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ALERTS

Let's re-energize the industry

Following the introduction of tax neutrality laws to facilitate the issuance of Sukuk by the UK, France and Luxembourg in recent weeks, Ireland is the latest EU state to join the club. The Irish finance ministry has introduced significant amendments to facilitate Islamic finance transactions, especially the origination and issuance of Sukuk. Dublin has emerged as an Islamic investment fund domicile to rival the Channel Islands and Luxembourg.

Elsewhere, matters concerning Islamic finance continue to move apace. An Islamic Development Bank unit is helping set up an Islamic bank in the Maldives. Zambia is formulating guidelines for Shariah compliant banking services, even though Muslims make up only about 12% of the country's 12.5 million people. The expectation is that the move to accommodate Islamic finance would help the economy of the southern African country through its potential to inject liquidity in the financial markets and its ultimate impact on the cost of funds. Zambia is in fact taking the cue from several African countries which have begun developing Islamic finance services to attract wealth and create jobs.


India is planning to overhaul the regulation of its financial system to attract investments from the Gulf and to encourage its largely unbanked Muslim population to save money in a Shariah compliant way. China, with 80 million Muslims, recently awarded its first license for Islamic banking to Bank of Ningxia, a move that could pave the way for Shariah compliant financing in the rest of the country.

Standard & Poor's (S&P) credit analyst Mohamed Damak said: "Islamic finance has become a recognized and specific segment of finance on its own with still-bright growth prospects. It is set to make further inroads in developed Western markets while Southeast

Asian countries will likely fuel the Islamic finance advance in Asia in 2010."

However, S&P said there are a number of important questions for which the answers are not necessarily yet clear but that may play a part in shaping the sector's future growth. Specifically in non-Muslim countries, and especially in Europe, they include the size of demand for Shariah compliant products, regulatory and tax environments, the support of the political and financial communities, sovereign Sukuk issuance, and the possibility of a common strategy for extending Islamic finance across EU countries.

Certainly, the need for a common strategy for the whole industry is becoming more obvious. The industry, and those who oversee it, needs to stop nitpicking on the Shariah qualifications of each others' products and begin to see the forest rather than the trees. The period since the height of the global financial crisis has shown that the Islamic finance industry has been largely unable to capitalize on the demand for a financial system in which its users will have greater trust.

There is certainly an urgent need to re-energize the industry and transform it into a more unified form. Instead of a Gulf versus Southeast Asia game plan, why not work towards developing a deeper consciousness of sincere collaboration that focuses on establishing common ground? The practitioners, regulators and other players must confront the challenges of working together towards having aggressive strategies that dispel all the popular misconceptions about Islamic finance and expose it for what it truly is. As prominent Asian banker Nazir Razak said, "We all know that the best of ideas will not be well received unless they are well explained." 

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FORWARD BANKING  **CIMB ISLAMIC**

Luxembourg's Tax Treatment of Islamic Finance

By Samia Rabia and Jean-Luc Dascotte

Luxembourg is considered to be one of the hubs for the development of Islamic finance in Europe. The Grand Duchy is today ranked second in the European Union for the listing of Sukuk. Currently, 16 Sukuk have been issued either by sovereign states — including Qatar, Dubai, Malaysia, Saudi Arabia and Pakistan (sovereign Sukuk) — or public or private companies (corporate Sukuk) listed on the Luxembourg Stock Exchange for an aggregate value of US\$5.5 billion.

Another of the numerous illustrations of Luxembourg's involvement is that a large number of national or private institutions — including the Ministry of Finance, ALFI (the Association of the Luxembourg Fund Industry) and LuxembourgForFinance — are actively taking part in committees or working groups which aim to identify any potential obstacles which may hinder Islamic finance's growth and to ensure that the legal and financial environment is particularly conducive to the expansion of Shariah compliant products and transactions.

In addition, the Luxembourg Central Bank became the first non-Muslim organization member of the Islamic Financial Services Board (IFSB) in August 2009. The State of Luxembourg would also contemplate to issue Sukuk.

Even if many Shariah compliant transactions are taking place in Luxembourg, including through the setting up of Shariah compliant funds, one of the obstacles hindering the development of Islamic finance in Luxembourg was the relative uncertainty as regards the tax treatment of different Islamic products which may have differed from standard transaction already known to the Administration des Contributions Directes (the tax authorities).

The tax authorities issued a circular on the 12th January 2010 summarizing the different Islamic products and their tax implications. It is the first official document issued by the tax authorities in relation to Islamic finance and is of practical importance for two reasons:

- It provides the first "official" definition of the Islamic products which already exist on the Luxembourg market.
- It explains and details the tax treatment of the Murabahah and Sukuk which are the most used Islamic products.

The definition of Islamic products

The products have been defined as follows:

Murabahah: Transaction allowing the client (the investor) to buy property without having to subscribe to an interest-bearing loan. The equity contributor (for example a bank) (the financier buys the property and then sells it to the investor on a deferred basis. This is a financial scheme to be used for any type of Shariah compliant asset, but principally for real estate (or stocks, commodities or such like).

Musharakah: Investment via a holding in which the share of the profit is determined beforehand and the losses apportioned to each investor are limited to the amount invested. The payments made in installments represent part repayment of the capital and part allocation of profit.

Mudarabah: Type of specialized investment in which the contributor and the beneficiary of the contribution share the profits. If the investment project fails, there is a risk of loss of the equity, but if the investment is profitable, the contributor is entitled to receive a fee for

services rendered. If the investment is not profitable, the contributor is not entitled to any fee.

Ijarah: Leasing agreement in which the contributor of equity (generally the bank) buys property on behalf of its client and then provides its client with the property in return for a rent over an agreed period.

Ijarah wa iqtina: Similar mechanism, with the possibility for the client to buy the property upon maturity of the contract.

Istisna: Consists of the financing of the production of property via an advance of payment for future delivery or a future payment for a future delivery.

Sukuk has been defined as a debt instrument whose income and capital return depend on the performance of underlying assets. Assets must be corporeal assets or the usufruct thereof.

On this basis, the major contribution of the circular is that the tax authorities clearly clarified the tax treatment of the revenues of each party deriving from transactions including Murabahah and Sukuk.

The taxation of Murabahah

Before the circular, the issue was whether the profits deriving from the sale of goods between the financier and the investor was to be:

- considered as acquired as from the signing of the agreement and therefore taxable forthwith in spite of the deferred payment; or
- treated as interest (and in this case taxed as accrued interest).

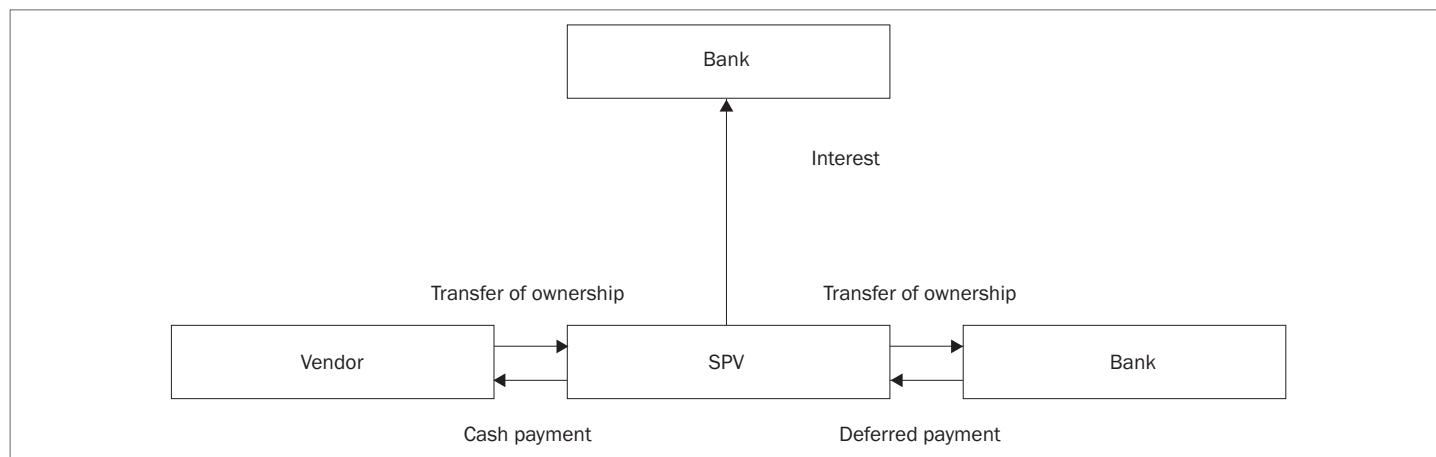
Applying tax law strictly to Murabahah would adversely affect its development in Luxembourg. The tax authorities consequently resorted to the substance-over-form approach of the transaction, as provided for by the Loi d'adaptation special (special consenting law), in order to characterize the profit realized by the financier as interest. Such treatment defers taxation of the income until the maturity of the transaction and the periodic payments is deductible at the level of the investor.

Nevertheless, such tax treatment is subject to the following conditions:

- The agreement between the parties must clearly state that the financier is acquiring goods with the aim of reselling them immediately or within a maximum period of six months following the initial acquisition.
- The agreement must clearly identify the financier's remuneration for his intermediary services, the financier's remuneration consisting of the deferred payment as counterpart, the purchase price paid by the client and the purchase price paid by the financier.
- The financier's remuneration must be expressly stated, known and accepted by both parties to the agreement.
- The financier's remuneration must be specified as the counterpart of the services provided to the client and resulting from the deferred payment granted to the Investor.
- For accounting and tax purposes, the remuneration must be deferred by the financier in its accounts for the duration of the

continued...

Luxembourg's Tax Treatment of Islamic Finance (continued)



deferred payments according on a straight line basis regardless of when the reimbursement is made.

The consideration received by the financier for his intermediary services cannot be spread out and is directly subject to tax.

Example: A bank grants a loan to a special purpose vehicle (SPV) held either by a bank or a trustee. The SPV uses the borrowed funds to buy real property and resells it immediately to the investor. The resale price will include the purchase price, plus the transaction costs, the consideration of the SPV and the accrued interest. At the level of the SPV, the Murabahah transaction amounts to a back-to-back loan, with a taxable profit margin which corresponds to the remuneration of the SPV for his intermediary services.

Taxation of Sukuk

Before the circular, one wondered whether such “certificates” could be regarded as debt from a tax perspective so that Sukuk’s revenues were deductible at the level of the issuer and the return was or not subject to withholding tax. According to the circular, the Sukuk’s tax treatment is that of a debt instrument, although the yield on the structure is commensurate with the return on the underlying asset (variable return), and the yield on Sukuk paid to the holders qualifies as interest. As a result, such interest is tax deductible at the level of the Sukuk issuer in the same way as interest on a conventional debt instrument, insofar as it is paid in the interest of the undertaking.

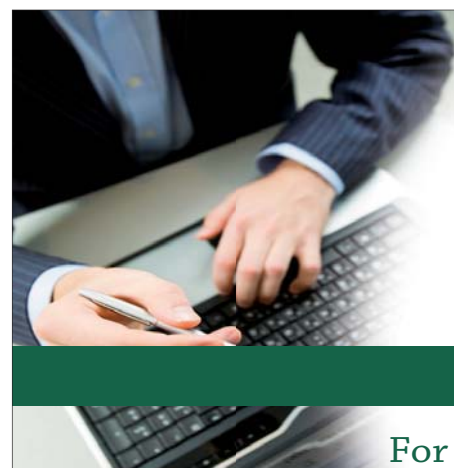
Luxembourg does not levy withholding tax on interest in most cases, except on payments of interest calculated based on profit distributions (profits shares), interest paid on profit-sharing bonds and on interest falling within the scope of the EC Savings Directive. The circular states that Sukuk is neither a profit-sharing instrument nor a participating bond. As a consequence, no withholding is to be levied on payment of the yield. However, the application of the Savings Directive should be checked on a case by case basis, and carefully monitored in light of the impending amendment of the directive.⁽²⁾



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