

CHAPTER 26

Taxation of Islamic financial products in Luxembourg

26.1 Introduction

For several years already, Luxembourg has been evolving as a global hub for Islamic finance. The Government has been instrumental in putting the measures and means in place to allow the development of Islamic finance. It has been the first European stock market to launch and list sukuk, has been the first European Member State to be admitted to the Council of the IFSB, and has organised frequent government sponsored missions to GCC countries, underlining its commitment to making Luxembourg a primary hub for the development of Islamic finance.

Luxembourg is indeed very well positioned to attract Islamic finance projects thanks to its highly qualified multicultural professionals, its favourable and flexible legal and regulatory environment (investment vehicles compatible with Islamic finance, securitisation law) and its state of the art investment fund industry (Luxembourg is the second fund domicile globally after the US).

Furthermore, another fact which supports the case of Luxembourg as a jurisdiction of choice is its favorable and very flexible tax environment, which is in constant evolution to meet investors' needs. Indeed, Luxembourg tax authorities issued two tax circulars in 2010 to describe the major principles of Islamic finance, define several Sharia compliant agreements (musharaka, ijara, istisn'a, murabaha, sukuk, mudaraba...) and clarify the tax treatment of murabaha and sukuk under Luxembourg tax law as well as the tax treatment in regard of registration duties and VAT applicable to murabaha and ijara agreements.

Those competitive advantages combined to governmental efforts have started to produce results since, as of today, Luxembourg is already the largest non-Muslim fund domicile with 7% of the global market share of

Shari'a-compliant funds. In addition, it is worth noting that sixteen sukuku are currently listed on the Luxembourg stock exchange.

26.2 Favorable legal and regulatory environment

In April 2008, the Government set up a cross-working group to review the compatibility of Luxembourg legal and regulatory environment with Islamic finance and identify possible obstacles to its development in Luxembourg. The report was very favorable and stressed the fact that Luxembourg is in a position to offer a range of legal vehicles that address the specific needs of Islamic investors and project promoters.

Luxembourg holding and investment vehicles can therefore all be considered as compatible with Shari'a principles and could be classified as follows:

- Regulated vehicles such as Part I UCITS and Part II UCI (undertakings for collective investments);
- Lightly regulated vehicles such as the SICAR (Investment Company in Risk Capital) or the SIF (Specialised Investment Fund);
- Unregulated vehicles such as the SOPARFI (Société de Participation financière – Fully taxable company) or the SPF (Private Wealth Management Company – Tax exempt company);
- Either regulated or unregulated vehicles depending on several criteria such as the Securitisation Vehicle (SV - based on the Law of 22 March 2004 on securitisation). Luxembourg vehicles are also well placed to support

the other new investment trends such as Microfinance and SRIs (Socially Responsible Investments) which are in line with certain moral values encouraged by the Shari'a.

26.3 Domestic and international taxation

Unlike some other jurisdictions, Luxembourg tax law is based on an economic approach (known as *wirtschaftliche Betrachtungsweise*) and substance over form principles. As a result, Luxembourg domestic tax law is considered as one of the most flexible of the European Union and is in constant evolution to meet financial professionals and foreign investors' needs. It goes without saying that the Luxembourg tax regime has been tried and tested over the years, which provides for tax certainty and security.

Although Luxembourg is an onshore jurisdiction with an aggregate corporate tax income rate of 28.59%, the flexibility of Luxembourg tax law (many exemptions are possible) combined to an appropriate tax planning often leads to significantly lower effective tax rate in the hands of Luxembourg fully taxable companies.

The main advantages of Luxembourg domestic tax law could be summarised as follows:

- an extensive participation exemption regime for corporate income tax on capital gains and dividend income as well as for net wealth tax purposes and outbound dividend payments
- an IP tax regime which provides an 80% tax exemption on income deriving from IP rights thanks to its broad scope (software, domain names, patents etc), resulting in an effective tax rate of 5.7%
- tax certainty and security thanks to the possibility to obtain, on a case by case basis, advance tax agreement letters from the Luxembourg tax authorities
- interests paid by Luxembourg companies are not subject to withholding tax in Luxembourg and are generally considered as deductible expenses for corporate income tax purposes
- no withholding tax on liquidation proceeds
- the financing of Luxembourg companies may be done through various debt, equity or hybrid instruments which ensure a tax-efficient overall structure as well as a tax-efficient profit repatriation to the investors
- no exit tax nor controlled foreign corporation (CFC) rules in Luxembourg domestic law
- a VAT rate of 15% which is the lowest VAT rate within the European Union

In regard to international taxation and as a founding member of the European Union, Luxembourg companies are entitled to the benefits of the parent-subsidiary, interest and royalties, and merger directives (they have

all been incorporated into domestic legislation).

Furthermore, Luxembourg companies have access to Luxembourg's wide network of double tax treaties with 59 treaties currently in force and 17 other treaties under negotiation or awaiting ratification. Luxembourg tax treaty network includes the United States, major European countries, India, China and Hong-Kong but also many Muslim countries all around the world.

The combination of a very attractive domestic tax law, access to European Union directives, and a wide treaty network, makes of Luxembourg a prime location for international tax planning.

26.4 Tax measures in favour of Islamic finance

In 2010, Luxembourg tax authorities issued two tax circulars to describe the major principles of Islamic finance, define several Shari'a-compliant agreements (*musharaka*, *ijara*, *istisna*, *murabaha*, *sukuk*, *mudaraba*...) and explain the tax treatment of certain Shari'a-compliant instruments.

The first one is the circular n° LG-A No. 55 issued by Luxembourg tax authorities (hereafter the "First Circular"), which aimed at clarifying the tax treatment of *murabaha* and *sukuk* under Luxembourg domestic tax law. According to the First Circular, *sukuk* are considered as debt for Luxembourg tax purposes, which imply that:

- any yield payment under the *sukuk* is treated as tax deductible at the level of the party that has issued the *sukuk*; and
- no withholding tax applies on such a yield payment under Luxembourg tax law¹.

In regard to *murabaha*, which is defined in the First Circular as a purchase and resale agreement with deferred payment, it stipulates that the income taxation can be deferred over the term of the transaction subject to the respect of the following conditions:

- the agreement between the parties shall clearly state that the capital provider acquires the targeted good with the objective of reselling it (immediately or within a period of time that cannot exceed six months after the acquisition)
- the predetermined mark-up, which stands for the remuneration of the capital provider for providing the funds, must be clearly specified in the agreement, and explicitly known and accepted by the parties involved;
- the remuneration must be spread over the deferral period for accounting and tax purposes in the finance provider's books (based on a straight-line method), regardless of when reimbursement is actually made.

The second tax circular that we have mentioned above, circular n°749 (hereafter the "Second Circular"), was issued on June 17th 2010 by Luxembourg VAT authori-

¹ EUSD implications should be limited given the residency of the *sukuk* holders and the nature of the instruments.

ties, and aimed at clarifying the tax treatment of murabaha and ijara agreements in regard to registration duties and VAT.

The Second Circular starts by defining a murabaha as a cost-plus sale agreement and an ijara as a leasing agreement. It also underlines that an intermediary structure, such as a SPV (special purpose vehicle), is often used to acquire the real estate in the context of murabaha or ijara arrangements.

The Second Circular reminds that the generally applicable rule according to which the sale of the shares of a Luxembourg company which owns real estate does not trigger transfer tax, by contrast to the sale of shares of a partnership or an economic interest grouping (GIE - groupement d'intérêt économique) which owns Luxembourg properties, which triggers a 6% transfer tax, as per article 9(1) of Law of December 21st, 2001. This rate may be increased to 7.2% if the seller discloses in the deed that the purpose of the transaction is to purchase the property to resell it. However, if the acquisition deed and the resale deed are registered at the same time, only a 1.2% transfer tax rate will apply.

If we summarise the above, the Second Circular stipulates that, under conditions, the acquisition of a property situated in Luxembourg under a murabaha arrangement is subject to a 1.2% transfer tax levied on the acquisition price of the property while a standard acquisition of Luxembourg located property is generally subject to a 6% transfer tax.

The Second Circular also aims to clarify the transfer tax treatment applicable predetermined profit margin agreed by both parties in a murabaha. According to the Second Circular, the latter is treated as capitalised interest and is therefore not subject to transfer tax, under the following cumulative conditions:

- the client must take possession of the property immediately after the resale;
- the time between the acquisition of the property and its resale to the client must not exceed 10 days; and
- the acquisition deed must contain a clause which specifies that the property was purchased under a murabaha agreement, which must be attached to the acquisition deed.

In regard to VAT implications, the Second Circular also confirms that SPVs created under murabaha and ijara agreements are subject to VAT and, in particular, to tax exemptions on certain real estate transactions as set forth in articles 44§1 f) and g) and 45 of Luxembourg VAT law. The Second Circular does not imply however that the transactions will be automatically liable to VAT.

25.5 Looking at the future of Islamic finance in Luxembourg

Luxembourg has taken very important steps in order to be viewed by the international community as a financial center which provides innovative and added-value solutions for Shari'a sensitive investors.

The efficient tax regime, the legal and regulatory flexibility and the two tax circulars on Islamic finance are three factors which contribute to provide for more security for Shari'a-compliant transactions carried out in or through Luxembourg.

But one should not forget that competition is very intense in Europe as financial centers such as Ireland and Malta are actively trying to develop their capabilities and attractiveness in Islamic finance. The offshore financial centers are also very well known by MENA based fund managers and investors who still use offshore corporate vehicles for their flexibility and ease of use.

Luxembourg financial center is at a turning point in regard to Islamic finance. The promotion of Luxembourg in the Middle East has started to produce results, but the market still needs to be educated in regard to the Luxembourg benefits for estate planning and cross border investments.

To achieve this objective, Luxembourg regulators and professionals should continue their regular visits to GCC countries and increase their presence in the Middle East by opening representation offices or desks which aims to promote Luxembourg locally and take part to/sponsor events important for the Islamic finance business community².

² The Central Bank of Luxembourg will host the IFSB annual summit in May 2011.