SUBMISSION on [Discussion paper on the review] of the taxation treatment of Islamic finance, banking and insurance products released 13 October 2010

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Introduction

The Islamic Finance industry in Australia has been around since February 1989 with the establishment of a community based co-operative called Muslim Community Co-operative Australia Ltd. I served as board directors from January 2007 to October 2010 and Managing Director from May 2008 to February 2010 having steered it through the turbulent GFC.

Within this time, MCCA has pioneered and established the market for Islamic Finance – lawyers have been educated and former staff of MCCA have established their own business initiatives with this innovative industry.

In my capacity as Managing Director, I submitted a paper to the Johnson Committee in person to the then Minister for Superannuation and Financial Services, Hon Chris Bowen in person on the barriers to Islamic Finance in Australia.

In February 2010, an opportunity arose to focus on the asset side of the IB&F, and Crescent Investments Australasia was established to offer wealth management products. Led by 4 high profile community leaders based in Sydney, the value proposition is largely aimed at the funds management and Superannuation within the Australian Muslim community at first, then to the wider Australian population in the second stages of its rollout. In June 2010 the responsible entity, a subsidiary of Crescent Investments Australasia, called Crescent Funds Management (Aust) Ltd, an unlisted public company embarked on developing Australia's first registered Shariah Compliant Australian Equity Fund Scheme – and using our appointed taxation adviser and auditor, Ernest & Young, we came across a number of challenges and the treatment of tainted income upon distribution of income was one of them. This will be addressed in this submission.

Crescent, myself in particular, have expertise in Islamic Banking and Finance, having presented in the Middle-East and GCC, toured with the Assistant Treasurer, Hon Senator Sherry, and the South-East Asian region and we have been advocates for Australia as an emerging market for IB&F. It gave me great pleasure to hear Hon Nick Sherry announce during the tour that he had directed a review of Islamic Finance to the Board of Taxation. In Australia i have lectured and presented on IBF as well as the Islamic Economic System[1] and how we can learn from such a system to benefit our own economy.

The board of Crescent, all community leaders, are committed to investing in this industry and are committed to its success.

We have attended the board's consultation meeting at the Grace Hotel on 11th November 2010 and we were proud that we could contribute solutions to issues raised on the day. In this paper we will provide a submission to the Board of Taxation Review on Islamic Finance released on 13th October 2010.

Further we have continued to raise the awareness of this BoT review in our travels around the world as we raise Australia's profile in this untapped gold mine for Australia's economy.

[1] Melbourne University – Graduate Management Certificate – Islamic Finance Module.
University of western Sydney – Parramatta Campus. Islamic Awareness week.

The Board of Taxation Review on Islamic Finance-terms of reference

Our submission will be made in conjunction with the terms of reference released on 12 May 2010 to the Board of Taxation. Specifically, the Board is asked to:

• identify impediments in current Australian tax laws (at the Commonwealth, State and Territory level) to the development and provision of Islamic finance products in Australia;

• examine the tax policy response to the development of Islamic finance products in other jurisdictions (including the United Kingdom, France, South Korea and relevant Asian jurisdictions); and

• make recommendations (for Commonwealth tax laws) and findings (for State and Territory tax laws) that will ensure, wherever possible, that Islamic finance products have parity of tax treatment with conventional finance products.

We make the point that the Expert Panel contains legal practitioners who have no experience in either Taxation or Islamic Finance and, apart from Mr John Master's more expert's should have been added from the United Kingdom as a way of integrating their experience as we move into the this critical phase.

Scope

We accept that in the past 20 years, Islamic Finance based contracts have largely been sold under the Uniform Consumer Credit legislation and now under the new Credit Code legislation. Whilst this has not been ideal, it is the best the Australian Muslim community can do to fulfil their spiritual requirements. This compromise has not been without it's challenges – MCCA has taken on the liability when underwriters have rejected mortgage default cases and industry loathes the idea that such a contract is taken to the courts for disputes given such contracts are not ratified under common law. All the more reason the BoT review is vital and grossly needed.

Our submission is focussed on asset based products such as funds management and superannuation. It is not meant to be technical, especially in so far as the application of the law is concerned.

It is the view of Crescent that the 80/20 rule apply to progress to avoid being caught up in controversial topics such as differences of Islamic Schools of Thought (5 +) which can be likened to Keynesian and Classical schools approach to macroeconomics with respect to monetary and fiscal policies. Other challenges are NOT to focus on taxation impacts of controversial products such as Tawarruq (s2.10 of the BoT review document) which are considered asset based contracts involving immediate cash advances.

This paper will also put forward some views about Islamic Finance especially in terms of a finance lease (Ijara) on a property acquisition that may implications to the Residential Tenancies Act (June 2010 as amended)

Crescent will also provide input into insurance products - Takaful which are not finance based products but can be related and integrated into the world of funds management where reserves of donations are adequate.

Tainted Income in Asset Management

Managed Funds

Crescent Investments Australasia has produced Australia's first wholesale and retail Australian Equity Fund. In setting up the structure with our outsourcing provider Whites Outsourcing, it became clear that treatment of tainted income was a challenge.

A definition for "Tainted Income" is already covered as part of s433 of the ITA 1936. However the definition of the Tainted Income as applicable to Islamic Finance is as follows:

1. Income derived from impressible sources such as businesses involved in manufacturing and sales of Alcohol, Tobacco, Pork products, interest/usury banking or financial services based products to name but some.
2. Income received from bank accounts
3. Part of permissible dividends declared and payable which is considered to be impermissible.

The key underlying principle behind tainted income is that investors should not receive this income. This has implications to the manner in which fund assessable and taxable income is calculated and derived. Further when calculating the Net Tangible Asset value, since no benefit has been derived from the tainted income, it should be excluded from the NTA which is used to calculate updated unit prices in a trust structure.

Ideally all tainted income should be paid directly to a registered charitable organisation eg Kidney or McGrath Foundation. The value of which should not be reported nor advised to investors or unit holders.

This section needs to be reviewed in light of the recent legislative changes introduced to the MIT withholding tax & Capital Account Election regime. Crescent is impacted by this election since our products will be heavily markets to institutional and professional investors from overseas and in particular the Middle-East and the GCC.

Opportunity: the BoT review does not address the taxation treatment of tainted income in managed funds. It also has not examined tainted income in light of MIT proposed changes.

Superannuation

The Superannuation Industry Supervision Act (SIS) makes clear distinction that once funds enter the 'super system' it can only leave the 'system' under strict conditions as supervised by Trustees of the Superfunds.

Today there are no “Shariah compliant” superannuation schemes recognised by community leaders. Products that exist are conventional superannuation products that have been rebadged as “Islamic” or “Shariah compliant” – generally these have been shunned by superannuants requiring such products. Crescent believes that up to $6B is invested on behalf of Australian Muslims where about 50% is invested in non Shariah compliant products.

Like managed funds, the issue arises in tainted in a very similar way. With SIS disclosure, a member must be privy to the tainted income and once the member is advised, they are required to donate an amount equivalent to a charity. Today many Australian Muslims are setting up high cost SMSF to select asset classes that do not experience tainted income eg commercial property acquisitions.

Again the board of taxation needs to address the treatment of this tainted income at the fund level prior to any distribution being made to the member of the superfund.

Crescent and other fund managers are embarking on setting up Shariah compliant superannuation funds and appointed back office administrators and fund accountants will need to be advised about the taxation treatment of tainted income and how they are to be reported.

Leases and Residential Tenancies Act

Section 2.16 and 2.17 of the BoT review paper defined Ijara (Operating lease) and Ijarah Muntahiah Bi Tamlik (Finance lease) respectively.

So far, working within conventional means and legislation, these products have been produced under the Credit Code legislation. However these products carry with them great risks:

1. The contracts modified slightly to give the look and feel of a lease to own contract will not hold up in court and could cost the financer and financier significant time, effort and money to uphold the terms of the contract to the presiding judge
2. The contracts modified slightly have been offered to Australian Muslims at a cost greater than the offerings of non conventional banks and banks
3. The underwriting policies of funders willing to modify the contract are very stringent with the Islamic Finance customers and most often about 60% of applicants are rejected – this is because funders are adhering to their credit code policies and legislation and are attempting to minimise risk to their finance portfolio.
4. Ultimately the end reporting would show a debt-like instrument which does not completely satisfy the customer

Lease to Own is a concept that is widely accepted by the Shariah. However the term “lease” would not indicate that the provisions of a debt related instrument would be needed. Instead the term lease should trigger the terms and conditions of a landlord and tenant relationship.

Under IBF it is possible that the funder becomes the landlord who will accept certain obligations and the tenant is willing to pay future cash-flows in the hope of owning the property after an agreed period. Essentially the tenant pays a mark up rental to use the beneficial rights (s5.26) to the property that is technically owned by the funder. The Australian legislation, starting with the tax aspects needs to recognise a funding arrangement under an Ijara contract under the provisions of the Residential Tenancies Act and does not constitute a debt in the conventional terms. This means that the word "rent" would uphold all the definitions currently attributed to the word "interest" in a conventional sense.

Insurance based products – Takaful

S2.19 of the BoT review defines this product. s2.19 makes reference to "profits" which is not entirely correct in our opinion as we do not feel a profit can be made when participants into takaful are making contributions. However we do agree in the concept of "risk sharing." In Crescent's terminology, Takaful is another term used to provide "protection" or "group risk sharing" against a calamity. The word "protection" is used rather than a "guarantee" which is often associated with conventional insurance based products.

Further to s4.115 of the BoT review, Takaful invites participants to donate on a monthly basis with a mutual desire to provide limited protection and assistance in the event of a calamity. At the end of the year, contributions not paid out for claims and fund expenses would be rebated back to the participants in their capacity as owners of the scheme. For example, a funeral fund is a good example of Takaful where the expenses of a funeral would be covered by the participants in the event of the death of a contributor. This type of product is permissible, whereas the conventional insurance product is where a cash payment is made upon a claim and excess premiums left in reserves are kept by the insurance company. A conclusion from this type of model is that it is based on a mutual (s4.118 makes reference to "principle of mutuality").

Crescent does not believe that the concept of "principle of mutuality" should give rise to the view that of carrying on an insurance business.

The community should be able to provide such a "principle of mutuality" for motor cars, boats, buildings, contents without fear of APRA defining them as "insurance products." Accordingly the tax treatment should reflect a mutual aid scheme rather than an insurance company where the premiums are considered assessable income. The contributions of a mutual aid or takaful scheme should not be defined and taxed as "premiums."

Takaful products could be Re-takaful (as in the case of Re-Insurers) which is particularly needed for the cases when a participant cause insurmountable damage such as colliding into an office tower where the costs are likely to run into the millions of dollars. Re-takaful companies can help minimise the risk of failure of Takaful products.

Finally Crescent expects to be able to invest such contributions in a Shariah compliant manner so that the rebate back to the members at the end of the calendar year could become higher. Crescent is in discussions with a Malaysian Takaful provider and we are addressing these issues from a taxation and legal structure point of view.

Conclusion and recommendations

The Board of Taxation review is a wonderful initiative to put Australia on the IB&F radar. Whereever I have travelled and made reference to the BoT review the response I get is that this is great and how soon before IB&F can be expanded into Australia. These are questions for Treasury to answer.

To this end, Treasury must be commended for producing this paper and although Crescent may not engage in Islamic Finance (debt based) products in the next few years, we feel the GST, CGT, and Income tax implications have been covered adequately.

The key challenge for IB&F, Crescent sees is the removal of double stamp duty on property acquisitions at the federal level where the acquisition was made for the purposes of financing a property. This form is much better than the use of the conventional mortgage.

On the Islamic Funds (asset based) we have provided some key points in the need to address taxation as it applies to Tainted Income within Trust and Superannuation structures. We feel that our appointed tax adviser, Ernest & Young will make their own submission covering the detail of these requirements.

It would be good to involve the industry practioners from here onwards in the development of a high level timetable and identify risks and issues for the planned removal of the taxation impediments to IB&F.

Finally our key recommendation would be for BoT to address taxation implications relating to the Islamic funds and asset management products impact of Tainted Income.