



**Australian Government**

**The Board of Taxation**

# REVIEW OF THE TAXATION TREATMENT OF ISLAMIC FINANCE

Discussion Paper

the **board** of **taxation**  
[www.taxboard.gov.au](http://www.taxboard.gov.au)

**Board of Taxation**  
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## FOREWORD

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The Board of Taxation (Board) has been asked by the Government to review the taxation treatment of Islamic finance products. This review arises from the report of the Australian Financial Centre Forum, *Australia as a Financial Centre – Building on our Strengths*, which recommended that the Board of Taxation undertake such a review ‘in order to ensure that Islamic finance products have parity with conventional products, having regard to their economic substance’ (Recommendation 3.6).

The purpose of this discussion paper is to facilitate the development of appropriate responses to remedy impediments in the law in a way that is consistent with the terms of reference for this review. To assist stakeholders the paper:

- examines the current approach to finance taxation in Australia;
- identifies issues associated with Australia’s current approach to the taxation of Islamic finance products; and
- examines the tax policy response to the development of Islamic finance products in other jurisdictions (including the United Kingdom, France, South Korea and other relevant jurisdictions).

Consultation with industry and other affected stakeholders and submissions from the public will play an important role in shaping the Board’s recommendations to the Government.

The Board has requested that submissions regarding this review be made by 17 December 2010 to enable the Board to finalise its report in the timeframe requested by the Government.

Annabelle Chaplain  
Chairman  
Working Group

Richard Warburton AO  
Chairman  
Board of Taxation



## EXECUTIVE SUMMARY

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The Board has been asked to review the taxation treatment of Islamic finance products and to 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.

Conventional banking and finance is based on interest bearing loans or investments, or equity financing arrangements. Islamic banking and finance provides equivalent functionality to conventional finance but the underlying arrangement is based on the trading of assets, profit and loss sharing investments or leasing arrangements.

The terms of reference ask that, if the Board concludes that amendments to the tax law are required, the Board should consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic financial products. In this regard, the terms of reference recognise that there are various tax frameworks or regimes in the current law that specifically deal with financial products.

Chapter 1 provides an overview of the review process including the terms of reference for the review, consultations and guidelines for submissions.

Chapter 2 provides an overview of the principles of Islamic finance including the main types of Islamic finance products. It also considers the opportunities that Islamic finance may provide Australia.

Chapter 3 summarises the frameworks in the existing tax law for the taxation of financial products. The frameworks include income tax, interest withholding tax, goods and services tax and state taxes.

Chapter 4 looks at how those frameworks apply, and the issues raised by them, in the context of case studies that are consistent with the principles of Islamic finance. The issues include uncertainty in the application of the law, double taxation, tax treatment that does not appropriately recognise the financing component of arrangements and increased cost of certain Islamic finance products in comparison to conventional finance.

Chapter 5 examines the tax policy response to the development of Islamic finance products in other jurisdictions.





## CHAPTER 1: INTRODUCTION

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1.1 The then Assistant Treasurer and the Minister for Financial Services, Corporate Law and Superannuation announced on 26 April 2010, that the Board would undertake a comprehensive review of Australia's tax laws to ensure that, wherever possible, they do not inhibit the expansion of Islamic finance, banking and insurance products.

1.2 In May 2010 the then Assistant Treasurer launched a book entitled *Demystifying Islamic Finance – Correcting Misconceptions, Advancing Value Propositions*. At the launch the then Assistant Treasurer said:

We are taking a keen interest in ensuring there are no impediments to the development of Islamic finance in this country, to allow market forces to operate freely. This is in line with our commitment to foster an open and competitive financial system, and a socially inclusive environment for all Australians. We also recognise that Islamic finance has great potential for creating jobs and wealth.

### TERMS OF REFERENCE

1.3 The then Assistant Treasurer announced the terms of reference for the review on 12 May 2010. 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.

1.4 In conducting the review, the Board has been asked to have regard to the following principles as far as possible:

- The tax treatment of Islamic finance products should be based on their economic substance rather than their form.

- Where an Islamic finance product is economically equivalent to a conventional finance product, the tax treatment of the two products should be the same.
- If the Board concludes that amendments to the tax law are required, the Board should consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic finance products.

1.5 The Board is asked to report to the Assistant Treasurer by June 2011.

### The review team

1.6 The Board has appointed a Working Group of its members comprising Ms Annabelle Chaplain (Chairman), Mr Richard Warburton, Ms Elizabeth Jameson, Mr Keith James and Mr Curt Rendall to oversee its review of the taxation treatment of Islamic finance products. The Working Group is being assisted by an Expert Panel, members of the Board's Secretariat, and officers from the Treasury and the Australian Taxation Office are also assisting in its consideration of the issues. The Expert Panel comprises:

- Mr Asad Ansari – Director, Deloitte;
- Mr Michael Barbour – General Manager Tax, Westpac;
- Mr Emmanuel Alfieris – Head of Trade, Westpac;
- Mr Hyder Gulam – Associate, Logie-Smith Lanyon Lawyers;
- Mr Zein El Hassan – Partner, Clayton Utz;
- Ms Kirsten Fish – Partner, Clayton Utz;
- Mr John Masters – Director, ING Bank Australia; and
- Mr Shahriar Mofakhami – Consultant, Greenfields Financial Services Lawyers.

### REVIEW PROCESSES

1.7 Consistent with the terms of reference for this review, if the Board concludes that amendments to the tax law are required, the Board will consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic finance products. For this reason the scope of the Board's discussion paper is aimed at examining those frameworks and identifying the limitations of Australia's current finance taxation law in delivering on the principles outlined in the terms of reference, particularly in the context of the type of arrangements commonly used in Islamic finance.

## Submissions

1.8 The Board is inviting written submissions to assist with its review. To assist those making submissions, the Board has prepared this discussion paper which:

- examines the current approach to finance taxation in Australia;
- identifies issues associated with Australia's current approach to the taxation of Islamic finance products; and
- provides an overview of the approach to the taxation of Islamic banking and finance in other jurisdictions.

1.9 Submissions should address the terms of reference set out in paragraph 1.3 and the issues and questions outlined in this discussion paper (a full list of questions is at Appendix A). It is not expected that each submission will necessarily address all of the issues and questions raised in the discussion paper. The closing date for submissions is 17 December 2010. Submissions can be sent by:

Mail to: The Board of Taxation  
C/- The Treasury  
Langton Crescent  
CANBERRA ACT 2600

Fax to: 02 6263 4471

Email to: [taxboard@treasury.gov.au](mailto:taxboard@treasury.gov.au)

1.10 Stakeholders making submissions should note that Board members and members of the Board's review team will have full access to all submissions to this review. All information (including name and contact details) contained in submissions may be made available to the public on the Board of Taxation website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like all or part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked 'confidential' will be determined in accordance with that Act.

## Consultation meetings

1.11 The consultation process will provide an opportunity to discuss the issues canvassed in more detail. The Board is planning consultation forums in Canberra, Sydney and Melbourne during the consultation period as a further mechanism for obtaining views and to assist stakeholders in preparing written submissions. Information regarding the consultation forums can be found on the Board of Taxation website, [www.taxboard.gov.au](http://www.taxboard.gov.au) or by calling the Board's Secretariat on 02 6263 4364.

1.12 The Board also proposes to hold targeted consultation meetings with selected stakeholders who have made submissions. The purpose of these meetings will be to clarify aspects of these submissions and to explore possible responses to issues raised in the submissions.

## CHAPTER 2: ISLAMIC FINANCE

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2.1 Islamic finance is a growing market. The global market for Islamic financial services, as measured by Shariah compliant assets, is estimated to have reached \$951 billion in 2008, a 25 per cent increase from \$758 billion in 2007. Assets have grown from about \$150 billion in the mid 1990s. Commercial banks account for the bulk of the assets with investment banks, sukuk<sup>1</sup> issues, funds and insurance making up the balance.<sup>2</sup>

2.2 The Austrade publication titled *Islamic Finance* (2010) identifies that the growth of Islamic finance is being driven by the following factors:

- Petrodollar liquidity: Foreign investment plays an important role for petrodollar investors, whose domestic economies and financial systems are too small to absorb all capital from oil export revenues. This presents significant opportunities for the Islamic banking and finance industry. Petrodollar liquidity is expected to remain high over the long term due to the finite supply of oil reserves;
- Muslim population: Relatively rapid Muslim population growth worldwide and rising living standards will see increased demand for Islamic finance;
- Low penetration levels: In spite of growth in the Islamic banking and finance industry, there remains a lack of depth across asset classes and products, signifying untapped potential. There is considerable scope for further development of Islamic banking and finance in countries such as Indonesia, India and Pakistan, which have the largest Muslim populations in the world; and
- Ethical character and financial stability of Islamic financial products: Islamic financial products have an ethical focus (notably excluding investment in alcohol and gambling) and a risk profile that will also appeal to a wider ethical investor pool.

2.3 Currently, the Middle East and South East Asia are the primary locations for Islamic capital. In particular, Malaysia, Iran and the majority of countries from the Gulf

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1 Sukuk is the Islamic finance equivalent of conventional tradable notes or bonds, which represents the ownership (actual or beneficial) by the sukuk holders in an underlying Shariah compliant asset or financing arrangement. Returns are paid to the investors in line with their proportional ownership in that asset and investment, and vary according to asset performance rather than the time elapsed.

2 International Financial Services London (IFSL) Research, *Islamic Finance 2010*, London, January 2010, p 1-2.

Co-operation Council (GCC) such as Kuwait<sup>3</sup> are seen as the main centres of Islamic finance, with significant activity also taking place in the United Kingdom and more recently in countries such as Turkey, Sudan, Egypt, Jordan and Syria and Asian countries such as Indonesia, Hong Kong, Singapore, Bangladesh, Pakistan and China.<sup>4</sup>

2.4 The Austrade publication identifies that some of the opportunities Islamic finance may provide Australia include:

- attracting foreign Islamic banks and conventional banks with Islamic windows<sup>5</sup> to establish operations in Australia;
- attracting investment in Australian assets and businesses from overseas Shariah investors and tapping into new funding sources through sukuk and other securitised issues;
- Australian based banks providing from Australia a range of Shariah compliant investment and financing products and services to Islamic banks, corporations, institutions and high net worth individuals in the Asia Pacific and the Gulf regions;
- fund managers establishing Shariah compliant funds for Asian and Gulf institutional and high net worth individual investors;
- local exchanges providing Islamic listings platforms for domestic and international issues of Shariah compliant instruments; and
- Australian based financial firms, professional services providers and educational institutions exporting their services into Asia and the Gulf.

## PRINCIPLES OF ISLAMIC FINANCE

2.5 The Islamic finance system is based on the principles of Shariah. The concept that the right to property should come from a person's own labour and the sanctity of contracts are core principles of Islamic finance. Risk sharing, prohibition of interest (a

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3 DFAT country information: Kuwait has significant investment in Australia, at A\$590 million in 2009, in real estate, hotels, banking and a liquid natural gas project. Kuwait Finance House, one of the largest Islamic banks in Kuwait, recently opened an office in Melbourne. Kuwait currently has plans to develop around \$325 billion worth of infrastructure and development projects, representing significant opportunities for Australian companies.

4 International Financial Services London (IFSL) Research, *Islamic Finance 2010*, London, January 2010, p 2.

5 An Islamic window is a specialised arm within conventional financial institutions that offer Shariah compliant products for their clients.

prohibition of pure debt security) and the elimination of contractual ambiguity and other forms of exploitation are some of the implications of these core principles.<sup>6</sup>

2.6 Standard and Poor's have summarised the main features of an Islamic economic system as follows:<sup>7</sup>

### Prohibition of paying and receiving interest

- Interest must not be charged or paid on any financial transaction.

### Prohibition of uncertainty or speculation

- Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

### Prohibition of financing certain economic sectors

- Financing of industries deemed unlawful by Shariah – such as weapons, pork and gambling – is forbidden.

### Principle of profit and loss sharing

- Parties to a financial transaction must share in the risks and rewards attached to it.

### Principle of asset backing

- Each financial transaction must refer to a tangible, identifiable underlying asset.

2.7 Islamic finance broadly describes banking and financial products or arrangements that comply with the principles of Shariah. Conventional banking and finance is based on interest bearing loans or investments, or equity financing arrangements. Islamic banking and finance provides equivalent functionality to conventional finance but the underlying arrangement is based on the trading of assets, profit and loss sharing investments or leasing arrangements.

2.8 Islamic banking, finance and insurance products are structured based on either one or a combination of Shariah compliant financing contracts or concepts. A summary of the main contracts follows.

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6 Iqbal, Z & Mirakhor, A *An Introduction to Islamic Finance: Theory and Practice* (Wiley 2007) p 53.

7 Standard and Poor's, *Islamic Finance Outlook 2010*, (2010) p 61.

### **Murabahah (Cost plus profit sale)**

2.9 Murabahah refers to the sale and purchase of an asset whereby the cost and profit margin are made known and agreed by all parties involved. The settlement for the purchase can be either on a cash basis, a deferred lump sum basis or on an instalment basis, which will be specified in the agreement.

### **Tawarruq (Cash finance sale)**

2.10 This is a variation of murabahah. Under a tawarruq contract a person buys a commodity or some goods on credit with an understanding of paying back the price either in instalments or in full in the future. The commodity is immediately sold by the person to a third party to obtain cash.

### **Istisna (Purchase order)**

2.11 Under an istisna contract a buyer will require a seller or a contractor to deliver or construct an asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties to the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of work completed.

### **Salam (Forward sale)**

2.12 Salam refers to a contract for the purchase of assets by one party from another party on immediate payment and deferred delivery.

### **Musharakah (Profit and loss sharing partnership)**

2.13 Under a musharakah contract a partnership is established by means of an agreement or arrangement whereby two or more parties agree that each of them contributes to the capital of the partnership either in the form of cash or in kind and shares in its profit and loss. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but a loss will be shared on the basis of equity participation.

### **Musharakah Mutanaqisah (Diminishing partnership)**

2.14 This is a musharakah contract in which one of the parties promises to purchase the equity share of the other party gradually until the title of the equity is completely transferred to them.

### **Mudarabah (Profit sharing partnership)**

2.15 Under a mudarabah contract one party provides capital and the other party acts as an entrepreneur who solely manages the project. If the venture is profitable, the



profit will be distributed based on a pre-agreed profit sharing ratio. In the event of a loss, the loss shall be borne solely by the provider of the capital unless it is due to the misconduct or negligence of the entrepreneur.

### Ijarah (Operating lease)

2.16 Under an ijarah contract a lessor (owner) leases out an asset to its client at an agreed rental fee and pre-determined lease period. The lessor retains ownership of the leased asset.

### Ijarah Muntahiah Bi Tamlik (Finance lease)

2.17 This is similar to the ijarah contract except that the lessor also makes a promise to transfer the ownership of the asset at the end of the lease period via a separate sale agreement or gift.

### Sukuk (Islamic bond)

2.18 Sukuk is the Islamic finance equivalent of conventional tradable notes or bonds, which represents the ownership (actual or beneficial) by the sukuk holders in an underlying Shariah compliant asset or financing arrangement. Returns are paid to the investors in line with their proportional ownership in that asset and investment, and vary according to asset performance rather than the time elapsed.

### Takaful (Insurance)

2.19 Under the takaful contract parties invest in a pooled investment vehicle where they joint-guarantee each other against specified events and profits are paid out to investors upon the occurrence of a specified event. The fund does not seek to make profits but to mitigate its losses. However, the fund may invest surplus funds in Shariah compliant assets or financing arrangements.

### Wakalah (Agency)

2.20 Wakalah is a contract of agency which gives the power to a person to nominate another person to act on their behalf based on agreed terms and conditions.

## ISLAMIC FINANCE IN AUSTRALIA

2.21 Australia has a Muslim population of about 365,000, that is, 1.7 per cent of the total population.<sup>8</sup> There are a small number of Shariah compliant financial products and services currently available in Australia.

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8 ABS 2006 Census.

2.22 There is no fully-fledged Islamic bank or Islamic banking window currently operating in Australia. Westpac and National Australia Bank have both introduced Shariah compliant products to the market. In February 2010, Westpac launched a Special Interbank Placement for Islamic Financial Institutions. The offering is based on commodity inventories. It was launched in conjunction with the release of Austrade's *Islamic Finance* publication. National Australia Bank offers a no interest loan scheme for low income earners (in receipt of Centrelink payments).<sup>9</sup>

2.23 In 2004, Victoria recognised that Islamic finance products should be placed on an equal footing with conventional finance products. One reform was the removal of double stamp duty charges on property purchases. Other changes included recognising the principle of profit sharing and allowing Islamic contracts to avoid certain terms which are not permitted, such as interest.<sup>10</sup>

2.24 A number of institutions have been established in Australia to meet the demand for Islamic finance products. The Muslim Community Cooperative Australia (MCCA), which is headquartered in Melbourne, provides Islamic mortgages. Two smaller firms, Sydney-based cooperative Islamic Cooperative Finance Australia (ICFA)<sup>11</sup> and Iskan Finance<sup>12</sup>, also offer consumers a range of products to facilitate the purchase of homes and funds for education.<sup>13</sup>

2.25 Kuwait Finance House Australia is the first foreign Islamic bank to set up operations in Australia. Currently, its focus is developing wholesale Islamic financial services here but it does have experience in serving the retail market in other jurisdictions such as in Malaysia.

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9 NAB offers No Interest Loans Schemes (NILS®) which by design would be Shariah compliant. NILS® is a community based micro-credit scheme. NILS are designed to offer people on low incomes the opportunity to access credit – for a modest amount, usually between \$800-\$1,000 – for an essential household item or service without any fees, charges or interest payments.

10 Victorian Government fact sheet *Islamic Finance, Melbourne, Victoria, Australia* April 2010.

11 Islamic Co-operative Finance Australia Limited, Auburn NSW Web: <http://www.icfal.com.au/>.

12 <http://www.iskan.com.au/>.

13 Cane, Elton *Retail Delivery & Distribution – Finance with faith* (Foresight Publishing 7 May 2010).

## CHAPTER 3: AUSTRALIA'S FINANCE TAXATION FRAMEWORK

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### OVERVIEW

3.1 The terms of reference ask that, if the Board concludes that amendments to the tax law are required, the Board should consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic finance products. In this regard, the terms of reference recognise that there are various tax frameworks or regimes in the current law that specifically deal with financial products. An issue for examination, therefore, is whether existing frameworks are appropriate for the taxation of Islamic finance products.

3.2 Accordingly, this chapter summarises the frameworks in the existing tax law for the taxation of financial products. Chapter 4 will look at how those frameworks apply and the issues raised by them, in the context of case studies that are consistent with the principles of Islamic finance.

3.3 The Australian finance taxation landscape is made up of substance, form and transaction based frameworks. For instance, various income tax frameworks introduced into the tax law as part of the taxation of financial arrangements reforms (TOFA) have been a response to the failure of general tax provisions to properly reflect the substance of financial products and the financial innovation that has been occurring. As a result, recent income tax reforms to finance taxation have been substance based. The capital gains tax (CGT) framework is a combination of form and substance based rules. The goods and services tax (GST) framework and state duty taxes are transaction based rules.

3.4 In terms of the general income tax provisions the general assessable income provision includes income when it is derived. Expenses incurred in deriving assessable income are deductible when incurred, provided that they are not of a private, domestic or capital nature. To a large degree income and expenses in relation to financial products are recognised for tax purposes when realised. Broadly speaking, the CGT provisions also operate on a realisation basis.

3.5 The traditional judicial approach has been to apply the general income tax provisions to financial products in accordance with their legal form. For example, under a finance lease, the lessor has been taxed on the full lease rentals while being able to deduct capital allowances as the owner of the relevant asset even where the

economic ownership of the asset is held by the lessee. Alternatively, for financial accounting purposes, only the finance charge component of the rental payment is recognised as income of the lessor (without any separate recognition of an expense for depreciation in respect of the asset).

3.6 Another aspect of the tax law outside the specific tax frameworks relating to financial products is that often there is little or no regard to the time value of money. For instance, a CGT event involving the deferral of payment for a disposal of a CGT asset. The proceeds for the purpose of working out whether there is a gain or loss is the nominal amount of the payment, notwithstanding that in substance there is a provision of an asset for its market value at the time it is provided, plus the advance of credit from the vendor of that value until the time of payment.

3.7 Reforms to finance taxation have accordingly sought to better reflect the economic substance of the relevant arrangements and how, in a commercial sense, the arrangements are used and viewed. This chapter sets out the frameworks that have been adopted to give effect to this substance based objective.

3.8 There are special tax arrangements for the taxation of trusts and partnerships. Trust and partnership arrangements are currently excluded from the definition of a financing arrangement.

3.9 Partnerships are associations of general law partners or limited partners carrying on a business in common with a view to profit and also include for income tax purposes an association of persons in receipt of income jointly. A partnership is not a taxable entity unless it is a corporate limited partnership. Each partner is taxable on their share of the net income of the partnership. Apart from certain venture capital limited partnerships and foreign hybrid entities, limited partnerships (referred to as corporate limited partnerships) are taxed like companies for income tax purposes.

3.10 The GST regime applies to the value added on most goods and services consumed in Australia. It applies at a uniform rate of 10 per cent to the supply or importation of taxable goods and services, based on their value. Difficulties in identifying the value added at the transaction level for certain financial supplies means that most financial supplies are input taxed rather than taxable under the GST regime. Input taxation means that entities making financial supplies are not liable to GST on the financial supply and cannot claim input tax credits for the GST paid on related financial acquisitions. Generally financial supplies have the meaning given by the GST Regulations.

3.11 Certain asset financing arrangements are treated as taxable supplies (and not financial supplies) for instance hire purchase and leasing, including leases that are finance leasing arrangements under financial accounting standards. Under a hire purchase, the GST is payable upfront on the sale consideration. Under a lease (including a finance lease) the GST is payable over the term of the lease. Dealing in an interest in a partnership or trust is also a financial supply. A partnership for GST

purposes has the same meaning as for income tax purposes and the partnership must register for GST if it meets the registration turnover threshold.

## TAXATION OF FINANCIAL ARRANGEMENTS (TOFA)

3.12 The various income tax frameworks or regimes introduced into the tax law as part of the TOFA reform include the debt/equity rules, the foreign currency gains and losses rules and the tax timing and hedging rules. These rules, some of which are described below, give greater weight to economic substance than the ordinary income and deduction rules of the income tax law. This is designed to improve the efficiency of financial decision making and to lower compliance costs.

### DEBT/EQUITY RULES

3.13 Financing arrangements can be either debt, equity or a combination of debt and equity. Broadly defined, a debt represents a right to have the money lent repaid with interest, while equity represents ownership of capital and typically a right to share in the profits. The debt/equity rules in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997) draw the border between debt and equity in such a way that the legal form of an interest is generally not characterised in a way that is at odds with its economic substance.

3.14 Division 974 defines what constitutes an equity interest in a company and what constitutes a debt interest for tax purposes. The debt/equity distinction determines the tax treatment of a return on a financing interest issued by a company. The definition of debt interest also constitutes a key component of the thin capitalisation regime as it is used to determine whether an entity has an excessive amount of debt. It is also relevant for withholding tax purposes, that is, where the dividing line is between what returns may be subject to dividend withholding tax and what may be subject to interest withholding tax. The interest withholding exemptions draw on the definition of debt interest.

3.15 Under Division 974, the test for distinguishing debt interests from equity interests focuses on a single organising principle – the effective obligation of an issuer to return to the investor an amount at least equal to the amount invested. If the term of the interest is ten years or less, the amount to be paid to the holder must equal or exceed the issue price in nominal value terms. If the term is greater than 10 years, the amount to be paid to the holder must equal or exceed the issue price in present value terms.

3.16 This test seeks to provide a more coherent, substance based test which is less reliant on the legal form of a particular arrangement. Relevant to the classification is the pricing, terms and conditions of the arrangement under which the interest is

issued. In order to determine what constitutes the relevant debt interest or equity interest as a matter of economic substance, Division 974 provides, in certain circumstances, for the aggregation of legally separate contracts.

3.17 In order to be a debt interest, a scheme must satisfy the debt test. The test is applied from the perspective of the issuer at the time when the arrangement came into existence. The key requirement of the debt test is that the issuer must have an effectively non-contingent obligation to provide a financial benefit that is substantially more likely than not to have a value that is equal to or greater than the value received from the holder. Financial benefits mean anything of economic value, including the asset being financed. An obligation is non-contingent if it is not contingent on any event, condition or situation other than the ability or willingness of that entity or connected entity to meet the obligation.

3.18 In order to be an equity interest, a scheme must satisfy the equity test, which is satisfied if the scheme is an interest in a company that is of a kind listed in the Division, unless it constitutes a debt interest. Broadly, those listed are:

- a share in a company;
- an interest that provides a right to a return from a company and either the right itself or the amount of the return is contingent on economic performance of, or at the discretion of the company; and
- an interest that may or will convert into such an interest or share.

3.19 Division 974 contains a tie breaker rule so that if an interest meets both the tests for a debt interest and an equity interest, it will be classified as a debt interest.

3.20 The debt/equity rules apply only to financing arrangements (and shares in companies). For this purpose, a financing arrangement is defined to be a scheme entered into or undertaken to raise finance for the entity, or a connected entity, or to fund another financing arrangement.

3.21 While Division 974 applies to a very broad range of debt instruments, equity instruments and hybrid instruments, it does not apply to all arrangements that raise finance. The definition of financing arrangement is used to limit the scope of the Division. That is, there are a number of arrangements that raise finance that are specifically excluded from the definition of financing arrangements in Division 974. For instance, certain lease or bailment arrangements, including, but not limited to, those that are subject to specific tax provisions. It should be noted that the exception to Division 974 for certain leases would not apply if the lessee has an obligation or a right

to acquire the leased asset. To the extent that an excluded arrangement raises finance, the scope of Division 974 is arguably form based.<sup>14</sup>

3.22 Further, while the debt test can apply to an interest in any entity, the equity test only applies to equity interests in companies. That is, the equity test will not apply to equity interests in trusts or partnerships, unless they are treated as companies for tax purposes, such as corporate limited partnerships.<sup>15</sup>

3.23 Deductibility of a return on a debt interest is not dependent on the return being interest. For example, returns in the form of dividends paid on a debt interest may be deductible, subject to certain limits. Generally speaking, a return paid on a debt interest will be deductible if it meets the general deduction criteria in section 8-1 of the ITAA 1997. That is, expenses incurred in deriving assessable income are deductible when incurred, provided that they are not of a private, domestic or capital nature.

## TOFA TAX TIMING RULES

3.24 The tax timing rules in Division 230 of the ITAA 1997 are intended to provide increased efficiency, reduced compliance costs and greater alignment between tax and commercial recognition of gains and losses made on financial arrangements.

3.25 The TOFA tax timing rules promote an economic substance over form approach, recognising that the law has not always kept pace with financial innovation.

The current income tax law has often placed greater emphasis on the form rather than the substance of financial arrangements. This has resulted in inconsistencies in the tax treatment of transactions with similar economic substance which has impeded commercial decision-making, created difficulties in addressing financial innovation, and facilitated tax deferral and tax arbitrage.<sup>16</sup>

3.26 Accordingly, the TOFA tax timing rules have regard to gains and losses rather than rely on form-based amounts such as interest. Division 230 defines 'financial arrangement' and sets out the tax timing methods under which gains and losses from financial arrangements are brought to account for tax purposes. These methods – accruals, realisation, fair value, retranslation, hedging and financial reports – determine the tax timing treatment of all financial arrangements covered by Division 230.

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14 Although, if the arrangement is covered by another specific financing provision, that provision may more appropriately deal with it in a substance based way.

15 Note however that there is a wider application of 'equity interest' for the purposes of Division 230 (TOFA tax timing rules) and Division 820 (Thin capitalisation rules) of the ITAA 1997.

16 Explanatory memorandum to the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2008* para 1.7.

3.27 Division 230 also effectively removes the capital/revenue distinction for most financial arrangements by treating the gains and losses on revenue account. One important exception is the elective hedging method which matches the characteristic of the gains and losses on the hedging financial arrangement to the revenue/capital characteristic of the underlying hedged item.

3.28 Broadly, a Division 230 financial arrangement is an arrangement where the rights and obligations under the arrangement are cash settleable. In addition, Division 230 applies to equity interests (under the elective fair value or financial report methods), foreign currency, non-equity shares in companies and certain commodities and offsetting commodity contracts. While these arrangements may not be cash settleable financial arrangements, they share some of the key characteristics of such arrangements, such as their money-like nature or the way they are dealt with by relevant parties to the arrangement.

3.29 Whether the rights and obligations are cash settleable needs to be tested on an ongoing basis. An important consequence of this is that a contract for the provision of goods or services can give rise to a financial arrangement. For example, under a deferred payment arrangement, parties to the arrangement may start to have a Division 230 financial arrangement upon the delivery of the non-monetary goods or property or upon the performance of services. This would occur when, at the time of delivery or performance, the only rights and/or obligations that remain under the deferred payment arrangement are to receive or pay the monetary consideration for the goods or property delivered or the service performed.

3.30 However, for compliance and administrative reasons, Division 230 does not apply to gains and losses arising from certain short term deferred payment arrangements. For instance, if the delay in payment is no more than 12 months after the receipt or delivery of the relevant non money or money equivalent goods, property or services.

3.31 If a deferred payment arrangement is within the scope of Division 230, it provides that, for the purposes of the income tax law, the cost of the arrangement is the market value of the relevant goods, property or services when they are delivered or performed.

3.32 For example, ABC Co enters into an agreement to sell a CGT asset (which is not a financial arrangement) to XYZ Co for \$100, and agrees to allow XYZ Co 18 months from delivery of the asset to pay. Upon the delivery date, the market value of the CGT asset is \$80. ABC Co has a financial arrangement consisting of its cash settleable right to receive \$100, and the cost of the financial arrangement is taken to be \$80. The difference between this cost (\$80) and the proceeds ABC Co receives from the financial arrangement (\$100), a \$20 gain, is taken into account under Division 230.

3.33 TOFA tax timing rules have wide application but some arrangements fall outside the scope of the regime even though, in terms of economic substance, they would or



could otherwise be financial arrangements. For example, Division 230 does not apply to certain lease or licence arrangements and interests in partnerships and trusts.

3.34 Further, Division 230 does not apply to certain gains or losses made from financial arrangements for compliance costs or other policy reasons. Such arrangements include arrangements held by small business, where they have an aggregated turnover of less than \$100 million, financial assets of less than \$100 million and assets of less than \$300 million, and arrangements held by individuals.

3.35 Generally, Division 230 treats gains and losses made from financial arrangements as assessable income and deductions, respectively, over the life of the financial arrangement (consistent with financial accounting treatment). Gains and losses and financial benefits are to be taken into account only once in working out a taxpayer's assessable income.

3.36 In broad terms, gains and losses from financial arrangements can be made in one of two ways: having a financial arrangement or disposing of a financial arrangement. In determining what constitutes a disposal, Division 230 takes into account the de-recognition criteria adopted by financial accounting standards. For example, if a financial arrangement is an asset, a legal transfer is effectively taken not to have occurred unless its effect is to transfer to another entity substantially all the risk and rewards of ownership of the asset.

3.37 Specific rules for bad debt deductions are included in the accruals and realisation methods which are the default tax timing methods under Division 230. A 'bad debt' for the purposes of Division 230 is intended to be the same concept as that encompassed in section 25-35 of the ITAA 1997. Broadly, a bad debt deduction is allowed where the taxpayer has written off, as a bad debt, a right to receive a financial benefit or part of a financial benefit. The amount of the deduction is limited to the amount of the gain that has already been assessed under Division 230, to the extent that the gain was reasonably attributable to the financial benefit which was written off as bad. That is, unless the taxpayer has lent money or bought a right to receive a financial benefit in the course of their business of lending money. In this situation, the allowable deduction includes the principal investment provided.

## HIRE PURCHASE AND FINANCE LEASE

3.38 The taxation of leases and hire purchase arrangements is based on an amalgam of legal form and economic substance based rules. In an attempt to better recognise the economic substance of certain arrangements the *Taxation Laws Amendment (No. 1) Act 2001* introduced new rules that re-characterised hire purchase and certain finance lease arrangements as a notional sale and loan. The rules apply if the hirer has a right or obligation to acquire the asset and the amounts payable for the use and acquisition of the asset exceed the price of the asset. The 'excess' amount is treated as the finance

charge. The provisions (Division 240 of ITAA 1997) only apply to hire purchase agreements that relate to goods.

3.39 If the notional sale and loan rules apply, periodic payments are divided into principal and finance charge components. The finance charge component will be assessable to the lessor and may be deductible to the hirer/lessee. Normally the hirer/lessee and not the lessor will be treated as the owner/holder of the goods for Division 240 purposes.

3.40 These effects displace the tax consequences that would otherwise arise from the arrangement. For example, the actual payments to the notional seller are not included in assessable income and the notional buyer cannot deduct the actual payments to the notional seller. Under a finance lease a taxpayer lessor might be the legal owner of an asset and derive assessable income through rental of the asset. However, the taxpayer has transferred some or all of the risks and benefits associated with ownership of the asset to the entity that was the 'real' or 'end' user of the asset for a consideration that reflects the investment in the asset and a finance charge.

3.41 The consideration for the notional sale is either the actual cost or the arm's length value. Where the property is trading stock, the normal consequences of disposing of, or acquiring, trading stock follow. In particular, the notional buyer can usually deduct the purchase price. If the property is not trading stock, the notional seller's assessable income will include any profit made on the sale and the notional buyer may be able to deduct amounts for the expenditure under Division 40 (capital allowances). The effect of the notional loan is that the notional seller's assessable income will include notional interest over the period of the loan and the notional buyer may be able to deduct notional interest payments.

3.42 Certain luxury car leases (other than short term hire arrangements and hire purchase agreements) are also treated as sale and loan transactions (Division 242 of the ITAA 1997).

3.43 Similarly, the *Tax Laws Amendment (2007 Measures No. 5) Act 2007* amended the income tax law to modify the taxation treatment of finance leases and similar arrangements between taxpayers and tax preferred end users (such as tax-exempt entities and non-residents) for the financing and provision of infrastructure and other assets. The scope of this division (Division 250 of ITAA 1997) is limited to tax preferred end-users.

3.44 If Division 250 of the ITAA 1997 applies to a finance lease or service concession arrangement, then capital allowance deductions will be denied and the arrangement for the use of the asset will be treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

3.45 Division 250 will apply to a taxpayer if, broadly:

- a tax preferred end user directly or indirectly uses, or effectively controls the use of, an asset; and
- the taxpayer does not have the predominant economic interest in the asset.

3.46 A tax preferred end user will include a government body whose income was exempt from tax or a non-resident that used the asset outside Australia for the purpose of producing income that was exempt from Australian tax. Certain relatively short-term, lower value arrangements (including arrangements applying to small business entities) are specifically excluded from the scope of Division 250.

3.47 Consideration received for lease assignments is subject to a special assessment provision (Division 45 of the ITAA 1997).

3.48 The limited recourse debt rules in Division 243 of the ITAA 1997 were introduced to prevent taxpayers from obtaining deductions greater than the total amounts paid. For instance, where assets are financed under hire purchase or by limited recourse debt arrangements, the total cost may not be expended if the principal amounts remain unpaid at the termination of these agreements. Capital allowances are based on the initial cost of an asset or specified capital expenditure but do not take into account any non-payment under related financing transactions.

3.49 A general principle of the income tax law is that, in order to claim deductions for expenditure relating to ownership of an asset (such as capital allowances), the owner must show that the expenditure has been incurred and the asset is used for the purpose of producing assessable income or in carrying on a business for that purpose.

3.50 Leases, including finance leases that are not subject to specific statutory provisions, are subject to the ordinary income and deduction rules. The lessor is assessable on the rental income from the leased asset and is entitled to deductions for any related asset funding costs and capital allowances. The lessee may be entitled to deductions for rental expenditure if the asset is used for income producing purposes.

## NON-RESIDENT WITHHOLDING TAX

3.51 Non-residents may be liable to Australian tax on Australian source income. Dividends and interest paid to non-residents are generally subject to a final withholding tax.

3.52 Dividend withholding tax is generally imposed at a flat rate of 30 per cent but, for dividends paid to residents of countries with which Australia has a tax treaty, the rate is generally limited to 15 per cent. Fully franked dividends, and unfranked dividends that are declared to be conduit foreign income, are not subject to

withholding tax. Special withholding tax rules apply to distributions made by managed investment trusts to foreign residents. Dividends paid in respect of non-equity shares (shares that are not equity interests under Division 974 of the ITAA 1997) are treated as interest and subject to interest withholding tax (IWT).

3.53 IWT is payable on Australian source interest derived by a non-resident unless an exemption applies.<sup>17</sup> Interest withholding tax is imposed at a flat rate of 10 per cent on the gross amount of the interest paid. Interest is generally regarded as an amount paid as compensation to a lender for not having the use of its capital. For withholding tax purposes, it includes amounts which:

- are in the nature of interest;
- can reasonably be regarded as having been converted into a form that is in substitution of interest; or
- are dividends in respect of non-equity shares.

3.54 The interest withholding tax provisions extend to hire purchase and similar arrangements involving Australian entities purchasing plant and equipment from non-residents. The provisions apply to the notional interest component of such arrangements (the excess of total payments made under the arrangements over and above the cost price of the goods).

3.55 There are a number of exemptions from interest withholding tax. For instance, subsection 128F(2) of the ITAA 1936 exempts from withholding tax the interest paid in respect of certain publicly offered debentures or debt interests. One of the conditions of the exemption is that the interest is paid by a 'company'. A company includes all bodies or associations corporate or unincorporated, but does not include partnerships (except corporate limited partnerships subject to corporate tax) or non-entity joint ventures.

3.56 Section 128FA provides a further interest withholding tax exemption to publicly offered unit trust debentures or debt interests.

3.57 Section 128GB of the ITAA 1936 exempts from withholding tax the interest paid by an offshore banking unit in respect of its offshore borrowings.

3.58 Broadly, these exemptions reflect a policy of encouraging flows of capital from abroad. The exemptions aim to reduce borrowing costs for Australian business and government so that they do not face a restrictively higher cost of capital, or constrained

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17 Interest paid on publicly offered debentures or specified debt interests issued by companies and public or widely held unit trusts are eligible for exemption from interest withholding tax. Interest paid on debentures and debt interests issued in Australia by the Commonwealth, States or Territories are also eligible for this exemption. In each case, the public offer test must be satisfied.

access to capital, as a result of the withholding tax burden being shifted to them from the non-resident. The exemptions are also intended to integrate the domestic and offshore debt markets, enhancing Australia's development as a centre for financial services.

3.59 Limitations to the availability of the exemptions recognise that some forms of capital raising have the potential to reduce the integrity of Australia's tax system. So for example, the exemptions are targeted at financial instruments expected to fulfil an arm's length capital raising function in circumstances where shifting of the tax burden to the Australian borrower is most likely to occur. The 'public offer test' confirms the policy intent of restricting the exemption to structured capital raisings for business activities while excluding related party transactions and individually negotiated loans.

3.60 In recognition of the evolving nature of financial markets and innovation in financial instruments, a regulation-making power was included in sections 128F and 128FA of the ITAA 1936 to enable the prescription of other financial instruments as eligible for exemption. The Explanatory Memorandum to the *Tax Laws Amendment (2007 Measures No.3) Act 2007* stated that:

It is anticipated that this power will only be used to prescribe financial instruments that are close substitutes for, and perform a similar role to, debentures. Consideration would also be given to the extent to which there is a detrimental impact on access to capital by Australian borrowers.

## INTERACTION BETWEEN CGT RULES AND FINANCE TAXATION & SECURITIES LENDING ARRANGEMENTS

3.61 The application of the CGT provisions to an arrangement will typically depend on the legal form of the arrangement, for example the transfer of legal ownership of an asset. If CGT applies, the legal form of the arrangement will also generally determine the way in which the CGT provisions are to be applied. Net capital gains made in accordance with the CGT provisions are a type of statutory income. The CGT provisions apply in conjunction with the ordinary income tax provisions. Generally, a CGT gain is reduced if another income tax provision applies to the amount. A capital gain or loss is generally disregarded if it is part of a financial arrangement to which Division 230 or Division 250 of the ITAA 1997 applies.<sup>18</sup>

3.62 An example of a CGT event being disregarded so as to give effect to the economic substance of a financial product can be found in the securities lending provisions of the tax law. Securities lending arrangements comprises a legal sale together with an agreement to buy back the securities (or replacement securities)

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<sup>18</sup> For taxpayers subject to Division 230 the gain on disposal of a financial arrangement is usually on revenue account.

within a certain period of time. The sale of the securities will give rise to a CGT event, but any capital gain or capital loss from the disposal of a borrowed security is specifically disregarded.

3.63 However, within the scope of the securities lending provisions the tax law recognises that the legal sale and purchase back of the relevant securities are, in substance, the borrowing of the money collateralised by the securities or, in substance, the borrowing of securities for a fee. Accordingly, the legal sale and the purchase back are disregarded for tax purposes.

## GST

3.64 GST is a multi-stage value added tax. A key feature of the GST is that it provides business to business relief so that it is ultimately the final consumer that bears the cost of the GST.

3.65 Within the conventional finance sector, products that arguably are economically equivalent to each other may be treated differently for GST purposes if the nature and structure of the product are different. For instance, the economic substance of acquiring an asset under a finance lease may be equivalent to taking out a loan and buying the asset. However, economic equivalence in this case does not convert to similar treatment for GST purposes. Taxpayers can choose which arrangement they want and bear the GST consequences of that arrangement.

3.66 One reason for different GST treatment is that some types of consumption do not lend themselves to taxation under Australia's invoice credit GST system. For instance, supplies that are classed as financial supplies – including loans, derivatives, share trading and life insurance – are input taxed.

3.67 This means that the supply is not taxable however the supplier cannot claim input tax credits for the GST component of the things it acquires for the purpose of providing that supply. Making these supplies input taxed overcomes difficulties in identifying the value-added margin on individual transactions, because input taxation does not require the service to be value added, but it may give rise to other distortions.<sup>19</sup>

3.68 The underlying policy is to input tax financial supplies only in cases where the consideration cannot be readily identified on a transaction by transaction basis. Given

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19 The *Australia's Future Tax System Report* (2009) found that the input taxation of financial supplies under the GST is inefficient, reduces competition and harms Australia's position as a regional services centre. Financial services should be taxed in an equivalent way to other forms of consumption. That is, the consumption of financial services by Australian households should be fully taxed and financial services used by businesses should be treated like any other business input.

this, it is not necessary that some arrangements such as hire purchase transactions, where the interest charge is separately identified and disclosed by the supplier, be input taxed. Following a recent review of financial supplies, the Government announced that the GST law will be amended to make the supply of hire purchase fully taxable. The change will mean that the GST treatment will not depend on the characterisation of the credit component.

3.69 For there to be a financial supply there must be a provision, acquisition or disposal of an interest, for consideration, in specified items. An interest means any form of property and includes a:

- debt or right to credit.
- mortgage over land or premises.
- right under a contract of insurance or guarantee.
- right to receive a payment under a derivative.
- right to future property.

3.70 Generally, under Australia's GST regime, supplies such as general insurance, leases including finance leases, hire-purchase, professional advice or broking services are treated as taxable. In addition, the provision of commercial property and new residential premises are taxable supplies whereas the provision of other residential premises is input taxed.

## STATE AND TERRITORY TAXES

### Victoria

3.71 Stamp duty typically applies to any purchase and declaration of trust of real property and chattels passing with the property. Duty is also payable on the purchase of motor cars. In Islamic financing transactions, there can be several transfers/declaration of trust of property as part of the financing arrangement.

3.72 In 2004, Victoria removed double stamp duty charges on property purchases by providing an exemption to dutiable transactions, generally on the second dutiable transaction in the arrangement. Other changes include recognising the principle of profit sharing and providing an equitable outcome in arrangements that avoid using certain terms which are not permitted, such as interest.<sup>20</sup>

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<sup>20</sup> Victorian Government fact sheet *Islamic Finance, Melbourne, Victoria, Australia* April 2010.

3.73 The policy intent of the changes is to ensure equity so that taxpayers who enter into these arrangements are treated on an equal footing with those who enter into conventional mortgages. The changes provide for an exemption from duty if the creation or cessation of the financing leads to more than one dutiable transaction.

3.74 Victoria has also moved to allow an exemption where there is a refinancing with another Financier if it gives rise to a dutiable transaction. Transfer duty would otherwise have been payable on the steps required to give effect to the refinancing.

3.75 Also, there is no specific exemption for the financing of the purchase of motor cars.

### New South Wales

3.76 Stamp duty typically applies to any purchase or declaration of trust of land and goods as well as goodwill, intellectual property and shares in an unlisted company and units in an unlisted unit trust scheme. Landholder duty may also be payable in connection with Islamic financing if shares or units are purchased. Duty is also payable on the purchase of motor cars.

3.77 Stamp duty on unlisted marketable securities, mortgages (in the limited circumstances in which it still applies), and on non-real property transfers will be abolished in New South Wales from 1 July 2012.

3.78 New South Wales does not have any special exemptions for Islamic financing transactions.

### Queensland

3.79 Stamp duty typically applies to any purchase or declaration of trust of real property and chattels as well as goodwill, intellectual property and miscellaneous assets. Land rich duty may also be payable in connection with Islamic financing if shares or units are purchased. Duty is also payable on the purchase of motor cars.

3.80 Queensland does not have any special exemptions for Islamic financing transactions.

### South Australia

3.81 Stamp duty typically applies to any purchase or declaration of trust of real property and chattels as well as goodwill, intellectual property and shares in an unlisted company and units in an unlisted unit trust scheme. Landrich duty may also be payable in connection with Islamic financing if shares or units are purchased. Duty is also payable on the purchase of motor cars.



3.82 South Australia does not have any special exemptions for Islamic financing transactions.

### Western Australia

3.83 Stamp duty typically applies to any purchase or declaration of trust of real property and chattels as well as goodwill, intellectual property and miscellaneous assets. Landholder duty may also be payable in connection with Islamic financing if shares or units are purchased. Duty is also payable on the purchase of motor cars.

3.84 Western Australia does not have any special exemptions for Islamic financing transactions.

### Tasmania

3.85 Stamp duty typically applies to any purchase and declaration of trust of real property and chattels passing with the property. Landrich duty may also be payable in connection with Islamic financing if shares or units are purchased. Duty is also payable on the purchase of motor cars.

3.86 Tasmania does not have any special exemptions for Islamic financing transactions.

### Northern Territory

3.87 Stamp duty typically applies to any purchase or declaration of trust of real property and chattels as well as goodwill, intellectual property and miscellaneous assets. Landholder duty may also be payable in connection with Islamic financing if shares or units are purchased. Duty is also payable on the purchase of motor cars.

3.88 Northern Territory does not have any special exemptions for Islamic financing transactions.

### Australian Capital Territory

3.89 Stamp duty typically applies to any purchase and declaration of trust of real property and chattels passing with the property. Landholder duty may also be payable in connection with Islamic financing if shares or units are purchased. Duty is also payable on the purchase of motor cars.

3.90 Australian Capital Territory does not have any special exemptions for Islamic financing transactions.

## OBSERVATIONS ON THE CURRENT FINANCE TAXATION LANDSCAPE

3.91 As indicated above, there are various approaches to the treatment of financial products under current taxation laws. Some provisions take a legal form based approach, others an economic substance based approach, and some evidence a mix of these approaches. Even those that apply an economic substance based treatment often have a scope that is, to some extent at least, based on legal form. One approach might be more appropriate than another in a particular context. For example, it may be important to give greater weight to form for transaction based taxes that are of a high volume nature and rely on one party to collect or withhold the tax.

3.92 The economic substance based frameworks in the current income tax law such as the tax timing rules, hire-purchase and the debt equity rules are designed to better reflect the commercial understanding of the relevant arrangements and to improve tax neutrality in financial decision making. This review is to consider to what extent the current frameworks, either in their current form or perhaps with some modification, provide a way to appropriately recognise Islamic financial products for income tax purposes.

## CHAPTER 4: ISSUES RAISED BY AUSTRALIA'S CURRENT APPROACH TO FINANCE TAXATION

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4.1 The purpose of this Chapter is to expose any issues that may be impediments to the development of Islamic finance. Each case study is consistent with the principles of Islamic finance and examines the application of the existing tax frameworks to enable a comparison with the tax treatment of the conventional equivalent product.

4.2 It is important to keep in mind that if the Board concludes that amendments to the tax law are required, the Board will consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic finance products. For this reason this Chapter is aimed at examining those frameworks and identifying the limitations of Australia's current finance taxation law in delivering on the principles outlined in the terms of reference rather than analysing Islamic finance arrangements and products in isolation.

### CASE STUDY ONE: COST PLUS PROFIT SALE<sup>21</sup>

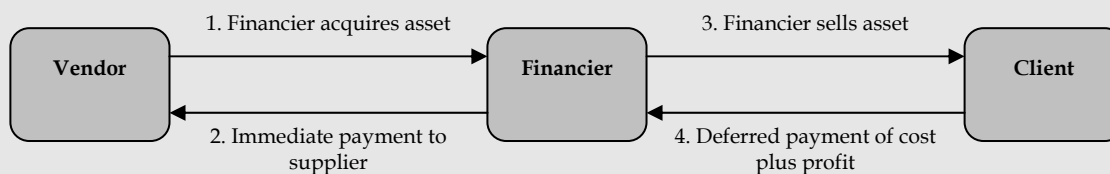
4.3 The purchase of residential property in Australia is typically financed by a mortgage arrangement. A mortgage over real property is a security for the lender. Under a conventional mortgage the property is purchased by the borrower using money borrowed from the lender. The property is transferred to the borrower and the borrower has to repay the loan amount plus interest as per the repayment schedule. The lender has a security over the property which means that if the borrower defaults, the lender can enforce a sale of the property to recover the money owed.

4.4 The economic substance of an Islamic mortgage product using cost plus profit sale is equivalent to a conventional mortgage. However, the form of the arrangement is different. In contrast to a conventional mortgage, the Financier will purchase the property and then sell it at cost plus a profit to the Client who will repay the cost plus profit on a deferred payment basis.

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21 Known as Murabahah: refers to the sale and purchase transaction of an asset whereby the cost and profit margin (mark-up) are made known and agreed by all parties involved.

### Case Study One: Cost plus profit sale (of a rental property)



Step 1: A Client agrees to purchase a house from a vendor. The Client approaches a resident Financier to finance the purchase. A purchase instruction with promise to purchase is completed by the Client which is a request that the Financier purchase the asset specified and an undertaking to purchase that asset from the Financier.

Step 2: If the Financier approves the financing, an Asset Purchase Agreement will be executed where the Financier purchases the asset (house) from the vendor on a cash basis for a purchase price of \$360,000. The Financier appoints the Client as its agent to purchase the asset. The asset is transferred to the Financier at this time.

Step 3: Asset Sale Offer and Acceptance notices will be executed, in which the Financier will offer to sell the asset to the Client on deferred terms at the purchase price (\$360,000) plus a profit component (\$384,341). The Financier will typically consider the prevailing mortgage interest rates for a similar credit risk. The Client will complete the Acceptance notice. The sale is executed and title is transferred to the Client with security granted to the Financier.

#### Example of Asset Offer Notice

Description of asset: residential property

Cost price: \$360,000

Settlement date: 1 September 2010

Profit: \$384,341 (8.4 per cent per annum)

Deferred payment price: \$744,341

Deferred payment date: 30 August 2030 (20 Years)

Step 4: The Client will pay the sale price of \$744,341 on an amortising monthly instalment basis over 20 years at \$3,101.42 per month. The schedule for payments will typically look the same as a conventional loan agreement, with the cost and profit components clearly set out.

4.5 The Board is of the view that the economic substance of the arrangement described in Case Study One is the equivalent of a conventional fixed interest loan backed by a mortgage (mortgage). That is, the principal equivalent is the cost price of \$360,000 and the interest equivalent is the profit component of \$384,341.

4.6 Therefore, considering the application of existing tax frameworks to a conventional mortgage, in principle, the following tax treatment should apply to Case Study One.

- If the property is an investment property and is used to generate assessable income the profit component should be deductible for the Client at the time that it is actually paid. The sale of the property would ordinarily be direct to the Client and the Client would pay any stamp duty, and the Vendor any GST on the transaction. The Client would incur stamp duty on any mortgage if the property is located in New South Wales. The cost price of the property should be the first element of the Client's cost base for CGT purposes. As deductible expenditure, the profit component should not form part of the cost base.
- For the Financier the profit component should be treated as a gain that it makes from a financial arrangement. Accordingly the tax timing rules in TOFA would determine the amount of the gain to be brought to account in each income year. The acquisition and disposal of the property by the Financier would not occur in the provision of a conventional mortgage and accordingly it should not have any practical tax consequences.

4.7 Because of the form of the arrangement the tax treatment of Case Study One under current tax frameworks will be different to a conventional mortgage used for investment purposes.

4.8 Duty would be payable on the initial purchase by the Financier and the sale to the Client. For example, the consequence of the purchase and sale by the Financier to the Client is that even though the Financier pays the duty on the acquisition this cost will be passed on to the Client (perhaps added to the cost of the property or an additional fee). In addition, the Client will incur a further duty charge when the property is transferred to them by the Financier. The result is that duty is paid twice on what is, in substance, one purchase.

4.9 Case Study One may also lead to tax uncertainty for the Client in relation to whether they can deduct the profit component, or whether this amount will form part of the cost base of the property for CGT purposes. The profit component may not be deductible under the general deduction provision (section 8-1 of the ITAA 1997) if it is paid to acquire a capital asset.<sup>22</sup> Section 25-85 of the ITAA 1997 facilitates a deduction in relation to a return on a debt interest by providing that deductibility is not prevented merely because the return secures a permanent or enduring benefit. However, it is arguable that the Client does not purchase the property in the course of any existing income producing activity and therefore the profit component included in the purchase price is not incurred in the course of gaining or producing assessable income (the expenditure is incurred at a point to soon).

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22 *Colonial Mutual Life Assurance Society Ltd v FCT* (1953) 89 CLR 428.

4.10 If the profit component is not deductible it will form part of the cost base of the property for CGT purposes and will only be taken into account in the future if the Client sells the property. This treatment fails to recognise that, in substance, the profit component is arguably equivalent to interest, is paid over the life of the arrangement and is not a capital cost of acquiring the property.

4.11 For the Financier, the TOFA tax timing rules are likely to apply which means the profit component is likely to be included in assessable income as a gain from a financial arrangement using the accruals method. This is the same tax treatment as for interest on conventional mortgages. If the Financier is a non-resident then the return may fall within the extended definition of interest for IWT purposes, depending on the terms of the specific agreement. That is, if it represents the increased price payable because of a delayed payment then it may be sufficiently similar to an amount paid as compensation to a lender for being kept out of the use of its money. This would be equivalent to a conventional mortgage provided by a non-resident.

4.12 The disposal of the house by the Financier to the Client would typically trigger CGT event A1. The capital gain may be reduced by the amounts included in the assessable income of the Financier under other provisions. The time of the event is when the contract for disposal is entered into. This is at the beginning of the arrangement. A capital gain arises if the proceeds exceed the cost base. The amount the Financier is entitled to receive would constitute proceeds from the CGT event, even if not yet received. However, if the Financier is subject to the TOFA tax timing rules the rules may operate so that the capital proceeds will be the market value of the property at the time it is provided. This will occur when the Financier starts to have a financial arrangement as consideration for the disposal of the property to the Client.

4.13 For GST purposes, if the house is new, the supply of new residential premises by the Vendor to the Financier is a taxable supply. However the supply of the premises by the Financier to the Client is an input taxed supply because the property is no longer new. If the house is an existing residential premises both supplies will be input taxed.

4.14 The GST consequences for a conventional mortgage and for the product described in Case Study One are largely equivalent, however, there may be a GST cost to the Financier associated with lost entitlement to reduced input tax credits in respect of acquisitions that relate to making input taxed supplies.

4.15 Generally there is no entitlement to input tax credit on acquisitions that relate to making input taxed supplies. However the GST law allows a reduced input tax credit entitlement in respect of certain acquisitions that relate to making input taxed financial supplies. For example, outsourced loan management services might be a reduced credit acquisition if the Financier provided a loan. No reduced credit acquisition would arise if the Financier acquired similar services but the transaction was in the form of a supply of residential premises rather than a financial supply.

4.16 Accordingly, there will not be GST neutrality between a conventional Financier lending funds to a client to purchase a house (and making a financial supply) and another Financier that structures its dealings in a way that seeks to deliver similar outcomes but does not give rise to financial supplies. This is because:

- if the terms of the sale from Financier to the Client do not incorporate a financial supply in addition to the supply of the house, then to the extent that similar acquisitions are required to put the deferred payment arrangement in place, the GST law will apply adversely to the Financier as against a conventional Financier. This is because no acquisition made by the Financier would be a reduced credit acquisition and therefore the Financier will not be entitled to any reduced input tax credits; and
- it would be expected that the Financier would embed the GST elements of prices it has paid to acquire reduced credit acquisitions into the profit component in its offer price to the Client. A conventional Financier could claim 75 per cent of full input tax credit on such acquisitions and so would be expected to on-charge that much less to its clients.

4.17 In the context of existing tax frameworks and the tax treatment of a conventional mortgage, the tax treatment or impediments to the development of the product described in Case Study One seem to be:

- double stamp duty (except in Victoria), but no land tax issue;
- for GST purposes, lost entitlement to reduced input tax credits for the Financier;
- uncertainty in relation to whether the profit falls within the definition of interest for the purposes of IWT; and
- tax uncertainty for the Client in relation to whether the profit component:
  - can be deducted under section 8-1 of the ITAA 1997, or
  - is a cost of acquiring the property and therefore included in the cost base for CGT purposes.

### Questions: Case Study One

Q1.1 Do you agree with the issues identified in the above summary? Do you have any further comments in relation to the issues identified?

Q1.2 What are the tax impediments in addition to those summarised to the development of the home financing product described in Case Study One?

Q1.3 How could tax neutrality be achieved in relation to:

- Income tax (including IWT);
- Stamp duty; and
- GST?

Q1.4 How would your answer be different if the property were a commercial property?

Q1.5 Please consider the application of stamp duty in the context of Islamic mortgage funds.

Q1.6 Have the Victorian amendments to the Duty Act worked effectively to provide a level playing field?

## CASE STUDY TWO: INTERBANK FINANCE<sup>23</sup>

4.18 Australia is a net capital importer which means Australian Financiers need access to offshore capital to meet the lending requirements of their Clients, Australian businesses and other consumers. Banks can access offshore finance through the use of a debt instrument. The instrument typically is structured in a way that meets the requirements for an IWT exemption such as the exemption for certain publicly offered debentures.

4.19 Islamic finance institutions can access offshore capital through the use of a reverse cost plus profit sale, as described in Case Study Two. The economic substance of the arrangement is equivalent to conventional debt instruments but the form of the arrangement is different. Instead of the bank offering the debt instrument directly to Financiers, an Investment agent will facilitate the financing arrangement (using the capital contributed by the Financiers) by making the initial commodity purchase and

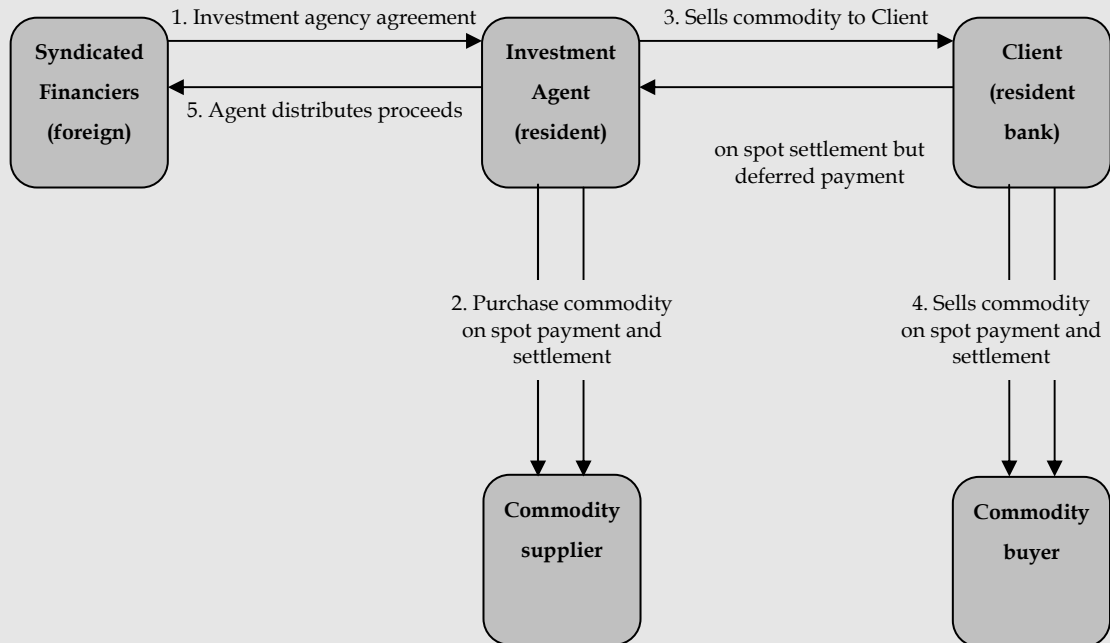
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23 Known as tawarruq (cash finance sale): A variation of murabahah, under a tawarruq contract a person buys a commodity or some goods on credit with an understanding of paying back the price either in instalments or in full in the future, and the commodity is immediately sold to third party to obtain cash.



selling it to the bank at a profit on deferred payment terms (similar to Case Study One). The bank then sells the commodity to access the cash and repays the cost plus profit to the Investment agent (Financiers) in accordance with the agreement.

**Case Study Two: Interbank finance**



Step 1: Non-resident Syndicated Financiers enter into investment agency agreement with an Investment Agent (Australian resident bank or Financier).

Step 2: Resident Investment Agent purchases commodity for example metals at purchase price from commodity Supplier on spot settlement and spot payment basis.

Step 3: Investment Agent as agent for the Non-Resident Syndicated Financiers sells commodity to Client (another Resident bank or Financier) at Sale Price (Purchase Price plus Profit) on spot settlement but deferred payment basis (Client owns commodity and owes debt to syndicated Financiers equal to Sale Price).

Sale price: AUD \$100 million (Purchase Price or Principal) plus AUD LIBOR (180 days) + 50 basis points

Profit: \$2,746,849 (5.57 per cent per annum)

Repayment: AUD \$102,746,849 (sale price payable at the end of 180 days)

Term of arrangement: 6 months (180 days)

Step 4: Client sells commodity to commodity buyer on spot settlement and spot payment basis and obtains cash (principal loan amount).

Step 5: Client pays Sale Price to Investment Agent at end of agreement and Investment Agent distributes proceeds proportionately to syndicated Financiers.

4.20 The Board is of the view that the economic substance of the arrangement in Case Study Two is equivalent to a debt instrument issued by the resident Client that is used for inter-bank financing. That is, the instrument is held in the resident Client, the sale price is equivalent to the face value of the debt instrument and the profit component is the equivalent to the return on the debt instrument. Therefore, in principle, the tax treatment of Case Study Two should be the same as for a conventional debt instrument used for inter-bank financing. This broadly implies the following tax treatment.

- For the non-resident syndicated Financiers, the return on the debt instrument should be interest for the purposes of IWT and subject to IWT unless an exemption applies. In determining whether an exemption applies the economic substance of the debt instrument should be the subject of the relevant test. The supply of the debt instrument would be a GST free supply for GST purposes.<sup>24</sup> The acquisition and sale of the commodity would not occur in a conventional issue of a debt instrument used for inter-bank finance and accordingly should not have tax consequences for the non-resident. This would imply that there should be no practical CGT, GST and income tax consequences from the trading conducted through a resident agent.
- For the resident Investment Agent, there should be no practical tax consequences arising from the trading activity as this would not occur in a conventional issue of a debt instrument used for inter-bank finance. However, the resident agent should be subject to income tax on any fees or other related income reasonably attributable to the services provided to the syndicated Financiers.
- For the resident Client, the profit component should be deductible subject to general deductibility rules. The timing of the deductions will be determined by ordinary rules or, if they apply, the TOFA tax timing rules in Division 230 of the ITAA 1997.

4.21 However, because of the form of the arrangement, the tax treatment of Case Study Two under current tax frameworks will be different to that applying to the use of a conventional debt instrument for inter-bank financing.

4.22 Interest withholding tax generally applies to interest derived by a non-resident and paid by a resident of Australia. For these purposes interest is given an expanded definition which includes amongst other things amounts that are in the nature of interest. The profit received by the resident agent on behalf of the non-resident Financiers may be considered to be in the nature of interest because in substance it represents the increased price payable because of the delayed payments and may therefore be sufficiently similar to an amount paid as compensation to a lender for being kept out of the use of its money. If this is the case, unless an exemption from withholding tax applies, the resident agent is required to withhold IWT from the

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24 See section 38-190 of the GST Act.

interest it receives because it would be interest to which the non-resident Financiers are, or will become, entitled to receive.<sup>25</sup> Alternatively, if the profit component is not in the nature of interest, it may not be taxed in Australia unless the non-resident Financiers have a permanent establishment in Australia.

4.23 In contrast to the substance based approach to determining what is interest for withholding tax purposes, the exemptions from withholding tax are based on the form of the arrangement. The arrangement described in Case Study Two may not be able to meet the requirements for an IWT exemption that would ordinarily be available to conventional debt instruments that have the same characteristics and substance as Case Study Two.

4.24 Subject to the public offer test, section 128F of the ITAA 1936 provides an exemption from IWT for, broadly, a debenture in a company, or for a debt interest in a company that is a non equity share, a syndicated loan or otherwise prescribed by regulation. It may not be possible to characterise the purchase of a commodity on deferred payment terms as described in Case Study Two as a debenture or non-equity share. However depending on the terms of the agreement it may be able to be characterised as a syndicated loan facility and therefore may be a syndicated loan for the purposes of the exemption under section 128F.<sup>26</sup>

4.25 It is unlikely that the exemption from withholding tax in relation to offshore borrowings of an Offshore Banking Unit would be available in the circumstances described in Case Study Two.

4.26 If the resident agent is a dependent agent of the non-resident Financiers, the non-resident Financiers may be regarded as having a permanent establishment in Australia. That means that the non-resident would be taxed on income attributable to the permanent establishment. Conventional inter-bank financing wouldn't ordinarily require a dependent agent.

4.27 If the commodity buyer is a resident, each supply of the commodity would be a taxable supply and therefore subject to GST. Input tax credits should be available. Even though a conventional debt instrument issued to non-resident Financiers would ordinarily be a GST free supply, the result for Case Study Two should be GST neutral because business to business relief from GST is provided. However, there may be a GST cost to the Financier in relation to lost entitlement to reduced input tax credits.

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25 Section 12-250 in Schedule 1 to the *Taxation Administration Act 1953*.

26 In particular, a written agreement is a syndicated loan facility under s 128F(11) if:

- (a) the agreement describes itself as a syndicated loan facility or syndicated facility agreement;
- (b) the agreement is between one or more borrowers and at least two lenders
- (c) under the agreement each lender severally, but not jointly, agrees to lend money to, or otherwise provide financial accommodation to, the borrower or borrowers; and
- (d) the amount to which the borrower or borrowers will have access at the time the first loan or other form of financial accommodation is to be provided under the agreement is at least \$100 million (or a prescribed amount).

4.28 The overall arrangement described in Case Study Two, when considered together, could give rise to a debt interest in the resident Client under Division 974 of the ITAA 1997.

4.29 The profit component should be deductible for the Client as it would be a loss necessarily incurred in carrying on its business. It would be a cost of raising circulating capital that the Client (resident bank) uses in its assessable income producing activities. If the TOFA tax timing rules do not apply to the arrangement, the timing of the deductions will be determined by ordinary rules. Although it would appear on the facts of Case Study Two that the obligation to pay the Investment Agent for the commodity becomes an existing liability immediately, payment is deferred and therefore may not be payable until a later income year. This may lead to tax uncertainty for the Client in relation to the timing of the deduction.

4.30 It is likely that the specific exception from the TOFA tax timing rules in Division 230 for short term trade finance will apply.

4.31 However, if the payment was deferred for more than 12 months, Division 230 would apply to the deferred payment arrangement. In this situation, the market value of the commodity at the time it was provided to the Client would be treated as the cost of the deferred payment arrangement. Further, the difference between the market value of the commodity at the time of being provided and the deferred payment would likely be deductible to the Client and assessable to the Investment Agent under Division 230 on an accrual basis.

4.32 As discussed in Chapter 3, the 12 month rule is to provide compliance costs savings for short term trade financing arrangements where the financing is to facilitate the trade of non-money or money equivalent goods, property or services. In this type of situation, where the main purpose of the arrangement is financing (for instance if the trade of goods, property or services is to facilitate financing) there may be an argument that the 12 month rule should not apply.

4.33 In the context of existing tax frameworks and the tax treatment of a debt instrument that is used for inter-bank financing, the tax treatment or impediments to the development of the product described in Case Study Two seem to be:

- equivalent stamp duty treatment;
- for GST purposes, lost entitlement to reduced input tax credits for the Financier and possibility of a greater cash-flow burden due to the upfront cost of GST;
- non-resident financiers may have uncertain tax outcomes related to whether the profit component is characterised as interest for IWT purposes;
- if the profit component is characterised as interest for IWT purposes, Australian borrowers may bear a restrictively higher cost of capital, or constrained access to

capital if IWT exemption does not also apply to economically equivalent Islamic financing arrangements;

- uncertainty in relation to the income tax treatment of the resident Agent; and
- if the TOFA tax timing rules do not apply, there may be uncertainty for the Client in relation to the timing of its deduction in relation to the profit component.

### Questions: Case Study Two

Q2.1 Can the potential cost to the Financier from lost entitlement to reduced input tax credits be quantified?

Q2.2 Should the profit component payable by the resident Client be subject to IWT and how could certainty be achieved?

Q2.3 Bearing in mind the Government's policy intent (that Australian business does not face a restrictively higher cost of capital, or constrained access to capital, as a result of the IWT burden being shifted from the non-resident lender to the Australian borrower):

- What are the specific withholding tax exemptions that, in principle, should be available in the circumstances described in Case Study Two?
- What element of the test is problematic?
- Why should the exemption be available in this case?
- How could the IWT provisions be amended to ensure the policy intent of the exemption is not compromised?

Q2.4 How is the tax treatment of the resident 'agent' different to the conventional equivalent? How should the resident 'agent' be taxed in principle?

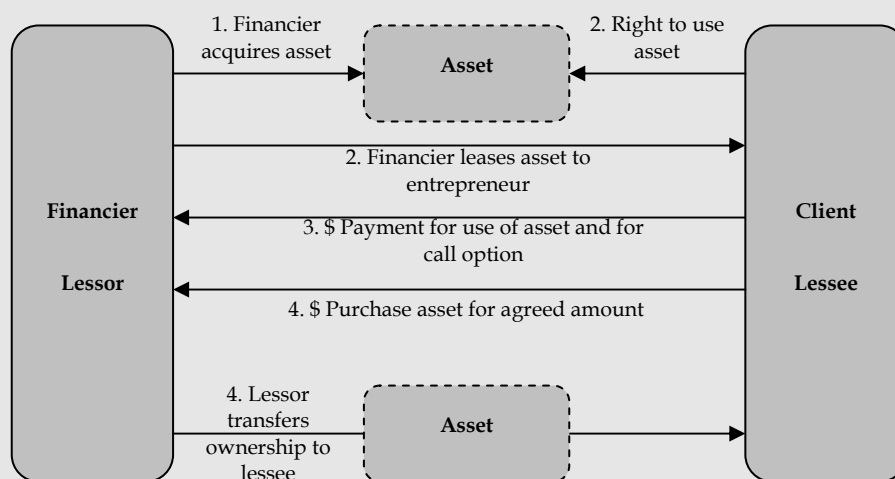
Q2.5 What security might be required for this type of arrangement? What happens in the event of default? Does this cause any tax impediments?

### CASE STUDY THREE: FINANCE LEASE AND HIRE PURCHASE<sup>27</sup>

4.34 Leasing arrangements are commonly used to finance the purchase of specific goods. Hire purchase is a form of financing used in business to finance the purchase of business assets such as machinery. Other finance leases can be used by a lessee to finance the acquisition of goods for use in its business.

4.35 Islamic finance lease arrangements are equivalent to conventional finance lease arrangements in economic substance and form. That means that such arrangements will be subject to the same tax treatment as conventional finance leases and hire purchase arrangements.

#### Case Study Three: Finance lease



Step 1: Client approaches Financier to finance Asset purchase and Financier purchases Asset from vendor at Purchase Price on cash basis (Financier owns Asset).

Step 2: The Financier leases Asset to Client for agreed lease Rental and lease term.

27 Known as Ijarah (Operating lease): Under an ijarah contract a lessor (owner) leases out an asset to its Client at an agreed rental fee and pre-determined lease period; or Ijarah Muntahiah Bi Tamlik (Finance lease): This is similar to the ijarah contract except that the lessor also makes a promise to transfer the ownership of the asset at the end of the lease period via a separate sale agreement or gift.

### Case Study Three: Finance lease (continued)

Step 3: Client pays lease Rental to Financier over lease term.

Financier: Resident bank or Financier (Lessor)

Client: Resident company (Client or lessee)

Purpose: Asset (machinery and equipment) financing

Tenor: 5 years

Amount: AUD 50 million (Purchase Price) [Principal]

Rental: LIBOR AUD 3M + 50bp [AUD 671,250] [5.37 per cent per annum]  
payable in advance quarterly

Step 4: Financier gifts or sells asset to Client on termination of lease at pre-determined price. The price will normally be equivalent to the cost of the asset.

Note: The cost of the asset may be proportionately added to the periodic lease payments instead of being paid at the end of the lease term.

4.36 Although the taxation treatment of the product described in Case Study Three would be equivalent to other leases, there is inherent complexity and uncertainty with the current taxation law as it applies to leases.

4.37 For instance, the limited scope of statutory income tax and GST provisions applying to certain finance leasing arrangements can lead to different tax treatment for economically equivalent arrangements. For example, a finance lease with an option to purchase will be taxed as though it were a sale and loan. In contrast, a finance lease without an option to purchase generally will be taxed according to ordinary principles. The potential for different tax treatment for like arrangements is not isolated to leases used in the context of Islamic finance.

4.38 Stamp duty would be payable on the initial purchase by the Financier and the final sale to the Client.<sup>28</sup> There is also a possibility of duty on the lease arrangement. However, this is not different to the duty treatment of conventional finance leases.

4.39 Under Division 240 of the ITAA 1997 hire purchase arrangements may be re-characterised as a notional sale and loan. Division 240 only applies to hire purchase agreements (including leases with options to purchase) that relate to goods. In the above case study a hire purchase will exist if:

- (Step 4) the hirer has the right, obligation or contingent obligation to buy the goods,

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28 Note that in NSW, stamp duty on non-real property transfers will be abolished from 1 July 2012.

- (Steps 3 and 4) the charge for the hire together with any other amount including for the purchase of the goods exceeds the price of the goods, and
- (Step 4) title does not pass until the option is exercised.

4.40 If this is the case, periodic payments are divided into principal and finance charge components. The finance charge component will be assessable to the lessor and may be deductible to the lessee.

4.41 Alternatively, if the lessee is a tax preferred entity then Division 250 of the ITAA 1997 applies to a finance lease, capital allowance deductions will be denied and the arrangement will be treated as a deemed loan that is taxed as a financial arrangement on a compounding accruals basis.

4.42 Division 240 and Division 250 and the Commissioner's Public Rulings in relation to certain leasing and similar arrangements ensure that the taxation treatment of payments in relation to an asset under a lease accords with the underlying nature of the arrangement. As a consequence, arrangements that are disguised purchase agreements or financing arrangements are treated as such, rather than as leases under the general income tax provisions.

4.43 However, ordinary principles apply to a lease that does not fall within Division 240 or Division 250. That is, ordinary rules about assessable income and allowable deductions will apply. Potentially, this can create uncertainty and disparity in the tax treatment of economically equivalent arrangements. It can also lead to the same tax treatment applying to arrangements that are not economically equivalent such as for operating leases compared to finance leases.

4.44 In addition to this, there may be further uncertainty and disparity in relation to the application of GST. Within the conventional finance sector alone, products that arguably are economically equivalent to each other may be treated differently for GST purposes where the nature and structure of the product differ. It may be argued for example that acquiring an asset under a finance lease is economically equivalent to taking out a loan and buying the asset. Economic equivalence does not convert to similar treatment for GST purposes with these two products. However, taxpayers can choose which arrangement they want and bear the GST consequences of that arrangement.

4.45 The Government announced that the GST law will be amended to make the supply of hire purchase fully taxable. The change will mean that the GST treatment will not depend on the characterisation of the credit component.

4.46 IWT treatment will depend on whether the profit component is characterised as interest for IWT purposes. Section 128AC of the ITAA 1936 applies to leases under which the lessee is entitled to purchase or require the transfer of the lease property on



termination or expiry of the lease. If the provision applies it deems part of the amounts paid by the Client to the Financier to be interest.

4.47 In the context of existing tax frameworks and the tax treatment of a finance lease, the tax treatment of the product described in Case Study Three would be equivalent for stamp duty, GST, IWT and income tax purposes.

### Questions: Case Study Three

Q3.1 Is the differential treatment of leases (based on the form of the leasing arrangement) an impediment to the development of Islamic finance?

Q3.2 Should the income tax treatment of leases be more broadly determined by the economic substance of the arrangement?

Q3.3 How can the interest equivalent and the principal be isolated if Division 240 does not apply?

Q3.4 How would your answer be different if this arrangement is used for home financing?

## CASE STUDY FOUR: PURCHASE ORDER<sup>29</sup>

4.48 Contractual arrangements can be used to finance building and construction projects. A contract in the nature of a purchase order will typically specify the details of the arrangement such as the specifications of the order, date for completion, how much will be paid for completion of the project and whether interim payments will be made.

4.49 The arrangement described in Case Study Four differs from a conventional purchase order in that the subject of the order is purchased by the Financier and then sold to the Client for its cost plus profit, on a deferred payment basis. In this way, the economic substance of the arrangement is comparable to a loan.

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29 Istisna (purchase order): Under an istisna contract a buyer will require a seller or a contractor to deliver or construct an asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties to the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of work completed.

#### **Case Study Four: Purchase order used for construction finance**

Step 1: Client approaches a Financier to finance construction of a warehouse to Client's specifications (Asset) and the Financier enters into Asset Sale Agreement with Client to construct Asset and sells Asset to Client at Sale Price on deferred payment basis.

Step 2: Financier constructs Asset or gets Asset constructed by Contractor (parallel purchase order) at the Financier's own cost (Purchase Price) and delivers Asset to Client as per Asset Sale Agreement (Client owns Asset and owes debt to Financier equal to Sale Price).

Step 3: Client pays Sale Price to Financier in periodic instalments over the term of the arrangement, starting from the time the purchase agreement is entered into.

#### **Example of purchase order agreement**

Financier: Resident bank

Client: Resident individual

Purpose: Construction financing

Term: 6 years

Amount: AUD 30 million (Sale Price)

Profit: 10 per cent per annum

Repayment: AUD\$1,250,000 payable in arrears quarterly based on Repayments Schedule itemising Profit [AUD\$7,643,767.71] and Purchase Price [Principal] [AUD\$22,356,232.29]

Security: First charge on Asset and site (land)

4.50 In economic substance this arrangement has no clear conventional equivalent.

4.51 The arrangement described in Case Study Four is a contract of sale subject to completion of the project in accordance with the specifications. The timing of the payments may change the tax treatment. For instance, if the payments were made during construction ordinary tax rules would apply and alternatively, if payments are made after construction, it is likely to be considered a financial arrangement that may be subject to TOFA.

4.52 The following tax treatment would apply if payments were made during construction:

- The amounts paid under the contract to the contractors would be income according to ordinary concepts and the outgoing for the Client would, in this case, be a cost of acquiring capital and therefore not deductible.

- If the underlying property title moves in this case study stamp duty may apply. Even if title doesn't move there could be stamp duty on the transfer of title to the construction if it constitutes a fixture.
- GST will apply to the transaction with input tax credits available if the supply is for a creditable purpose.

4.53 Alternatively, if the payments are made after construction or after delivering the asset to the Client:

- It is likely that there will be a financial arrangement for the purposes of the TOFA tax timing rules. Those rules will apply to determine when gains or losses from the financial arrangement are brought to account and should lead to an outcome that is equivalent to a conventional deferred payment arrangement.
- GST will be payable on the taxable component and input taxed for the debt component.

4.54 Normally duty does not apply to the construction of a building (only to the prior purchase of the land) but in this case the transfer of the completed asset from the Financier to the Client will incur duty on the value of the land and the completed building.

4.55 If the Financier is a non-resident the payments it receives from the Client may be subject to PAYG withholding at a rate of 5 per cent. This applies to certain types of payments made to foreign entities for the construction, installation and upgrade of buildings, plant and fixtures as well as for related activities. If the payments are characterised as interest for IWT purposes they will instead be subject to IWT.

4.56 The tax treatment of the arrangement described in Case Study Four would be the same as for equivalent conventional arrangements for GST, IWT and income tax purposes. Income tax treatment will depend on whether the arrangement can be considered to be a financial arrangement or not. IWT treatment will depend on whether the profit component is characterised as interest for IWT purposes. There may be additional duty payable.

#### Questions: Case Study Four

Q4.1 What is the equivalent conventional product?

Q4.2 Will the application of ordinary income tax rules be an impediment to the development of this type of Islamic finance product?

Q4.3 Will GST apply appropriately?

Q4.4 Is there an additional duty cost compared to the conventional equivalent?

Q4.5 What are the PAYG withholding and IWT issues caused by the Financier's relationship with the Contractor?

Please explain your answers using examples or a description of the circumstances that give rise to the issue.

Q4.6 How could any tax impediments be resolved?

#### CASE STUDY FIVE: PRE-PAID FORWARD SALE<sup>30</sup>

4.57 A forward sale can be used to finance the manufacture of goods. An order is made (quantity, specifications and delivery date) and typically paid for at the time of the order. Under the agreement described in Case Study Five, the Financier pays for the forward sale (at less than the face value of the goods), takes delivery of the goods and then sells the goods to a third party at the cost of the goods plus a profit component or under a separate financing arrangement.

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30 Salam (forward sale): refers to a contract for the purchase of assets by one party from another party on immediate payment and deferred delivery.

### Case Study Five: Pre-paid forward sale

Step 1: Financier enters into commodity purchase agreement with Client whereby the Financier pays the Client the Purchase Price in advance. The agreement must be for fungible goods such as agricultural products, raw materials or semi-manufactured goods.

Step 2: Client delivers commodity to certain pre-agreed specifications and quantity to Financier on pre-agreed future Delivery Date.

Step 3: Financier sells delivered commodity at Sale Price which may be at Profit on immediate or deferred payment basis in the market or to a third party Financier that had entered into separate commodity sale with same specifications and quantity on the same Delivery Date.

Financier: Resident bank or Financier

Client: Resident individual

Purpose: General purpose, working capital or export and import financing

Delivery date: 30 days (1 month) from date of the agreement with Client

Amount: AUD\$3,000,000 (Purchase Price) [Principal]

Profit: AUD\$19,726.03 [8 per cent per annum] being difference between Purchase Price and pre-agreed parallel Sale Price [AUD\$3,019,726.03]

Note: Purchase Price can be agreed for example 10 per cent below spot price in market which could 'lock-in' Profit to Financier via parallel sale with third party. Sale Price can be benchmarked in parallel Salam at for example LIBOR AUD 1M + 300bp plus Purchase Price.

4.58 The Board is of the view that the economic substance of this arrangement depends on the particular set of facts. The Client's obligation to deliver the commodity, and the Financier's right to receive the commodity, would initially suggest that this is not a financial arrangement on the basis that the relevant rights/obligations are not cash settleable.

4.59 However, to determine whether this arrangement is an ordinary trading arrangement or, instead, should be treated as financial arrangement, it is necessary to consider the nature of the arrangement more closely. Division 230 does this by looking at the way the rights/obligations are dealt with.

4.60 That is, the right and obligation under the arrangement that exists upon prepayment is the right to receive, and the obligation to provide the commodity. While this is not money or money equivalent, the right/obligation may nevertheless be cash settleable in certain circumstances so as to bring the prepaid forward purchase arrangement within the scope of Division 230.

4.61 Some of these circumstances are where:

- the Financier deals with the right to receive the commodity in order to generate a profit from a dealer's margin;
- the Financier is able to cash settle the right and the purpose of receiving the commodity is not to satisfy the Financier's normal business requirements; and
- the Financier has a right to receive the commodity under a contract; it has a practice of dealing in the commodity through the performance of offsetting contracts to provide the commodity; its sole or dominant purpose in entering into the contract is not to obtain the commodity as part of its expected purchase, sale or usage requirements; it has made a fair value or financial reports election under Division 230; and for financial accounting purposes the contract is classified or designated as at fair value through profit or loss.

4.62 Further, there is a legislative proposal (Tax Laws Amendment (2010 Measures No 4) Bill 2010) under which the nature of the commodity and the purpose of the arrangement would be considered to see whether it is, in substance, a financial arrangement as opposed to an ordinary commercial trade. In particular, it is proposed that if the commodity is readily convertible into money or money equivalent, there is a liquid market for the commodity and the purpose of the arrangement is to provide finance, then the right to receive, or the obligation to provide the commodity will be cash settable.

4.63 If the arrangement is treated as a normal business contractual arrangement then it will be taxed according to ordinary concepts of assessable income and allowable deductions. For tax purposes, a receipt of income in advance (a forward sale) is not assessable until the goods are delivered.

4.64 From the Client's perspective the Financier pre-purchases the commodity from the Client for less than the face value to enable the Client to manufacture the goods. The Client's obligation ends when it delivers the goods to the Financier.

4.65 The Financier generally will enter into a parallel agreement with a third party to sell the goods for the face value (inclusive of an agreed profit component). When the Financier receives the goods they complete the transaction with the third party by delivering the goods for the agreed price (inclusive of the profit component). The third party may pay in full on delivery, as a parallel pre-paid forward sale or under a separate financing arrangement.

4.66 GST will apply to each transaction with input tax credits available if the supply is for a creditable purpose.

4.67 The tax treatment of the arrangement described in Case Study Five would be the same as for equivalent conventional arrangements for stamp duty, GST, IWT and income tax purposes.

### Questions: Case Study Five

Q5.1 What is the equivalent conventional product?

Q5.2 Will the application of ordinary income tax rules be an impediment to the development of this type of Islamic finance product?

Q5.3 Will GST apply appropriately?

Q5.4 Is there an additional duty cost compared to the conventional equivalent?

Please explain your answers using examples or a description of the circumstances that give rise to the issue.

Q5.5 How could any tax impediments be resolved?

## CASE STUDY SIX: PROFIT AND LOSS SHARING PARTNERSHIP<sup>31</sup>

4.68 Raising capital through a business arrangement such as a partnership or joint venture is an alternative to debt or equity arrangements. Business ventures are typically much more flexible than debt or equity arrangements but may involve more risk. The return on such activities generally is taxed according to ordinary concepts of assessable income and allowable deductions, although this general tax framework interacts with other frameworks such as for the taxation of partnerships or joint ventures.

4.69 A diminishing profit and loss sharing partnership enables Islamic term financing. As a partner to the contract, the Financier is not entitled to a fixed rate of return and shares the variable profits generated by the partnership as agreed in the contract according to the capital contributions. The Financier enters into the arrangement with the objective of transferring the ownership to the Client. The Client enters a separate agreement to purchase the Financier's share of the asset at an agreed price. The

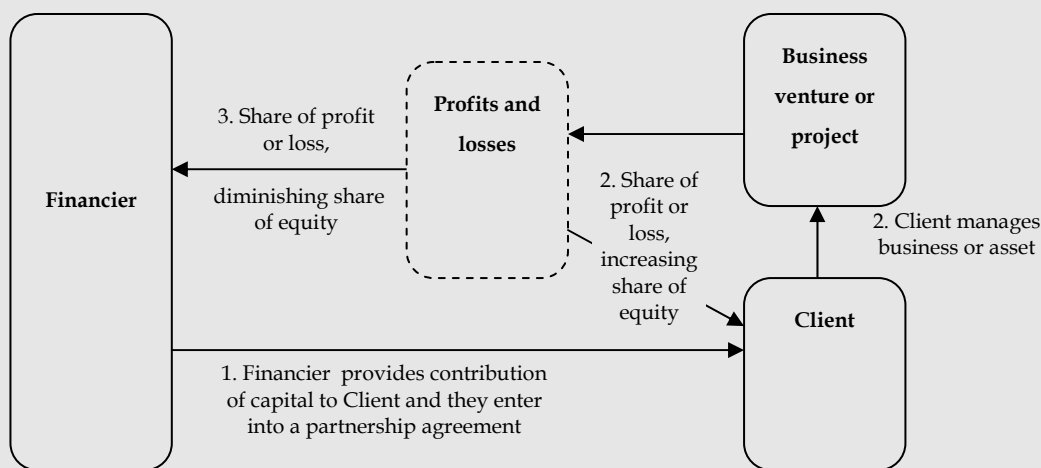
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31 Musharakah (profit and loss sharing partnership): Under a musharakah contract a partnership is established by means of an agreement or arrangement whereby two or more parties agree that each of them contributes to the capital of the partnership either in the form of cash or in kind and shares in its profit and loss. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but a loss will be shared on the basis of equity participation.  
Musharakah mutanaqisah (diminishing partnership): This is a musharakah contract in which one of the parties promises to purchase the equity share of the other party gradually until the title of the equity is completely transferred to them.

Financier's interest diminishes over time of the partnership agreement. Both partners must share losses.

4.70 The arrangement described in Case Study Six, in form, has similar features to a general partnership. In economic substance the arrangement could be compared to a debt arrangement. However, the Case Study does not easily fit within existing tax frameworks for either partnership taxation or financial arrangements.

**Case Study Six: Profit and loss sharing partnership (diminishing share of equity)**



Step 1: Client and Financier form a partnership whereby the Client contributes cash or usufruct rights<sup>32</sup> of certain assets as capital and Financier contributes cash as capital (Client and Financier jointly own Asset or Project).

Step 2: Client is appointed as Managing Agent to manage Asset over the term pursuant to management agreement.

Step 3: Profits are distributed to Client and Financier based on pre-agreed Profit Ratio but losses are distributed pro-rata to contribution of capital.

Step 4: Client purchases Financier's ownership at pre-agreed redemption Price (Client would own Asset).

32 Usufruct may be described as the right of enjoying the use and advantages of another person's property short of destruction.



### **Case Study Six: Profit and loss sharing partnership (diminishing share of equity) (continued)**

#### **Example of partnership arrangement**

Financier: Resident bank or Financier (Partner)

Client: Resident individual or company (Partner and Managing Agent)

Purpose: Project or plant financing

Term: 2 years

Amount: AUD 300 million (Asset)

Financier: AUD 180 million cash (Principal)

Client: AUD 120 million usufruct rights of machinery

Profit Ratio: Financier 50 per cent and Client 50 per cent

Losses: Financier 60 per cent and Client 40 per cent

Redemption: AUD\$180 million (Principal) or market price if so negotiated

Notes: Distribution of for example 10 per cent per annum can be payable for example quarterly if profits but no Distribution if losses. Profit to Financier can be for example LIBOR AUD 2Y + 200bp if profits but any losses to Financier are 60 per cent. Client undertakes to purchase Financier's ownership via separate agreement.

4.71 If the arrangement described in Case Study Six is considered to be a tax law partnership, the partners will be subject to tax on their share of income and losses of the partnership.

4.72 If the Financier is a non-resident, they would need to lodge an income tax return and account for all of their Australian source income arising from the partnership. The effect is that they would be subject to a higher amount of tax than if the return on their capital was characterised as interest subject only to IWT.

4.73 The payment for the acquisition of part of the equity held by the Financier may give rise to CGT consequences. In effect, there is a disposal of part of the Financier's CGT asset, which will result in a CGT event occurring. The resulting CGT event will also create valuation issues as the amount paid by the Client will be pre-determined at the commencement of the arrangement and may not represent the market value of the CGT asset acquired.

4.74 A change in the composition of the partnership (resulting from the change in equity stakes) technically amounts to a dissolution and reconstitution of the partnership. However, it is possible for a partnership agreement to include a continuance clause which provides that the partnership can continue, and maintain the

same TFN, ABN and GST registration. If a partner exits a partnership, the partnership will cease to exist.

4.75 GST will treat each payment to acquire a share of the equity as a series of input taxed supplies.

4.76 Stamp duty would be payable on the initial purchases by the partners, then on the incremental purchases by the partner and then on the incremental buy out by the final owners. Non-diminishing partnership would only be dutiable on the initial purchase by the partners.

4.77 The tax timing rules in Division 230 could potentially apply to the arrangement described in Case Study Six if:

- the interest in the partnership is a financial arrangement; and
- there is more than one class of interest in the partnership; and
- the interest in the partnership is not an equity interest.

4.78 Generally, interests in partnerships are not within Division 230 because they are not financial arrangements. In addition, there are a number of exceptions that may prevent Division 230 from applying to this arrangement.

4.79 On legal form the arrangement would likely be viewed as an arrangement that gives rise to returns from the carrying on of a business as partners as opposed to interest from a debt arrangement. Consideration must be given to the economic substance and intention of the partnership arrangements and whether such arrangements are equivalents of conventional financial products that bear interest, or are more akin to conventional partnership arrangements. The difference in treatment will be relevant for stamp duty characterisation as well.

4.80 The approach taken in the UK is particularly relevant for this case study. In the UK the profit share return is treated as interest for income tax purposes if the following basic conditions are satisfied:

- one of the parties to the arrangements must be a Financial Institution;<sup>33</sup>
- the arrangements must be of the type and nature described in the legislation including that the eventual owner must have the exclusive right to occupy or otherwise use the asset and be exclusively entitled to the income, profits or gain arising from or attributable to the asset; and

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33 A Financier includes a bank (for UK tax purposes), a UK building society, a wholly-owned subsidiary of the foregoing, certain persons authorised to carry on consumer credit or hire business in the UK or a non-UK person authorised to take deposits or other repayable funds from the public and grant credit on its own account.

- the alternative finance return or the profit share return must equate to, in substance, a return on an investment of money at interest.

4.81 In the context of existing tax frameworks and the tax treatment of a partnership or a financial arrangement, the tax treatment or impediments to the development of the product described in Case Study Six seem to be:

- stamp duty may be payable on each partial transfer of equity from the Financier to the Client;
- there may be CGT consequences for each partial transfer of equity from the Financier to the Client;
- for GST purposes, each payment to acquire a share of the equity is an input taxed supply. While this may be equivalent to a conventional loan in that no GST is payable, there is likely to be an increased compliance cost relating to the reporting of the GST and potentially lost access to reduced input taxed credits for the Financier resulting in a higher cost of finance for the Client;
- if the Financier is a non-resident the return may not be considered interest for IWT purposes; and
- for income tax purposes TOFA may not apply and the Financier may instead be taxed as a partner in a partnership.

### Questions: Case Study Six

Q6.1 What is the conventional equivalent to the arrangement described in Case Study Six?

Q6.2 What is the potential demand for this product in Australia? Can the potential demand be quantified?

Q6.3 Should the income from the arrangement described in Case Study Six be treated, in substance, as:

- a repayment of principal and interest; or
- income or loss from a partnership; or
- ordinary business income?

Q6.4 How could the appropriate income tax treatment be achieved?

Q6.5 What security might be required for this type of arrangement? What happens in the event of default? Does this cause any tax impediments?

**Questions: Case Study Six (continued)**

Q6.6 How would your answer be different if the purpose of the arrangement is to finance the purchase of a residential property?

Q6.7 If you believe the arrangement described should be taxed as if it is a loan, how could an exception to partnership taxation or the application of ordinary income tax concepts, GST and stamp duty laws be provided?

Q6.8 What other approach could be implemented to achieve tax neutrality?

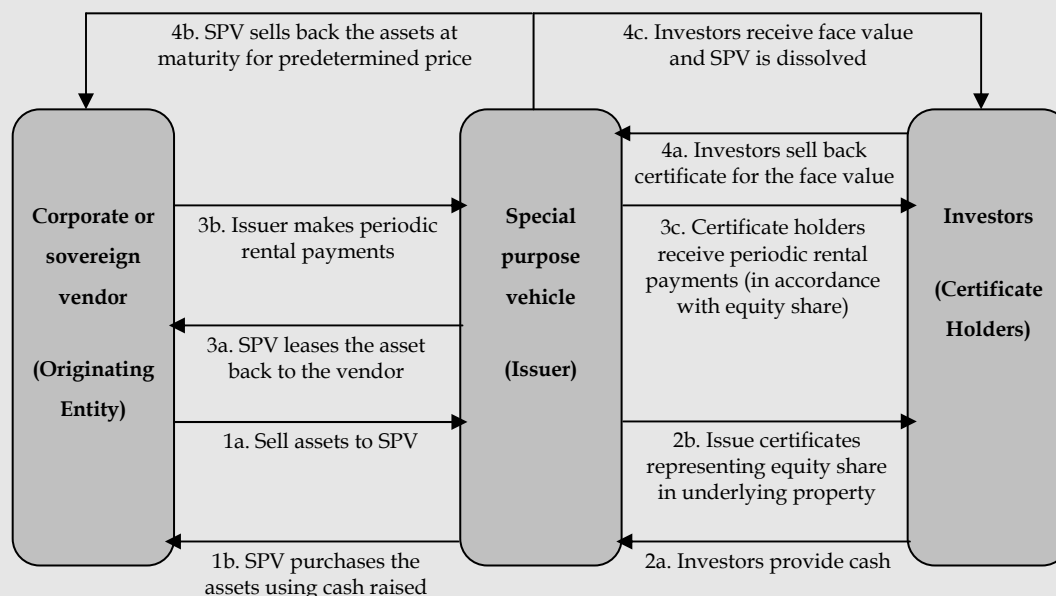
**CASE STUDY SEVEN: LEASE BACKED ISLAMIC BOND<sup>34</sup>**

4.82 As outlined in Chapter Two, interest and uncertainty is prohibited under Shariah law and thus Islamic finance products are based on a combination of profit and loss sharing, trade and leasing arrangements. Equity based financing arrangements have proved to be a relatively easy channel to introduce Shariah compliant finance products into the conventional financial markets. In many countries such as the UK, France and Ireland, Shariah compliant equity based investments co-exist with conventional investments with minimal change to the regulatory environment and tax laws. However, Islamic bonds do not fit as easily into existing tax frameworks.

4.83 Conventional bonds are debt instruments issued by government or companies on a fixed or a floating interest basis. Bonds are typically a medium to long term facility. The feature that distinguishes an Islamic bond arrangement from a conventional bond is that an Islamic bond is asset backed and the certificate represents an undivided share in the underlying asset as opposed to a conventional bond which is a debt security providing a right to income from the issuing entity.

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34 Sukuk (Islamic bond): Sukuk is the Islamic finance equivalent of conventional tradable notes or bonds, which represents the ownership (actual or beneficial) by the sukuk holders in an underlying Shariah compliant asset or financing arrangement. Returns are paid to the investors in line with their proportional ownership in that asset and investment, and vary according to asset performance rather than the time elapsed.

**Case Study Seven: Islamic bond backed by a finance lease**

An Australian electricity company (Vendor) needs to raise \$500 million to finance an upgrade of its infrastructure over the next five years. The entity identifies an asset or a pool of assets with an approximate value of \$500 million.

Step 1: Once the assets to be securitised are identified the assets are sold to an Australian resident special purpose vehicle (SPV) using a purchase agreement. A purchase undertaking is entered into by Vendor.

Step 2: The SPV, as trustee, raises the cash to purchase the assets by issuing certificates to investors. The certificate holder has a proportionate beneficial interest in the underlying assets held by the SPV and entitlement to income generated through the asset.

Step 3: The SPV then leases the assets back to the original owner and distributes the rent to the certificate holders. The periodic distribution to certificate holders is equivalent to the interest coupon on a conventional bond and can be set by reference to a fixed or floating rate of return (6 million + 50bp). A service agreement is entered into between the SPV and the Vendor.

Step 4: At the end of the defined term (five years), the Vendor (original entity) agrees to purchase the assets back at a predetermined price. The certificate is then sold back to the SPV by the investors for the face value and the SPV is dissolved.

4.84 In substance the Islamic bond supported by a leasing arrangement is a securitisation arrangement for the lessee and uses an instrument, the certificate, which offers a fixed or floating return that can be traded on the secondary market. This trading can only be done on the basis that the certificate holder takes a pro-rata ownership of the asset, including all the risks associated with ownership except that

the ownership risks are effectively transferred back to the lessee under the service agreement. The certificates holders are owners of the asset jointly, with its benefits and risks spread according to their proportion of ownership.

4.85 The following tax treatment should apply in order for the Islamic bond to have parity of tax treatment with a conventional bond:

- The certificate represents a debt instrument issued by the originating entity. The certificate is a CGT asset and subject to CGT including its creation and disposal. The return on the certificate should be subject to normal rules of deductibility. It should also be considered to be interest for the purpose of IWT. Access to IWT exemptions should be determined objectively based on consideration of the arrangement as a whole.
- There should be no practical tax consequences associated with the establishment of the SPV and the transfer of assets to the SPV as this would not occur in the case of conventional bonds.

4.86 The actual tax treatment of the arrangement described in Case Study Seven is considered in the following paragraphs.

#### Debt/equity rules

4.87 Under the debt/equity rules in Division 974 of the ITAA 1997 it is the scheme, as defined, that is tested. Whether a series of transactions are part of a single scheme or constitute more than one scheme is a question of fact. Merely because transactions are undertaken in one agreement does not necessarily mean that they are all part of the one scheme. To enable specific circumstances to be taken into account, the Commissioner has a discretion to treat a particular scheme as constituting two or more separate schemes. If there are related schemes, it may be necessary to integrate the related schemes. Together they may give rise to a debt or equity interest.

4.88 On the facts presented in Case Study Seven, whether or not any debt or equity interests arise is mainly dependent upon:

- determining whether there is one scheme or more than one scheme and, if more than one scheme is identified, determining if they are related and, if so, whether they should be integrated;
- identifying the relevant Issuer(s);
- determining whether under the relevant scheme(s) the Issuer(s) are under any effectively non-contingent obligations to provide financial benefits; and

- whether it is substantially more likely than not the value of the financial benefit(s) provided will be at least equal to the value of the financial benefits received.<sup>35</sup>

4.89 Whether the relevant scheme gives rise to a debt interest in the SPV<sup>36</sup> will depend, amongst other things, on the value of financial benefits provided by the SPV under an effectively non-contingent obligation (having regard to the pricing, terms and conditions of the relevant scheme), being at least equal to the value of the financial benefits received. If the SPV's obligation to repay the full face value of the certificates at the end of the five year term is contingent on any event, condition or situation then it is unlikely that the SPV will be under an effectively non-contingent obligation to repay the face value.

4.90 Alternatively, the SPV will be under an effectively non-contingent obligation if its obligation to repay the face value of the certificates is not subject to any contingency, and cannot be deferred or waived in any circumstance. If that is the case, then on the assumption that the certificates' issue price is equal to their face value, it is substantially more likely than not that the nominal value of the financial benefits provided by the SPV will be at least equal to the value of the financial benefits received. If this is the case the scheme may give rise to a debt interest in the SPV under Division 974.

#### TOFA tax timing rules

4.91 The TOFA Working Group to the Finance and Investment Sub Committee of the National Tax Liaison Group (NTLG) is currently considering the application of TOFA tax timing rules (Division 230 of the ITAA 1997) to securitisation arrangements and it is expected that a discussion paper will be issued shortly.<sup>37</sup> This may have implications on the application of Division 230 to this arrangement.

4.92 However, in considering the application of Division 230 generally to this arrangement, regard should be had to the matters detailed in the following paragraphs.

#### *Equity financial arrangement*

4.93 If the Certificate is an equity interest, it is not necessary to test the arrangement to determine whether Division 230 applies to it because an equity interest is specifically deemed to be a financial arrangement. Accordingly, Division 230 will have limited application depending on the tax timing method elections made by the relevant taxpayer(s).

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35 The arrangement outlined in Case Study Seven ends in five years, hence the value of a financial benefit received or provided under the relevant scheme is its value calculated in nominal terms.

36 Whether the Case Study also gives rise to debt or equity interests in other entities has not been considered for the purposes of this paper.

37 see Finance and Investment Taxation of Financial Arrangements Working Group minutes – 11 March 2010, available at [www.ato.gov.au](http://www.ato.gov.au).

### *Cash settleable financial arrangement*

4.94 When considering the definition of a cash settleable financial arrangement in Division 230, it is necessary to correctly identify the arrangement. Once the arrangement is identified it is necessary to consider whether that arrangement is a cash settleable financial arrangement. Importantly each of the rights to receive, or obligations to provide, a financial benefit must be considered in order to determine if any of the rights and obligations are not insignificant and non-cash settleable. If the arrangement has not insignificant non-cash settleable rights and/or obligations the arrangement will not be a financial arrangement to which Division 230 will apply.

### *Exclusions*

4.95 Where a financial arrangement is identified, it is necessary to consider whether any of the exclusions apply. For example, Division 230 does not apply to a right carried by an interest in a trust, or an obligation that corresponds to such a right, if:

- there is only one class of interest in the trust; or
- the interest is an equity interest in the trust (as defined); or
- for a right or obligation relating to a trust – the trust is managed by a finds manager or custodian, or a responsible entity (as defined in the *Corporations Act 2001*) of a registered scheme (as so defined).

### *Finance leases*

4.96 Lease agreements are specifically carved out of the TOFA regime. Therefore the lease side of this arrangement will be brought to tax under either Division 240 (assuming the assets constitute goods) or Division 250 (if there is a tax preferred end user) of the ITAA 1997.

4.97 Division 240 uses the concepts of notional seller and notional buyer for the purposes of determining tax treatment. Notional seller is defined in subsection 240-17(1) as being an entity who is party to the arrangement and who is the actual owner of the property or the owner of the property because of a previous operation of Division 240. In the above situation the SPV will be the notional seller. Notional buyer is defined in subsection 240-17(2) as an entity who is party to the arrangement and, under the arrangement, has the right to use the property. In the above situation the lessee will be the notional buyer.

4.98 A potential result of Division 240 applying will be that the initial sale, before the lease agreement is entered into, will be treated under CGT provisions.

### *IWT*

4.99 If the rental received by the SPV from the lessee is characterised as interest for IWT purposes, that characterisation will flow through to non-resident beneficiaries



(certificate holders) under section 128A(3), and they will be subject to IWT. Even if the rental received from the lessee is not interest within the expanded definition in section 128A(1AB), a portion of it may be deemed as interest under section 128AC of the ITAA 1936. This provision applies, broadly, to leases under which the lessee is entitled to purchase or require the transfer of the lease property on termination of the lease. If this provision applies, the non-resident certificate holders will be subject to IWT.

4.100 In contrast to a conventional bond, characterising an Islamic bond as a debenture is problematic for the purposes of the IWT exemptions under sections 128F or 128FA. While the certificates may be characterised as a debt interest, it would be difficult to characterise them as non-equity shares or a syndicated loan.

## CGT

4.101 The sale of the assets by the electricity company to the SPV is a CGT event (A1). The agreement to transfer the use and enjoyment of the assets is also a CGT event (B1) if the title in the asset will or may pass to the other entity at the end of the agreement. However, Division 240 of the ITAA 1997 provides for the inclusion of amounts under hire purchase agreements in assessable income. If an amount is included in assessable income under Division 240, the anti-overlap provisions would need to be considered to determine the amount the capital gain (if any) should be reduced by.

4.102 The issuer will have to account for the gain on the initial sale to the SPV (capital proceeds less cost base). The capital proceeds from a CGT event is the total value of the money received or entitled to receive in respect of the CGT event unless a modification can be applied. If CGT event B1 happens the capital proceeds from the CGT event should be equal to the repurchase amount in the agreement and should exclude the periodic rent (finance charge) as this is not a capital payment. An adjustment may need to be made if the final payment to repurchase the assets is more or less than the amount agreed to. The final transfer of the assets from the SPV back to the issuer may not be a CGT event if B1 has already happened in respect of those assets. If the final transfer triggers CGT event A1 the market value substitution rules may apply as the price agreed to at the start of the arrangement may no longer reflect the true market value of the assets.

4.103 The creation of the certificates (representing the right to proportionate beneficial ownership of the underlying assets) by the SPV and the subsequent disposal of certificates by the holders will be CGT events (D1 or E1 and C2 or A1 respectively).

4.104 A foreign resident can disregard a capital gain or loss unless the relevant CGT asset is a direct or indirect interest in Australian real property or relates to a business carried on by the foreign resident through a permanent establishment in Australia. Foreign resident portfolio certificate holders will be able to access the CGT exemption on disposal of certificates. Foreign residents that have a non-portfolio interest will only

be able to access the exemption if the underlying assets are not taxable Australian real property.

## GST

4.105 A lease based Islamic bond involves a series of supplies for the purposes of GST.

4.106 The first supply is the sale of the relevant property by the Lessee to the SPV. If a commercial building or property that is not existing residential property (including new residential premises and commercial residential premises) is sold, the supply will be taxable. The Lessee will need to pay GST on the sale and the SPV will generally be entitled to an offsetting input tax credit.

4.107 The second supply is the lease of the property by the SPV to the Lessee.<sup>38</sup> If the supply is not a residential property, it will be taxable and GST will need to be remitted by the SPV while the Lessee will be entitled to an offsetting input tax credit. In some cases the terms of the lease arrangement may be such that it amounts to a hire purchase arrangement rather than a lease in which case it will still be taxable but will not be considered a periodic supply.

4.108 The third supply is the issue by the SPV of the Islamic bonds to investors. The treatment of this supply involves a number of complex issues. To begin with, there are three possible ways in which this supply could be characterised.

4.109 First, it could be the supply of a security. Supplies of interests in or under securities are included in the definition of financial supply in the GST regulations. As a result this supply will be input taxed. Provided the SPV exceeds the financial acquisitions threshold, GST will not be payable on the supply by the SPV, but input tax credits will not be available for related acquisitions by the SPV.

4.110 Secondly, the certificates could instead be characterised as the assignment of right to a payment stream under a securitisation arrangement. The consequences of such a characterisation would be much the same as if it were characterised as a security. Such supplies are also input taxed financial supplies as they are considered to be a debt arrangement under the GST Regulations.

4.111 Finally, the supply could be considered as the sale of a partial interest in the underlying property. In this case the treatment would follow that of the property as outlined above in relation to the first and second supplies.

4.112 However, it should be noted that if a supply is an export it will be GST free regardless of its normal treatment. The first two supplies (the lease and sale), will not be exports as they are supplies of real property in Australia. However, the supply of

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38 It should be noted that if the SPV and Lessee are members of the same GST group the first and second supplies may be able to be disregarded for GST purposes as intra-group transactions.

the Islamic bonds may, where the bond is supplied to a non-resident, be an export and hence may be GST free.

### Stamp duty

4.113 Stamp duty is a transaction based tax and applies generally to any transfer of ownership in real property. Stamp duty may be payable on the transfer of the assets from the Vendor to the SPV and the subsequent transfer from the SPV back to the Originating Entity.

4.114 In the context of existing tax frameworks and the tax treatment of a conventional bond, the tax treatment or impediments to the development of the product described in Case Study Seven seem to be:

- stamp duty may be payable on each transfer of assets by the Vendor to the SPV and by the SPV to the Originating Entity;
- equivalent treatment for GST purposes except that the GST treatment of the supply of the certificates is uncertain;
- if the Certificate holders are non-residents the return may be considered in the nature of interest for IWT purposes. Certificate holders may not have access to the IWT exemptions; and
- for income tax purposes the tax treatment of the Issuer, the SPV and the resident Certificate Holders is uncertain.

### Questions: Case Study Seven

Q7.1 What are the impediments in current Australian tax laws (at the Commonwealth, State and Territory level) to the development and provision of this Islamic finance product in Australia?

Q7.2 What can we learn from overseas jurisdictions?

Q7.3 Is legislative change required to address the impediments, uncertainty or complexity in the application of the current law?

Q7.4 Are there other options such as administrative solutions or ATO rulings?

Q7.5 What are the specific provisions or aspects of the law that should be amended?

Q7.6 What are the integrity issues?

Q7.7 Would there be any other tax issues if the Islamic bonds were issued by a sovereign entity such as a state government?

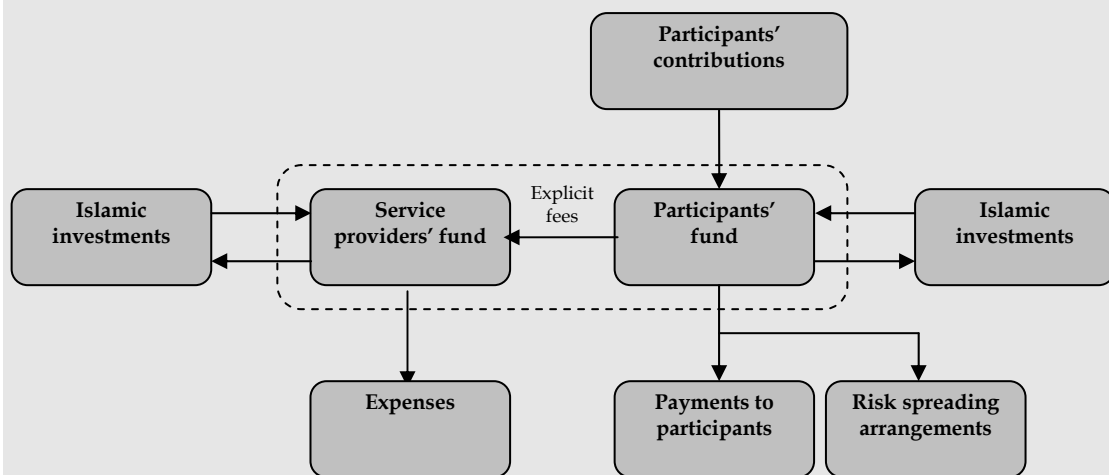
## CASE STUDY EIGHT: ISLAMIC RISK SHARING ARRANGEMENTS<sup>39</sup>

4.115 The Board has been asked to review Australia's tax laws to ensure that, wherever possible, they do not inhibit the expansion of Islamic finance, banking and insurance products. Islamic risk sharing arrangements are based on a pooled investment vehicle where profits are paid out to contributors for specified events. The fund does not seek to make profits but to mitigate its losses. However, any surplus profits made may be distributed to participants, and in some situations, participants may need to make further contributions to mitigate losses.

4.116 The members contribute the funds and service providers manage the investments and receive compensation in the form of fees. The investments made with these funds must be Shariah compliant. Those operating the arrangement must keep the participants' funds separate from the service providers' funds. The funds arising from the contributor's contributions are used to make payments to contributors, and to pay any expenses including amounts paid to other parties sharing the risks.<sup>40</sup> The service providers make charges to the contributors' fund for operating the arrangement, and are responsible for paying operating expenses.<sup>41</sup>

4.117 One of the critical differences between contemporary insurance models and Islamic risk sharing arrangement is the participant's right to receive surplus profits but at the same time, they are liable to pay additional contributions if the contributions are not enough to meet all the losses incurred during the period.

### Case Study Eight: Risk sharing arrangement consistent with Shariah principles



39 Takaful (Insurance): Under the takaful contract parties invest in a pooled investment vehicle where they joint-guarantee each other against specified events and profits are paid out to investors upon the occurrence of a specified event. The fund does not seek to make profits but to mitigate its losses, but may invest surplus funds in Shariah compliant assets or financing arrangements.

40 Under conventional Australian insurance arrangements, insurers pay premiums to other insurers (reinsurers) to spread their risk or cover major losses from specific events such as large hailstorms.

41 Austrade *Islamic Finance* January 2010 p 33.

4.118 Australian income tax law recognises a 'principle of mutuality' in relation to certain arrangements involving funds contributed for a common purpose. This principle may affect the tax treatment of certain transactions. There are also specific tax law provisions in section 121 of the ITAA 1936 which, broadly, treat a mutual insurance association as a company carrying on insurance business, and whose assessable income specifically includes insurance premiums received from its members or others.

4.119 Ordinary principles in relation to assessable income and allowable deductions apply to insurance companies, as modified by specific provisions for general insurers (Division 321 of the ITAA 1997) and life insurers (Division 320). For instance, payment of claims on risk policies by an insurance company is generally an allowable deduction.<sup>42</sup> In Australia there are also a range of other approaches under which risk is pooled by way of collective contributions, and the tax treatment of these depends on their particular characteristics.

4.120 There appear to be no specific tax barriers to the establishment of Islamic risk sharing arrangements. However, their characterisation under Australian general and income tax law including stamp duty treatment in relation to insurance products would need to be established. This will enable an evaluation of their taxation treatment, in addition to any tax issues in relation to Islamic financing alternatives in which they invest.

### **Questions: Case Study Eight**

Q8.1 What is the potential demand for this product in Australia? Can the potential demand be quantified?

Q8.2 In comparison to the tax laws that apply to conventional insurance products, will any aspect of Australia's tax laws inhibit the expansion of Islamic insurance?

Q8.3 How could we achieve a level playing field for the taxation of Islamic insurance?

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42 Insurance premiums paid by an employer for workers compensation insurance and accident insurance are usually deductible. Premiums paid by a business to insure their business are also deductible. Personal sickness and accident premiums (income protection) are generally deductible. Deductions are not allowed if the premiums are paid under arrangements that are not legally enforceable.



## CHAPTER 5: INTERNATIONAL APPROACH

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### UNITED KINGDOM

5.1 The UK Government is seeking to develop and support Islamic finance in the country as a policy of social inclusion (the UK has around 1.647 million Muslims, or 2.7 per cent of its population)<sup>43</sup> and as part of its strategy to promote London as a 'Western' Islamic financial centre.

5.2 In 2003, the UK launched a series of legislative amendments of its taxation, legal and regulatory regimes to ensure a level playing field between Islamic finance and conventional finance.

5.3 The tax legislation does not mention the Shariah or use any Islamic finance terms. Instead, the legislation creates a set of definitions for use in UK tax law. For borrowing arrangements that fall within the definitions<sup>44</sup> the legislation specifies how to determine the 'finance cost' and how that finance cost is treated by both the payer and recipient. Except for the bond alternative, one of the parties to the transaction must be a Financial Institution.<sup>45</sup>

5.4 Broadly speaking, if the rules apply the finance cost is brought within the same tax rules as those that apply to interest.<sup>46</sup> Similar changes were made to facilitate alternative deposit arrangements based on profit sharing arrangements. Essentially the law ensures that the return is taxed as if it were interest where it equates in substance to an interest like return. This required the 'switching off' of tax rules that might otherwise treat the return as a distribution.

5.5 In addition to the introduction of income tax rules for alternative finance arrangements to improve certainty of tax treatment, the UK introduced progressive changes to the incidence of stamp duty land tax to remove double taxation. Initially the

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43 Pew Research Centre, *Mapping the Global Muslim Population – A Report on the Size and Distribution of the World's Muslim Population*, October 2009.

44 Referred to in the legislation as purchase and resale or diminishing shared ownership arrangements.

45 A Financier includes a bank (for UK tax purposes), a UK building society, a wholly-owned subsidiary of the foregoing, certain persons authorised to carry on consumer credit or hire business in the UK or a non-UK person authorised to take deposits or other repayable funds from the public and grant credit on its own account.

46 PricewaterhouseCoopers, *Taxation of Conventional and Shariah Compliant Mortgages*, November 2008, p 9.

changes were made for individuals entering into Islamic mortgage arrangements and then the rules were extended to equity sharing arrangements and companies.

5.6 In 2007 changes were introduced to facilitate the issue of sukuk, or alternative finance investment bonds. The legislation seeks to apply the same tax treatment that would be applicable were the alternative finance investment bond to be a debt instrument. To achieve tax neutrality, further changes also were required to the stamp duty land tax and stamp duty reserve tax.

## IRELAND

5.7 Irish Revenue and Customs Tax Briefing 78 (October 2009) outlines their approach to the taxation of Shariah compliant products. Broadly, the approach in Ireland has been to tax the Shariah compliant product in the same manner as the conventional economic equivalent. For instance, the gross roll up taxation regime which applies to Irish regulated funds does not impose tax on profits or gains of the fund but requires the fund to deduct tax on the happening of certain chargeable events. These arrangements apply irrespective of whether the fund is Shariah compliant or a conventional fund.

5.8 New legislation has been introduced that will facilitate Islamic financing arrangements. The transactions covered by the legislation are credit transactions, deposit transactions and investment transactions. The explanatory memorandum to the Finance Bill 2010 states that the amendments in relation to Islamic finance are:

designed to extend the tax treatment applicable to conventional finance transactions to Shari'a products which are the same in substance as the conventional products.

5.9 It does this by defining the finance transactions and essentially treats the return on the products defined as interest for the purposes of Irish tax law. For instance, the legislation clarifies that the sukuk certificate should be considered a security and confirms that the investment return on that certificate should be treated as interest on a security for the purposes of the Taxes Act. In addition, it confirms that the sukuk issuer will be entitled to a deduction in respect of the coupon paid as though it was a conventional interest payment.<sup>47</sup>

5.10 Amendments have also been made to the Stamp Acts to ensure that no stamp duty will arise on the issue, transfer or redemption of a sukuk certificate. Amendments have also been proposed to the value added tax (VAT) Act to exempt from VAT specified financial transactions. For instance, Islamic finance transactions where those transactions correspond to financial services transactions as listed in the VAT Act.

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47 PricewaterhouseCoopers *Ireland's new Finance Bill enhances its attractiveness for Islamic funds* 2010.



## SOUTH KOREA

5.11 In South Korea a primary policy objective is to remove taxation barriers to the issue of sukuk. As South Korea has no trust equivalent the view is that a SPV established to facilitate a sukuk issue would be subject to corporate taxation on the periodic lease payments and the payments to the sukuk holders would not be deductible.

The main hurdles, are taxation issues relating to double stamp duty, value added tax (VAT) and capital gains; and the definition of what constitutes a security. From a conventional point of view, sukuk for instance, may look like asset-backed securities or like investment certificates. There must be a standard guideline that sukuk is considered as securities.<sup>48</sup>

5.12 South Korea are looking to remove tax barriers to the establishment of a market for sukuk, putting them on equal footing to conventional bonds.

## FRANCE

5.13 The policy approach of the French authorities is to achieve a level playing field between Islamic and conventional instruments. No legislative changes were found necessary. Instead the removal of tax barriers has been achieved through the release of tax guidelines ensuring that ordinary French tax rules apply appropriately to Islamic financing arrangements that resemble debt instruments.

5.14 On 24 August 2010, the French Tax Authorities issued several guidelines that explain how Shariah compliant transactions will be treated for tax purposes under French law. The guidelines specifically consider murabahah, investment sukuk, ijarah, and istisna.

5.15 For instance the guidelines for a murabahah arrangement provide certainty that the total price paid by the Client includes:

- the initial purchase price (first transfer of ownership from the Vendor to the Financier);
- a brokerage fee; and
- the profit component.

5.16 In addition the guidelines provide that the client must exclude, from the depreciable value of the asset (i.e. book value), the profit component and the brokerage

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48 Mushtak Parker *Islamic financial products face hurdles in S. Korea* ARAB NEWS Published: Feb 14, 2010 available at: <http://arabnews.com/economy/islamicfinance/article17010.ece?service=print>.

fee. When the Client sells the asset, however, the brokerage fee will be added back to the value of the asset when assessing any capital gain. Similarly the guidelines specify that for the Financier, the profit margin corresponds to the remuneration of a deferred payment which is treated as interest income for tax purposes.

## SINGAPORE

5.17 The policy approach of the Singapore Government has been to align tax treatment of Islamic contracts with the treatment of conventional financing contracts they are economically equivalent to.

5.18 Singapore provides a stamp duty remission if a qualifying Islamic financing arrangement is entered between a Financial Institution and any purchaser with regards to the acquisition of property in Singapore.

5.19 The Singapore government has recognised that given the nature and structure of Islamic financial products, they tend to attract more tax than their conventional equivalent.<sup>49</sup>

## MALAYSIA

5.20 Malaysia has established itself as an Islamic financial hub in the region. With the establishment of the Malaysia International Islamic Financial Centre (MIFC), aimed at promoting Malaysia as a key global player in Islamic finance, Malaysia has introduced a regulatory framework for Islamic financing as well as tax laws which seek to ensure that Islamic financial transactions are taxed on an equal footing with conventional financing transactions, but go further to provide tax incentives to the Islamic financial sector to promote the growth of this sector.<sup>50</sup>

5.21 In an address to the Conference of Presidents of Law Associations in Asia the Deputy Governor of the Central Bank of Malaysia said in relation to Islamic finance and Malaysia's role:

The policy, which was later emulated by many countries around the world, ensures neutrality to tax treatment between Islamic and conventional financial products and services, a move which enhances the attractiveness of Islamic financial products as competitive alternative to conventional banking ... In the early phases of development, Malaysia had looked into the legal impediments that might hinder Islamic finance. What

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49 Khan, H & Bashar, O 'Islamic Finance: Growth and Prospects in Singapore' U21 Global Working Paper Series, No. 001/2008, p 4.

50 Bhupalan, Renuka *An Introduction to Islamic Finance and the Malaysian Experience* (2009) Tax and Malaysia.

lies ahead is to harmonise existing laws such that it accommodates and facilitates Islamic finance in the most legally efficient way possible ... Countries that intend to promote Islamic finance must also have laws that are clear and easily enforceable. In this respect, having common laws, or a reference point for laws on Islamic finance, would serve to benefit the industry worldwide.<sup>51</sup>

5.22 The Islamic Financial Services Board was established in 2003 in Kuala Lumpur. It provides guidance that is intended to promote global prudential standards and guiding principles for the Islamic banking and insurance industry and capital markets. The guidance indicates that a key criterion in distinguishing between Islamic investment and Islamic finance is the existence of a regular cash flow from a Client in respect of the asset. The existence of such a cash flow indicates that the entity is providing debt financing to the Client for the asset, while the absence of such a cash flow indicates that the entity has invested in the asset on its own account.

5.23 To provide parity under Malaysian tax law, profits derived from Islamic financial transactions are treated as interest for tax purposes and the payment of profits by the borrower will be treated as interest costs for tax purposes.

Any reference in this Act to interest shall apply, *mutatis mutandis*, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah.<sup>52</sup>

5.24 In addition, the definition of tax law partnerships has carved out associations established for the purposes of enabling Shariah compliant financing. Also, the payment of interest by licensed banks/Financial Institutions to non-residents is generally exempt from withholding tax under Malaysian tax law. This exemption has been extended to also cover licensed Islamic banks/Financial Institutions in respect of payments of profit.<sup>53</sup>

5.25 Malaysia has a ten year exemption for Islamic banks on income derived from Islamic banking conducted in international currencies. There are also broad tax exemptions on income derived from Malaysian issued sukuk and income for Malaysian based Islamic fund management and for Islamic advisory services.

5.26 From the perspective of a Client, the functionality of an Islamic bank or Islamic window is equivalent to conventional banks in that they offer deposit accounts which provide a return to the depositor and credit facilities (business and consumer) including home financing. Islamic banks utilise agency agreements, profit and loss

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51 Luncheon address by Mr Mohammad bin Ibrahim, Deputy Governor of the Central Bank of Malaysia, at the 21st Conference of Presidents of Law Associations in Asia: 'Islamic Finance and Malaysia's Role', Kuala Lumpur, 27 July 2010.

52 Section 2(7) Income Tax Act 1967 (Malaysia).

53 Bhupalan, Renuka *An Introduction to Islamic Finance and the Malaysian Experience* (2009) Tax and Malaysia.

sharing arrangements, finance leases and trade (sale and purchase) to support these products.

Islamic financial instruments are asset-based (Murabahah, Salam, and Istisna which are based on the sale or purchase of an asset, and Ijarah which is based on selling the benefits of such an asset), profit-sharing (Musharakah and Mudarabah), or Sukuk (securities) and investment portfolios and funds which may be based on the above assets.<sup>54</sup>

## INDONESIA

5.27 Indonesia, a civil law country, has introduced laws to recognise trust structures and thus enable the establishment of SPVs. This removed what had been a significant barrier to the use of sukuk to raise finance. In addition, the Indonesian parliament passed a law last year removing double taxation on Islamic instruments as of April 2010.

5.28 Data from the Office of the Coordinating Minister for Economic Affairs shows that Indonesia now has five Shariah commercial banks, 27 Shariah windows and 131 Shariah financing units.<sup>55</sup>

5.29 A significance of this growing market to Australia is that to operate an Islamic deposit account based on profit sharing arrangements an Islamic finance institution needs access to a secondary market of Shariah compliant investments. The significant retail banking sector in Malaysia and the emerging market in Indonesia will see demand for Islamic investments continue to grow in the region. This demand could be serviced through the establishment of Islamic windows of conventional banks and through the establishment of an Australian sukuk market.

### Questions: Chapter Five

Q9.1 Considering the terms of reference for this review, please provide any comments you may have on the approaches taken to the taxation of Islamic finance in other jurisdictions.

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54 IFSB *Capital adequacy standard for institutions (other than insurance institutions) offering only Islamic financial services* (2005) p 2.

55 Antara News Indonesia *Three banks to open sharia units soon* (20 May 2009).

# APPENDIX A: SUMMARY OF QUESTIONS

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## CHAPTER FOUR

### Case Study One: Cost plus profit sale

1.1 Do you agree with the issues identified in the above summary? Do you have any further comments in relation to the issues identified?

1.2 What are the tax impediments in addition to those summarised to the development of the home financing product described in Case Study One?

1.3 How could tax neutrality be achieved in relation to:

- Income tax (including IWT);
- Stamp duty; and
- GST?

1.4 How would your answer be different if the property were a commercial property?

1.5 Please consider the application of stamp duty in the context of Islamic mortgage funds.

1.6 Have the Victorian amendments to the Duty Act worked effectively to provide a level playing field?

### Case Study Two: Interbank finance

2.1 Can the potential cost to the Financier from lost entitlement to reduced input tax credits be quantified?

2.2 Should the profit component payable by the resident Client be subject to IWT and how could certainty be achieved?

2.3 Bearing in mind the Government's policy intent (that Australian business does not face a restrictively higher cost of capital, or constrained access to capital, as a result of the IWT burden being shifted from the non-resident lender to the Australian borrower):

- What are the specific withholding tax exemptions that, in principle, should be available in the circumstances described in Case Study Two?

- What element of the test is problematic?
- Why should the exemption be available in this case?
- How could the IWT provisions be amended to ensure the policy intent of the exemption is not compromised?

2.4 How is the tax treatment of the resident 'agent' different to the conventional equivalent? How should the resident 'agent' be taxed in principle?

2.5 What security might be required for this type of arrangement? What happens in the event of default? Does this cause any tax impediments?

### Case Study Three: Finance lease and hire purchase

3.1 Is the differential treatment of leases (based on the form of the leasing arrangement) an impediment to the development of Islamic finance?

3.2 Should the income tax treatment of leases be more broadly determined by the economic substance of the arrangement?

3.3 How can the interest equivalent and the principal be isolated if Division 240 does not apply?

3.4 How would your answer be different if this arrangement was used for home financing?

### Case Study Four: Purchase order

4.1 What is the equivalent conventional product?

4.2 Will the application of ordinary income tax rules be an impediment to the development of this type of Islamic finance product?

4.3 Will GST apply appropriately?

4.4 Is there an additional duty cost compared to the conventional equivalent?

4.5 What are the PAYG withholding and IWT issues caused by the Financier's relationship with the Contractor?

Please explain your answers using examples or a description of the circumstances that give rise to the issue.

4.6 How could any tax impediments be resolved?

### Case Study Five: Pre-paid forward sale

- 5.1 What is the equivalent conventional product?
- 5.2 Will the application of ordinary income tax rules be an impediment to the development of this type of Islamic finance product?
- 5.3 Will GST apply appropriately?
- 5.4 Is there an additional duty cost compared to the conventional equivalent?

Please explain your answers using examples or a description of the circumstances that give rise to the issue.

- 5.5 How could any tax impediments be resolved?

### Case Study Six: Profit and loss sharing partnership

- 6.1 What is the conventional equivalent to the arrangement described in Case Study Six?
- 6.2 What is the potential demand for this product in Australia? Can the potential demand be quantified?
- 6.3 Should the income from the arrangement described in Case Study Six be treated, in substance, as:
  - a repayment of principal and interest; or
  - income or loss from a partnership; or
  - ordinary business income?
- 6.4 How could the appropriate income tax treatment be achieved?
- 6.5 What security might be required for this type of arrangement? What happens in the event of default? Does this cause any tax impediments?
- 6.6 How would your answer be different if the purpose of the arrangement is to finance the purchase of a residential property?
- 6.7 If you believe the arrangement described should be taxed as if it is a loan, how could an exception to partnership taxation or the application of ordinary income tax concepts, GST and stamp duty laws be provided?
- Q6.8 What other approach could be implemented to achieve tax neutrality?

### Case Study Seven: Lease backed Islamic bond

- 7.1 What are the impediments in current Australian tax laws (at the Commonwealth, State and Territory level) to the development and provision of this Islamic finance product in Australia?
- 7.2 What can we learn from overseas jurisdictions?
- 7.3 Is legislative change required to address the impediments, uncertainty or complexity in the application of the current law?
- 7.4 Are there other options such as administrative solutions or ATO rulings?
- 7.5 What are the specific provisions or aspects of the law that should be amended?
- 7.6 What are the integrity issues?
- 7.7 Would there be any other tax issues if the Islamic bonds were issued by a sovereign entity such as a state government?

### Case Study Eight: Islamic risk sharing arrangements

- 8.1 What is the potential demand for this product in Australia? Can the potential demand be quantified?
- 8.2 In comparison to the tax laws that apply to conventional insurance products, will any aspect of Australia's tax laws inhibit the expansion of Islamic insurance?
- 8.3 How could we achieve a level playing field for the taxation of Islamic insurance?

## CHAPTER FIVE

- 9.1 Considering the terms of reference for this review, please provide any comments you may have on the approaches taken to the taxation of Islamic finance in other jurisdictions.



## APPENDIX B: SUMMARY OF TAX TREATMENT UNDER EXISTING TAX FRAMEWORKS

Islamic finance product — form, substance and conventional equivalent	Tax benchmark	Comparison
<b>Case Study One: Cost plus profit (murabahah)</b>		
<p>Form: trade</p> <p>Substance: loan</p> <p>Conventional equivalent: loan</p>	<p>If the property is an investment property and is used to generate assessable income the interest is generally deductible to the Client at the time that it is actually paid.</p> <p>The Client would pay any stamp duty, and the Vendor any GST on the transaction.</p> <p>The cost price of the property should be the first element of the Client's cost base for CGT purposes.</p> <p>For the Financier the interest is a gain that it makes from a financial arrangement. Accordingly the tax timing rules in TOFA would determine the amount to be brought to account in each income year so that the interest should be assessable income at the time that it accrues.</p>	<p>Double stamp duty (except in Victoria), but no land tax issue;</p> <p>For GST purposes, lost entitlement to reduced input tax credits for the Financier;</p> <p>Depending on the terms of the agreement, IWT applies to non-resident Financiers in the same way as for a conventional mortgage provided by a non-resident; and</p> <p>Tax uncertainty for the Client in relation to whether the profit component:</p> <ul style="list-style-type: none"> <li>– can be deducted under section 8-1; or</li> <li>– is a cost of acquiring the property and therefore included in the cost base for CGT purposes.</li> </ul>

Islamic finance product — form, substance and conventional equivalent	Tax benchmark	Comparison
<b>Case Study Two: Interbank finance (tawarruq)</b>		
<p>Form: trade</p> <p>Substance: loan</p> <p>Conventional equivalent: debt instrument</p>	<p>For the non-resident syndicated Financiers, the return on the debt instrument is interest or in the nature of interest and subject to interest withholding tax unless an exemption applies.</p> <p>The supply of the debt instrument would be a GST free supply for GST purposes.</p> <p>For the resident Client, the profit component should be deductible subject to general deductibility rules.</p> <p>The timing of the deductions will be determined by ordinary rules as the TOFA tax timing rules in Division 230 of the ITAA 1997 will not apply.</p>	<p>Equivalent stamp duty treatment;</p> <p>For GST purposes, lost entitlement to reduced input tax credits for the Financier and possibility of a greater cash-flow burden due to the upfront cost of GST;</p> <p>Non-resident financiers may have uncertain tax outcomes related to whether the profit component is characterised as interest for IWT purposes;</p> <p>If the profit component is characterised as interest for IWT purposes, Australian borrowers may bear a restrictively higher cost of capital, or constrained access to capital if IWT exemption does not also apply to economically equivalent Islamic financing arrangements;</p> <p>Uncertainty in relation to the income tax treatment of the resident Agent; and</p> <p>If the TOFA tax timing rules do not apply, there may be uncertainty for the Client in relation to the timing of its deduction in relation to the profit component.</p>
<b>Case Study Three: Finance lease (ijarah muntahiah bi tamlik)</b>		
<p>Form: lease</p> <p>Substance: loan</p> <p>Conventional equivalent: finance lease</p>	<p>Taxed as a lease or a finance lease (sale and loan) depending on the circumstances.</p>	<p>In the context of existing tax frameworks and the tax treatment of a finance lease, the tax treatment of the product described in Case Study Three would be equivalent for stamp duty, GST, IWT and income tax purposes.</p>

Islamic finance product — form, substance and conventional equivalent	Tax benchmark	Comparison
<b>Case Study Four: Purchase order (istisna)</b>		
<p>Form: trade</p> <p>Substance: deferred payment finance</p> <p>Conventional equivalent: no clear equivalent</p>	<p>The arrangement described in Case Study Four is a contract of sale subject to completion of the project in accordance with the specifications. The timing of the payments may change the tax treatment. For instance, if the payments were made during construction ordinary tax rules would apply and alternatively, if payments are made after construction, it is likely to be considered a financial arrangement.</p>	<p>The tax treatment of the arrangement described in Case Study Four would be the same as for equivalent conventional arrangements for GST, IWT and income tax purposes.</p> <p>Income tax treatment will depend on whether the arrangement can be considered to be a financial arrangement or not. IWT treatment will depend on whether the profit component is interest for IWT purposes.</p> <p>There may be additional duty payable.</p>
<b>Case Study Five: Pre-paid forward sale (salam)</b>		
<p>Form: trade</p> <p>Substance: trade/financial arrangement</p> <p>Conventional equivalent: no equivalent</p>	<p>The client's obligation to deliver the commodity, and the Financier's right to receive the commodity, would initially suggest that this is not a financial arrangement on the basis that the relevant rights/obligations are not cash settleable. However, there may be circumstances where it is cash settleable and therefore could be a financial arrangement.</p>	<p>The tax treatment of the arrangement described in Case Study Five would be the same as for equivalent conventional arrangements for stamp duty, GST, IWT and income tax purposes.</p>

Islamic finance product — form, substance and conventional equivalent	Tax benchmark	Comparison
<b>Case Study Six: Profit and loss sharing partnership (musharakah)</b>		
<p>Form: partnership</p> <p>Substance: depends on the arrangement</p> <p>Conventional equivalent: no equivalent</p>	<p>Generally, most interests in partnerships are not within Division 230 because they are not financial arrangements. In addition, there are a number of exceptions that may prevent Division 230 from applying to this arrangement.</p>	<p>Stamp duty may be payable on each partial transfer of equity from the Financier to the Client.</p> <p>There may be CGT consequences on each partial transfer of equity from the Financier to the Client.</p> <p>For GST purposes, each payment to acquire a share of the equity is an input taxed supply. While this may be equivalent to a conventional loan in that no GST is payable, there is likely to be an increased compliance cost relating to the reporting of the GST and potentially lost access to reduced input taxed credits for the Financier resulting in a higher cost of finance for the Client.</p> <p>If the Financier is a non-resident the return may not be considered in the nature of interest for interest withholding tax purposes.</p> <p>For income tax purposes TOFA may not apply and the Financier may instead be taxed as a partner in a partnership.</p>
<b>Case Study Seven: Lease backed Islamic bond (sukuk)</b>		
<p>Form: investment trust</p> <p>Substance: debt instrument</p> <p>Conventional equivalent: no equivalent but similar to a bond</p>	<p>The debt instrument (bond) issued by the originating entity is a CGT asset and subject to CGT including its creation and disposal.</p> <p>The return on the bond is interest and therefore subject to normal rules of deductibility and IWT.</p> <p>IWT exemptions are generally available.</p>	<p>Stamp duty may be payable on each transfer of assets by the issuer to the SPV and by the SPV to the issuer.</p> <p>Equivalent treatment for GST purposes except that the GST treatment of the supply of the certificates is uncertain.</p> <p>If the Certificate holders are non-residents the return may be considered interest for IWT purposes. Certificate holders may not have access to the IWT exemptions.</p> <p>For income tax purposes the tax treatment of the Issuer, the SPV and the resident Certificate Holders is uncertain.</p>