ALLEN & OVERY

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# Islamic finance taxation

## *Where are we now?*

EDITORIAL

Islamic finance is a fast developing area in many jurisdictions around the world. In recent years, the market for Islamic financial products has experienced double-digit rates of growth and has an estimated global worth in the hundreds of billions of dollars.

With the increasing importance of Islamic finance, this has led to a focus on how Islamic finance transactions are taxed. In some jurisdictions, where there is no overriding substance over form doctrine, the application of existing tax rules to Islamic financing structures can often have adverse consequences or involve difficult points of analysis.

Many governments are keen to promote the growth of Islamic finance in their jurisdictions and have become aware of the need to ensure that the tax rules operate as fairly and clearly as possible. In recent years in a number of jurisdictions, new laws have been introduced or guidance published which seeks to deal with the taxation of Islamic finance transactions. A key aim is often to create a "level playing field" with the treatment of equivalent conventional products.

This article is intended to provide an overview, as at March 2012, of how Islamic finance taxation is dealt with in various jurisdictions, including Australia, Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, the United Kingdom and the United States.

For further information about Allen & Overy's Islamic Finance practice please click here, or for more information about Allen & Overy's global Tax practice please click here. Alternatively, please speak to your usual contact.

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# Australia

The Australian Government regards Islamic financing as a central element of its strategy to make Australia a financial hub in the Asia Pacific region. In 2010, the Australian Board of Taxation carried out a comprehensive review of Australia's tax laws in order to identify obstacles to the development of Islamic financial products in Australia. The Board was also asked to make recommendations (for Commonwealth tax laws) and findings (for State and Territory tax laws), having regard to the approach taken in other jurisdictions.

The terms of reference for the review stated that, in conducting the review, the Board should have regard to the following principles:

- The tax treatment of Islamic financial products should be based on their economic substance rather than their form.
- Where an Islamic financial product is economically equivalent to a conventional product, the tax treatment of the two products should be the same.
- If the Board concluded that amendments to the tax law were required, the Board was to consider whether adjustments could be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic financial products.

The Board completed its review of the taxation treatment of Islamic Finance in June 2011 and has provided its report to the Government. However, we understand that the release of the report to the public will not occur until the Government has had time to consider the report in full.

# Belgium

At present, Belgium does not have specific tax laws which focus on Islamic finance. The previous Minister of Finance announced the establishment of a working group focussing on the subject. However, there has been no news since that announcement and it is unclear whether the current Minister of Finance will pursue the initiative.

Our Belgium offices have been involved in a number of *Shari'a* compliant real estate acquisition transactions.

# France

Tremendous efforts have been made by the French authorities over recent years to promote Islamic finance in France. These efforts have been supported by different lobbying groups such as Paris Europlace, a financial think tank whose objective is to promote Paris as an international financial market.

A key milestone was the launch by Christine Lagarde (Minister of Economy and Finance) in September 2008 of a working group whose purpose was to analyse how French tax law should be amended in order to facilitate the implementation in France of *Shari'a* compliant structures. The idea was to reduce or eliminate tax

costs deriving from those structures and which had been identified by practitioners as major barriers to implementing such structures.

In December 2008, Paris Europlace released an analysis of the development of Islamic finance and potential opportunities for the French economy, with ten proposals as to how Islamic finance might be developed in France. Since then, the French tax authorities have released guidelines to clarify the tax treatment of *murabaha*, investment *sukuk*, *ijara* and *istisna* arrangements with respect to corporate income tax, registration fees, VAT and business tax.

Our Paris office has been involved in the implementation of a number of *murabaha* structures (including commodity *murabaha* and share *murabaha*, often in relation to French properties). In 2012 it was involved in the implementation of the first French SPPICAV (a closed REIT-like fund regulated by the French *Autorité des Marchés Financiers*) financed through a *murabaha* structure.

Our Paris office is also a contributor to Paris Europlace, and in particular to the Islamic Finance Committee, and has assisted the *Autorité des Marchés Financiers* in developing a specific listing division for *sukuk*.

# Germany

There are no special rules in Germany focussing on Islamic finance and prior to 2009 there was little evidence that the Government was actively seeking to support the development of Islamic finance in Germany.

However, in response to growing interest in *Shari'a* compliant investments in Germany, the German banking regulator (*Bundesanstalt für Finanzdienstleistungsaufsicht*) has so far hosted two Islamic finance conferences in Frankfurt (in October 2009 and May 2012) where, *inter alia*, the tax treatment of different Islamic finance products was discussed. This demonstrates the Government's interest in *Shari'a* compliant investments in Germany even though at present no regulatory or tax related changes are contemplated in this regard.

Our German offices have been involved in several Islamic finance transactions, including the establishment of an atypical silent partnership under German law as part of a *Shari'a* compliant financing involving an Islamic bank and the *Shari'a* compliant acquisition of German-*situs* real estate.

# Italy

In Italy there are no specific tax laws or guidance dealing with Islamic finance transactions, and the Government has not indicated that it intends to provide any incentives towards the development of Islamic finance.

Our Italian offices have advised on some Islamic finance transactions, including the acquisition of a commercial asset involving a *Shari'a* compliant financing scheme.

# Luxembourg

For nearly 30 years, Luxembourg has played a role in the growth of the Islamic finance industry in Europe, and the Government is keen to promote its development.

Although, currently, Luxembourg does not have any legal rules specifically targeted at Islamic finance, the Government has published guidelines aimed at facilitating Islamic finance transactions, and awareness of the industry has been promoted through conferences and working groups. In April 2009, the Government announced the following measures to promote Islamic finance in Luxembourg:

– a working group, composed of the main business actors in this field, has been appointed to identify potential obstacles to the development of Islamic finance in Luxembourg;

– the Government has asked the tax authorities to analyse the characteristics of Islamic finance transactions and to propose measures to ensure that such transactions will be treated as much as possible like traditional financing and banking transactions;

– the Government is also analysing to what extent Islamic finance products, such as *sukuk*, may be used to finance certain government activities; and

– finally, the Government announced that it will support the application of the Central Bank of Luxembourg to become the first non-regional member of the Islamic Financial Services Board (the **IFSB**).

On 12 January 2010, the tax authorities in charge of direct taxes (*Administration des contributions directes*) issued guidelines to clarify certain Luxembourg tax aspects of *murabaha* and *sukuk* structures. By virtue of these guidelines, *murabaha* and *sukuk* transactions should mostly be assimilated to conventional financing methods for Luxembourg income tax purposes. The A&O briefing on these changes can be found here.

On 17 June 2010, the tax authorities in charge of indirect taxes and value added tax (**VAT**) (*Administration de l'Enregistrement et des Domaines*), published guidelines to clarify the registration tax and VAT aspects of *murabaha* and *ijara* structures. The A&O briefing on these changes can be found here.

The Government continues to promote Luxembourg as an Islamic financial centre and, in May 2011, Luxembourg hosted the eighth IFSB summit.

Our Luxembourg office has experience in advising on Islamic finance transactions, including in relation to a *murabaha* financing, setting up a *Shari'a* compliant Luxembourg securitisation company and advising on Luxembourg tax aspects in relation to a default and the consequences thereof in the context of an existing *murabaha* deal.

Members of the Luxembourg team have also written articles on the Luxembourg tax treatment of Islamic finance transactions, including real estate *murabaha* transactions in Luxembourg, and are part of a working group for the promotion of Islamic finance chaired by the Luxembourg agency Luxembourg For Finance.

# Netherlands

There is no specific tax legislation regarding Islamic finance in the Netherlands. The Ministry of Finance and the Dutch Central Bank have shown some interest in Islamic finance, with several studies being carried out. However, it remains the case that only a few Islamic finance transactions have been carried out to date in the Netherlands. If *Shari'a* compliant instruments are structured properly from a Dutch tax point of view, payments on these instruments (a) should be deductible for Dutch tax purposes; and (b) may not be subject to Dutch withholding tax.

# Spain

Spain does not have any specific laws which specifically focus on Islamic finance, although there are signs that some Spanish banks are increasingly providing *Shari'a* compliant retail products.

# United Kingdom

In the last decade, the Government has demonstrated that it is keen to promote the development of Islamic finance in the UK. This has reflected significant growth in both the wholesale and retail Islamic finance sectors.

Since 2003, a number of changes to the tax legislation have been introduced, aimed at facilitating Islamic finance transactions. The Government's policy objectives are, first, to establish and maintain London as Europe's gateway to international Islamic finance; and, secondly, to ensure that everybody, irrespective of their religious beliefs, has access to competitively priced financial products. Accordingly, the tax legislation dealing with Islamic finance transactions applies to "alternative finance arrangements" which do not need to be *Shari'a* compliant as such.

In order to deliver these policy objectives, the Government's main aim has been to remove uncertainty in the tax legislation. The key principles are that: (a) treatment should follow the economic substance of the transaction; (b) treatment should be on the same basis as equivalent financial products that bear interest; (c) ordinary tax rules should be applied where possible; and (d) rules that give undesirable or unpredictable results should be amended.

The Government has introduced legislation making provision for the following types of "alternative finance arrangement": (a) purchase and resale arrangements (intended to describe *murabaha* arrangements); (b) diminishing shared ownership arrangements (relating to diminishing *musharaka* arrangements); (c) deposit arrangements (relating to *mudaraba* arrangements); (d) profit share agency arrangements (relating to *wakala*); and (e) investment bond arrangements (intended to facilitate *sukuk* transactions). The Government has also announced that it is considering introducing rules dealing with *Shari'a* compliant variable rate financing arrangements and derivatives.

Where the alternative finance arrangement legislation applies, the parties are, broadly speaking, treated as if they have entered into a loan for UK tax purposes. The profit return element (referred to as "alternative finance return") is treated as if it were interest payable under the relevant loan.

There are also provisions which provide for relief from Stamp Duty Land Tax (**SDLT**) for certain *Shari'a* compliant structures (including certain *ijara*, *murabaha* and *sukuk* arrangements).

Because of EU law constraints, there is, however, no specific UK VAT legislation which specifically deals with *Shari'a* compliant transactions, although guidance has been provided by the UK tax authorities.

At one stage, the Government was considering the feasibility of issuing wholesale sovereign *sukuk*. However, in 2008 it was announced that that issuing such sovereign *sukuk* would not represent value for money at that time, although the situation is understood to remain under review.

Our London tax department has been involved in a wide number of Islamic finance transactions, ranging from *murabaha* financing and sub-participation arrangements to *sukuk* transactions, including providing advice to UK banks on structuring *sukuk* issuances. Members of the department have also been involved in HMRC's Islamic Finance Tax Technical Working Group.

# United States

The US Internal Revenue Code of 1986 does not provide for rules which specifically deal with Islamic finance transactions. Instead, the US federal tax consequences of such transactions turn on the application of fundamental principles that govern a wide variety of financing transactions.

There is no specific active support from the Government/ other local regulatory authorities for the development of Islamic finance.

Our New York and London US tax teams have advised on the US tax consequences of a number of *sukuk* transactions, including *sukuk* issued by the Republic of Indonesia and the Federation of Malaysia, respectively.

# Key contacts

If you require advice on any of the matters raised in this document, please call any of our Tax partners or your usual contact at Allen & Overy.


Andrew Stals
Partner
Australia
Tel +61 2 9373 7857
andrew.stals@allenovery.com

Patrick Smet
Partner
Belgium
Tel +32 2 780 24 31
patrick.smet@allenovery.com

Christopher Thompson
Associate
Belgium
Tel +32 2 780 24 58
christopher.thompson@allenovery.com

Jean-Yves Charriau
Partner
France
Tel +33 1 40 06 53 60
jean-yves.charriau@allenovery.com

Mathieu Vignon
Partner
France
Tel +33 1 40 06 53 63
mathieu.vignon@allenovery.com

Asmus Mihm
Partner
Germany
Tel +49 69 2648 5796
asmus.mihm@allenovery.com

Tim Spranger
Associate
Germany
Tel +49 69 2648 5437
tim.spranger@allenovery.com

Francesco Bonichi
Partner
Italy
Tel +39 06 6842 7566
francesco.bonichi@allenovery.com

Michele Milanese
Associate
Italy
Tel +39 06 6842 7573
michele.milanese@allenovery.com

Jean Schaffner
Partner
Luxembourg
Tel +352 44 44 5 5410
jean.schaffner@allenovery.com

Paul Berna
Associate
Luxembourg
Tel +352 44 44 5 5228
paul.berna@allenovery.com

Godfried Kinnegim
Partner
Netherlands
Tel +31 20 674 1120
godfried.kinnegim@allenovery.com

Gerard van der Linden
Associate
Netherlands
Tel +31 20 674 1217
gerard.vanderlinden@allenovery.com

Carlos Albinana
Partner
Spain
Tel +34 91 782 99 21
carlos.albinana@allenovery.com

Christopher Harrison
Partner
UK
Tel +44 20 3088 3638
christopher.harrison@allenovery.com

David Hughes
Partner
UK
Tel +44 20 3088 3630
david.hughes@allenovery.com

Mark Middleditch
Partner
UK
Tel +44 20 3088 3698
mark.middleditch@allenovery.com

Vimal Tilakapala
Partner
UK
Tel +44 20 3088 3611
vimal.tilakapala@allenovery.com

Craig Cohen
Senior Counsel
USA
Tel +1 212 756 1162
craig.cohen@allenovery.com

Jack Heinberg
Partner
USA
Tel +1 212 610 6383
jack.heinberg@allenovery.com

**Allen & Overy LLP**

One Bishops Square, London E1 6AD, United Kingdom
Tel +44 20 3088 0000
Fax +44 20 3088 0088
www.allenovery.com