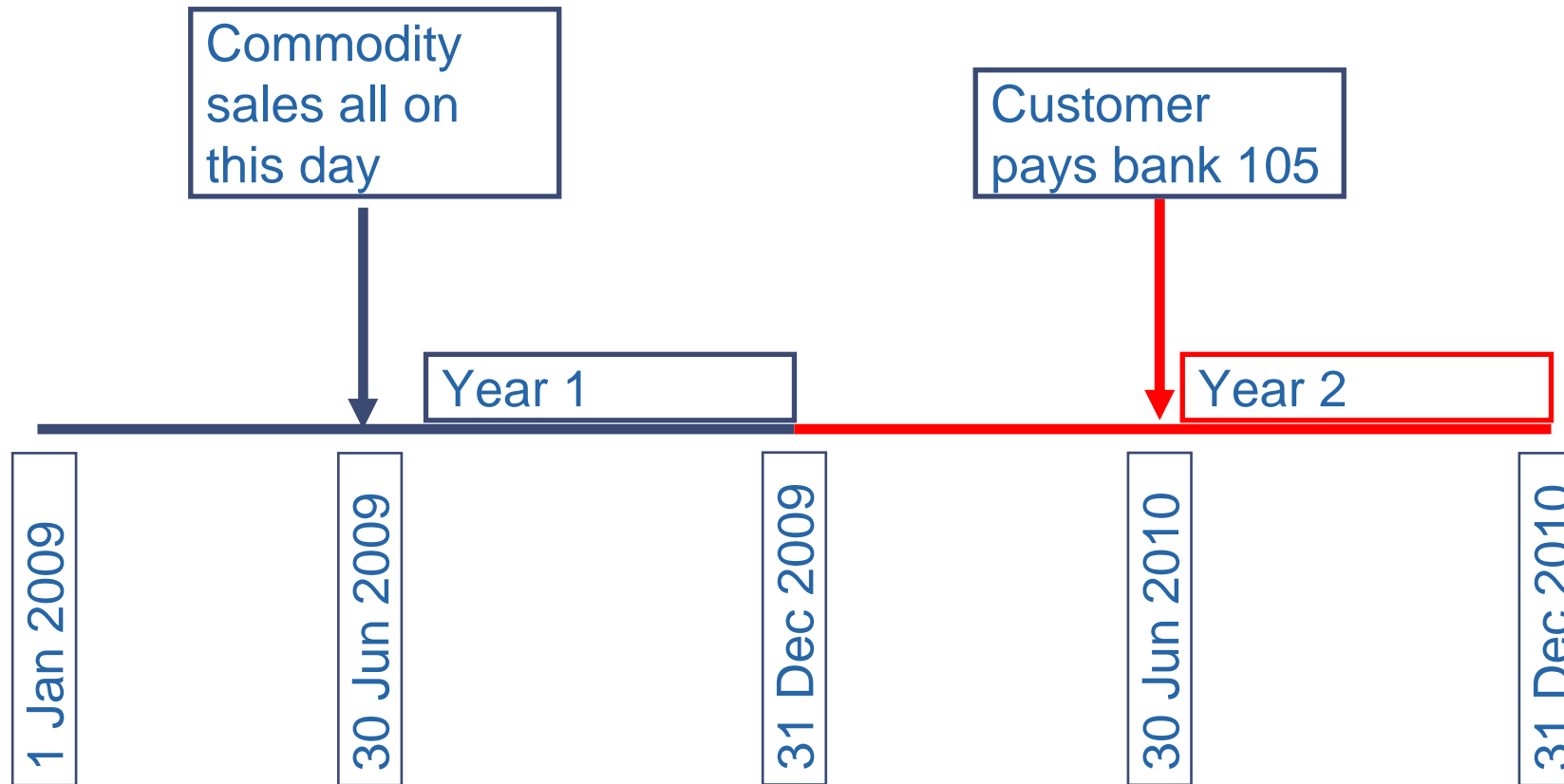
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# Tawarruq example



Equivalent to 5% interest bearing loan by Bank to Customer

# Timeline



# Bank's tax treatment

## Legal approach

- Bought copper for 100 on 30 June 2009
- Sold copper for 105 on 30 June 2009
- Trading profit of 5 is all taxable in 2009

## Economic approach

- Financing transaction NOT commodity trading
- Bank is lending 100 for 12 months to earn 5
- 2 ½ taxable 2009
- 2 ½ taxable 2010

# Customer's tax treatment

## Legal approach

- Bought copper for 105 on 30 June 2009
- Sold copper for 100 on 30 June 2009
- Loss 5
- Customer not a copper trader: 5 loss not deductible
- Transaction not genuine trading; profit never possible

## Economic approach

- Borrowed 100 for 12 months at 5 cost
- Finance cost deduction 2 ½ in 2009
- Finance cost deduction 2 ½ in 2010

## UK solution

Specific tax law

Makes tax result = economic approach given above

# Computation of business profits - tax systems classified

Legal approach

Economic approach



UK

USA

Netherlands

Specific tax law needed for  
Islamic finance

Zero or limited need for  
specific tax law

Comments apply to business income  
Transaction tax issues are separate

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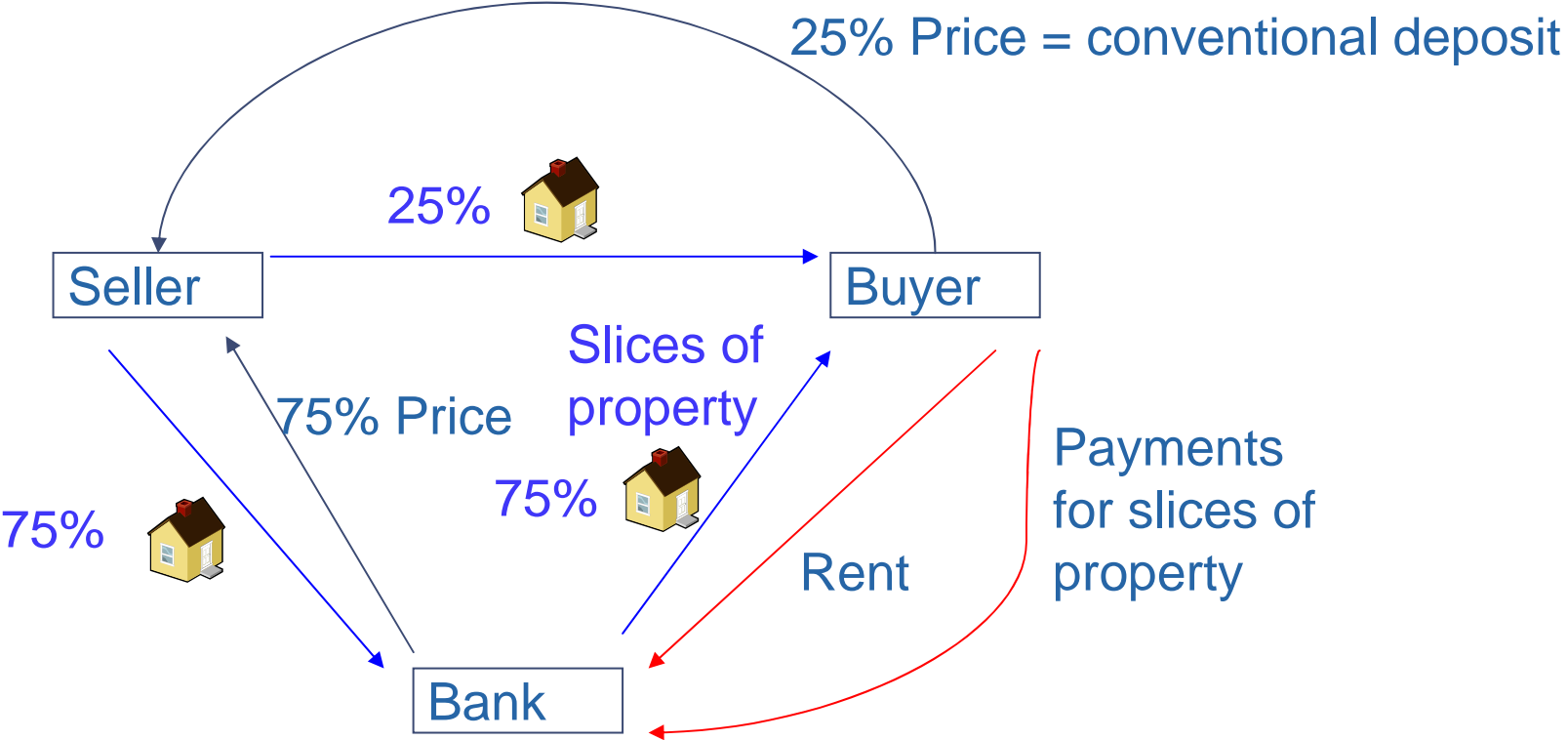
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### **Transaction Taxes**

- **Diminishing musharaka mortgage**
- Ijara sukuk

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# Transaction taxes: diminishing musharaka mortgage



Buyer has sole occupancy and pays rent to Bank on proportion owned by Bank.

# Real estate transfer tax (RETT)

## Conventional mortgage

- Single transfer: Seller >> buyer
- One payment of RETT

## Islamic mortgage as illustrated

- 25% Single transfer: Seller >> buyer – one RETT
- 75% Double transfer: Seller >> bank >> buyer
- 75% Two payments of RETT

## UK solution

Specific tax law

Eliminates RETT on sale bank >> buyer if conditions of tax law met

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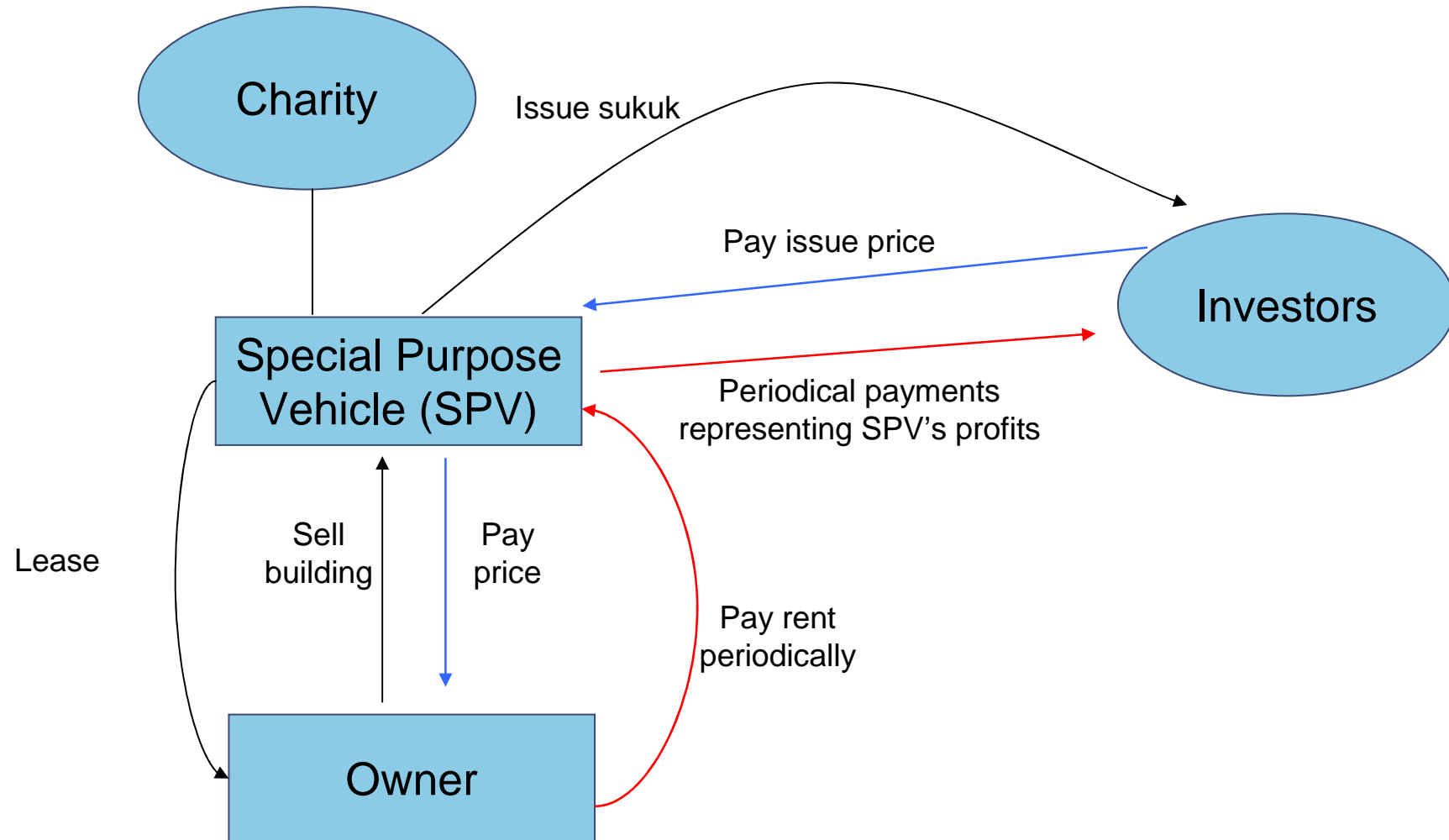
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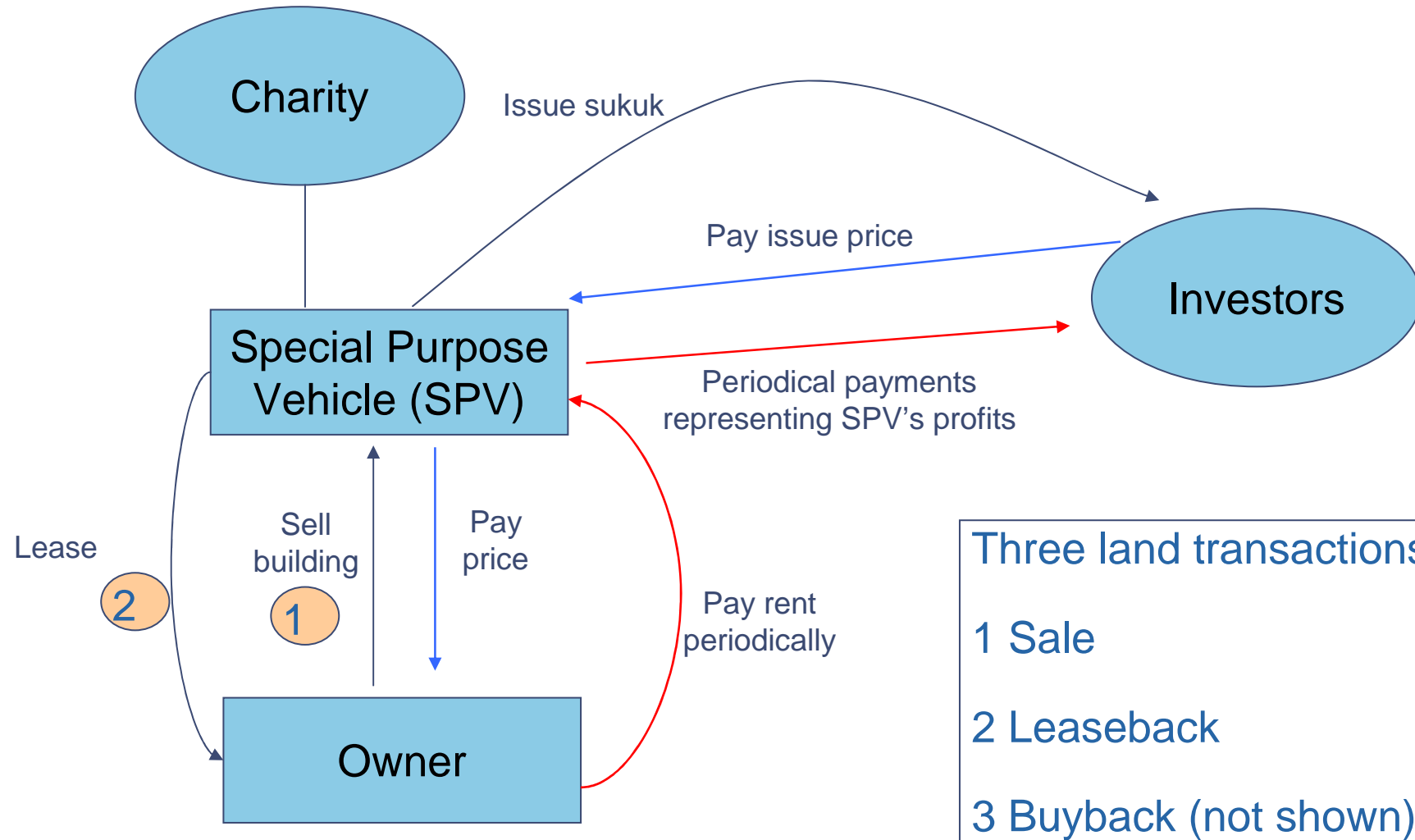
- Diminishing musharaka mortgage
- **Ijara sukuk**

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# Transaction taxes: ijara sukuk



# Multiple real estate transactions: RETT

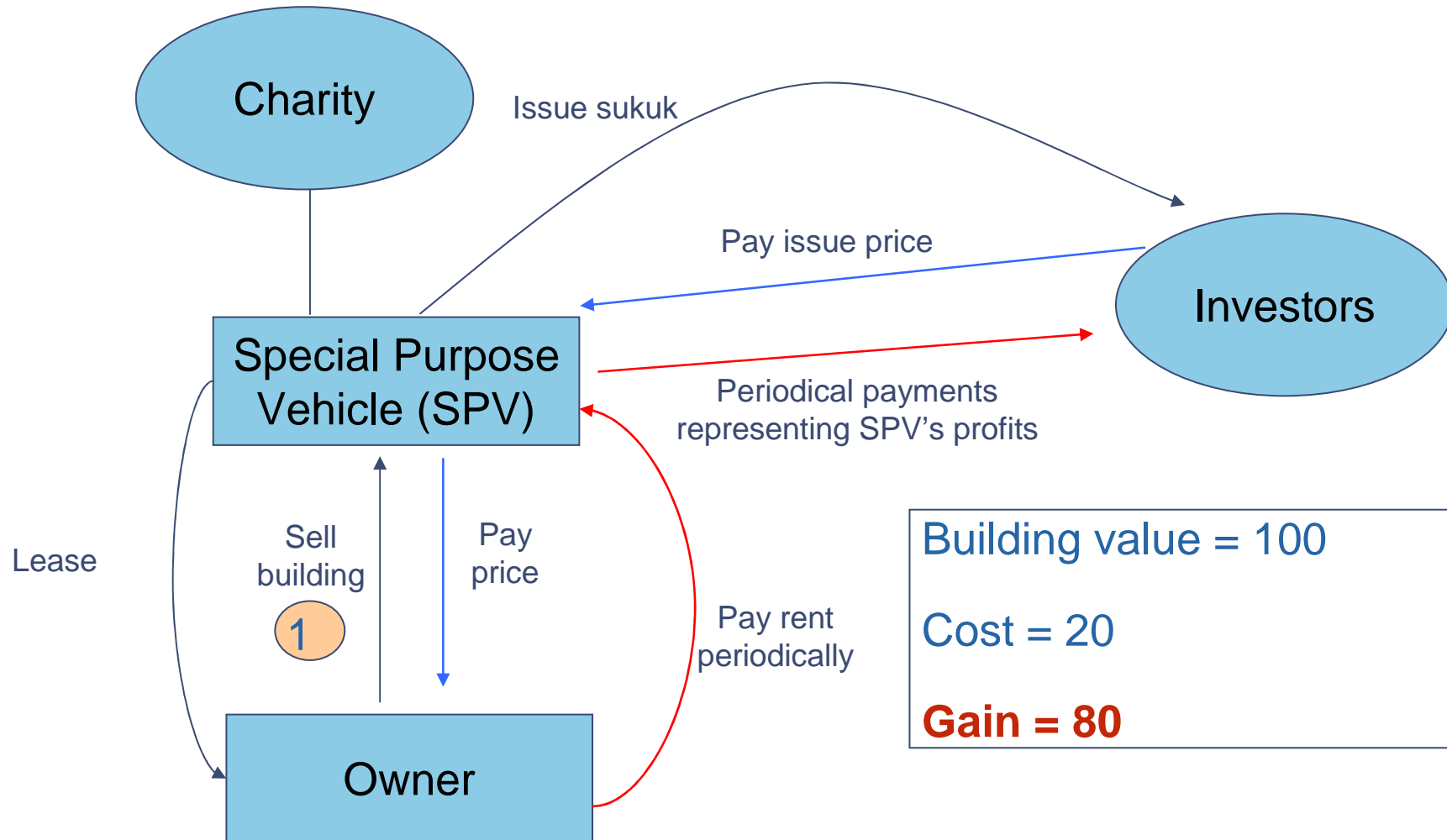


# UK solution

Specific tax law

Eliminates all RETT if conditions of new tax law met

# Taxation of latent capital gains



# UK solution

Specific tax law

Sale to SPV ignored provided conditions of new tax law met

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# The UK approach to Islamic Finance taxation

Goal: equal transaction = equal treatment  
Religion neutral

# Religion neutral

- Law must apply to everyone equally
- No mention of Islamic finance

<b>Tax law</b>	<b>Islamic finance</b>
Purchase and resale	Murabaha
Deposit	Mudaraba
Profit share agency	Wakala
Diminishing shared ownership	Diminishing musharaka
Alternative finance investment bond	Sukuk

## Section 47 FA 2005 – Alternative finance arrangements: purchase and re-sale

*(1) Subject to subsection (3) and section 52, arrangements fall within this section if they are arrangements entered into between **two persons** under which—*

*(a) a person (“X”) **purchases an asset and sells it**, either immediately or in circumstances in which the conditions in subsection (2) are met, to the other person (“Y”),*

*(b) the amount payable **by Y in respect of the sale (“the sale price”)** is greater than the amount paid by X in respect of the purchase (“the purchase price”),*

*(c) all or part of the sale price **is not required to be paid until a date later than that of the sale**, and*

*(d) the difference between the sale price and the purchase price equates, **in substance, to the return on an investment of money at interest.***

*(2) The conditions referred to in subsection (1)(a) are—*

*(a) that X is a financial institution, and*

## Section 47 FA 2005 – Alternative finance arrangements: purchase and re-sale – continued

*(b) that the asset referred to in that provision was purchased by X for the purpose of entering into arrangements falling within this section.*

*(3) Arrangements do not fall within this section unless at least one of the parties is a financial institution.*

*(4) For the purposes of this section “the effective return” is so much of the sale price as exceeds the purchase price.*

*(5) In this Chapter references to “alternative finance return” are to be read in accordance with subsections (6) and (7).*

*(6) If under arrangements falling within this section the whole of the sale price is paid on one day, that sale price is to be taken to include alternative finance return equal to the effective return.*

*(7) If under arrangements falling within this section the sale price is paid by instalments, each instalment is to be taken to include alternative finance return equal to the appropriate amount.*

*(8) The appropriate amount, in relation to any instalment, is an amount equal to the interest that would have been included in the instalment if—*

## Section 47 FA 2005 – Alternative finance arrangements: purchase and re-sale – continued

- (a) the effective return were **the total interest payable on a loan by X to Y of an amount equal to the purchase price,***
- (b) the instalment were a part repayment of **the principal with interest, and***
- (c) the loan were made **on arm's length terms and accounted for under generally accepted accounting practice.***

## UK legislative history

2003 – Islamic mortgages: eliminated double stamp duty land tax (SDLT, the UK's RETT) on individuals' mortgages

2005 – Income computation for murabaha and mudaraba

2006 – Tax rules for wakala and diminishing musharaka. Islamic mortgages for partnerships and companies

2007 – Tax framework for sukuk

2008 – Countered of SDLT avoidance scheme enabled by 2006 changes

2009 – Eliminated SDLT, capital gains tax and tax depreciation recapture on transfer of assets to sukuk issuing SPV and transfer back

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# French murabaha and sukuk legislation

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IMPOT SUR LE REVENU (IR). IMPOT SUR LES SOCIETES (IS). TAXE SUR LA VALEUR AJOUTEE (TVA). DROITS

D'ENREGISTREMENT. TAXE PROFESSIONNELLE (TP). REGIME APPLICABLE AUX OPERATIONS DE MURABAHA ET

AUX SUKUK

NOR : ECE L 09 00001 J

Bureaux A, B1, B2, C2, D1 et D2

# What the French legislation covers

Taxation of the financier's profit as interest

Treatment of non-resident financiers

Exclusion of financier's profit from the immovable property transfer tax regime

Treatment for local business taxation and minimum tax contribution

Treatment of registration fees and VAT

Tax treatment of sukuk

## Quashing of new French sukuk tax law

The French government issued a bill aimed at improving the access to credit for SMEs and the functioning of the financial markets. For allowing to get credit from overseas through Islamic Finance products, a provision of the bill aimed in this respect at adapting the regime of "fiducie" (French equivalent or alike of the "trust") to allow the issue of Sukuks.

A group of MPs challenged that provision (and others) before French Constitutional Court as not relating to the purpose of the Bill itself. The Constitutional Court sustained that position in Decision no 2009-589 DC of 14 October 2009 (no link with the initial purpose of the Bill), and declared that the provision was therefore not in line with the Constitution.

That decision should not mean that the adaptation of the law to allow Islamic finance products is not constitutional per se, but rather that the procedure which was used to introduce the change was not the proper one.

# The UK is a legislative pioneer in the West.

# Its approach to Islamic Finance can be followed by all countries who wish to legislate for tax equality.

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