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Trends in taxing Shariah Structures

03 August 2010

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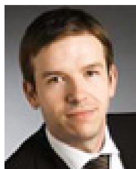
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Introduction
The slightly altered words of Shakespeare "we know where we are, but we know not where we may be" may be self evident in many spheres of life. However the words are certainly very apt when one looks at the changes that have been made to the tax laws in various jurisdictions to facilitate Shari'ah compliant financing. In this article we have a bird's eye look at how Shari'ah compliant financing in the UK, US, Germany, Luxembourg and Ireland have been/will be facilitated in the future and are attractive for Shari'ah compliant investors in making their real estate or private equity investments, in or through such jurisdictions.

Why worry about Tax?
Tax can be an inhibition to Shari'ah compliant financing because various jurisdictions' tax codes have not been designed with Shari'ah compliant structures in mind. However, the UK, French, Luxembourg and Irish Governments have amended or clarified their tax codes in order to facilitate Shari'ah compliant financing.

What are different jurisdictions doing?
As you would expect, different jurisdictions are adopting different approaches according to their existing tax codes. Broadly the approaches can be divided into two categories:
substance over form; and
(ii) form over substance with amended/new legislation.

Substance over form
In adopting the substance over form approach, each of the US, German (guidance has been sought), Luxembourg (guidance issued) and French (guidance issued) authorities look at the objective economic goals of the transactions rather than just to the legal form of the commercial arrangements.

The basic requirement of the tax authorities in each of the US, Germany and Luxembourg in order to identify a debt for tax purposes is to look for an indebtedness in the form of an unconditional, legally enforceable obligation for the payment of money. In several Shari'ah compliant structures, there will be a clear obligation for the payment of money, with a separate price for the delayed repayment of that indebtedness.

US
From a practical perspective, it is important that the documentation should clearly show and identify the principal and the price for the deferral which should be clearly calculated by reference to the length of the

deferral (the "**profit amount**").

For leasing transactions (including in the context of Sukuk transactions), it is already well established in the US that there can be a financing lease or an operating lease. The lease payments can be broken into two distinct components, namely principal and interest. The documentation should also clearly state that the parties intend that the lessee will be treated as owner of the property for tax purposes.

The Shari'ah advisers will require the lessor to be responsible for the maintenance of the assets. Thus, such cost is passed back to the lessee through additional rent provided the Shari'ah adviser is satisfied with this. Furthermore, it is important that the transaction documentation does not preclude the parties from utilising the substance over form approach and that it is clear that the parties intend that the arrangements be treated as finance arrangements for tax purposes.

Any transaction involving the US must also take into account state and local tax issues especially if the assets are located in the US. Although most state and local rules generally follow the US federal rules in terms of determining the characterisation of transactions, this is not always the case and local and state taxes can vary widely from state to state.

Luxembourg

The Luxembourg authorities have accepted the use of Shari'ah compliant structures as financing transactions and have issued guidance to this effect. The guidance issued by the Luxembourg tax administration in the form of a circular (the " **Circular**"), refers to Islamic finance as the "financial instruments used by investors who wish to manage their investments observing the values of Islam". In particular, the Circular addresses the tax treatment of the murabaha and the sukuk. With regards to the murabaha, the Circular allows the profit to be recognised over the life of the murabaha where certain requirements are met.

With regards to the sukuk, the Circular provides that it should be treated in the same way as a conventional bond is treated.

It is also possible to obtain formal interpretation confirmation from the Luxembourg authorities, which gives comfort for the investor and the investee provided proper disclosure is made.

Germany

There is currently no specific guidance from the German tax authorities on the treatment of Shari'ah compliant finance arrangements but this is being actively sought. With respect to existing Shari'ah compliant investment in Germany to date investors in real estate and private equity, the Shari'ah compliant structuring associated with such investments has been implemented outside of the country (for example, in Luxembourg).

Given the lack of guidance from the tax authorities, such Shari'ah compliant structures must be capable of fitting within the appropriate tax definitions. The general definition of (debt) interest under German income tax law is the temporal commitment of capital against compensation. The traditional murabaha would probably be considered as debt financing by the buyer for German tax purposes as - substance over form - the fair market value of the underlying commodity is below the amount the buyer finally has to pay under the murabaha. The deferred price in such murabaha is, from the German tax law perspective, compensation for financing the acquisition under the murabaha.

Once certain structural requirements are met and the criteria of the tax authority's circulars on leasing, the tax implications of the "ijara lease" mean that it should be considered as debt financing. One would

expect that the typical ijara lease would be treated as a financing lease, therefore subject to the same German tax rules on deductions for finance costs.

In real estate finance transactions there are no specific exemptions from German Real Estate Transfer Taxes ("**RETT**") for Islamic compliant structures, thus it is necessary to adopt other structures which may enable the RETT to be avoided or reduced.

Form over substance and enabling legislation

In jurisdictions where tax is determined more on form over substance, the challenge for the authorities in introducing rules to facilitate Shari'ah compliant financing is to strike a balance between flexibility for the Shari'ah compliant investors and investees and loss of revenue for the Government if the tax rules are too widely drafted.

In the UK and Ireland, the form of a transaction is generally the basis on which that transaction is taxed, although not exclusively. Thus the UK and Ireland have introduced rules which treat certain arrangements (which would be expected to be regarded as Shari'ah compliant) in the same way for tax purposes as conventional debt arrangements.

UK

At a very basic level, the conditions set out by the UK legislation include the requirement for there normally be a "financial institution" involved and the return by or to the financial institution must equate to an amount which one would reasonably expect to be a return on capital lent.

In order for a murabaha, which is often used in private equity financings, to qualify as a financing the conditions are not onerous, provided the basic conditions are met and the assets used do not give rise to VAT, stamp duty, stamp duty reserve tax (SDRT) or SDLT. It is relatively easy to achieve this by using the sale of certain metals or metal related instruments in practice.

However, the landscape is more complicated when dealing with real estate financing or a sukuk backed by real estate assets. Normally, a special purpose vehicle ("**SPV**") is used to generate the ijara lease and create the cashflow. Thus, in addition to the tax aspects associated with a conventional real estate financing, one has to look at the capital/chargeable gains, VAT and SDLT implications for the lender, borrower and the SPV.

However, unless such SPVs meet the qualifying criteria to be a financial institution, certain SDLT, corporation tax and capital gains tax reliefs will not be available. While a "financial institution" is broadly defined, a SPV will only qualify in limited circumstances. Furthermore, refinancing can raise additional tax issues which have yet to be resolved.

In 2009, the UK introduced further rules to facilitate the issue of the sukuk backed by real estate assets. However, these rules still need some tweaking before they can operate smoothly on a standalone basis unless one were to use existing rules to supplement the new rules.

In addition, it is worth noting that the UK authorities are still working with interested parties in refining its legislation to ensure that the political objectives can be reached without providing an avoidance mechanism for other taxpayers.

Ireland

Ireland has introduced legislation to facilitate the use of certain Shari'ah compliant financing techniques, described as "specified financial transactions". Like the UK, the specified financial transactions will have

to meet certain requirements and can be broadly categorised as credit transactions (like the murabaha), deposit transactions (akin to the mudaraba) and sukuk transactions, which are seen as akin to investment transactions. The Explanatory Notes to Ireland's Finance Bill 2010 state that the legislation "is designed to extend the tax treatment applicable to conventional finance transactions to Shari'ah products which are the same in substance as the conventional products." The scheme of the Irish legislation follows, to a limited extent, the UK legislation but provides a broader definition to "financial institution" as well as not having such a detailed list of requirements.

Conclusion

New rules or the imaginative and proper use of existing rules provide opportunities for Shari'ah compliant investors who seek to expand the geography of their investment base, spread their risk or explore new, more or better opportunities in a cost efficient way. In addition such rules provide investees with more options for raising investment for new or existing strong ventures. The investors' and investees' due diligence of such opportunities should consider the tax implications and the means of reducing any unnecessary tax cost considering the new rules, guidance or opportunities.

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