

# European Forum of Islamic Finance

## Tax system requirements for Islamic Finance

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- Islamic Finance

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The United Kingdom approach

## Illustrative transaction

### Conventional purchase

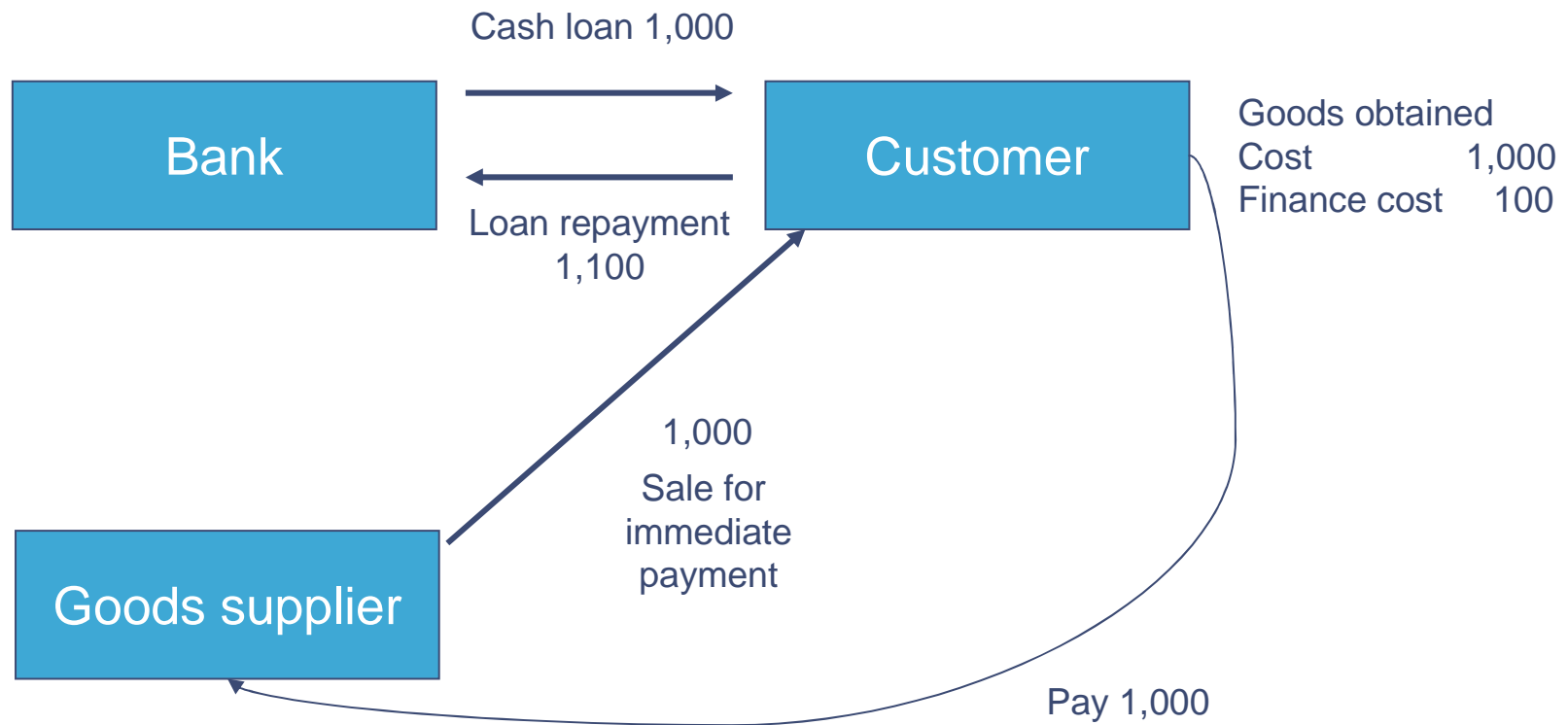
- Machine delivered, cost 1,000
- Pay immediately by borrowing bank loan
- Two year bank loan @ 5% simple interest payable on repayment
- Five year machine life

### Islamic purchase

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

**Identical cash flows**

# Conventional purchase

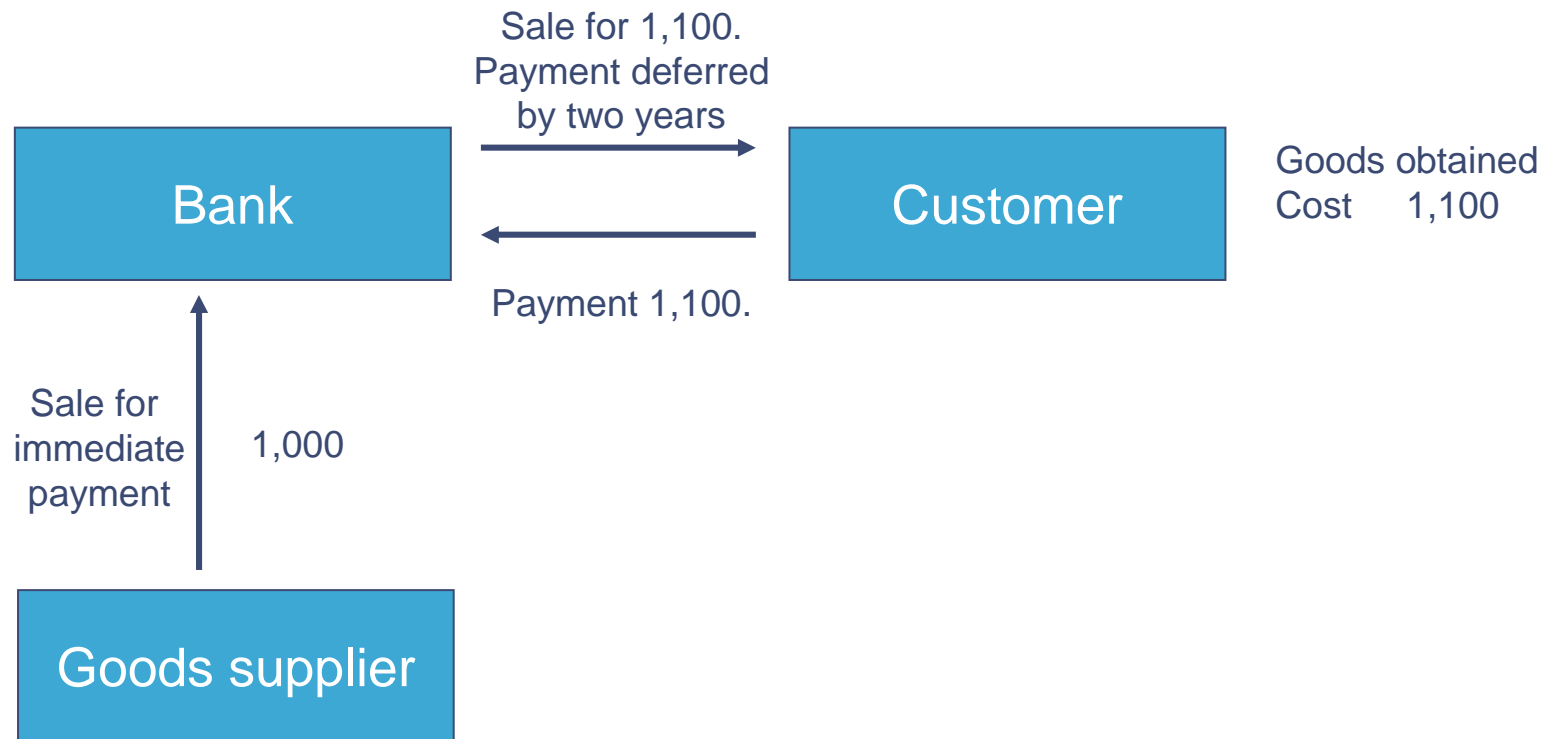


# Conventional purchase tax deductions

Interest on accruals basis

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



Implications of tax system type

## Legal evaluation of Islamic purchase

There is no cost of finance

The machine cost 1,100

Machine is paid for two years after delivery

Islamic purchase tax deductions  
 Following legal analysis  
 Amortise more expensive machine, no finance cost

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

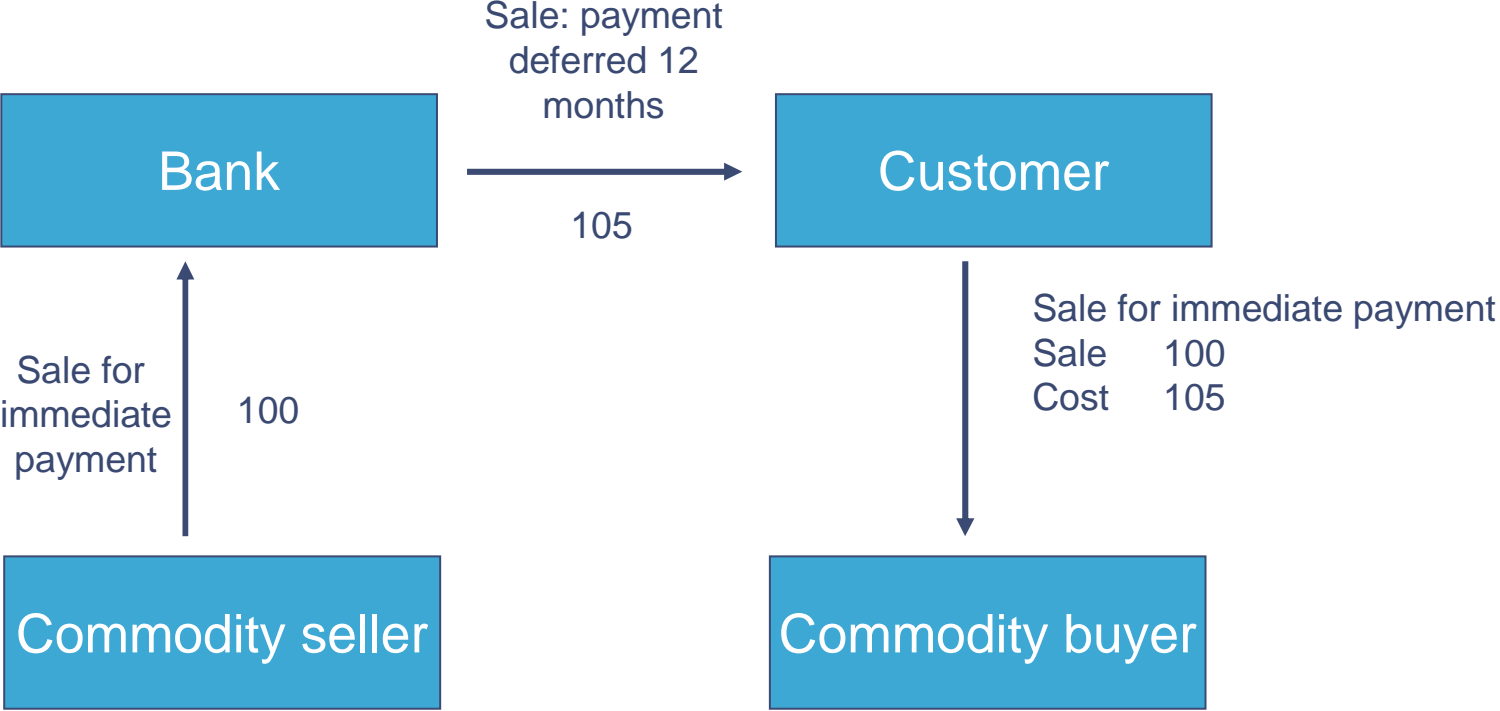
50 per year finance cost

## Islamic purchase tax deductions

Following economic analysis

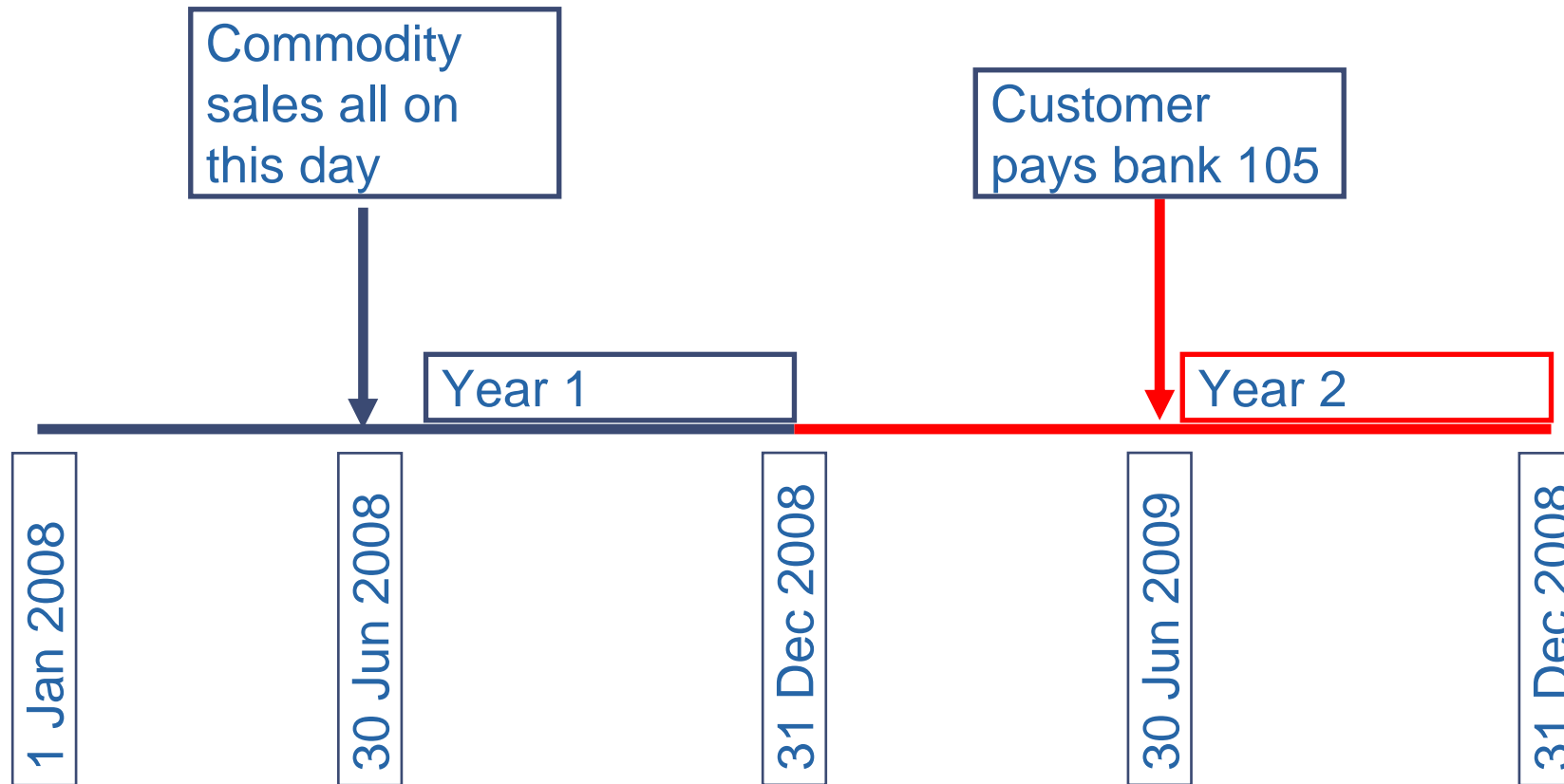
Year	Amortisation	Finance cost	Total
1	200	50	250
2	200	50	250
3	200		200
4	200		200
5	200		200
<b>Total</b>	<b>1,000</b>		<b>1,100</b>

# Tawarruq



Equivalent to 5% interest bearing loan by Bank to Customer

# Timeline



# Bank's tax treatment

## Legal approach

- Bought copper for 100 on 30 June 2008
- Sold copper for 105 on 30 June 2008
- Trading profit of 5 is all taxable in 2008

## Economic approach

- Financing transaction NOT commodity trading
- Bank is lending 100 for 12 months to earn 5
- 2 ½ taxable 2008
- 2 ½ taxable 2009

# Customer's tax treatment

Legal approach (= UK tax law before 2005)

- Bought copper for 105 on 30 June 2008
- Sold copper for 100 on 30 June 2008
- Loss 5
- Customer not a copper trader: 5 loss not deductible
- Transaction not genuine trading; profit never possible

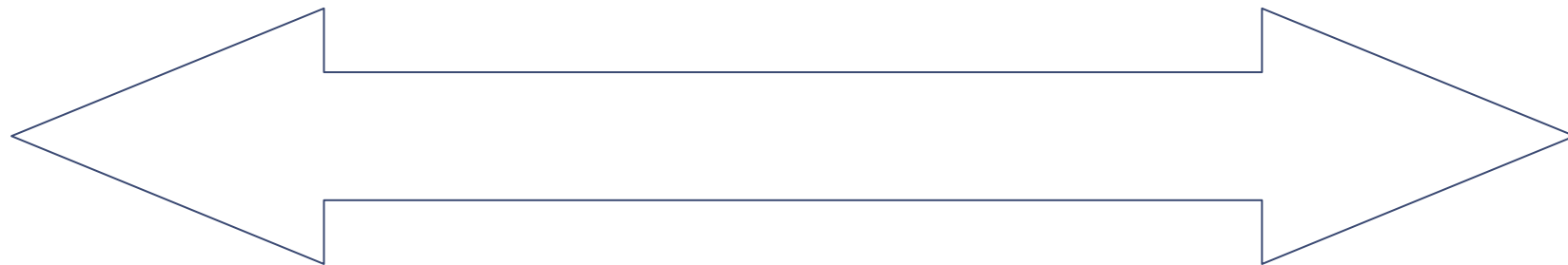
Economic approach

- Borrowed 100 for 12 months at 5 cost
- Finance cost deduction 2 ½ in 2008
- Finance cost deduction 2 ½ in 2009

# Computation of business income - tax systems classified

Legal approach

Economic approach



UK

USA

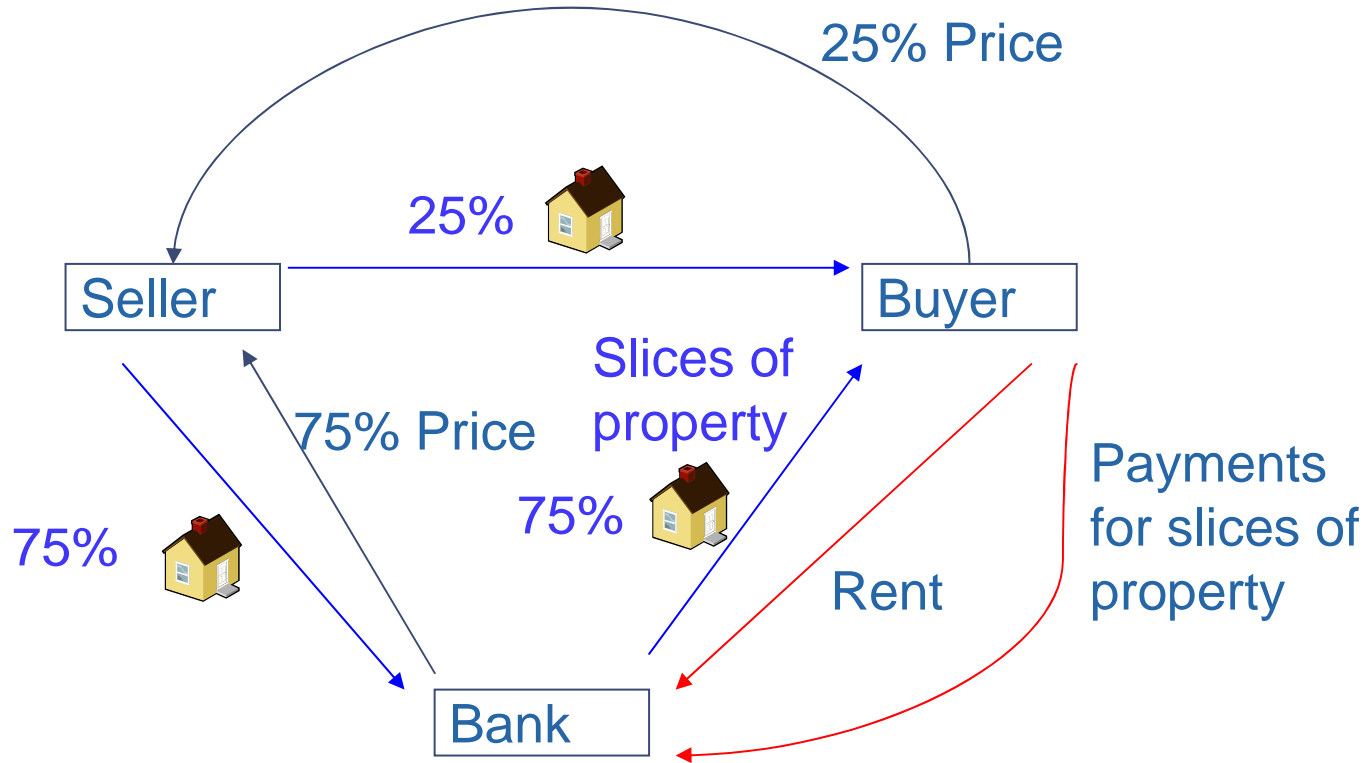
Netherlands

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

# Islamic mortgage with diminishing musharaka – 25% deposit



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

# Real estate transfer tax (RETT)

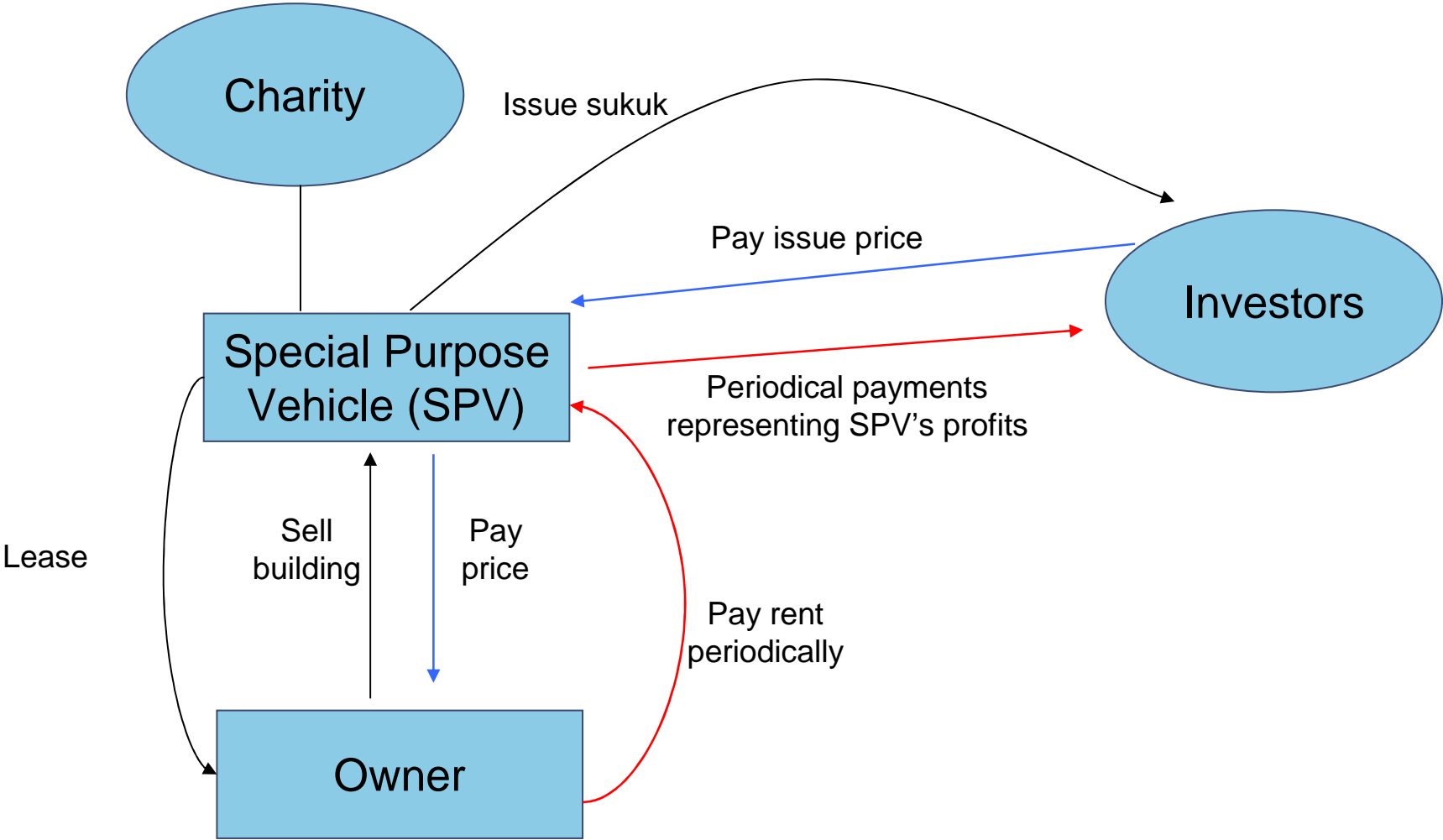
## Conventional mortgage

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

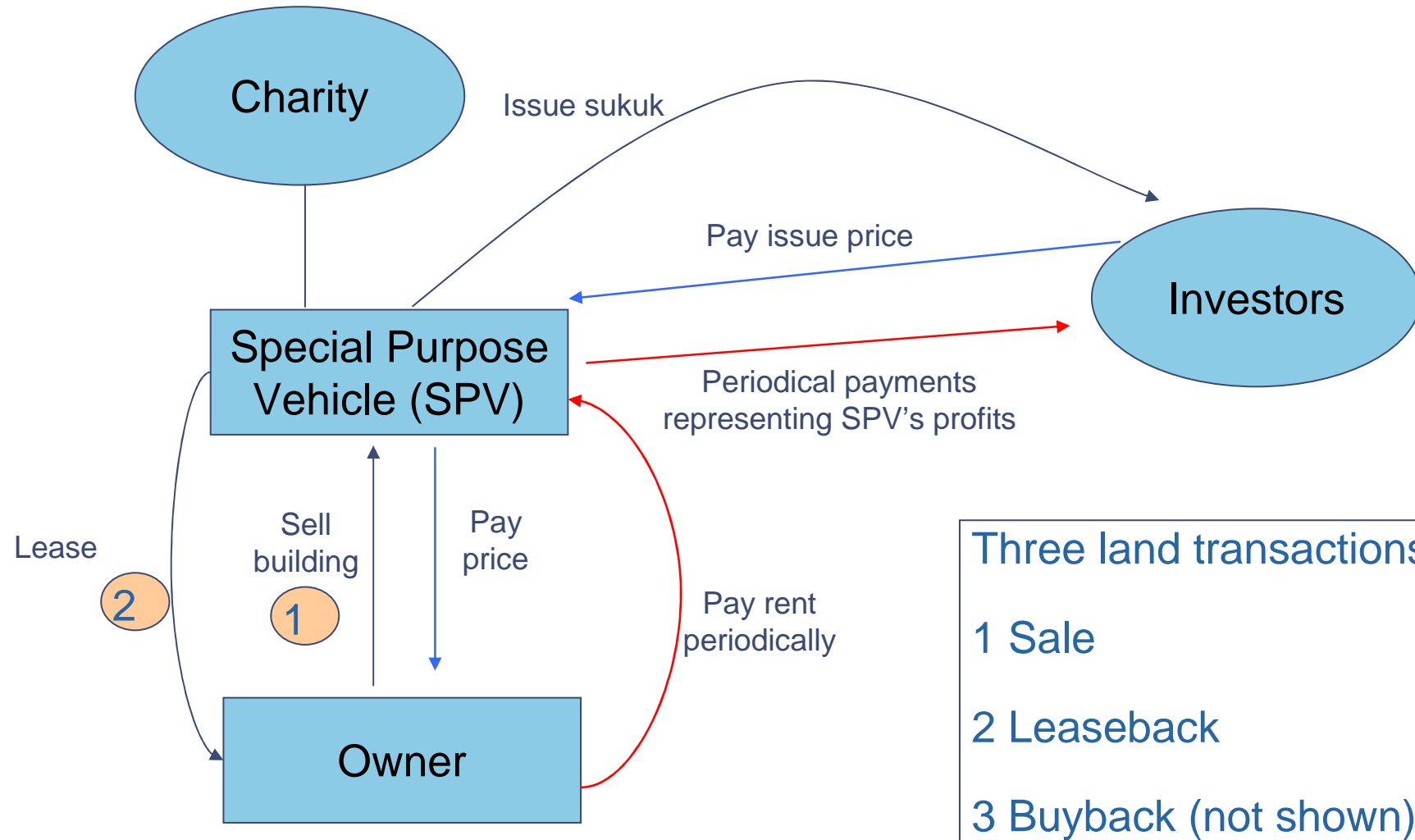
## Islamic mortgage as illustrated

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

# Ijara sukuk

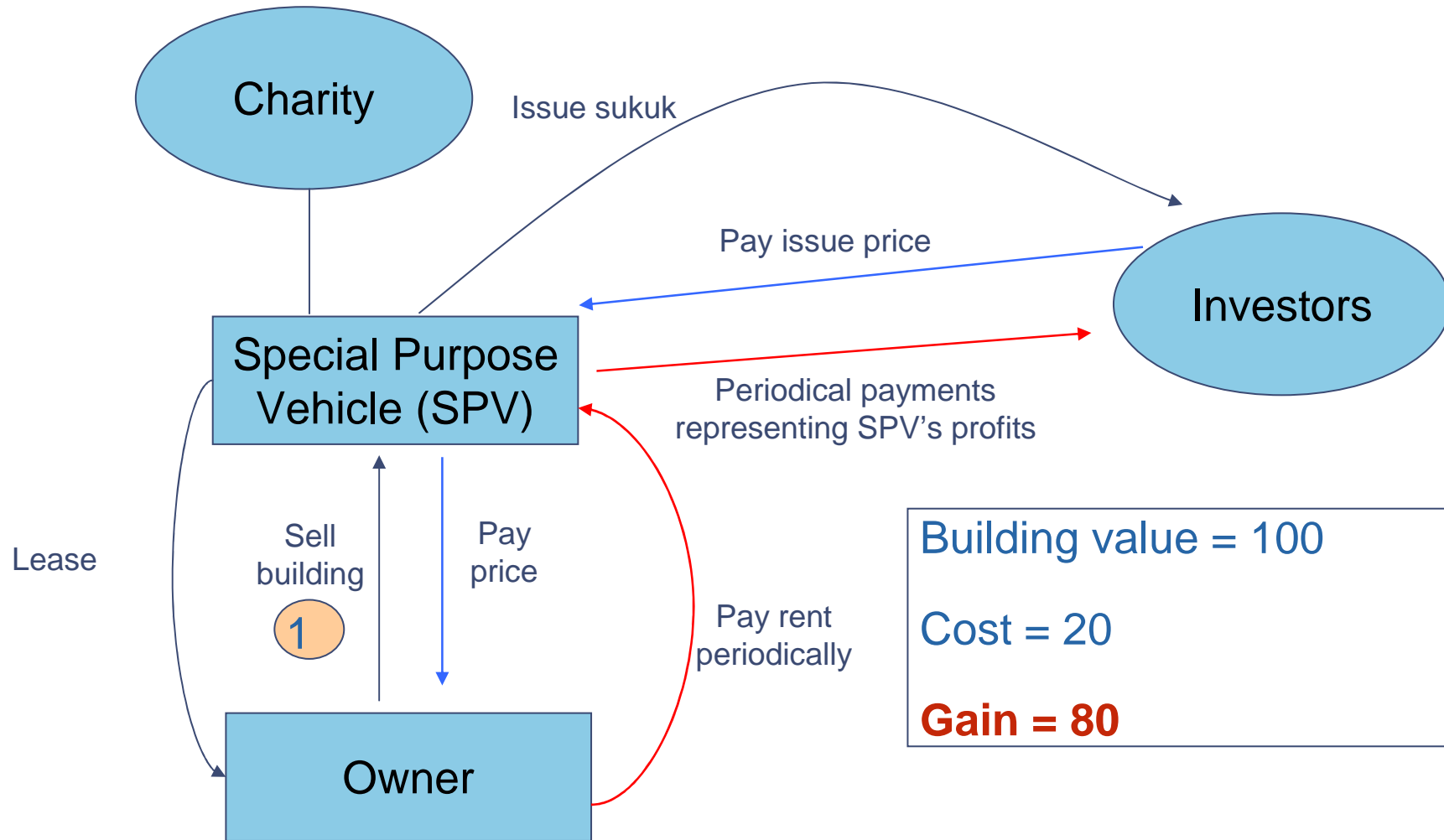


# Multiple real estate transactions: RETT



- Three land transactions:
- 1 Sale
  - 2 Leaseback
  - 3 Buyback (not shown)

# Taxation of latent capital gains



# The UK approach to Islamic Finance taxation

Goal: equal transaction = equal treatment

Religion neutral

Avoid affecting everyone

Deeming approach

Override of specific obstacles

# 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.***

## Avoid affecting everyone

Normal sales with extended payment?

One party **MUST** be a financial institution

- Except sukuk rules

# Financial Institution

- Bank
- Building Society
- Wholly owned subsidiary of a bank or building society
- Consumer Credit Act 1974 license
- Person authorised outside UK to receive deposits from public

# Deeming approach

- If within statutory definitions
  - Customer's expense **treated for tax purposes** in the same way that interest is treated
  - Same for financial institution
- Law is **not** saying the payment **is** interest

# Override of specific obstacles

- Anti-avoidance rules to stop equity finance being disguised as debt
  - ICTA 1988 s.209(2)(e)(iii) “securities under which... the consideration given... is ... dependent on the results of the company’s business”
  - interest treated as “distribution” ( = not tax deductible)
- Specific override in Alternative Finance Arrangements legislation

## UK legislative history

2003 – Islamic mortgages: eliminated double stamp duty land tax (UK 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

# The UK is a legislative pioneer in the West.

# Its approach to Islamic Finance can be followed by all Western countries.

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