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Review of the taxation treatment of Islamic finance products
The Board of Taxation
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Review of the Taxation of Islamic Finance Products

Dear Members of the Board

We are pleased to respond to the Board of Taxation release and discussion paper of 13 October 2010 concerning the Board review to:

- Identify impediments in current Australian tax laws (at the Commonwealth, State and Territory level) to the development and provision of Islamic financial products in Australia;
- Examine the tax policy response to the development of Islamic financial 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 financial products have parity of tax treatment with conventional products

initiated by the then Assistant Treasurer on 18 May 2010.

We commend the Board for a quite comprehensive discussion paper which in our view examines the impediments to the taxation of Islamic finance products, and the policy response of various other countries - the first and second heads of the terms of reference - very effectively.

Our focus in this response is principally in relation to the third head of the terms of reference, to consider the appropriate recommendations (for Commonwealth tax laws) and findings (for State and Territory tax laws) that will ensure, wherever possible, that Islamic financial products have parity of tax treatment with conventional products.

The Board's examination of various countries' approach to the tax laws, in chapter 5 of the discussion paper, highlights the diversity of approaches.

As noted in the Board's discussion paper, UK tax law has been amended since 2003 with the objective of equalising the tax treatment of Islamic and non-Islamic financial transactions. This has been done carefully to have no specific tax law for Islamic finance but instead to express the principle that the same tax law should apply to all citizens, regardless of religion.

UK tax law now defines certain types of transactions, using language that is religion-neutral. For example the Finance Act (FA) 2005 s.47 defines a transaction called 'purchase and resale' that happens to correspond to murabaha. The legislation then identifies the mark-up inherent in the transaction and aligns the tax treatment of the mark-up to that of interest for tax purposes.

So some of the UK tax law concepts align to Islamic transactions very broadly as follows:

UK tax designation	Islamic finance equivalent
Deposit	Mudarabah
Purchase and resale	Murabaha
Profit share agency	Wakala
Diminishing shared ownership	Musharakah
Alternative finance investment bond	Sukuk

However the Australian legislative approach needs to have regard to the highly complex and prescriptive nature of Australia's tax law dealing with financial transactions. These include:

- The debt-equity rules of Division 974 (all references are to the Income Tax Assessment Act 1`997 unless otherwise stated)
- The foreign currency rules of Division 774 and 960
- The taxation of financial arrangements rules ("TOFA 3&4") of Division 230
- The infrastructure finance rules of Division 250
- The existing trust rules including Division 6C and reform project for managed investment trust rules
- The capital gains tax rules for inward investment (Division 855) and outward investment rules of Division 768.
- The withholding tax rules governing interest and dividends.

We submit therefore that:

- 1) The Australian experience of highly prescriptive law, designed to achieve a high level of certainty, has resulted in excessive complexity, very prescriptive rules which in fact send the signals to the Australian Taxation Office of the need for a highly legalistic interpretation which causes complexity. We refer for example to the comments of the Review of Australia's Future Tax System on complexity.
- 2) We do not favour a project to amend the existing legislation hugely complex minute detail. We submit that such an approach would:
 - a) Take such a long time to implement that it would not attract capital invested through Islamic finance products into Australia in the near term
 - b) Add huge additional volume to the tax law and run counter to the simplification being sought
 - c) Add complex prescriptive language which would invite new levels of dispute and controversy with the Australian Taxation Office

- d) Not achieve the objectives of the government.
- 3) We favour instead an overlay approach to the existing law, to provide tax equivalence for Islamic financial products. That should include:
- a) Legislation to set out the very clear policy of government to provide tax equivalence in the tax treatment of Islamic finance products with their equivalent non-Islamic finance products
 - b) Prescribe that the policy is a substance over form approach, to align the treatment of common finance products and others yet to be developed with their conventional equivalents
 - c) Specify that the equivalence will mean that the tax treatment of the Islamic finance products will cause their substance to replace the form and the tax consequences which would flow from that form including implications relation to the treatment of
 - i) Income
 - ii) Expenses
 - iii) capital expenditure
 - iv) withholding taxes and
 - v) capital gains.

So if an Islamic finance product was to be treated as equivalent to an interest-bearing loan, that interest characterisation would extend to the TOFA 3&4 rules, the infrastructure finance rules, the foreign currency rules, interest withholding tax rules and the debt equity rules to name but a few consequences.

This equivalence rule would require specific provisions applicable for purposes of the various financial arrangements rules. But in our view these would be general, wide-ranging statements of equivalence, and not hundreds or thousands of amendments percolating through the entire tax legislation.

- d) The use of regulations to provide further detail as required. We reiterate that the Board should recommend strongly the use of regulations rather than primary taxation law to implement these reforms.
 - e) Adjust the administration powers of the Commissioner of Taxation to comprehensively extend these powers to enable a substance over form administrative approach. Australia's desire for efficient tax treatment of Islamic products would not benefit from a repeat of the minute and lengthy interpretive and administrative complexity which has surrounded Australia's tax rules for financial arrangements, and their need for continuous amendments to highly complex laws.
- 4) This process should require an ongoing consultation and governance process. It will not be single package. The UK experience, for example, illustrates the ongoing process of refinement of the UK tax laws to deal with developing Islamic Finance practices.

As the UK HM Treasury noted in its October 2009 'Legislative framework for the regulation of alternative finance investment bonds (sukuk) summary of responses':

1.2.2 Since 2003, there have been several initiatives by the Authorities to create a 'level playing field' for Islamic finance. For example, in the 2009 Budget Report³ the Government introduced a number of tax changes for alternative finance investment bonds (AFIBs). In line with the aforementioned objectives and the wider objective of creating a level playing field for the UK financial services sector, our consultation paper considered the policy objectives and proposed a legislative framework for the regulatory treatment of AFIBs.

The ongoing consultation and development process will need to:

- a) Develop the law and regulations to deal with the core rules and the first tranche of instruments to be considered and
- b) Develop later adjustments and monitor further regulations as will be required.

In our view this process will require an enduring working group or taskforce with an initial life of say four years, with scope to extend the life of that group.

We note that this equivalence approach is used in Singapore and is apparently operating satisfactorily to meet the needs of stakeholders.

We would be pleased to participate in the development of the law, through a working group or other consultation processes. Our participation will be supported by the Ernst & Young fully dedicated team of more than 200 senior tax specialists across the GCC (Gulf Cooperation Council) countries and the wider Middle East who have anchor relationship with their counterparts in the USA and Europe. They work as one team on cross-border transactions. They provide a range of client and product specific service offerings for existing structures as well as new transactions.

If you would like to discuss this submission please contact in the first instance Daryl Choo on +61 2 9248 4472, Alf Capito on +61 2 8295 6473 or Tony Stolarek on +61 3 8650 7654.

Yours sincerely

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