Australian Government

The Board of Taxation

REVIEW OF THE TAXATION TREATMENT OF ISLAMIC FINANCE

A Report to the Assistant Treasurer

the board of taxation
www.taxboard.gov.au

The Board of Taxation
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FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its review of the taxation treatment of Islamic finance.

The Board established a Working Group chaired by Ms Annabelle Chaplain to oversee the review. The Board conducted consultation with stakeholders and an appointed Expert Panel, in addition to assistance received from officials from the Treasury and the Australian Taxation Office. The Board would like to thank all those who so readily contributed to assist the Board in conducting the review.

The ex officio members of the Board — the Secretary to the Treasury, Dr Martin Parkinson PSM, the Commissioner of Taxation, Mr Michael D'Ascenzo AO, and the First Parliamentary Counsel, Mr Peter Quiggin PSM — reserved their final views on the issues canvassed in this report for advice to Government.

On behalf of the Board, it is with great pleasure that we submit this report to the Assistant Treasurer.

Chris Jordan AO
Chairman, Board of Taxation

Annabelle Chaplain
Chairman of the Board's Working Group

EXECUTIVE SUMMARY

On 26 April 2010 the then Assistant Treasurer and the then Minister for Financial Services, Corporate Law and Superannuation announced that the Board of Taxation 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.

Following the announcement of the review and the terms of reference, the Board released a discussion paper in October 2010 that summarised the frameworks in the existing law for the taxation of financial products. It looked 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. It is important to note that the Board has conducted its review on the basis of its understanding of common Islamic finance structures. However, nothing in this report should be taken to suggest that a particular product or case study described is compliant with Shariah law.

The discussion paper also examined the various tax policy responses to the development of Islamic finance in other jurisdictions.

The submissions to the Board in response to the discussion paper confirm that there are impediments in current Australian taxation laws (at the Commonwealth, State and Territory levels) to the development and provision of Islamic finance products in Australia. This review has confirmed that the main impediments are:

- access to interest withholding tax exemptions;
- stamp duty on asset backed finance products[1] if the asset is dutiable property; and
- uncertainty in relation to the application of general income tax provisions.

The Board is mindful that, as indicated in the Johnson report, access to diverse sources of offshore capital is important in the context of Australia being a net capital importer. The Board recognises that Islamic finance may provide a further finance option to help meet this demand, particularly for infrastructure projects in Australia. The Johnson report stated that the 'greatest opportunity for Australia in terms of accessing offshore capital pools at competitive rates would appear to be in the area of developing Sharia compliant wholesale investment products'. However, the Board has formed the view based on consultations that the incidence of interest withholding tax and stamp duty on asset backed finance products are cost prohibitive to the development and provision

1 Asset backed finance products in the context of stamp duty are discussed at paragraph 4.3.

of Islamic finance for the funding of infrastructure projects in Australia. For Islamic finance to be a viable source of funds for Australian borrowers, these impediments must be addressed to put Islamic finance on a more level playing field and to open up this new source of funds for Australian borrowers.

The combined effect of the Board's recommendations (if implemented) will ensure that Australia's tax laws, wherever possible, do not inhibit the development and provision of certain Islamic finance products in Australia. They seek to do this by:

- recommending that access to interest withholding tax exemptions be made available for publicly offered Islamic finance products that exhibit equivalent economic characteristics to debentures or to those debt interests that are currently eligible for the exemption; and

- encouraging the States and Territories to provide relief from stamp duty so that it does not arise where there is a synthetic[2] disposal or acquisition that would not have occurred had it not been to give effect to a financial arrangement.

In addition, the Board has made recommendations that seek to provide increased certainty in relation to the application of the general income tax provisions to particular financial arrangements used to support Islamic finance products. They seek to do this by recommending:

- an amendment to the income tax law to ensure that, in respect of a deferred payment arrangement whose main purpose is the raising or provision of debt finance, the finance gain or loss is treated the same as interest on a conventional borrowing;

- an extension to the application of the hire purchase provisions (which re-characterise an arrangement as a notional sale and loan); and

- that, in consultation with industry, the Australian Taxation Office provide guidance on the current taxation treatment of Islamic finance products to resolve particular areas of uncertainty.

The Board's recommendations should not provide special treatment for Islamic finance. They are intended to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance. The Board's recommendations will not make broad changes to existing finance taxation frameworks nor do they propose that amendments apply solely to Islamic finance. The Board has sought to ensure that its recommendations for change are consistent with the policy intent behind those frameworks. In particular, the Board's recommendations respect the different tax treatment of debt and equity.

2 This concept is further explained in paragraph 4.11.

The Board considers that the revenue impact of the changes is likely to be negligible as the current tax treatment inhibits the use of Islamic finance in Australia. This, however, is not based on the undertaking of a formal costings process.

The Board also considers that amendments to the law must be targeted appropriately to ensure that they do not undermine the integrity of the current provisions and do not provide an opportunity for tax arbitrage.

CHAPTER 1: INTRODUCTION

BACKGROUND

1.1 As covered in the Board's discussion paper, the global market for Islamic financial services, as measured by Shariah compliant assets, is estimated to have reached US$895 billion in 2010, up from US$822 billion in 2009.[3] Assets have grown from about $150 billion in the mid 1990s. Commercial banks account for the bulk of the assets with investment banks, sukuk[4] issues, funds and insurance making up the balance.[5]

1.2 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.

- 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.

1.3 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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3 The Banker, *Top 500 Islamic Financial Institutions*, November 2010.

4 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.

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

Co-operation Council (GCC) such as Kuwait 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.[6]

1.4 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[7] 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 issuers of Shariah compliant instruments; and
- Australian based financial firms, professional services providers and educational institutions exporting their services into Asia and the Gulf.

1.5 The Australian Financial Centre Forum, in November 2009, released a report titled *Australia as a Financial Centre: Building on our strengths* (Johnson report). The Forum hosted a roundtable focused on taxation of Islamic finance, which found that the taxation and regulation of Islamic financial products should present 'no obstacles, but no special treatment': in other words, a 'level playing field'. This finding was reflected in the Forum's recommendation in the Johnson report that:

> ... the Treasurer refer to the Board of Taxation the question of whether any amendments to existing Commonwealth taxation provisions are necessary in order to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance.

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

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

1.6 In response, the then Assistant Treasurer and the then 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.

1.7 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

1.8 The then Assistant Treasurer announced the terms of reference for the review on 12 May 2010. Specifically, the Board was 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.

1.9 In conducting the review, the Board was 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.

1.10 The Board was asked to report to the Assistant Treasurer by June 2011.

THE REVIEW TEAM

1.11 The Board of Taxation is an independent, non-statutory body established to advise government on various aspects of the Australian taxation system (refer to Appendix D for the Charter of the Board). The Board appointed a Working Group of its members comprising Ms Annabelle Chaplain (Chairman), Ms Elizabeth Jameson, Mr Keith James and Mr Curt Rendall to oversee its review of the taxation treatment of Islamic finance products.

1.12 The Board also appointed an Expert Panel which consisted of tax professionals and representatives from the financial sector who were chosen for their expertise to assist with the review. The Expert Panel comprises:

- Mr Asad Ansari — Director, Deloitte;
- Mr Michael Barbour — General Manager Tax, Westpac;
- Mr Emmanuel Alfieris;
- 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.

1.13 The Expert Panel members assisted the Board with technical and practical advice on the key issues and recommendations and the technical content of this report. The Board appreciates their valuable contribution.

1.14 In addition, the Board consulted extensively with the Treasury and the Australian Taxation Office (ATO). The Board in particular would like to thank Mr Roger Paul from the Treasury, Mr Ross Brookes and Mr Alex Vourgoutzis from the ATO and their respective teams for their contribution to this review and the report.

REVIEW PROCESSES

1.15 The Board has consulted widely in developing the recommendations in this report. Consultation with industry and other affected stakeholders and submissions from the public played an important role in shaping the Board's recommendations to the Government.

Discussion paper

1.16 The Board developed a discussion paper to facilitate public consultation. It was released in October 2010. The purpose of the discussion paper was 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 (see Appendix C for an extract of relevant case studies from the discussion paper). To assist stakeholders the paper:

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

Submissions

1.17 The Board requested written submissions on the review by 17 December 2010. The Board received 16 submissions, 15 of which are available to the public and can be obtained from the Board of Taxation's website. Appendix B contains a list of the parties who provided submissions and agreed to have their submissions made public. The Board thanks all parties who provided submissions and appreciates the effort and time taken by these parties in putting forward their issues and proposing recommendations.

Consultation meetings

1.18 The consultation process provided an opportunity to discuss the issues canvassed in more detail. The Board held public consultation forums in Sydney and Melbourne as a further mechanism for obtaining views and to assist stakeholders in preparing written submissions.

1.19 The Board also held targeted consultation meetings with selected stakeholders. The purpose of these meetings was to clarify aspects of the review and to explore possible responses to issues raised in the submissions.

CHAPTER 2: ISSUES WITH AUSTRALIA'S CURRENT TAXATION TREATMENT OF ISLAMIC FINANCE PRODUCTS

2.1 The Board's starting point for this review was to examine the existing finance taxation frameworks to gain an understanding of the impediments in current Australian taxation laws (at the Commonwealth, State and Territory levels) to the development and provision of Islamic finance in Australia. In particular, the Board looked at existing tax frameworks to determine to what extent these enable:

- the tax treatment of Islamic finance products to be based on their economic substance rather than their form; and
- the same tax treatment for economically equivalent finance products.

2.2 The examination of existing frameworks revealed some consistent treatment between certain conventional finance arrangements and certain Islamic finance products. As may be expected, provisions which give greater weight to economic substance or are drafted generically to cover a broad range of financial products are more likely to provide parity of treatment between conventional finance arrangements and forms of Islamic finance that have the same function as conventional arrangements. Take, for example, the Taxation of Financial Arrangements (TOFA) rules, which give greater weight to economic substance than the ordinary income and deduction rules of the income tax law and have regard to gains and losses rather than to form based amounts such as interest. They are more likely to provide parity of treatment between conventional finance arrangements and forms of Islamic finance that have the same function as conventional arrangements.

2.3 In contrast to the TOFA provisions the interest withholding tax exemptions which in part rely on concepts of 'interest' (although with an extended meaning) and debenture may not allow economically equivalent products to gain access to the exemptions. Similarly, a key reason for the introduction of the debt/equity test into Australian income tax law was to ensure that arrangements that are in substance equity are recognised as such and cannot be structured in a way that enables them to be taxed as debt. Islamic finance arrangements may be structured as equity in form but the arrangement may be in substance debt. These non-traditional arrangements, because of the different structures used, may present some administrative challenges in seeking to identify the economic substance of the arrangements.

2.4 The Board considers that there are impediments in current Australian taxation laws (Commonwealth, State and Territory) to the development and provision of Islamic finance in Australia. This review has confirmed that the main impediments relate to:

- access to interest withholding tax exemptions;
- stamp duty on asset backed finance products if the asset is dutiable property; and
- uncertainty in relation to the application of general income tax provisions.

2.5 The main issues that are raised in submissions and consultations are summarised in the following paragraphs.

INCOME TAX

2.6 A primary concern that came through in submissions in relation to income tax is the uncertainty of the current tax treatment for certain Islamic finance products. That is, what would constitute income to the financier (and the character of that income) and what would be a cost of finance to the client, particularly if the arrangement would not fall within the TOFA tax timing rules in Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997). Further uncertainty exists in relation to the application of the debt test (in the debt/equity provisions) to structured Islamic finance arrangements, such as that described in amended case study seven of the Board's discussion paper (an amended version of case study seven is reproduced at Appendix C).

LEASES

2.7 The taxation of leases is an exception to the taxation of financial arrangements. That is, certain leases are specifically carved out from the operation of the debt/equity and the TOFA tax timing rules. Submissions to the review seem comfortable that Division 240 of the ITAA 1997 deals appropriately with hire purchase arrangements. However, the scope of Division 240 is determined by the form of the arrangement, and as such, leases that are equivalent, in substance, to a hire purchase agreement can fall outside the rules. A concern raised in the submissions is that the re-characterisation by Division 240 of a lease as a notional sale and loan will not apply to leasing arrangements used to finance the purchase of certain assets such as a house or certain commercial assets that are not goods. Finding a way to address this particular issue was a priority for the Board.

2.8 One submission emphasises the importance of retaining the current distinction between hire purchase arrangements and general leases as general leases provide flexibility and may provide tax advantages.

PARTNERSHIPS

2.9 Submissions are in favour of providing special taxation treatment for partnership arrangements that are for the purposes of providing financing and demonstrate certain characteristics. A number of submissions, but not all, considered that an approach akin to that provided in the UK would be appropriate.

Interest withholding tax (IWT)

2.10 Submissions that address IWT seem broadly comfortable that the return payable on various Islamic finance products could satisfy the extended definition of interest. However, of the submissions that provide comment, the prevalent view was that access to various IWT exemptions is problematic. Finding a way to address this particular issue was a priority for the Board.

Offshore banking units (OBUs)

2.11 Although not specifically raised in written submissions, public consultations revealed that there is some uncertainty about whether OBUs would get concessional tax treatment under Division 9A of the *Income Tax Assessment Act 1936* (ITAA 1936) for income derived from Islamic finance transactions. It was submitted that Islamic finance transactions should come within the definition of 'OB activity' (provided they are economically equivalent to conventional transactions that come within the current definition of OBU activity).

GST

2.12 Submissions express mixed views on the GST issues. One view is that Islamic finance arrangements should be treated like financial supplies and should therefore be input taxed (and that changes should also be made so that reduced input tax credits are made available). Another view is that input tax treatment of financial supplies is inefficient and, if possible, the arrangements should be taxable supplies and subject to GST.

Stamp duty

2.13 The majority of submissions express the view that stamp duty should be addressed by the States and Territories through a targeted exemption approach. Targeted consultations further revealed that Islamic finance products involving dutiable assets would be unlikely to be provided without appropriate stamp duty relief. The Board considers that addressing this issue is a priority in terms of achieving the overall objectives of this review.

CHAPTER 3: THE BOARD'S RECOMMENDATIONS

OVERVIEW

3.1 From a broad policy perspective the Board has reflected on the findings of the Johnson report. Of particular significance is that Australia is, and is likely to remain, a net importer of capital. In relation to accessing offshore capital, the Johnson report states that:

> Australia needs access to a diverse range of offshore savings pools to finance domestic investment needs. Any tax measures that raise the cost of imported capital thus warrant close scrutiny. Sensible policy changes that improve access to offshore pools of capital at competitive rates are clearly in Australia's interest, as they lower investment financing costs ... Recent funding pressures on some foreign banks in Australia resulting from difficulties in the wholesale credit markets has impacted on the capacity of many smaller and medium sized companies to raise debt capital in Australia, and reinforced the need for more diversified funding sources ... Access to offshore savings pools is not only desirable and sensible for Australia as a capital importing country, it can also help to further the Government's objective of greater international engagement of our financial sector. Given that Australia does not have excess capital domestically to invest offshore, greater offshore investment necessitates open access to offshore capital.

3.2 The Board is mindful that, as the Johnson report indicates, access to diverse sources of offshore capital is important in the context of Australia being a net capital importer. The Board recognises that Islamic finance may provide a further finance option to help meet this demand. Australia's taxation system has some features or frameworks that are specifically designed to facilitate the injection of foreign capital into Australia. The foreign resident capital gains tax exemptions are an example of this. Australia's tax system also typically treats returns on debt more favourably than returns on equity. The Board's recommendations necessarily respect the distinction in Australia's current tax laws between the taxation treatment of debt and equity.

3.3 Based on submissions and targeted consultations the Board has formed the view that there are certain asset backed (or asset based) Islamic finance structures (with certain terms and conditions present) that could fit within existing finance taxation frameworks such as the debt/equity rules and the TOFA tax timing rules. A number of the asset backed structures can be utilised to support a range of different finance products in Australia. These are:

- Murabahah (Cost plus profit sale): 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 or Commodity Murabahah (Cash finance sale): 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.

- Ijarah Muntahiah Bi Tamlik (Finance lease): Under an ijarah muntahiah bi tamlik contract a lessor (owner) leases out an asset to its client at an agreed rental fee and pre-determined lease period. The lessor 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 (ijarah): Sukuk is the Islamic finance equivalent of conventional tradable notes or bonds, which represents the beneficial interest of the sukuk holders in an underlying Shariah compliant asset or financing arrangement. Returns are paid to the investors in line with their proportional beneficial interest in that asset and investment.

3.4 A number of submissions agree that sukuk is the product that represents a significant opportunity in terms of attracting capital to Australia. Norton Rose state in their submission that:

> 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.

3.5 It should be noted that during the consultation process the Board found that the sukuk product described in amended case study seven in its discussion paper (which is asset backed) has a variation (asset based) which it understands is the more common structure. See Appendix C for an amended version of case study seven.

3.6 The Board has been asked 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 (see Chapter 3 of the Board's discussion paper). The Board recognises that there are various tax frameworks or regimes in the current law that specifically deal with financial products. In forming its recommendations, the Board has considered whether adjustments can be made to the existing tax frameworks rather than the development of specific provisions directed solely at Islamic financial products.

3.7 With this in mind, the Board's recommendations broadly aim to ensure that certain asset backed (or asset based) Islamic finance products have parity of tax treatment with conventional finance products under existing finance taxation frameworks. The combined effect of the Board's recommendations (if implemented) will ensure that Australia's tax laws, wherever possible, do not inhibit the development and provision of certain Islamic finance products in Australia. They seek to do this by:

- recommending that access to interest withholding tax exemptions be made available for publicly offered Islamic finance products that exhibit equivalent economic characteristics to debentures or those debt interests that are currently eligible for the IWT exemption; and

- encouraging the States and Territories to provide relief from stamp duty so that it does not arise where there is a synthetic disposal or acquisition that would not have occurred had it not been to give effect to a financial arrangement.

3.8 In addition, the Board has made recommendations that seek to provide increased certainty in relation to the application of the general income tax provisions to particular financial arrangements used to support Islamic finance products. They seek to do this by recommending:

- an amendment to the income tax law to ensure that, in respect of a deferred payment arrangement whose main purpose is the raising or provision of debt finance, the finance gain or loss is treated the same as interest on a conventional borrowing;

- an extension to the application of the hire purchase provisions (which re-characterise an arrangement as a notional sale and loan); and

- that, in consultation with industry, the ATO provide guidance to confirm the current taxation treatment of Islamic finance products to resolve particular areas of uncertainty.

3.9 The Board's recommendations will not make broad changes to existing finance taxation frameworks nor do they propose that amendments should apply solely to Islamic finance. The Board has strived to find the best solution to the tax issues identified and has recognised that this could be in the form of ATO guidance[8], legislative change, or a combination of both. The Board has sought to ensure that its recommendations for change are consistent with the policy intent behind those frameworks. In particular, the Board's recommendations respect the different tax treatment of debt and equity. The issue is whether Islamic finance products are treated

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8 See the ATO's *Practice Statement PSLA 2008/3 Provision of advice and guidance by the ATO* which explains each form of advice and guidance provided by the ATO.

appropriately within the tax frameworks that look to the economic substance of an arrangement, and whether form based rules work in a way that is consistent with the purpose and principles of those frameworks.

3.10 The Board considers that the revenue impact of the changes is likely to be negligible as the current tax treatment inhibits the use of Islamic finance in Australia. This, however, is not based on the undertaking of a formal costings process.

3.11 The Board also considers that amendments to the law must be targeted appropriately to ensure that they do not undermine the integrity of the current provisions and they do not provide an opportunity for tax arbitrage.

INCOME TAX

Issue 1: Uncertainty as to the characterisation of the return on an Islamic finance product (murabahah)

3.12 Under Australian income tax law, the return on debt financing is ordinarily treated as a revenue gain to the financier and a revenue loss to the issuer. Deductibility for the issuer 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.

3.13 However, there is a comparatively high level of uncertainty as to whether the return on certain Islamic finance products will be characterised as a capital or revenue gain or loss. A consequence of this is that clients using a deferred payment arrangement (murabahah or commodity murabahah) to finance the purchase of an investment asset, such as shares or property, may not be able to deduct the finance cost. This is because it may be characterised as a cost of acquiring the asset and therefore would be capital in nature, or it may be incurred at a point too soon to be incurred in the course of gaining or producing assessable income. Similarly, it would be uncertain as to when the gain to the financier is brought to account.

3.14 In consideration of this issue, the Board has focused on case studies one and two in its discussion paper, which are reproduced at Appendix C. These are broadly referred to as deferred payment arrangements.

Views in submissions

3.15 Several submissions confirm that there is uncertainty as to whether the cost of finance in respect of a deferred payment arrangement would be deductible under section 8-1 of the ITAA 1997 or, rather, it would be included in the cost base of the asset for capital gains tax purposes.

3.16 CPA Australia and Freudenberg & Nathie suggest in their submissions that the term financial charge be introduced into the tax legislation. The financial charge would be assessable income for the financier and would represent the 'cost' of finance for a borrower and may be deductible under section 8-1 of the ITAA 1997 if appropriate.

3.17 The Board's discussion paper recognises that if the TOFA tax timing rules apply then they will provide parity of treatment. Norton Rose state, in response to suggestions to expand Division 230 of the ITAA 1997:

> ... 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.

Board's consideration

3.18 The Board recognises that deductibility of the finance cost on a deferred payment arrangement is primarily an issue for taxpayers or arrangements outside the TOFA tax timing rules and the debt/equity rules. There is considerable uncertainty as to the extent that general tax principles can characterise the finance gain or loss as such for tax purposes if the arrangement does not take the ordinary form of finance.

3.19 The Board is of the view that, in this situation, the tax law should be amended to ensure that the finance gain or cost of finance in respect of Islamic deferred payment arrangements (as described in case study one and two of the Board's discussion paper) is treated in the same way as interest on conventional borrowings. This should be for the purposes of enabling the identified finance charge to be treated as a revenue gain or loss from the deferred payment arrangement. However, the Board is of the view that this approach should not apply to specific arrangements such as leases, partnerships and hire purchase arrangements.

3.20 To give effect to this outcome, consideration should be given to distinguishing between arrangements whose:

- main purpose is to facilitate trade, that is, short term, non-monetary arrangements involving the acquisition or provision of a non-monetary item but with a financing element (such as short term trade credit arrangements) that are carved out of the debt/equity and TOFA tax timing provisions; and
- main purpose is the raising or provision of debt finance.

3.21 That is, the Board is of the view that this recommendation should apply to arrangements where the main purpose is the raising or provision of debt finance, irrespective of whether the arrangement is covered by the debt/equity or TOFA tax timing provisions. At the same time, this recommendation should have appropriate regard for the treatment of arrangements whose main purpose is to facilitate trade

(rather than raise or provide debt finance) and in respect of which these provisions have compliance savings exceptions.

3.22 This recommendation should not provide special treatment for Islamic finance but is intended to ensure that Islamic deferred payment arrangements (as described in case studies one and two in its discussion paper) have parity of treatment with conventional products, having regard to their economic substance and purpose.

Recommendation 1

Amend the income tax law to ensure that, in respect of a deferred payment arrangement whose main purpose is the raising or provision of debt finance, the finance gain or loss is treated the same as interest on a conventional borrowing.

Amendments to the law must have appropriate regard to the existing compliance savings exceptions (for short term trade focused arrangements).

Issue 2: Some finance leases are not taxed based on their substance (as a notional sale and loan)

3.23 The taxation of certain leases is an exception to the taxation of financial arrangements in that certain leases are specifically carved out from the operation of the debt/equity and TOFA tax timing rules. Under Division 240 of the ITAA 1997, some hire purchase arrangements may be re-characterised as a notional sale and loan. Division 240 only applies to hire purchase agreements that relate to goods. The result in that case is that 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.

3.24 It is important to note that the application of Division 240 is determined by the form of the arrangement, and as such, leases that are equivalent, in substance, to a hire purchase agreement can fall outside the rules.

3.25 Hire purchase agreement means:

- a contract for the hire of goods where:
  - the hirer has the right, obligation or contingent obligation to buy the goods; and
  - the charge that is or may be made for the hire, together with any other amount payable under the contract (including an amount to buy the goods or to exercise an option to do so), exceeds the price of the goods; and
  - title in the goods does not pass to the hirer until the option is exercised; or

- an agreement for the purchase of goods by instalments where title in the goods does not pass until the final instalment is paid.

3.26 Some Islamic finance products are structured as a lease with an option to purchase and are intended to provide the same outcome as a hire purchase arrangement. However, because of the form of the arrangement, or the asset that is the subject of the arrangement, the product may not be taxed under Division 240. The result is that the product is taxed as an ordinary lease. In consideration of this issue, the Board has focused on case study three in its discussion paper, which is reproduced at Appendix C.

Views in submissions

3.27 A concern raised in the submissions is that the re-characterisation will not apply to leasing arrangements used to finance the purchase of certain assets such as a house or certain commercial assets that are not goods.

3.28 In relation to leases, CPA Australia consider in their submission that determining tax treatment based on the form may provide more certainty but a substance based approach would be more appropriate. They suggest that one way to achieve a substance based approach might be to consider whether economic ownership/risk has been effectively transferred from the financier to the borrower. They are of the view that while Division 240, if it applies, provides an appropriate result, it should apply to all hire-purchase arrangements, not just those relating to goods.

3.29 Blake Dawson agree that there is scope for extending the operation of Division 240. They also note in their submission the importance of retaining the different tax treatment that applies to general leasing arrangements.

> The income tax treatment of leasing arrangements is well established and has been the subject of many reviews and much consideration, including judicial consideration, over time. It is not appropriate to adjust the taxation of leasing to align with other taxing regimes, as there are many commercial and legal differences between general leasing arrangements and finance transactions.

3.30 Blake Dawson are of the view that re-characterisation would only be appropriate in cases where there is a purchase option, consistent with the current treatment under Division 240.

Board's consideration

3.31 The Board is of the view that leasing arrangements that achieve the same overall result of a hire purchase arrangement should also be taxed based on their substance, that is, as a sale and loan. There are Islamic finance lease products that achieve an equivalent economic result to hire purchase arrangements but fall outside the operation of Division 240 of the ITAA 1997. This means that their tax treatment may not be based on the economic substance of the arrangement, and the arrangement

would be treated the same as other leases that fall outside the operation of Division 240.

3.32 The Board notes that there is a longstanding industry practice to use leases as they provide:

- flexibility (can achieve the same result of hire purchase without 'lock in'. For example, the lessor is not obliged to sell the asset to the lessee at the end of the arrangement); and
- tax advantages.

3.33 The Board recognises that a change that is broad in its application will also significantly change existing rules. For instance, under the current law a sale and leaseback arrangement will not be taxed under Division 240 if the asset is land. The Board considers that it is appropriate that such arrangements be taxed based on their economic substance. The Board has formed the view, based on submissions and consultations, that hire purchase is a preferred Islamic finance structure. As such, it is important to the potential development of and provision of Islamic finance in Australia that this product be widely available. To ensure that parity is achieved for hire purchase structures that are intended to be economically equivalent to a loan, the Board is of the view that parties to the arrangement should be taxed under Division 240 of the ITAA 1997, provided certain conditions are met. This will ensure current leasing arrangements that do not have a purchase option are not affected by the change.

3.34 In expanding the application of Division 240, consideration should be given to the application of section 240-115 (another person, or no person taken to own property), especially where there is a separate purchase option with a third party. This may affect whether the provisions apply appropriately.

3.35 This recommendation should not provide special treatment for Islamic finance but is intended to ensure that Islamic finance hire purchase products have parity of treatment with conventional debt finance products, having regard to their economic substance.

Recommendation 2

Amend the income tax law to:

- expand Division 240 of the ITAA 1997 so that it applies to hire purchase arrangements relating to all assets (not just goods); and
- ensure that Division 240 will apply to credit arrangements that have the same characteristics as a hire purchase arrangement.

Issue 3: Uncertainty as to whether the return on Islamic finance products will be characterised as interest for interest withholding tax purposes

3.36 IWT is payable on Australian source interest derived by a non-resident unless an exemption applies. 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.

3.37 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).

3.38 There may be uncertainty as to whether the return on certain Islamic finance products would meet the extended definition of interest (and, in relation to amended case study seven, uncertainty as to whether this characterisation can flow through to beneficiaries of a trust). In consideration of this issue, the Board has focused on case study one, two and seven in its discussion paper, which are reproduced at Appendix C.

Views in submissions

3.39 Those who made submissions in response to this issue generally are of the view that the finance cost on a deferred payment arrangement would satisfy the extended definition of interest and be subject to IWT. However, the view is that the tax treatment of the return on a lease arrangement that is outside the operation of Division 240 is uncertain. One option suggested to address the uncertainty is to expand the definition of interest.

Board's consideration

3.40 Based on views in submissions and targeted consultations, the Board considers that the current expanded definition of interest is broad enough to recognise the return on the relevant Islamic finance products, provided it is not considered a return on an equity interest in a company. However, to provide certainty, the Board is of the view that the ATO should clarify whether the return on the products described in case studies one, two and seven, will generally come within the expanded definition of interest if they exhibit certain features.

3.41 In relation to amended case study seven, the Board considers that it may not be necessary for non-resident certificate holders to hold a debt interest in order to achieve equivalent tax treatment under the current law (subject to Issue 4, IWT exemptions, discussed below). This is because for withholding tax purposes, as noted above, if the sukuk actually represents beneficial interests in a trust estate and the return on the sukuk represents distributions of trust income, then provided the income from the underlying transaction which is included in the trust estate's income is interest for withholding tax purposes, it will retain this character when paid out through the trust to the non-resident sukuk holders.

3.42 In this regard, in tax ruling IT 2680 *Income tax: withholding tax liability of non-resident beneficiaries of Australian trusts* the ATO has stated that:

- a non-resident beneficiary is liable for withholding tax when the beneficiary derives a dividend or interest included in the income of an Australian trust estate. The time at which the beneficiary derives the dividend or interest income is when the beneficiary becomes presently entitled to it;
- it is implicit in the wording of subsection 128A(3) that, for withholding tax purposes, dividend income and interest income derived by a trustee of a trust estate retain their character as income of those types when a beneficiary becomes presently entitled to a share of the income of the trust estate.

3.43 This will also be the case for unit holders in a widely held unit trust provided the underlying arrangement is an eligible investment business such as a hire purchase arrangement (to which Division 240 of the ITAA 1997 applies) or a Division 230 arrangement.

3.44 The Board considers that it is not necessary to make legislative changes. Rather, the Board is of the view that, in consultation with industry, ATO guidance should be provided to clarify the likely tax treatment for certificate holders. The Board has provided a description of a product that may assist in the development of ATO guidance (see amended case study seven in Appendix C). The product description has been developed with the Expert Panel and other industry representatives. The Board has developed the product description based on what it understands to be the most commonly used sukuk product in other jurisdictions. The Board accepts that there are

a range of different views in relation to whether certain features would be accepted by Shariah advisors, however, it has necessarily chosen the product that is, in substance, the most 'debt-like'.

3.45 The Board has considered the possibility that ATO guidance may reveal an impediment to Islamic finance that cannot be addressed under the current law. If such an impediment is revealed, the Government should consider legislative options to address it. Any legislative option should be consistent with existing withholding tax frameworks and should be consistent with the taxation treatment of economically equivalent conventional products. If legislative change is required, the definition of interest should be examined to determine whether it can be expanded to include a finance charge on financial instruments or a return on a debt interest.

Recommendation 3

In consultation with industry, the ATO should provide guidance on whether the return on a deferred payment arrangement (case study one and two) or an asset based lease security (amended case study seven) will generally come within the expanded definition of interest for IWT purposes.

If, in the course of providing ATO guidance, an impediment to Islamic finance is revealed that cannot be addressed under the current law, the Government should consider legislative options to address it.

Issue 4: Eligibility for the interest withholding tax exemptions

3.46 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. Section 128FA provides a further interest withholding tax exemption to publicly offered unit trust debentures or debt interests. Section 128GB of the ITAA 1936 exempts from withholding tax the interest paid by an offshore banking unit in respect of its offshore borrowings.

3.47 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 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.

3.48 Limitations on the availability of the exemptions recognise that some forms of capital raising have the potential to reduce the integrity of Australia's tax system. 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.

3.49 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 financial instrument would have to be a debt interest for the regulation power to be available. 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.

3.50 It is unlikely that certain Islamic finance products will have access to interest withholding tax exemptions that would ordinarily be available for equivalent conventional products such as debentures. This is because an asset backed (or asset based) security would not be considered a debenture under subsections 128F(9) and 128FA(8) of the ITAA 1936. This may be a significant impediment to the development and provision of certain Islamic finance products in Australia.

3.51 Interest paid by a person on an offshore borrowing may also be exempt from withholding tax if when the borrowing took place the person was an offshore banking unit (OBU). For the purposes of this exemption:

- 'interest' carries its ordinary and extended meaning;
- an 'offshore borrowing' is a borrowing in any currency, by a current or former OBU, from a non-resident who is not a related person; and
- 'borrow' includes raise finance by the 'issue' of a bond, debenture, debt interest, bill of exchange, promissory note or other security or similar instrument.

3.52 In relation to OBUs, the Explanatory Memorandum to the *New International Tax Arrangements (Managed Funds and Other Measures) Act 2005* noted that:

> The inclusion of debt interest in the definition of security will update the concept of 'offshore borrowing' in relation to offshore banking units because the definition of 'borrow' in section 128AE includes the raising of finance through the issue of a security. This will make it clear that interest paid on any type of debt interest, including non-equity shares, may qualify for the IWT exemption under section 128GB. It will also clarify the scope of section 128NB.

3.53 In consideration of this issue, the Board has focused on case study two and amended case study seven in its discussion paper, which are reproduced at Appendix C.

Views in submissions

3.54 A key issue raised in submissions is whether certain arrangements could satisfy the requirements for the IWT exemption under section 128F (or section 128FA).

3.55 To address this problem, Blake Dawson suggest in their submission that changes would be required to include an asset backed security in the scope of transactions to which the interest withholding tax exemptions in section 128F and section 128FA could apply.

Board's consideration

3.56 The Board is mindful that access to diverse sources of offshore capital is important in the context of Australia being a net capital importer. The Board recognises that Islamic finance may provide a further finance option to help meet this demand, particularly for infrastructure projects in Australia. The Johnson report stated that the 'greatest opportunity for Australia in terms of accessing offshore capital pools at competitive rates would appear to be in the area of developing Sharia compliant wholesale investment products'. However, the Board has formed the view based on consultations that a lack of access to interest withholding tax exemptions and stamp duty on asset backed finance products are cost prohibitive to the development and provision of Islamic finance for the funding of infrastructure projects in Australia. For Islamic finance to be a viable source of funds for Australian borrowers, these impediments must be addressed to put Islamic finance on a more level playing field and to open up this new source of funds for Australian borrowers.

3.57 As mentioned above, the scope of the OBU IWT exemption in relation to offshore borrowings by OBUs includes the raising of finance by the issue of debt interests. For this reason, the exemption may be available for the commodity murabahah arrangement described in case study two.

3.58 The Board is of the view that the law should be amended to ensure that access to IWT exemptions in section 128F and 128FA of the ITAA 1936 are not precluded by nature of the fact that the product is asset backed or asset based. That is, the exemptions should be made available for certain asset backed arrangements such as a commodity murabahah (case study two) and an asset based securitisation arrangement (amended case study seven) provided the arrangement meets the public offer test and is economically equivalent to either a debenture or a debt interest that is currently eligible for the IWT exemptions (a non-equity share, a debt interest which consists of

two or more related schemes where one or more of them is a non-equity share, or a syndicated loan).[9]

3.59 The regulation making power in sections 128F and 128FA of the ITAA 1936 was introduced to deal with the emergence of new financial products that are close substitutes for, and perform a similar role to, debentures. This power is only available where the financial product gives rise to a debt interest. This is the case for a commodity murabahah which can give rise to a debt interest. However, the regulation making power would not be available for asset based securitisation arrangements as they are unlikely to give rise to debt interests for certificate holders. Broadly, an interest will not be a debt interest if it is a short term non-monetary arrangement.

3.60 The Board considers that amendments to the law must be targeted appropriately to ensure that they do not undermine the integrity of the IWT exemptions and they do not provide an opportunity for tax arbitrage. Relevant characteristics of amended case study seven that could assist with targeting any amendments to the law include:

- it is a special purpose trust established for the sole purpose of giving effect to the finance arrangement, and the trust is not taxed as a corporate;
- the only income of the trust is interest for IWT purposes;
- the arrangement entered into by the trustee is either a financial arrangement to which Division 230 applies or a hire purchase arrangement to which Division 240 applies; and
- the trust must meet the public offer test (although, this may need to be amended to consider the particular circumstances of case studies two and seven).

3.61 One policy or law design issue that will need to be addressed is that there are a number of arrangements that raise finance that are specifically excluded from the definition of financing arrangements in Division 974[10] and Division 230[11]. The Board considers that these exclusions should be turned off for arrangements that are for a financing purpose as opposed to trade, consistent with the exception considered for Recommendation 1.

3.62 This recommendation will ensure that Islamic finance products that are economically equivalent to a debenture or a debt interest will have equivalent eligibility for the IWT exemptions. This recommendation will provide greater access to capital on equivalent terms as conventional finance. To the extent that these

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9 The arrangements to be covered should include case study two and the amended version of case study seven in Appendix C.

10 These include exclusions for certain leases and schemes that are for less than 100 days.

11 These include short term trade arrangements where there is no more than 12 months between the payment and the provision of goods, other property or services.

arrangements are already being used, and the Australian borrower is absorbing the cost of the IWT, this change will have a cost to revenue.

3.63 This recommendation should not provide special treatment for Islamic finance but is intended to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance.

Recommendation 4

Amend the income tax law to ensure that access to IWT exemptions in section 128F and 128FA of the ITAA 1936 are made available for publicly offered Islamic finance products (as described in case study two and amended case study seven) that exhibit equivalent economic characteristics to debentures or those debt interests that are currently eligible for the IWT exemptions.

Amendments to the law must be targeted appropriately to ensure that they do not undermine the integrity of the IWT exemptions and they do not provide an opportunity for tax arbitrage.

Issue 5: Offshore banking activity of an offshore banking unit

3.64 Division 9A of the ITAA 1936 provides tax concessions for the income derived by an offshore banking unit (OBU) from offshore banking activities. These concessions complement the exemption from interest withholding tax in relation to the offshore borrowings of an OBU (see above) and were designed to facilitate the growth of Australia as a viable offshore banking centre. Section 121D of the ITAA 1936 lists the type of activities that qualify as an offshore banking activity (OB activity) for the purpose of determining assessable OB Income of an OBU which is concessionally taxed at an effective rate of 10 per cent.

3.65 Included in the list of activities in section 121D that qualify as OB activities is 'borrowing or lending activity'. 'Borrow' and 'lend' are defined in section 121C to include raising finance by the issue of a security and providing finance by the purchase of a security respectively. 'Security' is in turn defined to mean a 'bond, debenture, debt interest, bill of exchange, promissory note or other security or similar instrument'.

3.66 There are also a number of other activities listed in section 121D that are potentially relevant to Islamic finance. They include trading activity, eligible contract activity investment activity, or any other activity declared by regulations to be an OB activity.

Views in submissions

3.67 This issue was raised in public consultation meetings. It was submitted that entering into Islamic finance transactions should come within the definition of 'OB activity' and attract the same tax concessions that are given to economically equivalent conventional finance transactions.

Board's consideration

3.68 The Board considers that entering into the Islamic finance transactions that are considered specifically in this report should be eligible as OB activities of an OBU and eligible for concessional tax treatment provided the other requirements of Division 9A are met. The Board also considers that enabling OBUs to access concessional tax treatment in relation to Islamic finance transactions that are economically equivalent to offshore banking activities will further facilitate the growth of Australia as a viable offshore banking centre.

3.69 However to deal with the uncertainty that was raised as an issue during the consultation process, the Board considers that the ATO should provide guidance to clarify whether certain Islamic finance products would come within the definition of OB activity under the current law. If ATO guidance reveals an impediment to Islamic finance that cannot be addressed under the current law, the Government should consider legislative options to address it.

Recommendation 5

In consultation with industry, the ATO should provide guidance on whether certain Islamic finance products would come within the definition of offshore banking activity under the current law.

If, in the course of providing ATO guidance, an impediment to Islamic finance is revealed that cannot be addressed under the current law, the Government should consider legislative options to address it.

Issue 6: Whether investment by a managed investment trust (MIT) in a sukuk would be an eligible investment business activity

3.70 MITs must limit their activities in a year to an eligible investment business (EIB) in order to retain trust taxation treatment under Division 6 of the ITAA 1936. Otherwise, they will be public trading trusts and be taxed like companies for the year, and their holders will be taxed like shareholders.

3.71 Division 6C defines an EIB as:

- investing in land for the purpose, or primarily for the purpose, of deriving rent;
- investing or trading in certain financial instruments, including shares in a company and units in a unit trust; and
- other similar financial instruments.

3.72 Investment in a sukuk is likely to be a key component of an Islamic fund's portfolio. It is uncertain as to whether investment in a sukuk would be an EIB within Division 6C of the ITAA 1936. There is also some uncertainty about the character of the return, as highlighted in the discussion about interest withholding tax. In consideration of this issue, the Board has focused on amended case study seven in its discussion paper, which is reproduced at Appendix C.

Views in submissions

3.73 This issue was raised in targeted consultation meetings. Although this issue was not specifically raised in submissions, the Board considers that it would be difficult to establish Shariah compliant managed investments without certainty on this issue.

Board's consideration

3.74 The Board considers that this review provides an opportunity to address potential areas of uncertainty to ensure that Australia's tax laws, wherever possible, do not inhibit the expansion of Islamic finance products. The Board considers that ATO guidance should be provided to clarify whether investment in a sukuk would be considered to be a 'similar financial instrument' within paragraph 102M(b)(xiii) of the ITAA 1936. Guidance should also clarify the character of the return on an asset based security (sukuk as described in amended case study seven). This is addressed by Recommendation 3.

3.75 The Board is of the view that investment in a sukuk could be considered an eligible business activity. ATO guidance will provide certainty and increased investment opportunities for Australian managed funds as well as removing a potential impediment for Islamic funds to be domiciled in Australia.

3.76 The Board has considered the possibility that ATO guidance may reveal an impediment to Islamic finance that cannot be addressed under the current law. If such an impediment is revealed, the Government should consider legislative options to address it. Any legislative option should be consistent with the existing tax treatment under the MIT regime.

Recommendation 6

In consultation with industry, the ATO should provide guidance on whether investment in a sukuk, by an Australian MIT, would be an eligible investment business activity.

If, in the course of providing ATO guidance, an impediment to Islamic finance is revealed that cannot be addressed under the current law, the Government should consider legislative options to address it.

Issue 7: The taxation treatment of partnerships and joint ventures is based on the form of the arrangement

3.77 A partnership is defined as partners that carry on a business in common and, for tax purposes, includes people who are in receipt of income jointly. The ATO has issued Taxation Ruling 94/8 which outlines factors taken into account in deciding whether persons are carrying on business as partners for income tax purposes.

3.78 There is uncertainty as to whether certain Islamic finance products would constitute a tax law partnership. If partnership-like arrangements are entered into with the intention of providing finance equivalent to that of a conventional loan, the application of the current law may result in tax treatment that is not based on the economic substance of the arrangement. However, the arrangement would be treated the same as an equivalent partnership arrangement.

Views in submissions

3.79 CPA Australia state in their submission that:

> When at the beginning of the arrangement it is the intention of the parties that the financier be bought out by the borrower, then it is suggested that the arrangement be treated as a repayment of principal and interest.

3.80 To achieve this, a number of submissions suggest an exception to partnership taxation akin to that provided in the UK.[12]

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12 The approach taken in the UK is to treat the profit share return as interest for income tax purposes if the following circumstances are met:
- one of the parties to the arrangements must be a financial institution;
- 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
- the alternative finance return or the profit share return must equate to, in substance, a return on an investment of money at interest.

3.81 Some submissions recognise the potential complexity in designing an exception to the general law to ensure that partnerships that are intended to be equivalent to a loan are taxed based on their economic substance. For instance, Blake Dawson state that:

> To achieve the result that the profit from the arrangement is considered interest (and not income from a partnership), specific amendments would need to be made to the legislation. We consider that significant attention would need to be given to integrity measures surrounding any amendment of this nature, as it would be a significant distortion to the current treatment of partnership income and would appear to differentiate the treatment between other partnership arrangements and diminishing [profit and loss sharing partnership] arrangements to the extent that distortion in commercial practices could arise.

3.82 In addition, in their submission, Blake Dawson recognise that based on current Australian tax law principles, the profit made by a partnership will not satisfy the definition of interest or the extended definition of interest for the purposes of the IWT provisions. Consequently these definitions would also require modification.

Board's consideration

3.83 The Board recognises that raising funds is not, and should not be, limited to debt. There is a place in Australian tax law for profit sharing arrangements such as partnerships and joint ventures. The Board considers that Islamic finance products that are based on profit sharing arrangements should not be re-characterised as debt as this would create complexity in the law and there are a number of alternative asset backed Islamic finance products that fit more easily within existing finance taxation frameworks. The Board considers that, in these circumstances, there is not a strong case from an Islamic finance perspective to treat certain profit sharing arrangements as the equivalent of debt interests.

Recommendation 7

In view of the existence of alternative Islamic finance products that fit more easily within existing finance tax frameworks, the current taxation framework for partnerships and joint ventures should not be amended.

Goods and services tax

3.84 Australia's GST regime applies to a very broad base, but there are some supplies of goods are services that are not taxable. For instance, Australia's GST law provides that some supplies are input taxed such as existing residential premises and financial services. 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.

3.85 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 products 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. For example, a hire purchase agreement is treated for GST purposes as a stand-alone sale or purchase in a tax period, so the same rules apply as they would for any sale and purchase of goods under an ordinary sale agreement.

Issue 8: Uncertainty over the GST characterisation of certain Islamic finance products

3.86 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 for this reason.[13]

3.87 This means that the supply is not taxable but the supplier cannot claim input tax credits for the GST component of the things it acquires for the purpose of providing that supply. Making financial 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 does give rise to other distortions.[14]

3.88 Whilst input taxation of financial supplies is the accepted international practice, Australia's treatment has some unique features. Australia applies input tax treatment to a much narrower range of financial supplies than in many other VAT/GST regimes. However, applying GST to a wider range of financial services results in a bias towards in sourcing which would not be a taxable supply. To reduce this distortion Australia's GST allows financial institutions to recover reduced input tax credits (RITCs) for certain listed acquisitions where input tax credits would otherwise be fully denied. The rate of RITC recovery is 75 per cent of the full input tax credit. In addition, input tax credits for making financial supplies are generally only denied once the entity exceeds the financial acquisitions threshold (FAT) such that many small businesses do not fall within the financial supplies input tax credit regime.[15]

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13 Existing residential premises, while also input taxed, are treated this way for different policy reasons, namely, to exclude the stock of existing houses from the GST tax base.

14 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.

15 The Government announced in May 2010 that it will lift the input tax credit threshold from $50,000 to $150,000 effective from 1 July 2012.

3.89 In principle, all financial services should be taxed in the same way that other goods and services are taxed so as to reduce potential distortions that result in businesses bearing embedded GST. As input taxation is a 'second best' solution it should generally only be applied to financial supplies in cases where the consideration cannot be readily identified on a transaction by transaction basis or where applying full taxation is impractical or results in significant compliance costs.

3.90 This approach is illustrated by the Government's recent announcement that the GST law will be amended to make all the components under a supply of hire purchase fully taxable where currently the interest charge, where separately identified and disclosed by the supplier, is input taxed. This decision followed a recent review of financial supplies conducted by the Commonwealth Treasury. The change will mean that the GST treatment will not depend on the characterisation of the credit component.

3.91 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.

3.92 The current entitlement to input tax credits relates to the character of the supplies being made and this is a fundamental feature of the GST. In a business to business context, trade based finance may provide a potential advantage over conventional finance in relation to entitlement to input tax credits. For instance, if the supply to the client is taxable, a financier could increase its recovery of GST compared to if the supply is treated as an input taxed financial supply.[16] Similarly, financial transactions involving supplies to non-residents are generally treated as GST-free and not input taxed giving rise to the same advantages noted above for taxable supplies.

3.93 In consideration of this issue, the Board has focused on case studies one and two in its discussion paper, which are reproduced at Appendix C.

Views in submissions

3.94 CPA Australia submit that the different application of GST to Islamic finance products compared with conventional financing arrangements highlights the problematic treatment of 'financial supplies' as input taxed for GST purposes. This treatment creates uncertainty as to characterisation of supplies. CPA Australia are of the view that there is a strong argument for GST to apply directly to financial supplies. Similarly, Freudenberg & Nathie agree that the GST treatment of financial supplies needs to be addressed. They note that technological advances may have improved the ability to subject financial supplies to GST.

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16 A Financier that adopts a revenue based apportionment approach to recover input tax credits on its overhead costs will have a higher rate of recovery the greater its proportion of taxable supplies.

3.95 Blake Dawson note that a financier would actually increase its recovery of GST under case study two arrangement (see Appendix C) compared to if it only made supplies of the conventional debt instrument. This is because the supply will be a fully taxable supply, and the financier should be able to claim back any GST incurred in acquiring the commodity as input tax credits. As the provision of a standard loan arrangement is an input taxed financial supply for GST purposes, no GST would ordinarily apply to the supply by the financier. The financier would not be entitled to claim back any GST incurred on its costs that relate to the loan.

3.96 Several submissions, including the Muslim Community Cooperative Australia (MCCA), are in favour of extending the definition of financial supplies to include certain Islamic finance transactions.

3.97 Similarly, Norton Rose thought that the UK approach should be taken in relation to the GST treatment of Islamic finance transactions. That is, the GST treatment should be no more or less favourable than the GST treatment accorded to the conventional equivalent transaction.

3.98 The Taxation Institute of Australia and the Australian Financial Markets Association support amending the GST regulations to include sukuks in the list of financial supplies.

Board's consideration

3.99 The Board notes that the GST treatment which currently applies to Islamic finance transactions impacts differently on different sectors of the market. Currently most submissions agree with the Board's analysis in its discussion paper that transactions between GST registered businesses that involve Islamic finance arrangements are generally advantaged over those involving standard loan/purchase arrangements. On the other hand, Islamic finance transactions involving end consumers may result in a small disadvantage.

3.100 It is clear from submissions to the Board that in order to achieve neutrality in GST treatment, there would need to be some legislative change. It is the Board's view that any legislative solution would require a fundamental change to the core GST provisions. A legislative solution may, for instance, require deeming supplies which are not financial supplies to be financial supplies. An amendment of this nature would require careful drafting or it could create complexity, disparate treatment in comparison to other taxable supplies, and may undermine the effectiveness and efficiency of the GST.

3.101 In light of the fact that the existing GST law currently favours most business to business transactions of an Islamic finance nature and the relative small disadvantage that may accrue to some transactions involving end consumers, the Board does not support a legislative change to the existing GST law at this time. The Board does not believe that the current GST law acts to the detriment of attracting Islamic finance to Australia.

3.102 The Board does not support the option to amend the GST regulations to specifically include relevant supplies in the definition of financial supplies. Determining the value of such implicit consideration for each individual supply, and for each party to the transaction, poses considerable challenges, complexity and compliance costs. Ultimately, taxpayers can choose which arrangement they want and will bear the GST consequences of that arrangement.

3.103 The Board notes however that some submissions identified that there remains some uncertainty on the characterisation of the 'profit' component under an Islamic finance arrangement. Blake Dawson, for example, note that this 'profit' component could be considered to be:

- a debt, credit arrangement or right to credit; or
- a charge or mortgage over real property (in the case of property transactions).

3.104 In either case, this component would be a financial supply for GST purposes and thus give rise to some input tax recovery on acquisitions. Alternatively, the Board understands that the 'profit' could be characterised as part of the consideration for the underlying transaction with the GST treatment following that of the underlying asset.

3.105 Whilst there is considerable guidance on the GST treatment of underlying transactions associated with Islamic finance products, there does appear to be a need for additional guidance on how the 'profit' component should be treated for GST purposes. Similar uncertainty is noted in the income tax treatment of the 'profit' (see Issue 1).

Recommendation 8

In consultation with industry, the ATO should provide guidance on the characterisation of the 'profit' component under a deferred payment arrangement for GST purposes. In particular, the guidance should clarify whether this 'profit' component could be considered to be:

- a debt, credit arrangement or right to credit; or
- a charge or mortgage over real property (in the case of property transactions).

Issue 9: Access to reduced input tax credits (RITCs)

3.106 Generally there is no entitlement to input tax credits on acquisitions that relate to making input taxed supplies. However the GST law allows a RITC entitlement in respect of certain acquisitions that relate to making input taxed financial supplies. The rationale for RITCs is to reduce the bias against outsourcing supplies used in making 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.

3.107 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:

- 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
- 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.

3.108 In consideration of this issue, the Board has focused on case study one in its discussion paper, which is reproduced at Appendix C.

Views in submissions

3.109 Blake Dawson recognise that if an acquisition relates to making financial supplies and is a reduced credit acquisition, a 75 per cent reduced input tax credit can be claimed on those acquisitions. However, costs that relate to the sale of the asset are not costs that relate to a financial supply and accordingly the 75 per cent reduced input tax credit is not available on these costs.

3.110 The MCCA submit that:

> there should be a provision to recognise a return paid to Islamic financial service providers as consideration and hence, the relevant supply should be treated as a financial supply ... In the absence of this treatment, Islamic financial service providers will not be entitled to the reduced input tax credits (RITCs) under Reg 40 of the GST Regulations 1999 which will render them highly uncompetitive in the Australian finance market.

3.111 The TIA and AFMA agreed that, to achieve parity in treatment, an amendment would be needed to allow for an RITC that did not relate to making a financial supply. However, the professional bodies note that if this is not expressed narrowly, other suppliers of input taxed residential premises may also be able to claim RITCs which they could not presently claim. If the amendment was narrow it would need to be

considered whether it would discriminate against other suppliers (such as vendors selling on deferred terms).

Board's consideration

3.112 The Board recognises that in the context of Islamic finance products used to finance the purchase of input taxed residential property, there is a potential, but not significant, GST cost to the financier resulting from lost entitlement to reduced input tax credits. However, the Board is of the view that this cost is likely to be relatively minor in the overall cost of finance and, considering its recommendations in relation to income tax deductions and its findings in relation to stamp duty, a change to the GST law is not essential to the development and provision of Islamic finance in Australia. The Board also notes that there are a range of other supplies that are also input taxed which are not financial supplies, for example, the supply of precious metals.

3.113 In addition, an amendment to the GST law to provide GST relief on certain costs that relate to input taxed supplies that are not financial supplies would need to be carefully targeted. Changes to the RITC rules may not be consistent with the policy for the provisions, would be complex and may create revenue risks in relation to an increased entitlement to credits beyond that intended and would require the agreement of the States and Territories. Any loss of entitlement to reduced input tax credits should be viewed in light of the potential for a more favourable GST outcome for the financial institution if the supplies are fully taxable.

3.114 The Board notes that, unlike those arrangements involving input taxed residential property, business to business transactions involving Islamic finance products have the potential to increase a financier's recovery of GST on its acquisitions compared with conventional financing arrangement. For the reasons given above, that is any lost entitlement to RITCs is likely to be relatively minor and an amendment to the law will increase compliance costs and complexity, the Board is not inclined to recommend that the GST law be changed to achieve neutrality.

Recommendation 9

The current RITC regime for financial supplies should be maintained and should not be extended to other input taxed supplies, such as input taxed residential premises.

INSURANCE

3.115 As noted in the Background to this report, takaful makes up only a very small part of Shariah compliant assets globally.

Views in submissions

3.116 The only insurance issues raised in submissions were regulatory in nature.

Board's consideration

3.117 The Board considers that the current demand for Shariah compliant insurance in Australia is very low and that it is unlikely that there will be significant interest in establishing takaful in the forseeable future. In addition, the Board considers that there are no aspects of Australian taxation law that would, in and of itself, be an impediment to the development and provision of an Islamic insurance product.

CHAPTER 4: THE BOARD'S FINDINGS

STAMP DUTY

4.1 The Board considers that the incidence of stamp duty on Islamic finance products backed by dutiable property is a significant impediment to the development and provision of Islamic finance products in Australia.

4.2 Each of the States and Territories levies stamp duty on conveyances (the transfer of property), both residential and commercial. The duty is usually remitted to the State Revenue Office by the purchaser of the property, based on its reported sale price (or the market price that is deemed to be a fairer representation of the value). The value of the property includes the value of land and buildings.[17]

4.3 Because Islamic finance transactions are frequently asset based, the transaction may involve multiple transfers of an underlying asset. If the asset is dutiable property, the transfers can give rise to additional dutiable transactions, in comparison to an economically equivalent arrangement such as a loan. In consideration of this issue, the Board has focused on case studies one, three and seven in its discussion paper, which are reproduced at Appendix C.

Views in submissions

4.4 In addition to the views expressed in submissions, a recurring theme through the consultation process was that stamp duty is a significant impediment to the development of Islamic finance in Australia.

4.5 CPA Australia state in their submission that:

> It is critical that there is not the imposition of multiple stamp duty on transactions pursuant to Islamic finance products.

4.6 Norton Rose recognise in their submission that:

> 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.

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17 Australia's Future Tax System Report, Volume 1, Part 2, page 251.

4.7 Norton Rose also notes that to qualify for the concessions in Victoria, a natural person must be involved in the transaction. This limits the application of the provisions to the acquisition of residential property.

4.8 The *Australia's Future Tax System* Report found that existing State stamp duties on property conveyancing are highly inefficient, distorting both residential and business use of property.[18] Further to this, the Report found that:

> Land value taxes should not include building values or be triggered by transactions as both of these can affect the use of land, which reduces the efficiency of the tax, and can be inequitable ... Since stamp duty applies to the whole property value, to some extent it taxes the capital used to improve land. While land is immobile, the capital used to improve it is not. Discouraging capital owners from investing in property improvements — particularly improving and selling property — is particularly inefficient.

4.9 A result is that businesses have an incentive to minimise transactions and investment in property.

Board's consideration

4.10 As a net importer of capital, it is important for Australian businesses to have access to a range of different sources of finance available internationally. The Board is of the view that stamp duty has the potential to make Islamic finance unviable for Australian businesses and governments. The Board's recommendations aim to ensure that certain asset backed Islamic finance products broadly have parity of tax treatment with conventional debt financing. The Board is of the view that its recommendations will have limited effect on the development and provision of Islamic finance in Australia if no relief from stamp duty is provided. The relief would need to be available for the structures the Board has identified, that is, commonly used asset backed Islamic finance products such as those described in Appendix C.

Example

A conventional loan is used to finance the purchase of land. Duty will be payable on the transfer of the property from the vendor to the purchaser.

Islamic finance, either a hire-purchase or a deferred payment arrangement, is used to finance the purchase of land. Duty will be payable on the transfer from the vendor to the financier and also, on the transfer from the financier to the client. If a hire-purchase is used, the land would be transferred to the client at the end of the finance arrangement. The duty on this transfer will be based on the value of the land, and buildings, at the time of the transfer (the improved or market value).

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18 At page 257.

4.11 In the above example of an Islamic finance arrangement the Board is of the view that, in substance, the client is the purchaser of the land and the transfer to the financier is a synthetic transaction that occurs only to give effect to the financing arrangement. That is, the only 'real' transfer is from the vendor to the client. The dutiable transfer, in substance, occurs at the beginning of the arrangement.

4.12 Some States and Territories may be able to provide clarity or guidance as to what relief may be available. However, one submission indicated that current relief, if available, may not be effective as the relief is only available at the conclusion of the arrangement.

4.13 The Board notes that broad based reform to stamp duty in preference to land tax, such as that recommended by the *Australia's Future Tax System* Report, may pose challenges for the States or Territories at this time.

4.14 For these reasons, the Board is of the view that relief from stamp duty is essential if certain asset backed Islamic finance products are to be a viable source of finance. Access to relief, in the first instance, should be based on the substance of the arrangement and could be limited to financial institutions or, in the case of a sukuk, a securitisation arrangement with particular features. Access to relief could be linked to particular tax provisions such as the debt test. Relief would then need to be on a transaction by transaction basis, perhaps through an application process. The relief, at least at the wholesale level, should be consistent across jurisdictions.

4.15 The Board is also of the view that State revenue will not be affected, provided relief from stamp duty is appropriately targeted, as such dutiable transactions would not otherwise occur. For instance, without stamp duty relief, the provision of Islamic finance in Australia is likely to be restricted to non-dutiable assets.

4.16 Submissions favour a legislative exemption. However, the Board recognises that it may be difficult for the States to design and target appropriate relief when they have not been asked to do so by affected taxpayers and may not have access to details and the nature of the transactions. The Board encourages industry to work with the States to ensure that relief is available on key transactions and it is appropriately targeted to protect revenue. For this reason, the Board is of the view that while the States may be guided by an overarching principle as to when relief should be available, the actual relief will always depend on the specific details and nature of the transaction.

Principle

Stamp duty should be payable only if there is a true, and permanent, transfer of risks and rewards relating to the property and not a synthetic disposal or acquisition that would not have occurred had it not been to give effect to a financial arrangement.

This means that, at least, there would have to be a financial arrangement for relief to be available. This could be linked to a relevant income tax definition such as that which may be developed in response to Recommendation 1.

Findings

The Board found that:

- The incidence of stamp duty on Islamic finance products backed by dutiable property is a significant impediment to the development and provision of Islamic finance products in Australia.

- Stamp duty, if it applies, may prohibit certain asset backed Islamic finance arrangements from taking place in Australia. That is, the incidence of duty may make a financing arrangement uncompetitive in comparison to conventional financing. This in turn may reduce the pool of available funds and/or drive up the cost of acquiring capital for Australian businesses.

- The States and Territories could consider providing relief from stamp duty. This relief may be available based on the substance of the arrangement but then could be provided on a transaction by transaction basis through an application process. This would enable the States to ensure that relief is appropriately targeted to protect revenue leakage. The States could ensure that, over time, guidance is provided so that there is certainty as to when relief would be available.

LAND TAX

4.17 Land Tax is imposed in each Australian state and territory except in the Northern Territory. As a general rule it is imposed on the unimproved value of land owned as at a particular date per year. The date varies from jurisdiction to jurisdiction.

4.18 Land Tax is imposed generally on the 'owner' of land. This is a word that is defined quite broadly. The liability of a particular parcel of land to land tax can depend on:

- who the owner is;
- the use to which the owner puts the land; and
- the use to which a lessee of the land puts the land.

4.19 In particular most jurisdictions provide an exemption from land tax for natural persons who occupy the land as their principal place of residence. This exemption may not apply if natural persons are not the owner under the land tax legislation. While this issue was not raised in submissions the Board considers that for fairness, the States and the Australian Capital Territory (ACT) should consider who should ultimately bear the cost of land tax for land backed Islamic finance transactions.

Principle

The Board is of the view that land tax should be payable, or exempt as the case may be, based on the underlying substance of the transaction and not the form that Islamic finance takes in any particular case.

Findings

The Board found that:

- The States and the Australian Capital Territory could consider amending their legislation to ensure that, after stripping away the form of the transaction, land tax should be imposed on the 'true owner' of the land. In addition, the true owner should enjoy whatever exemptions are applicable to such owner and should incur such liabilities as would normally be incurred.

APPENDIX A: LIST OF RECOMMENDATIONS (AND FINDINGS)

RECOMMENDATIONS

Recommendation 1

Amend the income tax law to ensure that in respect of a deferred payment arrangement whose main purpose is the raising or provision of debt finance, the finance gain or loss is treated the same as interest on a conventional borrowing.

Amendments to the law must have appropriate regard to the existing compliance savings exceptions (for short term trade focused arrangements).

Recommendation 2

Amend the income tax law to:

- expand Division 240 of the ITAA 1997 so that it applies to hire purchase arrangements relating to all assets (not just goods); and
- ensure that Division 240 will apply to credit arrangements that have the same characteristics as a hire purchase arrangement.

Recommendation 3

In consultation with industry, the ATO should provide guidance on whether the return on a deferred payment arrangement (case study one and two) or an asset based lease security (amended case study seven) will generally come within the expanded definition of interest.

If in the course of providing ATO guidance an impediment to Islamic finance is revealed that cannot be addressed under the current law, the Government should consider legislative options to address it.

Recommendation 4

Amend the income tax law to ensure that access to IWT exemptions in section 128F and 128FA of the ITAA 1936 is made available for publicly offered Islamic finance products (as described in case study two and amended case study seven) that exhibit equivalent economic characteristics to debentures or those debt interests that are currently eligible for the IWT exemptions.

Amendments to the law must be targeted appropriately to ensure that they do not undermine the integrity of the IWT exemptions and they do not provide an opportunity for arbitrage.

Recommendation 5

In consultation with industry, the ATO should provide guidance on whether certain Islamic finance products would come within the definition of offshore banking activity under the current law.

If in the course of providing ATO guidance an impediment to Islamic finance is revealed that cannot be addressed under the current law, the Government should consider legislative options to address it.

Recommendation 6

In consultation with industry, the ATO should provide guidance on whether investment in a sukuk, by an Australian MIT, would be an eligible investment business activity.

If in the course of providing ATO guidance an impediment to Islamic finance is revealed that cannot be addressed under the current law, the Government should consider legislative options to address it.

Recommendation 7

In view of the existence of alternative Islamic finance products that fit more easily within existing finance tax frameworks, the current taxation framework for partnerships and joint ventures should not be amended.

Recommendation 8

In consultation with industry, the ATO should provide guidance on the characterisation of the 'profit' component under a deferred payment arrangement for GST purposes. In particular the guidance should clarify whether this 'profit' component could be considered to be:

- a debt, credit arrangement or right to credit; or
- a charge or mortgage over real property (in the case of property transactions).

Recommendation 9

The current RITC regime for financial supplies should be maintained and should not be extended to other input taxed supplies, such as input taxed residential premises.

FINDINGS

Stamp duty

The Board found that:

- The incidence of stamp duty on Islamic finance products backed by dutiable property is a significant impediment to the development and provision of Islamic finance products in Australia.
- Stamp duty, if it applies, may prohibit certain asset backed Islamic finance arrangements from taking place in Australia. That is, the incidence of duty may make a financing arrangement uncompetitive in comparison to conventional financing. This in turn may reduce the pool of available funds and/or drive up the cost of acquiring capital for Australian businesses.
- The States and Territories could consider providing relief from stamp duty. This relief may be available based on the substance of the arrangement but then could be provided on a transaction by transaction basis through an application process. This would enable the States to ensure that relief is appropriately targeted to protect revenue leakage. The States could ensure that, over time, guidance is provided so that there is certainty as to when relief would be available.

Land tax

The Board found that:

- The States and the Australian Capital Territory could consider amending their legislation to ensure that, after stripping away the form of the transaction, land tax should be imposed on the 'true owner' of the land. In addition, the true owner should enjoy whatever exemptions are applicable to such owner and should incur such liabilities as would normally be incurred.

APPENDIX B: LIST OF PUBLIC SUBMISSIONS

Blake Dawson

Clark, David

Condon, Paul

CPA Australia

Crescent Investments Australasia

Department of NSW Treasury and Department of Industry & Investment NSW

Ernst & Young

Financial Services Council

Freudenberg, Brett & Nathie, Mahmood

Janson, Vickie

MCCA Ltd

Norton Rose

Taxation Institute of Australia and Australian Financial Markets Association

APPENDIX C: CASE STUDIES FROM THE BOARD'S DISCUSSION PAPER

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.

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.

CASE STUDY THREE: HIRE PURCHASE

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.

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.

Amended case study seven: Asset based security[19]

Please note: This case study has been revised and amended since the release of the discussion paper. In particular, an asset based sukuk is distinguished from an asset backed sukuk. An Australian electricity company (Vendor) needs to raise $500 million to finance an upgrade of its infrastructure over the next five years. The Vendor 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 (or beneficial interests in the assets) are sold by the Vendor to an Australian resident special purpose vehicle (SPV) using a purchase agreement. A purchase undertaking is given by the Vendor (as Obligor) in favour of the SPV trustee.

Step 2: The SPV trustee raises the cash to purchase the assets by issuing certificates to investors. The certificate holder has an undivided proportionate beneficial interest in the underlying assets held by the SPV trustee that confers an entitlement to income generated through the asset.

Step 3: The SPV trustee then leases the assets back to the original owner (Lessee) 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 servicing agency agreement is entered into between the SPV and the Lessee.

Step 4: At the end of the defined term (five years), the Obligor (original owner) agrees to purchase the assets back at a predetermined price. The purchase price paid by the Obligor is used by the SPV trustee to redeem the certificates for their face value and the SPV is dissolved.

Asset based sukuk

Under this transaction, the Vendor only transfers a beneficial interest in the assets to the SPV trustee. On maturity or if an event of default occurs, the Vendor (as Obligor) undertakes to purchase back the assets for a predetermined amount and this amount is

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19 The distinguishing features of asset based and asset backed sukuk and the details of the transaction documents as described in amended case study seven are taken from the chapter by Yavar Moini, Head of Islamic Banking, Morgan Stanley, titled 'Comparisons and differences between sukuk and conventional products' in Part II of 'Sukuk and Islamic Capital Markets', 2011, 1st edn, Globe Investment Publishing Limited, pp 35-50.

used by the SPV trustee to redeem the certificates. However, the certificate holders have no recourse against the assets. On exercise of the put by the SPV trustee under the purchase undertaking, the rights and interests of the SPV trustee in the assets is transferred back to the Obligor. In that event, the certificate holders are only entitled to the payment of the purchase price from the Obligor and rank as unsecured creditors of the Obligor in respect of that debt obligation.

Transaction documents

Purchase Agreement

The Vendor sells the assets to the trustee of the SPV. The purchase price for the assets is received from the investors in the sukuk.

This case study originally involved an asset backed sukuk, which means that legal title to the asset passes to the SPV trustee. In an asset based sukuk, only a beneficial interest is conferred upon the SPV trustee.

Lease Agreement

The SPV trustee leases the assets back to the original owner (Lessee). The Lessee is responsible for the ordinary maintenance of the assets while the SPV trustee (as Lessor) is responsible for maintenance of a capital nature. The lease agreement contains the usual terms and conditions for an arms' length lease agreement. Importantly, any event that results in the termination of the lease is also an event of default under the sukuk. As required under Shariah principles, the total loss of the asset is an event of default.

Servicing Agency Agreement

The SPV trustee usually appoints the original owner as its servicing agent (Servicing Agent), under which the Servicing Agent is responsible for all maintenance of a capital nature as well as taking out all necessary insurance in respect of the assets. This commercially means that the original owner is responsible for making good on any total loss of the asset.

Purchase Undertaking

This is a unilateral promise given by the Vendor (as Obligor) in favour of the SPV trustee and provides an irrevocable undertaking by the Obligor to buy the assets at a specified price on the trustee's exercise of this put option. The exercise price is equal to the aggregate of the redemption amounts of the certificates (that is, their full face value) together with any outstanding payments under the lease agreement.

On maturity or an event of default, the SPV trustee will exercise the put under the purchase undertaking pursuant to which the Obligor will purchase the assets and the SPV trustee will distribute the sale proceeds to the investors to redeem the certificates.

Sale Undertaking

This unilateral promise is given by the SPV trustee in favour of the Vendor and represents a call option for the Vendor. This defines the events under which the sukuk may be called by the Vendor, which may be limited to certain tax events or may be at the discretion of the Vendor (as in the case of certain sovereign sukuk).

Declaration of Trust

This document governs the relationship between the SPV trustee and the certificate holders. It contains the declaration by the SPV trustee to hold the assets on trust for the benefit of the certificate holders. It includes the powers and responsibilities of the trustee and the rights and obligations of the certificate holders.

Event of default: asset based sukuk

While an asset based sukuk confers an equitable interest in the underlying assets, this equitable interest is conferred only to entitle the investors to the profit produced by the assets. However, it does not give the investors any recourse to the assets on maturity or if an event of default occurs. In those circumstances, the certificate holders are only entitled to require the SPV trustee to exercise the put under the purchase undertaking, which in turn will require the Obligor to purchase the assets at a specified price.

The exercise of the purchase undertaking transfers all rights and interests of the SPV trustee in the assets back to the Obligor and creates an unsecured debt obligation for the Obligor in respect of the purchase price. Accordingly, once exercised, the certificate holders effectively have the same rights as unsecured creditors of the Obligor.

Under an asset based sukuk, investors are placed in the same legal position as holders of a conventional bond. The purchase undertaking ensures that the credit risk is solely based on the credit worthiness of the Obligor, with no recourse to the assets to meet any shortfall.

Agency Agreements

The agents involved in a sukuk issuance are similar to those found in a conventional bond issuance and include:

- the principal paying agent who is responsible for all payment services in relation to the sukuk and ensures that the trustee pays the stipulated payments to the certificate holders;
- the reference agent calculates the amounts payable under the certificates;
- the replacement agent replaces old certificates with new ones if there is any change to the terms of the sukuk;
- the transfer agent transfers individual certificates in favour of holders and informs the registrar to enable the appropriate certificate to be issued;

- the registrar maintains the register which records the ownership details of individual certificates and any cancellations or replacements;
- the delegate trustee is given the powers and responsibilities of the trustee in relation to exercise of the purchase undertaking on maturity or if an event of default occurs.

The above agency roles (except the delegate trustee) are usually performed by the trustee services division of a bank. The delegate trustee is usually a professional trustee company that is appointed where the SPV trustee is a shelf company incorporated in a foreign jurisdiction. However, it is also possible that the SPV trustee is a professional trustee company which performs the same function as the shelf company and its delegate trustee.

Costs Undertaking

This undertaking is given by the Vendor in favour of the SPV trustee under which the Vendor agrees to pay all transaction costs in relation to the sukuk issuance.

Subscription Agreement

This agreement is entered into by all investors with the SPV trustee, which contains the terms and conditions under which investors subscribe to the certificates.

APPENDIX D: MEMBERS, CHARTER OF THE BOARD OF TAXATION AND CONFLICT OF INTEREST DECLARATION

MEMBERS

The members of the Board of Taxation are:

Chairman

Mr Chris Jordan AO

Deputy Chairman

Mr Keith James

Members

Ms Annabelle Chaplain

Ms Teresa Dyson

Mr John Emerson AM

Ms Elizabeth Jameson

Mr Curt Rendall

Ex officio members

Mr Michael D'Ascenzo AO (Commissioner of Taxation)

Dr Martin Parkinson PSM (Secretary to the Treasury)

Mr Peter Quiggin PSM (First Parliamentary Counsel)

Secretariat

Members of the Board's Secretariat who contributed to this report were Ms Brenda Berkeley (Secretary) and Ms Megan Butcher.

CHARTER

Mission

Recognising the Government's responsibility for determining taxation policy and the statutory roles of the Commissioner of Taxation and the Inspector General of Taxation, the Board's mission is to contribute a business and broader community perspective to improving the design of taxation laws and their operation.

Membership

The Board of Taxation will consist of up to ten members.

Up to seven members of the Board will be appointed by the Treasurer, for a term of up to three years, on the basis of their personal capacity. It is expected that these members will be appointed from within the business and wider community having regard to their ability to contribute at the highest level to the development of the tax system. The Chairman will be appointed by the Treasurer from among these members of the Board. If the Treasurer decides to appoint a Deputy Chairman, he or she will also be appointed from among these members of the Board. Members may be re appointed.

The Secretary to the Department of the Treasury, the Commissioner of Taxation and the First Parliamentary Counsel will also be members of the Board. Each may be represented by a delegate.

Function

The Board will provide advice to the Treasurer on:

- the quality and effectiveness of tax legislation and the processes for its development, including the processes of community consultation and other aspects of tax design;
- improvements to the general integrity and functioning of the taxation system;
- research and other studies commissioned by the Board on topics approved or referred by the Treasurer; and
- other taxation matters referred to the Board by the Treasurer.

Relationship to Other Boards and Bodies

From time to time the Government or the Treasurer may establish other boards or bodies with set terms of reference to advice on particular aspects of the tax law. The Treasurer will advise the Board on a case by case basis of its responsibilities, if any, in respect of issues covered by other boards and bodies.

Report

The Chairman of the Board will report to the Treasurer, at least annually, on the operation of the Board during the year.

Secretariat

The Board will be supported by a secretariat provided by the Treasury, but may engage private sector consultants to assist it with its tasks.

Other

Members will meet regularly during the year as determined by the Board's work programme and priorities.

Non government members will receive daily sitting fees and allowances to cover travelling and other expenses, at rates in accordance with Remuneration Tribunal determinations for part time public offices.

The Government will determine an annual budget allocation for the Board.

Conflict of interest declaration

All members of the Board are taxpayers in various capacities. Some members of the Board derive income from director's fees, company dividends, trust distributions or as a member of a partnership.

The Board's practice is to require members who have a material personal interest in a matter before the Board to disclose the interest to the Board and to absent themselves from the Board's discussion of the matter, including the making of a decision, unless otherwise determined by the Chairman (or if the Chairman has the interest, the other members of the Board).

The Board does not regard a member as having a material personal interest in a matter of tax policy that is before the Board merely because the member's personal interest may, in common with other taxpayers or members of the public, be affected by that tax policy or by any relevant Board recommendations.