tination jurisdiction (with limited or no taxation right to the source jurisdiction).

• In some situations, the tax residence of the borrower may be affected owing to 'control and management' issues arising with a non-resident Islamic finance partner. This should not be the case in most situations. However, if it arises and the tax residence is impaired, the entrepreneur may not be entitled to avail of tax treaty benefits.

• A duplicate (and irrecoverable) charge to VAT costs may arise, in the source as well as the destination jurisdiction.

19.4. Accounting for Islamic finance products

The expansion of Islamic finance creates a pressing need for harmonized international accounting standards. This is more relevant these days, given the fact that most of the prevailing accounting standards, such as, International Accounting Standards (or the International Financial Reporting Standards) cannot be applied across the board to Islamic financial transactions.

AAOIFI has published some accounting standards for Islamic financial institutions and industries which are being followed in certain Gulf States. In addition, certain other countries have also issued local accounting guidelines for Islamic financial products and services. However, for inherent limitations, a lot of variations arise in the accounting treatment under AAOIFI Accounting Standards as compared to other sets of accounting standards. For example, AAOIFI Standards require that all leases should be recognized as operating leases regardless of the fact that certain leases carry the characteristics of being recognized as finance leases.

The accounting standards issued by AAOIFI so far are limited to accounting for financial institutions, and do not provide guidance on the accounting treatment of the counterparties in quite a few instances. For example, the accounting treatment of the counterparty for a diminishing musharaka transaction is not clear, i.e. whether the asset should be recognized on the balance sheet, and if so, at what value, and how the progressive payments should be accounted. Considering that these Standards are at an evolutionary stage however, the framework of AAOIFI Standards does suggest that where accounting treatment is not provided for under AAOIFI Standards, the accounting treatment under any alternative accounting standards should be considered.

In some cases, the accounting practice adopted by market players in the Islamic financial industry does not conform to the legal and the Shari'a form of the transaction. For example, general takaful companies are recording the gross amount of premium as their income whereas under the rule of Shari'a, the takaful funds belong to the policyholders and cannot be diverted automatically to the takaful company.

In summary, as the accounting profit is normally a key determinant in the computation of taxable income in most countries, it is the need of the hour for the accounting profession to rise up to the challenge.

19.5. Looking ahead

Islamic finance has now come out of the infancy stage and yet there remains a need for a consistent accounting and tax treatment of Islamic financial transactions. Given that the Islamic financial market is growing at a fast pace, there is an urgent need to adopt a top down approach. As a starting point, the Organisation for Economic Cooperation and Development (OECD) should take up the initiative and modify the model double taxation convention to accommodate Islamic financial transactions, and ensure that they are taxed on par with their conventional counterparts. Major financial centres (such as the UK, France, and Ireland) have already started the process of amending their tax laws to accommodate Islamic finance transactions. An initiative by the OECD will certainly boost the comfort level of other jurisdictions, and incentivise them to modify their local tax laws to make Islamic finance a mainstream part of their financial system. This can provide an alternative way of doing business which would certainly help in avoiding the current financial debacle that we have recently just witnessed.

CHAPTER 20
International Taxation

20.1. Introduction

TThis section seeks to highlight various aspects of international tax planning that should be considered as Islamic finance continues to grow from a niche to mainstream mode of finance. In this article, we will also explore why Luxembourg might assume a pivotal role for Shari'a-compliant fund management.

20.2. Product evolution

Financial transactions largely utilized the concepts of ijara and murahaba until not too long ago. As the principles of Islamic finance gained stronger footing in the Western World, practitioners and scholars presented an array of other contractual forms adhering to Shari'a rules - such as istisna', salam, and mudaraba - to address the modern business needs. More recently, and certainly more significant is the concept of sukuk. Sukuk is the Islamic finance's equivalent of bond certificates or securities. A primary differentiating factor between a conventional bond and a sukuk is that a holder of a sukuk certificate obtains an undivided beneficial ownership in the underlying assets pertaining to the project for which it has been issued. This means the holder, depending on the type of sukuk, has rights to participate in the regular income generated by the business activity, as well as to the upside potential gains resulting from the sale of such assets.

Apart from carrying a low risk profile due to the inherent restrictions placed under the Shari'a mode of finance, the equity based sukuk such as the mudaraba sukuk, musharaka sukuk and ijara sukuk may be tradable on secondary markets, adding to its attractiveness. Whilst sovereign bodies from Malaysia to Bahrain have made several sukuk issuances, this attractive feature has also caught the attention of western governments – the State of Saxony-Anhalt in Germany made the debut European sovereign sukuk issuance in 2004; the UK government announced its intentions to issue a sovereign sukuk, in addition to recently making changes in the UK tax law to facilitate an equal tax treatment in respect to a sukuk issuance. More recently, there has been talk of the Grand Duchy of Luxembourg contemplating its own sovereign sukuk issuance.

20.3. Importance of tax planning

Any of the transactions mentioned above would carry a certain tax cost when carried out under the conventional financial system. Similar tax costs can be expected with an Islamic finance transaction – but to suffer an additional tax burden for a Shari'a-compliant transaction that achieves a similar end result may seem unfair. In the case of multi-jurisdictional transactions, tax costs could be punitive in the absence of proper tax planning, not to speak of adding considerably to the complexity (and profitability) of a transaction. Hence, in addition to meeting Shari'a standards, a transaction should also be tax-efficient from an international tax perspective, and this is accomplished with the comprehension of the accounting treatment in a given country, i.e. GAAP, IFRS etc., and the addressing of domestic tax and regulatory laws.

The desired commercial targets, and the challenge of minimizing tax leakages associated with an international investment become even more real in the wake of ever-evolving tax laws, new trade agreements between countries, special government incentives, and of course the manoeuvring through a range of intermediary holding jurisdictions. A structure designed to ensure the least amount of exposure to local tax costs, when considered from a cross border perspective, may not translate into a structure that would achieve overall tax efficiency. An efficient corporate tax structure should take into consideration the following tax implications:

• Investment level: Profits derived from a business activity are generally subject to national taxation, which in some cases can be quite high. Tax costs applicable during the term of an investment, and at exit require careful consideration – for example, whether depreciation deductions are available; whether financing costs are deductible against the income; whether regular income and capital gains are taxed differently; what is the withholding tax mechanism upon repatriation of funds, and whether any tax relief is available pursuant to a Double Tax Treaty (DTT).

• The choice of investment vehicle, whether to use debt or equity financing, foreign exchange limitations, permanent establishment concerns for non-resident entities, and employee tax matters are some of the more important aspects that need to be considered. In addition, particularly with real estate investments, one has to consider various transactional costs relating to tax - such as land registration tax, capital duties or stamp taxes on shares, municipal taxes, etc. Indirect taxation adds yet another layer which needs to be appropriately addressed.

• The investor level: Depending on an investor's tax home, repatriation of profits from the country of investment may be subject to income tax and/or withholding tax. The character of income also influences whether or not, and to what extent, it may be subject to tax and more importantly, if relief is available pursuant to a DTT. The investor's profile and duration of investment generally dictates the choice of vehicle - opaque or transparent - and therefore the character of income available for repatriation.

• Holding platform level: A good holding company location generally boasts a good DTT network; minimal income spreads subject to no or low tax rates, excellent repatriation mechanisms and a good regulatory framework, among others. As previously mentioned, the choice of a holding location is generally influenced by the underlying investment and investor match, e.g. Cayman Islands is quite common for investments into the US; Luxembourg provides a good entrance into various European jurisdictions; Bahrain and Mauritius or more recently, the UAE has been favoured for investments into the Middle East North African region; and Hong Kong or Singapore see a large part of investments into the Asian economies.

Keeping in mind the above factors, it is easy to see that a poorly designed tax structure can make an investment lose its attractiveness in terms of after-tax profits. Putting these international tax planning issues in the context of Islamic finance transactions may at first seem quite a daunting task. However, a systematic approach which maintains adherence to Shari'a principles on the one hand and respects a country's local tax laws on the other hand requires careful analysis – some of the questions which must be asked from a tax perspective are: What stage of the transaction gives rise to a taxable event? What is the nature and method of non-cash items being exchanged? When does the ownership in a property pass between parties involved? What is the timing and character of income and related deductions? Does interposing a common jurisdiction provide any advantage?

20.4. The role of the tax authorities

As noted earlier, depending on a country's tax system, a conventional financial transaction may result in a higher tax cost when modified to comply with Shari'a laws simply because the country's tax system is not equipped to recognize Islamic mode of financing. This penalizing factor can deter investments into that country, where the investor otherwise may be keen to invest.

In this respect, the UK has taken the lead in demonstrating the need for such flexibility to accommodate a growing alternative financial model that carries a promising market potential. This is evident from the last four Finance Acts[202] (FA) that have all introduced provisions adapting the UK tax law, to recognize the substance of Shari'a-compliant transactions. Similarly, the Monetary Authority of Singapore[203] followed the UK's example in creating a level playing ground for both Conventional finance and Islamic finance. Whilst other countries are at varying stages in addressing the importance of recognizing Islamic finance transactions and related tax implications, the French Tax Authorities set the most recent (February, 2009) example in issuing guidelines[204] in relation to murahaba instruments as well as the issuance of sukuk. Not surprisingly, and perhaps due to historic business ties between France and MENA region in general, this welcome change has brought Paris in competition with London to become the western centre of Islamic Finance in a very short spell of time.

To illustrate the impact of such disparity and how it has been addressed, let's consider an abridged example of a mudaraba sukuk structure, where a company in need of financing enters into a mudaraba contract with a trust specifically created for this transaction. The company sells its assets to the trust and immediately leases them back. The trust issues sukuk certificates to its investors in return for the proceeds which are forwarded to the Company for use in its business. As the Company makes lease payments to the trust, the trust makes periodic payments to the investors. At the end of the term of sukuk certificates, the company buys back the assets and the trust returns the capital to its investors, unless the company opts for a refinancing arrangement.

According to the UK tax law, absent of the FA changes, the mudaraba contract closely resembles a partnership, and the lease payments made by the company to the trust appear to take the form of profit distribution to the trust[205]. The trust is taxable on its share of partnership profit, therefore resulting in reduced payments to sukuk holders, who may or may not be able to obtain a refund of UK taxes paid by the trust. In contrast, a debt structure would provide deductible interest payments to the company from a tax perspective, and there would be no UK withholding tax on interest income to investors. In addition, there might be multiple transaction taxes, particularly stamp duty land tax ('SDLT') in the case of real property, since the assets (technically) change hands more than once.

[202] www.opsi.gov.uk/acts

[203] www.mas.gov.sg

[204] Bulletin Officiel Des Impots 4FE/09

[205] UK taxation of Islamic Finance, July 2006, Mohammed Amin, http://pwc.blogs.com/islamicfinance

Over the years, the UK tax law has adopted several changes, for example the elimination of multiple SDLT[206] charge, introducing concepts of 'alternative finance investment bond' and 'diminishing shared ownership' which reflect the sukuk and the diminishing musharaka respectively. Of course, the UK does not intend to provide specific treatment for transactions adhering to Shari'a principles, but it has recognized the disparity in (the UK) tax treatment between a conventional and Islamic instrument. Following the FA changes, subject to meeting specific requirements and depending on the nature of transaction involved, the new provisions in the law accord similar tax treatment for a conventional and Shari'a-compliant transaction.

In France, since the publication of guidelines earlier this year, it is possible to treat payments made by the fiducie (equivalent of a trust) to the sukuk holders as interest, hence deductible from the taxable basis – thus providing for an equitable tax treatment. Further, if the investor is a non-French resident, the guidelines provide for an exemption from withholding tax on interest payments. Previously, the sukuk payments to investors would constitute distribution of profits and therefore not be deductible, and potentially subject to dividend withholding tax. It is important to note that the guidelines' flexibility in according interest treatment to sukuk payments, does not release a company's obligation to follow normal rules related to interest deductibility limitations under the French Tax Code.

On the other end of the spectrum, we note countries whose tax structure is designed to take into consideration the principles of substance over form when analyzing the tax treatment of a transaction, e.g. the United States and the Netherlands. Luxembourg is another jurisdiction that presents a unique flexibility in terms of its policies and the attitude of its authorities, which is friendly towards alternative finance techniques on the premise of substance over form. Typically, an advanced tax clearance is recommended in these countries before implementing Shari'a-compliant structures, but generally speaking it should be possible to achieve similar tax results to a Conventional transaction.

20.5. Luxembourg and cross-border Shari'a-compliant investment structures

A large part of the Islamic investor base is concentrated in Asia and the Middle East, where there is a long history of trade with Europe – with opportunities riding on the back of petrodollars. To structure tax efficient investments between Asia and Europe is not straight forward, and typically, the corporate legal structures use an intermediary location such as Ireland, the Netherlands, Jersey and Luxembourg.

Sitting at the heart of Europe, Luxembourg offers excellent opportunities from an international taxation perspective to structure through-bound investments – be it conventional finance or Islamic finance. As a key global investment management centre, and a recognized holding platform, Luxembourg offers a range of vehicles, financing products and repatriation mechanisms, and is an ideal location to facilitate Shari'a-compliant transactions. It offers a prudent and friendly legal framework that allows companies to utilize any of the Islamic instruments mentioned above in a tax efficient manner. An advanced tax clearance is recommended, as in most other jurisdictions.

The Luxembourg Financial Services Authority – CSSF – offers varying degrees of regulatory supervision while maintaining a pragmatic, proactive and a flexible business approach. To accommodate various investor categories with differing needs, Luxembourg offers some of the most tax efficient investment vehicles.

Key attractive features of the Luxembourg regulated investment fund vehicles include an exemption from corporate income tax, municipal business tax and the net worth tax. These vehicles are also exempt from dividend and interest withholding tax paid to foreign investors, with the exception of the EU savings directive.

• société d'investissement à capital variable ("SICAV"),

• société d'investissement à capital fixe ("SICAF"), and

• fonds commun de placement (FCP).

In the case of informed investors who may wish for less regulation and greater flexibility in terms of investment strategy, (but with a similar set of tax benefits as a regulated vehicle), Luxembourg offers the following options.

• société d'investissement en capital à risqué ("SICAR"), and

• specialized investment fund ("SIF")

SICAR is an attractive vehicle format for Shari'a-compliant venture capital and PE funds that do not utilize interest based financing. With moderate regulatory supervision, and its tax neutrality - the SICAR is designed to be flexible, so promoters can structure them according to investor needs. Another key feature is the ability to set up compartments underneath the main fund vehicle, which can accommodate Conventional as well as Shari'a investor needs – while still maintaining a clear distinction amongst the two.

The SIF provides maximum flexibility in terms of tax exemptions while adhering to a regulated framework. It may take a contractual form with a management company, or be set up as a corporate vehicle – depending on investor needs. A unique aspect of relevance to Middle Eastern investors based in the UAE or Bahrain for example, where corporate profits may not be subject to tax, is the fact that SIF is not liable to withholding taxes in Luxembourg regardless of the investor not being subject to an income tax regime.

Luxembourg also caters to investors who desire an unregulated investment vehicle by providing the following two options:

• société de gestion de patrimoine familial ("SPF"), and

• société de participation financière ("SOPARFI").
The exemption from taxation of dividends received from substantial shareholdings, or participations, in both

[206] Finance Act, 2003

qualifying resident and non-resident companies, and also of capital gains arising upon the sale thereof, is one of the major attractions of Luxembourg as a holding company centre. Being exempt from corporate income tax, municipal business tax, net worth tax, and dividend withholding tax, a SPF provides an alternative for private wealth management.

A SOPARFI is a regular Luxembourg company that is fully taxable. However, several financing mechanisms exist, which may reduce the effective tax rate to close to zero. The use of hybrid financing may allow upward interest payments to the parent company without being subject to withholding tax in Luxembourg. In addition, the SOPARFI should receive dividends tax free from qualifying participations, and can make tax-free capital gains on their disposal.

The underlying corporate setup could take the legal form of commercial companies such as société à responsabilité limitée ("S.à r.l."), société Anonyme ("S.A."), société en commandite par actions ("S.C.A."), société en commandite simple (" S.C.S."), société en nom collectif ("S.N.C."), depending on the specific investor/investment needs. S.C.S. and S.N.C. are tax transparent partnerships in Luxembourg, but have legal personality. The income tax rate in Luxembourg is 28.59% (21% Corporate Income Tax + 0.84% surcharge + 6.75% Municipal Business Tax). However, in practice, the effective tax rate tends to be much lower due to various dividend and capital gain exemptions available if certain conditions are met. Other attractive features include:

• 100% participation exemption regime for dividends and capital gains

• No interest (except for savings) or royalty withholding tax

• No withholding tax on liquidation proceeds

• There is no activity test or passive income test

• A wide double tax treaty network[207] that is continuously growing – more recently Luxembourg has signed DTTs with Hong Kong, India, the UAE, and Bahrain

• No capital duty or stamp taxes on shares

• No thin capitalization rules, although an 85-15 debt-equity ratio is necessary to avoid interest payments being re-characterized as dividend distributions. Of note to Islamic investors is the fact that debt instruments without a fixed rate of return may qualify as equity for debt-equity ratio purposes, thereby enabling up to 99% asset-linked financing

• New Intellectual Property ("IP") regime (as of 1/1/2008) providing for an 80% exemption of net income from certain IP (royalties and capital gains)

• There is no CFC legislation

Furthermore, Luxembourg offers a very attractive range of financing structures, such as preferred equity certificates, which could be used to erode the tax base and at the same time allow flexibility in investment and cash flows. Luxembourg also provides extremely efficient repatriation structures, such as convertible loans, profit participating loans, tracking loans or real estate certificates which may help address cash trap issues in certain cases. These financing and repatriation instruments may be structured in a manner that attaches the financial results to the underlying assets of a company thereby meeting the required Shari'a principles.

Another point of interest to Islamic investors may be the Luxembourg Securitization Vehicle[208]. Under the provisions of the Law of 22 March 2004 assets can be securitized in a variety of ways. The aim has been to provide a legal framework that can cope with both simple and complicated structures. Vehicles can be either corporate or be set up as a fund, as a regulated or non-regulated entity, with an actual or economic ('synthetic') transfer of ownership and as a single or double vehicle. In addition to providing a flexible and practical legal structure, this law introduces an interesting regime for corporate securitization vehicles. They are exempt from net worth tax but are fully liable to corporate income tax and municipal tax, and should therefore qualify for reduced foreign withholding tax under Luxembourg's tax treaties.

With a stable tax legislation and flexible investment orientated tax environment, the Grand-Duché de Luxembourg presents excellent tax planning solutions to investors in Islamic finance not only from the Middle East, but around the world. Since the first listing of sukuk in Europe was made on the Luxembourg Stock Exchange, the number of sukuk listings has steadily climbed to sixteen with a total value of US$ 7.3 billion[209].

20.6. Looking ahead

It is clear today that Islamic finance has outgrown its image and territorial reach as previously understood - in the east and the west alike. In its modern form, Islamic finance presents enormous potentials for cross border trade, and offers a coherent and sensible alternative finance framework, which builds on deeper rooted principles pertaining to ethics, human values and a harmonious social structure.

Consequently, Shari'a scholars, practitioners and advisors come together to reinvent Islamic financial techniques to suit current business needs, and a host of governments take initiatives to address discrepancies in providing level tax treatment. Looking at the current state of the Islamic finance sector that has crossed US$ 1 trillion in investments with a potential of US$ 4 trillion[210] (and is growing at more than 10% annually), it is obvious that the changing face of global economy has much to benefit in harnessing the power of Islamic finance. As discussed, it is vital to curtail the tax leakages that may result from poorly structured investments in the age of rapidly changing and evolving legal, regulatory and tax framework. Recognizing a strong interplay between Conventional and Islamic finance, one may argue that traditional financial centres may be well placed to facilitate the growth of Islamic finance internationally. Luxembourg, in particular, may provide maximum flexibility in its regulatory framework combined with an extremely efficient tried and tested tax regime that encourages discussion oriented solutions adhering to substance over form principles.

[207] Currently, Luxembourg has 53 double tax treaties, and 21 more in various stages of negotiation. For details, see: http://www.impotsdirects.public.lu/dossiers/conventions/conv_vig/index.html

[208] IBFD. Luxembourg in International Tax Planning, Philip J. Warner and Marc Schmitz

[209] www.bourse.lu

[210] Moody's report on Islamic Banking, 2009