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Dear Sirs

Review of the Taxation Treatment of Islamic Finance - Discussion Paper

The Norton Rose Group (**Norton Rose**) is pleased to make submissions in response to the invitation to do so extended in the Board's October 2010 Discussion Paper relating to the Review of the Taxation Treatment of Islamic Finance (**Discussion Paper**).

Norton Rose has long been involved in assisting clients involved in Islamic finance transactions, and has over 50 lawyers across the world who are members of the firm's Islamic finance group. Our firm has consistently won awards in recognition of its expertise in this area – most recently the 2010 Islamic Finance News Best Service Providers Poll in the Law Firm Category.

Norton Rose welcomes the Board of Taxation review of taxation treatment of Islamic finance products. We believe that it is apparent from the Discussion Paper that the potential impact of Australia's revenue laws on transactions which are structured in a Shariah compliant manner is a significant impediment to those transactions being undertaken at all in Australia.

Norton Rose considers that Australia would be well served by following the example set in the United Kingdom in relation to the measures that have been taken in that country to make provision in its tax laws for Shariah compliant financing. These measures have the advantage of being relatively simple and their stated aim was to place transactions structured in a Shariah compliant manner on a similar footing, so far as the tax consequences were concerned, to Western transactions which sought a similar economic outcome.

A summary of Norton Rose's view so far as the Australian tax treatment of Islamic finance is concerned is as follows:

- (1) Australia's income tax laws at present have too much uncertainty and complexity in their operation so far as their application to some important forms of Islamic finance are concerned;
- (2) having regard to the comment in (1), it is believed that legislative reform is necessary in order to provide a degree of certainty to the taxation treatment of Islamic finance products;
- (3) the legislative reform needs to be at both a Federal level and a State and Territory level:
 - (a) at a Federal level so far as the application of income tax and GST is concerned; and

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- (b) at a State and Territory level so far as the application of stamp duty is concerned;
- (4) in relation to Federal tax reform, Norton Rose believes that this should be able to be achieved reasonably expeditiously and fairly simply, following the example set by the type of tax reform that has occurred in the United Kingdom; and
- (5) in relation to State and Territory reform of the stamp duty laws, it is hoped that there may be some coordination possible at a State and Territory level so as to avoid unnecessary complexity and potential confusion as to the application of a particular State's or Territory's stamp duty regime to a particular form of Islamic finance transaction.

Further elaboration on each of these points is provided below.

1 Application of Australia's income tax laws

Norton Rose believes that Australia's income tax laws have too much uncertainty and complexity in their application to Islamic finance transactions at present and represent, in our experience, a significant obstacle to the undertaking of some significant forms of finance of this type in Australia.

Some of the issues apparent in Australia's tax laws were raised by Peter Norman (a Norton Rose partner based in Sydney) and John Challoner (a Norton Rose partner based in London) in an article entitled "Shariah Compliant Financing in Australia" (2010) 13 The Tax Specialist 186 (**Article**) – which is attached. The comment was made in that article:

"...in a comparison between a Shariah compliant structure and its Western counterpart, the objective sought to be achieved in the Shariah compliant structure frequently involves a number of additional steps. These additional steps usually complicate the Australian tax analysis of these structures."

This article provides observations on various Australian (Federal and State) tax issues relevant to several of the Islamic finance techniques dealt with in the Case Studies provided in the Discussion Paper, namely:

| Islamic Finance Techniques Dealt with in Article | Corresponding Technique in Case Study in Discussion Paper |
|---|--|
| <i>Tawarruq</i> (or reverse- <i>Murabaha</i>) | Case Study One: Cost Plus Profit Sale |
| Commodity <i>Murabaha</i> | Case Study Two: Interbank Finance |
| Not covered (<i>Ijara</i> discussed) | Case Study Three: Finance Lease and Hire Purchase |
| <i>Wakala</i> | Not covered |
| <i>Istisna'a</i> | Case Study Four: Purchase Order |
| Not covered | Case Study Five: Pre-paid Forward Sale |
| <i>Musharakah</i> | Case Study Six: Profit and Loss sharing Partnership |
| <i>Sukuk</i> | Case Study Seven: Lease Backed Islamic Bond |
| Not covered | Case Study Eight: Islamic Risk Sharing Arrangements |

While there may be some variations between the Islamic finance techniques described in the Article and the corresponding case studies dealt with in the Discussion Paper, the tax issues raised are similar.

The Discussion Paper observes, with respect to Case Study One: Cost Plus Profit Sale, that it “is the equivalent of a conventional fixed interest loan backed by a mortgage” (at page 28) but, due to the form of the arrangement, the tax treatment “will be different to a conventional mortgage used for investment purposes” (at page 29). The consequence, according to the Discussion Paper, is that there can be “tax uncertainty” in relation to aspects of the income tax treatment of this structure. There is also observed to be a lack of GST neutrality between the treatment of a Western form of finance and its Shariah compliant counterpart.

In Case Study Two: Interbank Finance, the Discussion Paper observes that while the economic substance of the transaction described is “equivalent to a debt instrument” (page 34) the tax treatment will be “different to that applying to the use of a conventional debt instrument for inter-bank financing” (page 34) and, again, there can be “uncertain tax outcomes” in several important respects (page 36).

Apart from commodity *Murabaha* transactions, Norton Rose believes that varieties of *Sukuk* transaction are likely to be an important form of Islamic finance that could be employed in Australia. This could allow large amounts of capital to be attracted to Australia. Malaysia, for example, has seen a tremendous growth in *Sukuk* issuance. Austrade’s 2010 *Islamic Finance* publication reports that, in June 2009, Malaysia accounted for outstanding *Sukuk* with a value of US\$66 billion. Malaysia has adopted various tax incentives to encourage the development of Islamic financing in that country. While in Australia it may not, for various reasons, be considered appropriate to offer incentives to attract Islamic finance, Norton Rose supports an approach that would confer the same tax treatment for an Islamic finance transaction as that which applies to the Western style financing arrangement to which it is economically equivalent.

2 Legislative reform

In view of the comments provided in section 1 above, Norton Rose considers that the most appropriate way to ensure that the same tax treatment is provided for an Islamic finance transaction as that which applies to its Western counterpart, is by means of legislative reform.

For many important forms of Islamic finance transaction, there are usually a number of steps employed to give effect to those transactions. Without there being a specific legislative basis which authorises the Islamic finance transaction to be subject to taxation or duty in accordance with its substance rather than its form (for income tax, GST and also stamp duty purposes), then the application of the existing tax and stamp duty framework will continue to give rise to uncertainty and non-neutral tax treatment for various important forms of Islamic finance techniques.

So far as Federal tax is concerned, it is not considered that this uncertainty and non-neutrality can be solved by the Australian Taxation Office (**ATO**) issuing rulings or determinations. The ATO can only work within the framework of the existing taxation legislation. Norton Rose is of the view that the current tax and stamp duty framework imposes significant constraints on the ability of the ATO to provide any meaningful comment that would allay the uncertainty in this regard.

3 Legislative reform at both Federal and State and Territory level

The tax constraints to the implementation of Islamic finance transactions in Australia exist at both Federal and State and Territory level. At the Federal level – through the application of existing income tax and GST rule to Sharia compliant financings. At a State and Territory level – through the application of stamp duty to Islamic finance transactions.

The issues at the Federal level were commented upon in section 1 above.

Because Islamic finance transactions are frequently asset based, giving effect to the transaction may involve the transfer of an underlying asset and, in some types of transactions, multiple asset transfers. Depending on the nature of the underlying asset, these transfers can give rise to stamp duty being payable that would not be the case with the Western equivalent transaction. The Discussion Paper comments on the potential stamp duty cost of implementing particular Islamic finance transactions:

- Case Study One: Cost Plus Profit Sale – potential double stamp duty cost
- Case Study Four: Purchase Order - potential higher stamp duty cost
- Case Study Six: Profit and Loss sharing Partnership - potential higher stamp duty cost
- Case Study Seven: Lease Backed Islamic Bond - potential higher stamp duty cost

Victoria implemented amendments to Part 5 of its *Duties Act 2000* which seek to eliminate the potential multiple application of stamp duty on certain Shariah compliant transactions involving land. The wording of the provisions does not make any specific reference to particular religion although it is clear that the provisions were introduced with Islamic transactions in mind. The Victorian government is to be praised for taking the initiative in this regard. However, a feature of the Victorian provisions is that a natural person must be involved in the transaction (as well as certain other requirements being satisfied) in order that it may qualify for concessional stamp duty treatment. This would limit the application of the provisions, as it would appear was intended, to home acquisitions and the like by natural persons and exclude commercial transactions involving companies or trusts.

As has been apparent from the experience with the policy background to various reforms to tax and revenue legislation that have occurred in the United Kingdom, there can be identified to be 2 main drivers behind legislative changes that seek to accommodate Islamic finance techniques:

1. the desire to accommodate the financing needs of Muslims, as a class of consumer, who seek to access finance in a way that is in accordance with their faith; and
2. as a means of encouraging foreign investment, access to capital markets and a level of commercial activity that can undertaken in a Sharia compliant manner.

It would seem apparent that the motivation behind the Victorian stamp duty reforms was in seeking to achieve the aim in 1. While this is a laudable objective in itself, in order to achieve the aim in 2 State and Territory amendments to stamp duty legislation will need to have application to companies and trusts as well as to natural persons.

Importantly, although there has been progress made in recent times towards a degree of harmonisation in the drafting of stamp duties legislation in the various States and Territories, there nevertheless remain significant differences in the application of stamp duty to particular transactions as between the various States and Territories. It is hoped that there is significant State and Territory acceptance of the need to make allowance for Shariah compliant transactions in stamp duty legislation so as to avoid the imposition of multiple, or higher, stamp duty than would apply to the Western style economic equivalent of those transactions. It is also hoped that there may be some coordination between the States and Territories to ensure that amendments that are proposed have some similarity as between the various States and Territories. If there are substantive differences in the drafting of the required amendments, that would not be in the interests of furthering the broader aim of encouraging Islamic finance in Australia. It would seem evident that States and Territories that do take a coordinated approach, and do not implement unduly complex amendments, are more likely to attract Islamic forms of investment and transactions than those that do not.

4 Federal tax reform

As indicated in section 1 above, Norton Rose is of the view that there is the need for amendments to be made to Federal income tax and GST legislation in order that these tax regimes do not impede the development of Islamic finance in Australia.

Major concerns, however, with any proposal to embark on amendments to tax legislation are:

- (a) the length of time taken to implement any reforms; and
- (b) the potential complexity of reforms enacted.

Norton Rose understands the need for due consideration to be given to proposals to make legislative changes to Australia's tax laws. However, experience has shown that the process involved can often be very protracted. As a consequence there can be an opportunity cost with delay in making the necessary legislative changes – particularly those changes that are designed to benefit the Australian economy. While many participants in Islamic finance and foreign investors seeking to make investments in a Shariah compliant manner may be attracted to Australia for various reasons, the potential uncertainty and complexity associated with employing certain types of Islamic finance techniques in Australia will result in many of those participants and investors looking at other countries to undertake the transaction. Australia then loses out on the benefits that those transactions and forms of investment can bring. The Financial Centre Forum Report of November 2009 (released by the government in January 2010) stated:

“The greatest opportunity for Australia in terms of accessing offshore capital pools at competitive rates would appear to be in the area of developing Shariah compliant wholesale investment products” (at p.70).

Australia does not have a reputation for simple tax laws. Norton Rose believes that the interests of fostering Islamic financing techniques in Australia would not be well served by introducing legislation which is unduly complex. It is believed that if, as the Board emphasises in the Discussion Paper, the objective is to have the same tax treatment for an Islamic finance product as that which applies to its Western counterpart to which it is economically equivalent, then Australia has the great advantage of learning from the experience in the United Kingdom as to the amendments to the legislation in that country that sought to achieve this result.

The Article provides a survey of some of the initiatives that were taken in the United Kingdom in order to place certain forms of Islamic finance transaction on an equal footing, so far as tax treatment was concerned, to the Western counterpart of that transaction.

In the United Kingdom, in order to avoid possible contentions that the legislative amendments discriminated in favour of a particular religion, the amendments made were couched in non-religious terms and the transactions to which they were directed were referred to as “alternative finance arrangements”.

For example, section 47 of the UK's *Finance Act 2005* was introduced to address tax issues associated with commodity *Murabaha* transactions (analogous to cost plus profit sales referred to in the Discussion Paper). The approach of this provision in the UK legislation is to describe, in fairly simple terms, the elements of the transaction, to look at whether the difference between the sale price and the purchase price equates, in substance, to the return on an investment of money at interest and to then treat that margin as the “alternative finance return”. The “alternative finance return” is then treated as interest for all United Kingdom tax purposes.

Norton Rose believes that the example of this approach is a straight forward and reasonably simple way to treat Islamic finance transactions in accordance with their economic substance rather than their form, and place the Islamic finance transaction on an equal tax footing with its Western counterpart.

It is believed that this approach should also be taken in relation to the GST treatment of Islamic finance transactions. Their treatment so far as GST is concerned, should be no more or less favourable than the GST treatment accorded to the Western counterpart transaction. Accordingly, if the Western form of transaction would have been input taxed, the Islamic finance transaction which has economic equivalence, should be accorded the same treatment.

The benefit of following the UK example lies in its simplicity and effectiveness. In the case of section 47 of the *Finance Act 2005* referred to above, by treating the “alternative finance return” as if it were interest for all tax purposes, it allows the other provisions of the income tax law to operate in respect of that return – so far as both the payer and payee are concerned. For taxpayers within the taxation of financial arrangements (TOFA) regime in Division 230 of the *Income Tax Assessment Act 1997*, the tax treatment of the “alternative finance return” could easily fall to be dealt with as a “gain” or “loss” from a “financial arrangement” (within the meaning given to those terms in Division 230). For taxpayers that are not within Division 230, the “alternative finance return” would be treated in accordance with other provisions in the tax legislation on a similar basis to if that return were as interest payment.

Australia may benefit from being made aware of two minor areas where the UK legislature did not get the UK legislative amendments quite right. One of the conditions which needed to be satisfied to fall within the

"alternative finance arrangements" covered under the UK legislation, was that one of the parties to the transaction had to be a "financial institution" (except in the case of *Sukuk*). However, the definition of "financial institution" was slightly defective. It extended to banks and wholly-owned subsidiaries of banks (with "banks" being defined by reference to the UK and EU banking regulations) but was also extended to (a) "a person who is authorised in a jurisdiction outside the UK to receive deposits... and that grant credits for its own account" and (b) insurance companies (again being defined by reference to relevant UK and EU regulatory requirements). Each of these requirements raised issues. Some non-EU institutions which were clearly "banks" (as that term is generally understood) failed to satisfy the test solely because deposit-taking was not an activity which required a licence in their home jurisdiction. In addition, it transpired that it was fairly easy for a company with no real insurance business to qualify as an insurance company merely by obtaining the relevant consent. This led to some companies obtaining the benefits of the provisions (particularly in relation to stamp duty land tax (**SDLT**)) in circumstances where this was not intended. Norton Rose believes that it is correct to require a financial institution to be a party to most of the qualifying arrangements but advocates care in drafting the relevant definition.

Some suggestions have been made to expand Division 230 of the *Income Tax Assessment Act 1997* so that it encompasses Islamic finance transactions and this may certainly be in the interests of some taxpayers whose arrangements are already subject to that Division. However, for other taxpayers not otherwise within the ambit of Division 230, and who do not wish their arrangements to be dealt with under that regime, an extension of the ambit of operation of Division 230 may be regarded negatively.

It is noted that Australia has made significant reforms in recent times to the income tax treatment of managed investment trusts (**MIT**). One significant benefit for foreign investors in MITs is that a 7.5% rate of withholding tax applies to fund payment made by a MIT where the payee is located in a country that has information exchange arrangements with Australia. While it is possible that a MIT structure could hold attraction for investment into Australia by Islamic investors, a significant constraint exists at present due to the very few countries with significant Muslim populations that have information exchange arrangements with Australia. There are no information exchange agreements at present with countries in the Middle East or with Malaysia. It is not known why this is the case. Norton Rose believes that it warrants investigation by the Board to see whether the position of Muslim countries may be improved so far as information exchange arrangements, and the ability of investors located in many Muslim countries to be able to benefit from the MIT reforms, are concerned.

5 State tax reform

As indicated in section 1 above, Norton Rose is of the view that, in addition to amendments that should be made to Federal tax legislation in order that the Federal tax regimes not impede the development of Islamic finance in Australia, amendments are also required to be made to the laws of the various States and Territories.

Because Islamic finance transactions are frequently asset based, the implementation of these transactions could potentially involve higher stamp duty costs and, in particular cases, multiple stamp duty charges may become applicable.

As indicated in section 1 above, it is hoped that the States and Territories would coordinate their approaches to stamp duty reform. As mentioned above, Victoria has already implemented changes to its stamp duty laws – although those amendments would need to be expanded so as to apply to forms of Islamic finance transactions involving companies and trusts.

In the UK, the absence of States and Territories has made the reform of its SDLT to accommodate Islamic finance transactions an easier task than that faced by Australia. The approach taken in the UK has been to modify the application of SDLT to "alternative finance arrangements" so that the same amount of SDLT is paid on those arrangements as would have been paid on a Western style transaction to which it is economically equivalent. The experience in the UK so far as amendments to the SDLT were concerned, was not without problems due to various SDLT avoidance schemes being devised so as to take advantage of the SDLT concessions for alternative finance arrangements. However, this led to a general tightening up of the wording of the provisions relating to the application of SDLT to alternative finance arrangements in order to prevent the exploitation of the reforms. States and Territories in Australia that have concerns with possible exploitation of stamp duty concessions that may be offered in respect of Islamic finance transactions would be well served by looking closely at the UK experience and response.

Many Australian States and Territories have provisions in their stamp duty legislation which are directed at stamp duty avoidance schemes, which should offer the States and Territories comfort in regard to concerns that stamp duty concessions aimed at Islamic finance transactions will be exploited or abused by taxpayers. However, if concessional tax treatment is offered by a State or Territory in respect of a transaction which is structured to give effect to an Islamic finance transaction, care needs to be taken in the drafting of those concessions so that they may be used by anyone, without reference to religious purpose or specific Muslim involvement, without the participants to the transaction being concerned that they may be regarded as involved in a stamp duty avoidance scheme.

We are pleased to have been able to provide comments to the Board concerning its Discussion Paper. Norton Rose looks forward to action being taken as a result of the Board's deliberations that will smooth the way for Islamic finance transactions to be undertaken in Australia.

Please contact any of the undersigned should you have any questions concerning this submission.

Yours faithfully

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