Excerpt from chapter 17:
Introduction: Islamic Banking
Introduction

General principles

[17.1] Islamic banking refers to financial activity which is consistent with principles of Islamic law. The key principles include the prohibitions on interest (riba), speculation and uncertainty (garhar, maysir), and the prohibition on investment in specific activities (haram). The return from Islamic banking transactions generally arises as profit and loss sharing from investment activity, or profit or fee from sale or lease of assets.

[17.2] Other related principles include prohibition of uncertainty in contract terms, prohibition of investment in banned products and services. In very general terms, the related financial transactions are underpinned by regular cashflows relating to identifiable tangible assets.

Specific country provisions

[17.3] Specific tax laws or tax rulings apply to amounts paid under Islamic finance arrangements in several countries. These provisions have sought to establish a system of taxation which is equivalent to the taxation of other commercial transactions, also known as a ‘level playing field’. Withholding tax or other taxation may therefore potentially apply to payments these structures.

[17.4] These issues were reviewed in PricewaterhouseCoopers Islamic Finance Tax Considerations Around the World ((PricewaterhouseCoopers, 2012): www.pwc.com/en_MY/my/assets/publications/islamic-finance-tax-booklet.pdf at 10 December 2013), and the Australian Board of Taxation in Review of the Taxation Treatment of Islamic Finance (Discussion Paper, October 2010; www.taxboard.gov.au at 9 December 2013). The Board of Taxation Working Group comprised Annabelle Chaplain, Richard Warburton, Elizabeth Jameson, Keith James and Curt Randall. The Board was also assisted by an Expert Panel comprising Asad Ansari, Michael Barbour, Emmanuel Alfieris, Hyder Gulam, Zein El Hassan, Kirsten Fish, John Masters and Shahriar Mofakhami). Both these publications are recommended for further reference. The following comments and discussions are an introduction to this broad topic.

[17.5] The United Kingdom introduced provisions that applied to Islamic financing structures as ‘alternative finance arrangements’ (Corporation Tax Act 2009 (c 4), Ch 6, Part 6, updating earlier provisions in Finance Act 2005 (c 7)). The provisions established a deemed ‘alternative finance return’ under these arrangements, and required this amount to be treated in the same manner as interest for tax purposes, rather than as distributions. (See Her Majesty’s Revenue and Customs, Corporate Finance Manual, ‘CFM44010 – Deemed loan relationships: alternative finance: overview’: www.hmrc.gov.uk/manuals/cfmmanual/CFM44010.htm at 9 December 2013.)

[17.6] The French tax authorities issued rulings in February 2009, principally providing for treatment assimilated to debt instruments for tax purposes, so that, in general, accruals taxation applied to murabaha profit, payments relating to sukuk are tax deductible, and the related payments are exempted from withholding tax when paid to non-French tax residents. (See Bulletin Officiel des Impôts, Direction Générale des Finances Publiques, 4 FE/09, No 22 du 25 février 2009, Régime Applicable aux Opérations de murabaha et aux sukuk) Tax administration updated guidelines including murabaha, ijara, istisna and sukuk were published in August 2010. (See Bulletin Officiel des Impôts, Direction Générale des Finances Publiques, 4 FE/S1/09 n° 78 du 24 août 2010: Régime applicable aux opérations de murabaha; 4 FE/S2/10 n° 78 du 24 août 2010 Régime applicable aux sukuk d'investissement; 4 FE/S3/10 n° 78 du 24 août 2010 Régime applicable aux opérations d'ijara; and 4 FE/S4/10 n° 78 du 24 août 2010 Régime applicable aux opérations d'istisna.)

Tax treaties

[17.7] There is a related issue as to whether payments made under Islamic financing products may be eligible for reduced withholding tax under tax treaties, as discussed by Mohammed Amin in ‘When do cross-border Islamic finance payments suffer withholding tax?’ (Islamic Finance News, 15 February 2012). Article 11(3) of the OECD 2010 Model Tax Convention on Income and on Capital, for example, defines interest as follows:
‘The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures…’

[17.8]
On this basis, for example, a murabaha contract relating to commodities which is essentially based on a deferred sale may potentially not be treated as interest where there is no related debt-claim. This can be contrasted to recent tax treaties such as the United States/United Kingdom 2001 tax treaty (Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, 24 July 2001, 2224 UNTS 247 (entered into force 31 March 2003)), which defines interest as follows:

‘The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor’s profits, and, in particular, income from government securities and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds or debentures, and all other income that is subjected to the same taxation treatment as income from money lent by the taxation law of the Contracting State in which the income arises…’

[17.9]
The murabaha contract may be treated as interest under this tax treaty because United Kingdom tax provisions now assimilate the return on Islamic financing products to the same tax treatment as interest. This would result in nil withholding tax for payments relating to that tax treaty.

Malaysia – tax incentives

[17.10]
A related development is the provision of specific tax concessions to encourage Islamic banking. This includes incentives provided under the Malaysia International Islamic Financial Centre (MIFC), including a ten year tax exemption earned from the Islamic banking business in foreign currencies, tax exemption on any profits paid out by Islamic banks to non-resident companies and institutions for deposits placed at the banks, and 20% stamp duty remission on approved Islamic finance instruments. (See PricewaterhouseCoopers, ‘Malaysia, Asia's Islamic Finance Hub’ 61, www.pwc.com/en_my/my/assets/publications/islamic-finance-hub.pdf at 10 December 2013.)
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