MCCA SUBMISSION TO BOARD OF TAXATION ON
THE REVIEW OF THE TAXATION TREATMENT OF ISLAMIC FINANCE

Preamble

1. This submission is made from the Board of Directors of MCCA Limited, the premier provider of Islamic financial services in Australia since 1989. Headquartered in Melbourne, it has a branch in Sydney with mobile offices in Perth, providing *Shariah* compliant mortgages and fund management products to all Australians. MCCA has around 7,500 shareholders and members with an ambition to become the first fully fledged Islamic bank in Australia.

Substance based tax treatment and parity

2. Based on the UK experience, it will be practical to tax Islamic finance products on the basis of the economic functions they perform rather than their legal (*Shariah*) structures and designs. Australian taxation regime has already introduced substance based tax rules in the areas of TOFA and debt/equity rules under Division 974 of the ITAA 1997.

   The Islamic financial service providers appreciate the regards of this review to treat Islamic finance products at parity with conventional finance products for taxation purposes.

Tie-breaker rule

3. For Islamic finance, there should be a tie-breaker rule so that if a product does not meet the test for a particular economic function, it will be treated for taxation purposes on the basis of its dominant function.

Deductibility of profit component

4. For investment properties and general business purposes, the profit component paid to the financier should be deductible under s 8-1 of the ITAA 1997. In substance, the profit component is the economic cost to the borrower which has a sufficient nexus to gaining or producing assessable income and hence, it should be deductible.

   In all Islamic finance products, the general principle of deduction is met as the owner of the product incurs the expenditure and the asset is used for the purpose of gaining or producing assessable income or in carrying on an enterprise. To create a level playing field for Islamic finance, business costs, even though they are called profits, should be accommodated under the general deductibility of s 8-1 of the ITAA 1997.

No CGT event A1 occurred due to structure of products

5. CGT event A1 occurs in a number of Islamic financial products and arrangements including cost plus profit sales, leasing, diminishing partnerships (*Musharakah Mutanaqisah*) and Islamic bond (*Sukuk*). Broadly speaking for these arrangements, the disposal of an asset by Islamic financial institutions to clients should not trigger CGT event A1 or other similar events. In substance, this is just the end of the financing term in the transaction. In reality, the title transferred at this point in time occurs purely due to the legal (*Shariah*) structure of the products and arrangements.

Return treated as consideration for financial supplies

6. Under Division 40 of the GST Act 1999, financial supplies are characterised as supplies for which interest is paid as consideration. As Islamic finance does not recognise interest as a price paid for a financial service, the entire GST financial supply regime seemingly becomes inoperative. To rectify this situation, 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.

   This characterisation of Islamic finance products as financial supply is to remove an impediment in the current tax laws in relation to Islamic finance. 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.

Shariah compliant mortgage products and entitlement to RITCs

7. In economic function and substance, Islamic mortgage products using cost plus profit sale (*Murabahah*), leasing (*Ijarah*), partnership (*Musharakah*) and diminishing partnership (*Musharakah Mutanaqisah*), are equivalent to conventional mortgage. Although their legal structures and designs are different, they essentially provide a loan to purchase properties and assets.

   Under Reg 40 of the GST Regulations 1999, loans are financial supplies. A financial supply is defined as a provision, acquisition or disposal of an interest for consideration. An interest relates to a debt, right under a contract or a right to receive a payment. All these conditions are satisfied by *Shariah* compliant mortgage products.

   Accordingly, *Shariah* compliant mortgage products should be treated as financial supplies and hence, RITCs should be allowed for acquisitions made to provide these supplies. In the absence of this treatment, these products would be prohibitively expensive which would act as an impediment to the development of this essential segment of the Islamic finance market in Australia.

GST treatment of Hire Purchase (*Ijarah*) based Islamic finance products

8. Although the Government has announced its plan to make the supply of hire purchase fully taxable as of 1 July 2012, products based on leasing concept will remain to be a huge issue for Islamic finance, especially in the mortgage market. Currently, a substantial number of properties are financed on the basis of a method called “leasing ending with ownership” (*Ijarah Muntahiya Bittammlik*). As these loans are designed as leasing, GST will apply to them which will make these products prohibitively expensive for consumers. (Imagine purchasing a house for, say, $800,000 and paying 10% GST on it. No borrower from conventional banks pays GST on loaned money).

   As provided under Division 240 of the ITAA 1997, the lease based Islamic finance products should not be treated as notional sale and loan. The intention and substance of these lease based arrangements is to provide a loan to acquire properties and assets.

   Division 250 of the ITAA 1997 would not be appropriate to apply as most of the clients for Islamic finance products would be non-governmental entities and they will be subject to ordinary taxation rather than their income treated as exempt income.

In the Islamic finance industry throughout the World, *Ijarah* or lease based products are used to provide loans to clients. It is primarily used as a method of finance in the real estate industry. Although the structure of many Islamic finance products is based on leasing arrangements, the economic function they perform is financing and hence, they should be treated as financial supplies and no GST should apply.

Non-resident withholding tax and financier withholding tax

9. As Islamic finance is not indigenous to Australia, it is highly likely that non-residents will be involved with *Shariah* compliant products and arrangements in our jurisdiction. It is also likely that a dependent agent will be present in Australia with transactions involving non-residents. Under s 6(1) of the ITAA 1936, if a resident agent is a dependent agent of the non-resident financier, the agent will be treated as a Permanent Establishment (PE) of the non-resident. In this case, the income or profit component will be attributed to the PE as business income and ordinarily taxed in Australia.

   DTAs, under *International Tax Agreements Act 1953*, facilitate cross boarder economic and financial engagements through preventing double taxation and eliminating fiscal evasion. It will be suggestive for the Board of Taxation to recommend the initiation of tax treaties with major countries of *Shariah* compliant finance activities.

   Returns paid for *Shariah* compliant products are generally derived on the basis of trading profits, rental payments or management fees. By definition, these returns are not interest in an ordinary sense of the term. Hence, we propose to identify "interest withholding tax" (IWT) as "financier withholding tax" (FWT) in the legislation. This will avoid any potential controversies in relation to the concept of finance in the Islamic law.

   The existing regime of dividend withholding tax (s 128 of the ITAA 1936) and royalty withholding tax (s 128B of the ITAA 1936) could be operative for transactions under Islamic finance.

   In relation to IWT, our views are as follows:

a) Rename it as FWT and tax it under the existing regime. This treatment will produce a fair outcome for Australia and non-residents as these payments are in the nature of interest or some would perceive to be as such in nature or
b) Apply the regulation-making powers provided by ss 128F and 128FA of the ITAA 1936 to exempt from tax. This will serve the legislative purpose of encouraging flows of capital from abroad and enhancing the development of Australia as a centre for financial services.

***Sukuk* treated as an ordinary financial arrangement**

10. Due to legal structure of *Sukuk* (Islamic bonds), it has implications for CGT, GST, debt/equity rules, TOFA timing rules, leasing and stamp duty. In substance, the economic function performed by *Sukuk* instruments is to provide financing backed by real assets. Hence, it should be treated as an ordinary financial arrangement and taxed accordingly.

    The *Sukuk* arrangements involve the legal sale of equity based securities together with an agreement to buy back the same securities within a certain period of time. Under Division 230 of the ITAA 1997, this arrangement could

be compared with securities lending arrangements and hence, any capital gain or loss could be treated as specifically disregarded.

The exclusions under Division 230 of the ITAA 1997 would apply to *Sukuk* arrangements. As it creates an interest in a trust, there is only one class of equity interest issued and there is a Responsible Entity for the SPV, the *Sukuk* arrangement will qualify for exclusion under this Division to disregard any capital gain or loss arising from this transaction.

It is highly likely that *Sukuk* issuance will attract interests from non-residents. Under s 855-15 of the ITAA 1997, if *Sukuk* instruments are backed by Australian real property or assets used in PE, non-residents will be subject to CGT in respect of capital gain or loss arising from these assets. There should be an exclusion introduced in this provision for non-residents in relation to *Sukuk* arrangements made under Islamic finance.

Removal of double stamp duty

11. In relation to Federal taxes, tax law should be amended to remove potential double stamp duties applicable to Islamic finance products in different market segments including mortgage, hire purchase and Islamic bonds. Transfer of titles in these products and arrangements occurs only due to legal structure and not because of a real change in ownership as intended in the imposition of stamp duties.

Removal of word "interest" in the legislation

12. For Islamic finance products based on cost plus profit sales and other methods, the word "interest" should not be used in the legislation. Rather the terms like profit, rent or fee, as appropriate, should be used to identify relevant returns.

    Returns paid for *Shariah* compliant products are generally derived on the basis of trading profits, rental payments or management fees. By definition, these returns are not interest in an ordinary sense of the term. Hence, we propose to identify them as they are derived as profits, rentals or fees. This will avoid any potential controversies in relation to the *Shariah* concept of finance.

Public awareness and perception issues

13. An appropriate level of public awareness campaign should be conducted in the community about the taxation treatment of Islamic finance to enhance *Shariah* compliant financial activities in Australia. This could be done through correspondence to industry groups, legal and accounting firms, regulatory agencies and community organisations.

    The suggested issues of the campaign would include the following: the facilitation of *Shariah* compliant finance is to attract funds from abroad and create employment opportunities for Australians; Islamic financial instruments are taxed on the basis of their economic functions and are not treated as interest-bearing methods of finance; Australian taxation system treats *Shariah* compliant finance products at parity with the conventional finance products.

Contact for further information

14. For further information and clarification on the taxation issues raised in this submission, please contact Mr. Mohammad Najjar, Acting General Manager, MCCA Limited at 03 9384 9030 or mohammad.najjar@mcca.com.au