

2.13

Takaful vs. Conventional Insurance

Mohammed Khan, PricewaterhouseCoopers

What is conventional insurance?

A normal insurance contract can be defined as an agreement whereby an insurer undertakes (in return for the agreed premium) to pay a policyholder a sum of money (or its equivalent) on the occurrence of a specified event. The specified event must have some element of uncertainty about it; the uncertainty may be either the fact that although the event is bound to happen in the ordinary course of nature, the timing of its occurrence is uncertain; or the fact that the occurrence of the event depends upon accidental causes, and the event, therefore, may never happen at all.

Essentially, insurance contracts include five elements:

1. Two parties – the insured and the insurer;
2. An agreed premium;
3. An amount to be paid to cover a specified loss or losses;
4. The specified loss or losses should have a remote chance of occurring; and
5. The policyholder who is taking out the insurance should have an interest in what is being insured (eg. they could own the item they are insuring).

Differences between takaful and conventional insurance

Shari'a vs. "man-made" laws

The first *fatwa* that explicitly prohibited commercial insurance in its modern application and its related activities was made by Ibn Abdeen (a Syrian Scholar) in 1834. While opinions vary among Muslim scholars, the overwhelming majority of them have concluded that modern conventional insurance contracts are unacceptable to Islam. In particular, life insurance

involves the use of certain elements that directly contradict the rules of Shari'a. These elements are:

- *Al-maisir* – this is also known as gambling. The policyholder loses the premium paid if he/she does not claim or the loss does not occur. On the other hand, the policyholder may be entitled to receive a bigger amount than what he/she deserves compared to the premium. In other words, the insurance company promises to pay a certain amount of money (indemnity) to the insured if the risk occurs and the insured agrees to pay another amount of money (premium) if the risk does not occur. This is not the case in a *takaful* business, where the policyholders are deemed to donate a sum of money to help each other in case anyone of them suffers a loss;
- *Gharar* – This is also known as uncertainty. It is against Shari'a rules to sell any contract involving uncertainty, doubt and probability. In Islam, uncertainty is prohibited in business contracts. In conventional insurance, neither the insured nor the insurer knows when the loss will occur or what will be the amount, or whether it will occur in first place. Alternatively, in *takaful* the policyholders fund is structured so that policyholders aid each other if a loss occurs. There is no guarantee from the company to the policyholder. The policyholders are grouped in a mutual assistance contract; there is no probability or uncertainty factor involved as they donate their contributions to the fund and they could receive a surplus from the principle of sharing the losses and profits. In fact there is no risk transfer (as the policyholder retain the risk), but there is risk sharing amongst the policyholders;
- *Riba* – This is also known as “interest” and defined as making money on money. Shari'a rules prohibit any activity involving interest. Most conventional insurers invest in interest-bearing assets (for example, the government or company bonds). *Takaful* businesses are restricted to an interest-free system. In theory, this means that a *takaful* entity must ensure that both its policyholder and shareholder funds must be invested in assets which do not have *riba* and that any bank that the *takaful* entity deals with should not be involved with the practice of *riba*.

Investments

Takaful businesses can only invest in Shari'a-compliant assets subject to local regulatory restraints (eg. in certain countries, there are restrictions on the percentage of assets one can invest in equities due to solvency restrictions). Conventional insurance businesses are only restricted by local regulatory restraints.

In Islam, the basic principle of investment is that reward must be accompanied by risk. On this basis, it is permissible to invest in Shari'a-approved stocks, as prices of equities and dividends from equities command no certainty in value. However, *takaful* businesses cannot invest in any investments that are:

- debt based (eg. bonds), as this violates the *riba* principle;
- have a guaranteed or minimum return on the investment, as this violates the risk/reward sharing principle; or
- based on *haram* practices (eg. casinos and gambling companies).

With the recent growing interest in Islamic finance, there are, however, innovative Shari'a-compliant investments, such as:

- Commodity *murabaha* – the Islamic equivalent of money market instruments that are based on the underlying value of commodities; and
- *Sukuks* – the Islamic equivalent of conventional bonds that are asset based rather than debt based.

The investment decisions are, however, the same for *takaful* and conventional assets, and involve consideration of the same questions. For example, which investments will enable the business to match the cash flows to the liability cash flows of the insurance/*takaful* business? What are the local regulatory restrictions?

The income from the investment of the policyholders fund is returned to the policyholders fund after the deduction of any "*mudaraba* fee". If the *takaful* structure includes a *mudaraba* fee, this is returned to the shareholders' fund.

Conclusion

Takaful is not a new concept – it has been around for centuries. *Takaful* business allows policyholders to enjoy the benefits of a mutual structure within a shareholder wrapper. *Takaful* business also has an explicit ethical structure which can be marketed to both Muslims and non-Muslims. Although both conventional and *takaful* businesses generate profits for the shareholders, in *takaful* business the expenses paid to the shareholders are explicitly transparent – in conventional insurance they are not necessarily so.

The following table summarizes the main differences between both systems.

	Takaful	Conventional
Benefits	Paid from the related participants' funds under mutual assistance.	Paid from the company reserves.
Investments	The funds shall be invested in any interest-free Shari'a-approved assets and also meet any required national insurance regulations and laws.	The funds may be invested in any assets so long as they meet required national insurance regulations and laws.
Operations	Operational mechanisms shall be in line with the Shari'a rules.	Operational mechanisms shall be in line with the national insurance regulations and laws.
Profit	Underwriting profit is distributed to the policyholders. Shareholders' profit is generated from the return on the investments of the shareholder capital and expenses paid to the shareholders by the policyholders for (i) managing the company on behalf of the policyholders; and (ii) managing the policyholders' investment funds on behalf of the policyholders.	Policyholders do not get any share of the underwriting profit (except in mutual companies); shareholders' profit is generated from the company's underwriting profit plus any investment returns.
Premiums	Paid premium is treated as both donation (<i>tabarru'</i>) and saving (<i>mudaraba</i>).	Paid premium creates an obligation against the insurer on a sale and purchase relation.
Company	Company is better known as an operator, which acts as a trustee, manager and also entrepreneur.	Relationship between the company and the policyholders is on one to one basis.
Shari'a	<i>Takaful</i> practices are free from the elements of <i>riba</i> and other prohibited elements, and is evolved around the elements of <i>mudaraba</i> , <i>tabarru</i> and other Shari'a-justified elements.	Conventional insurance (including mutual insurers) may involve <i>riba</i> and some other elements, which may not be justified by Shari'a principles.
Policyholder Fund	The policyholder fund belongs to the policyholders on collective basis and is managed by the shareholders.	All (ie. both policyholder and shareholder) funds belong to the company, though separation of assets may be maintained between shareholders and policyholders for specific insurances (eg. with profits).
Regulations	The operational mechanisms and products must be Shari'a-compliant and be in accordance with required national laws and insurance regulations.	Operational mechanisms and products have to be in accordance with the required national laws and insurance regulations.

2.14

Human Resources and Training for Islamic Financial Activities

Mohammad Shafique, Institute of Islamic Banking and Insurance

Introduction

Developing over the past three decades, Islamic banking has become a viable financial approach that is seen as a rapidly growing interest for both Muslim clients and non-Muslim investors. With its value-orientated system, Islamic finance stands apart from conventional banking. For Muslims, it is a question of moral conscience and religious obligation. For non-Muslims, its attractiveness lies in its ethical foundations and its potential for lucrative returns on investments. Today, more than 300 Islamic banks and financial institutions are operating in the Middle East, Asia, Europe, America and Africa. The rapid growth of the *sukuk* (Islamic bonds) market and the increasing demand for investments according to Islamic principles are addressing the liquidity management problems of Islamic financial institutions (IFIs). This is also attracting the resources and attention of the financial world to develop Islamic financial instruments, thus promoting the Islamic finance industry at a macro level in the overall framework of the global financial system.

The availability of well-informed and trained human resources at all levels to cater the needs of the emerging Islamic finance industry has, however, lagged behind the pace of its development. One major problem that IFIs are facing in almost all parts of the world has been the lack of availability of staff possessing adequate competence in procedures and expertise in Shari'a-related banking functions – a prerequisite to run the asset-backed and value-oriented financial system. As a result, many IFIs are headed and staffed by people who have moved from the conventional financial system, and this includes just as many personnel involved in structuring and sales of Shari'a-compliant products. The conventional mindset does, to some extent, limit the approach of structuring and executing transactions in the Shari'a-compliant financial system, particularly in innovative products, to compete with conventional financial instruments.

In order for IFIs to operate within the parameters defined by the Shari'a, they have to be supervised by scholars who are well versed in Shari'a and its approach to economic and financial issues. However, such scholars are also in short supply. As a result, their services are overstretched, and many sit on the Shari'a Supervisory Board of different banks. With the exception of a small number of scholars, a key factor in the prevailing shortage is that they may be well versed in Shari'a rulings, but they are not sufficiently well versed in the complexities of present day banking and financial issues.

Against this backdrop, the principles that guide all financial dealings within the ambit of the Shari'a, as well as continuing training for implementation of these principles, cannot be overemphasized in building professionals and Shari'a scholars, who are committed to developing an alternative financial system. To fill this human resource gap, there are only a few well-established organizations in the world that are dedicated to providing education and training for professional development in the emerging field. Among the well known are:

- the Islamic Research and Training Institute of the Islamic Development Bank based in Jeddah, Saudi Arabia;
- the Institute of Islamic Banking and Insurance (IIBI), UK;
- the Bahrain Institute of Banking and Finance, Bahrain;
- the Islamic Banking and Finance Institute, Malaysia;
- the International Centre for Education in Islamic Finance, Malaysia;
- the Securities and Investment Institute;
- the Association of Business Executives;
- CASS Business School; and
- the Chartered Institute of Management Accountants in the UK.

These are some of the institutions offering courses internationally in Islamic finance.

The Islamic Finance Project, a part of the Islamic Legal Studies Programme at Harvard Law School in the US, aims to study the field of Islamic finance from a legal and Shari'a point of view, and to therefore increase the interaction between theory and practice in Islamic finance.

There are also many local organizations providing courses and training, and some of the leading Islamic banks also offer their own in-house training. In addition, there are also a growing number of academic institutions in the UK that are offering qualifications in Islamic finance, for example:

- Durham University;
- Markfield Institute of Higher Education;
- University of Reading; and
- Bangor University.

Outside the UK, the two well-known educational institutions are the

International Islamic University of Malaysia, and the International Islamic University in Islamabad, Pakistan.

Academic institutions are providing a valuable service; however, the organizations that are developing practical education and training programmes often provide the best platform to promote professional development for the Islamic finance industry. While it was necessary to import talent from the conventional sector for running the IFIs at the formative stage, it cannot be relied upon for a long term and has many associated problems. Key is the reputation risk for the IFIs, as many of these personnel, well trained in the conventional sector, cannot be expected to look deep down for alternatives, which comply with the letter as well as the spirit of Shari'a principles.

The continuing education of all stakeholders – customers, Shari'a scholars, management, regulators, ratings agencies and shareholders and the public at large – is required to make Islamic finance a viable alternative. Though the Islamic Financial Services Board in Malaysia, the Accounting and Auditing Organization of Islamic Financial Institutions and the International Islamic Financial Market based in Bahrain are doing commendable work in developing international standards for the Islamic finance industry, this still requires personnel with an understanding and ability to implement these standards.

Human resource development

While every IFI already has a department for human resource management, these departments need to place the same level of importance on professional education and training as their conventional counterparts and, to that extent, also allocate sufficient financial resources to this important area. Human resource development may be defined as an organized learning process to optimize the growth and productivity of the members of an organization for achieving the organizational goals. It is a continuous learning process to enable the staff to transfer new knowledge to the workplace, and to improve their performance and growth, thus leading to an improvement in productivity, which in turn leads to the growth and success of the organization.

When an organization develops and trains its staff, a sense of belonging is implanted in them, which is indeed very important for the success of the organization. When the staffs feel that they belong to an organization, they go out of their way to improve it. A sense of belonging is developed among employees when the organization cares about their well-being, professional growth and development of their employees. In organizations where a sense of belonging is absent, the employees are demoralized and are bound to decline in terms of productivity relative to their competitors.

In pursuing this vision, many IFIs are no doubt carrying out training internally; however, there is also a need to work with the external service

providers who can provide a wider base of knowledge and also practical learning experiences that reflect the developments around the world.

In IFIs, the human resource management function needs to also take a more formal approach in developing staff at all levels and providing sustainable programmes for career progression and self-development, and for improving the quality of operations. If the IFIs do not invest in upgrading the skills of their staff, they may not be able to convince their potential customers and fully exploit market opportunities.

Management

Executives and senior managers in management are required to give the highest priority to governance issues, because they are also responsible for implementing the Shari'a rules, policy and processes that affect the way in which the business of an IFI is conducted. These relate to leadership, risk management, transparency, accountability, effectiveness and coherence in ensuring Shari'a-compliance. Management must always be reminded that while there will always be pressure to compete with conventional interest-bearing products, the alternatives offered by Islamic finance through participatory modes such as *musharaka* or *mudaraba* are considered the ideal modes of Islamic finance as they comply in substance as well as in form with Shari'a principles.

Operations, marketing and sales

The performance of operations in IFIs, focusing on the quality of their operations personnel, must have an important place in the corporate strategy with the purpose of gaining competitive advantage. Focused training in this area can groom new, as well as existing staff to be assets for IFIs, and the closer IFIs get to this goal, the higher the efficiency and employee satisfaction.

Customer satisfaction is the key to success for any business enterprise. It is therefore imperative that the front-line staff in an IFI interacting with customers and the market place is competent and knowledgeable about the Shari'a-compliance of products and services on offer, and able to provide information about these products and service delivery systems. At the same time, front-line staff can provide valuable feedback to the management on customer satisfaction as well as their other views that are important in formulating product development and marketing strategies.

Product development, legal issues and documentation

Products must increasingly be structured and implemented in a way that stands up to scrutiny from Shari'a advisory boards. With increasing liquidity

of IFIs, lending, treasury and fund management require appropriate financial instruments to undertake large and complex transactions. This opens up a huge new challenge for those involved in structuring and marketing such instruments, whether they are retail, corporate, capital raising or investment products. With a significant number of people working on structuring such complex transactions having conventional banking background and not enough experience and practice of Shari'a essentials and desire to compete for returns, management invariably places enormous demands on the structuring team to come up with innovative Islamic financial instruments that can compete with conventional financial products that are permissible under Shari'a. For this to successfully take place, the relevant staff must always have a very clear understanding of the characteristics and strict parameters underlying Islamic financing structures as well as a detailed analysis of the various points of contention over Shari'a documentation and legal requirements, and how these issues can be addressed.

Technology

In today's environment, the operations of financial institutions are supported by a complex network of computer systems and software applications. With the growing complexities of banking regulation and supervision and the additional layer of Shari'a compliance, systems adopted by IFIs must be structured to conform to legal and regulatory as well as strict Shari'a requirements. Staff using information technology systems should be properly trained as part of the implementing processes and self-regulating the products and services offered by IFIs, as well as building clients' confidence in the institutions.

Shari'a scholars

In order to widen the base of Shari'a scholars, there is a need for setting up separate courses tailored to produce scholars who have a thorough grounding in Shari'a and its approach to financial issues, and by making existing *fatwas* available to all financial institutions. With a view to giving access to the *fatwas* issued by various Shari'a scholars, the IIBI collected the available *fatwas* relating to financial issues and compiled these in three volumes, titled "Compendium of Legal Opinions on the Operations of Islamic Banks", which covers the key contracts in Islamic finance and their applications.

While there are already steps taken in this direction in Malaysia, the UK and other jurisdictions, these are few and patchy, and there is a need to coordinate these initiatives to bring wider participation from Shari'a scholars. Furthermore, Shari'a scholars on the advisory boards of IFIs are required to undergo regular training to engage in continuous interactions

with the management of IFIs in building and implementing broad, coherent policies, at a domestic and international level.

Conclusion

There should be an increasing level of interaction between the industry and organizations providing Islamic finance education and training. Current professional education and training providers also need to coordinate to establish standards and to ensure they work towards a common agenda. They should also consider making strategic alliances with each other, which will create synergies and possibly better value to the potential learners of Islamic finance. Needless to say, this will require separate efforts to “train the trainers” to produce more trainers capable of delivering dedicated quality Islamic finance training.

Both governments and regulators need to be conversant with the demands of the Islamic financial system and should facilitate Shari’a-compliant transactions within their overall regulatory and legal framework. Ensuring that all personnel, whether they are Shari’a scholars, industry practitioners or regulators, have closer interaction in key markets, learn from each others’ experience and familiarize themselves with key issues and trends in the Islamic financial services industry will certainly be helpful for sustainable growth of the industry.

The late founder and chairman of the IIBI, Muazzam Ali, strongly believed that embedding a learning culture that is imperative in every IFI is the only way to compete in the global market place and keep up with competition from the conventional financial institutions in a fast changing world. However, to do this successfully, it requires more than just another round of restructuring the training function and also requires a holistic and systematic approach to learning. The industry as a whole needs to implement initiatives that will allow a more sustainable environment for training, development and growth of new talent into the system, which may include creation of a variety of human resource development programmes. Unbiased education and training from independent organizations supported by professionals, the industry and regulators is the formula for successful promotion and implementation of Islamic finance and its sustainable growth in the future.

2.15

Taxation

Mohammed Amin, PricewaterhouseCoopers

Introduction

Tax law varies between countries, reflecting each country's legal and political systems and economic history. In the context of Islamic finance, the key requirements are that a tax system should provide a "level playing field" between conventional and Islamic finance, so that extra costs are not imposed upon Shari'a-compliant transactions.

Countries where Islamic finance has been conducted for many decades (in some cases many centuries) generally have tax systems which give parity of treatment to conventional and Islamic finance. However, Islamic finance can pose challenges for the tax systems of countries where it is new.

Summary of the generic issues involved

The issues are most easily explained using the following hypothetical example:

A company wishes to purchase a machine, to be delivered immediately, with a manufacturer's price of \$1,000. The machine will be useable for five years. If purchased with conventional finance, the customer will pay for this machine immediately, financed by a bank loan of \$1,000, carrying simple interest at 5 per cent per year, with all of the interest to be paid in full when the loan is repaid after two years (as demonstrated in Diagram 1).

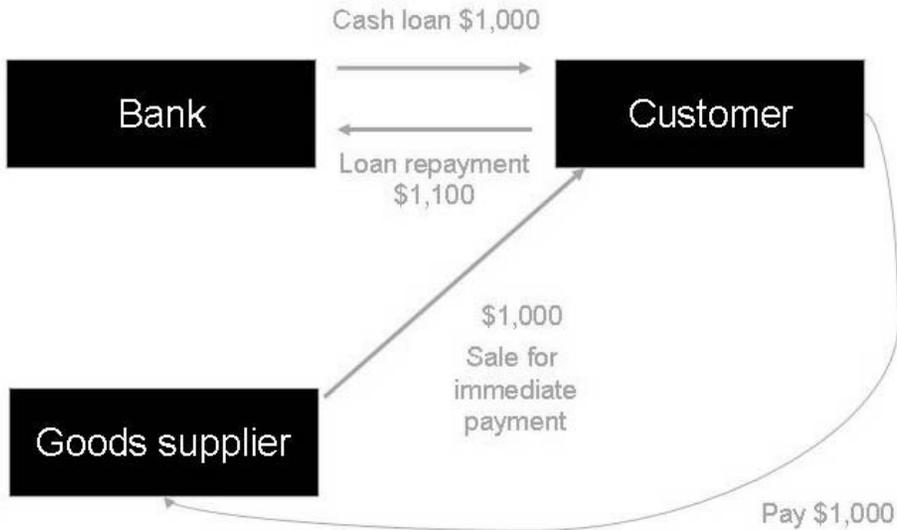


Diagram 1. Conventional purchase

If acquired with Islamic finance, the bank will purchase the machine from the manufacturer for \$1,000 and resell it to the customer for \$1,100 with immediate delivery, permitting the customer to only pay the bank the price after two years (as demonstrated in Diagram 2).



Diagram 2. Islamic purchase

In both scenarios, the customer has the same cash flows, obtaining the machine for immediate use and paying out \$1,100 after two years.

Tax analysis

Tax law is specific to each country, and varies in complexity. For simplicity, assume a hypothetical tax system under which capital equipment, such as this machine, can be amortized for tax purposes, on a straight line basis, commencing only after the machine has been paid for. Tax relief for finance costs is given on an accruals basis over the life of the debt.

Conventional finance tax analysis

The hypothetical tax system, developed in an environment of conventional finance, has no problems computing the tax deductions the customer is entitled to as shown in Table 1 below. The key principles underlying the tax treatment are that the customer has paid for the machine on delivery (even though financed by a bank loan) so the tax amortization starts immediately, and the customer will be paying \$100 interest to the bank, spread evenly over the two-year life of the loan.

Table 1. Conventional purchase tax deductions

Year	Amortization	Interest	Total
1	\$200	\$50	\$250
2	\$200	\$50	\$250
3	\$200	–	\$200
4	\$200	–	\$200
5	\$200	–	\$200
Total	\$1,100	–	\$1,100

Islamic finance tax analysis

When the customer acquires the machine under Islamic finance, it is not paid for until after two years, and the legal contracts record no cost of finance. Instead there is the purchase of a machine costing \$1,100, which is only paid for two years after delivery. There are two fundamentally different ways for the hypothetical tax system under consideration to look at this Islamic finance transaction.

Follow the legal form

If the tax treatment follows the legal form of the contract, there is no cost of finance. There is simply the purchase of a machine costing \$1,100, paid for two years after delivery. Under the assumed tax system, tax amortization only commences upon payment, and the tax deductions are shown in Table 2.

Table 2. Tax deductions with Islamic finance following legal form

Year	Amortization	Interest	Total
1	\$0	\$0	\$0
2	\$0	\$0	\$0
3	\$366	–	\$366
4	\$366	–	\$366
5	\$367	–	\$367
Total	\$1,100	–	\$1,100

The total tax deductions that arise are \$1,100, as with the conventional finance purchase. However, the key difference is that no tax deductions arise in the first two years since the machine has not been paid for. The deductions only arise in years three, four and five.

A basic principle of financial economics is that where two cash flow patterns have the same total, but one set of cash flow arises earlier than the other, then it is more valuable. Here the tax deductions with conventional finance are more valuable than the tax deductions that arise with Islamic finance. This difference illustrates why a tax system that follows the legal form fails to properly accommodate Islamic finance without specific adaptations.

Follow the transaction economics

The other way that the hypothetical tax system could look at the Islamic finance purchase transaction is to consider its underlying economics; the machine which the customer receives is worth only \$1,000, despite the customer agreeing to pay the bank \$1,100 for the machine. \$1,000 is the price at which the manufacturer sells the machine to the bank and is also the price at which the manufacturer would sell the machine to the customer if the customer could pay for it immediately.

Accordingly, the only reason the customer is willing to pay the bank \$1,100, which is \$100 more than the manufacturer would charge, is because the customer is going to pay the bank two years after delivery. Paying a larger amount for the privilege of paying later is the essence of what a finance cost is. Accordingly in economic terms there is a finance cost of \$100, and since this relates to the two-year period the annual finance cost must be \$50.

If the tax system follows the above economic analysis, then it will recognize this finance cost. Furthermore, since the customer is bearing this finance cost, then tax amortization should be given from delivery just as it is where payment is made on delivery financed with a conventional bank loan. The tax deductions with this analysis are shown in Table 3 and are of course identical to those with conventional finance.

Table 3. Tax deductions with Islamic finance following economic analysis

Year	Amortization	Finance cost	Total
1	\$200	\$50	\$250
2	\$200	\$50	\$250
3	\$200	–	\$200
4	\$200	–	\$200
5	\$200	–	\$200
Total	\$1,000	–	\$1,100

The tax systems of some major Western countries

The author has previously surveyed a number of tax systems to consider how well they dealt with some common Islamic finance transactions. It showed that there is a spectrum, illustrated in Diagram 3.

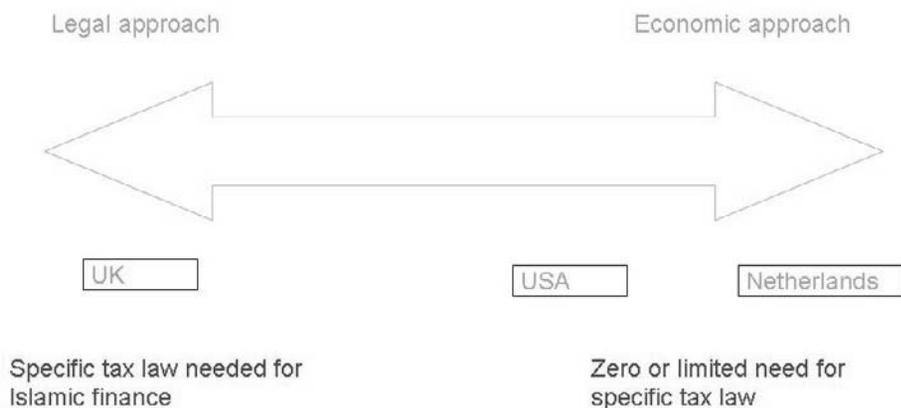


Diagram 3. Tax systems classified

Some tax systems, such as in the UK, have long established principles of following the legal form of transactions in most cases. Such systems do not accommodate Islamic finance well unless specific legislation is enacted for it, as the UK has done. Other tax systems, such as in the Netherlands, find little difficulty with Islamic finance, as they primarily look to the economic consequences of the transaction to determine the tax treatment.

However, even where a tax system follows the economic substance of the transaction for computing business profits, there remains the possibility of it failing to provide a “level playing field” for Islamic finance due to transaction taxes.

In the example discussed above, in the conventional finance transaction, the machine is sold once, by the manufacturer to the customer who is the

end user. In the Islamic finance transaction, the machine is sold twice, once by the manufacturer to the bank, and again by the bank to the customer. This creates the risk of two applications of sales taxes or value added taxes. While many tax systems contain reliefs which apply in the case of such successive sales, in every case one needs to consider whether such reliefs will apply, or whether the Islamic finance transaction will suffer higher transaction taxes than a conventional finance transaction. Tax administrators considering changes to their tax systems to facilitate Islamic finance need to consider transaction taxes as closely as the tax law governing the calculation of business income and expenses.

The UK's approach to the taxation of Islamic finance

Stamp duty land tax changes

The first changes made to the UK tax system to facilitate Islamic finance addressed the question of residential mortgages. Islamic house finance in the UK typically involves a bank purchasing a property and then selling it to the customer. This can be an immediate sale at a higher price with deferral of payment such as the machine purchase illustrated above, ie. a *murabaha* transaction.

Alternatively diminishing *musharaka* can be used with the householder and the bank purchasing the property together. The bank rents its share of the property to the householder, and sells its share to him or her in tranches over the life of the arrangement. Under either the *murabaha* or the diminishing *musharaka* structure, the property is being sold twice, whereas in the case of a conventional mortgage there is a single sale from the vendor to the householder. Each sale would be subject to stamp duty land tax (SDLT) – the UK's real estate transfer tax – charging the Islamic transaction twice.

Accordingly, in the Finance Act (FA), 2003, the UK legislated to eliminate the double charge to SDLT where a property is sold to a financial institution (as defined) and then sold on to an individual. The key provision is found in section 71A, of which a portion is set out below:

1. This section applies where arrangements are entered into between a person and a financial institution under which:
 - (a) the institution purchases a major interest in land or an undivided share of a major interest in land (“the first transaction”);
 - (b) where the interest purchased is an undivided share, the major interest is held on trust for the institution and the person as beneficial tenants in common;
 - (c) the institution (or the person holding the land on trust as mentioned in paragraph (b)) grants to the person out of the major interest a lease (if the major interest is freehold) or a sub-lease (if the major interest is leasehold) (“the second transaction”); and

- (d) the institution and the person enter into an agreement under which the person has a right to require the institution or its successor in title to transfer to the person (in one transaction or a series of transactions) the whole interest purchased by the institution under the first transaction.
- 2. The first transaction is exempt from charge if the vendor is:
 - (e) the person; or
 - (f) another financial institution by whom the interest was acquired under arrangements of the kind mentioned in subsection (1) entered into between it and the person.
- 3. The second transaction is exempt from charge if the provisions of this Part relating to the first transaction are complied with (including the payment of any tax chargeable).

When first legislated, this relief applied only where the end customer was an individual, but it has since been extended to acquisitions by partnerships and companies. The section originally had its own free-standing definition of financial institution, but this has now been harmonized with the definitions used below for computing income and expense.

Computation of income and expense

The tax law changes were introduced by the FA, 2005, with subsequent expansion of the range of transactions covered in the FA, 2006 and the FA, 2007. A review of the legislation enables one to “reverse engineer” the design considerations that underlie it. There are four significant features:

1. Tax law must apply equally to all taxpayers;
2. Tax law changes should not impact upon transactions not intended to be covered;
3. Legislation should not be longer than is necessary; and
4. Addressing specific obstacles to Islamic finance.

Tax law should apply equally to all taxpayers

Strictly speaking, the UK has not enacted any Islamic finance legislation. A search of FA, 2005 will fail to find words such as Islamic, Shari’a, *tawarruq* or any other term used specifically in Islamic finance. The reason is that the tax treatment of a transaction cannot be allowed to depend upon whether it is Shari’a-compliant. As well as introducing significant uncertainty into the UK tax system, introducing Shari’a considerations would create a situation where all taxpayers were not receiving identical tax treatment.

Instead, the UK identified certain types of transaction widely used in Islamic finance, and ensured that those types of transaction received appropriate tax treatment. This is illustrated by FA, 2005 section 47: “Alternative Finance Arrangements”, reproduced here in full as originally legislated:

1. Subject to subsection (3) and section 52, arrangements fall within this section if they are arrangements entered into between two persons under which:
 - (a) a person (“X”) purchases an asset and sells it, either immediately or in circumstances in which the conditions in subsection (2) are met to the other person (“Y”);
 - (b) the amount payable by Y in respect of the sale (“the sale price”) is greater than the amount paid by X in respect of the purchase (“the purchase price”);
 - (c) all or part of the sale price is not required to be paid until a date later than that of the sale; and
 - (d) the difference between the sale price and the purchase price equates, in substance, to the return on an investment of money at interest.
2. The conditions referred to in subsection (1)(a) are:
 - (e) that X is a financial institution; and
 - (f) that the asset referred to in that provision was purchased by X for the purpose of entering into arrangements falling within this section.
3. Arrangements do not fall within this section unless at least one of the parties is a financial institution;
4. For the purposes of this section “the effective return” is so much of the sale price as exceeds the purchase price;
5. In this chapter references to “alternative finance return” are to be read in accordance with subsections (6) and (7);
6. If under arrangements falling within this section the whole of the sale price is paid on one day, that sale price is to be taken to include alternative finance return equal to the effective return;
7. If under arrangements falling within this section the sale price is paid by instalments, each instalment is to be taken to include alternative finance return equal to the appropriate amount;
8. The appropriate amount, in relation to any instalment, is an amount equal to the interest that would have been included in the instalment if:
 - (g) the effective return were the total interest payable on a loan by X to Y of an amount equal to the purchase price;
 - (h) the instalment were a part repayment of the principal with interest; and
 - (i) the loan were made on arm’s length terms and accounted for under generally accepted accounting practice.

Reading section 47, it is clear that it was designed to facilitate *murabaha* and *tawarruq* transactions. However, it nowhere uses those terms and nothing in section 47 limits its application to Islamic finance. If a transaction falls within section 47, the tax treatment follows automatically, regardless of whether the transaction is (or was intended to be) Shari’a-compliant.

Tax law changes should not impact upon transactions not intended to be covered

Commercial sales of goods often involve a credit period for the customer. It would unduly complicate UK tax law if every sale of goods with deferred payment required identification of the price that would have prevailed if no credit were given, and then giving separate tax treatment for the implied cost of the credit. Consider for example a food manufacturer selling hundreds of thousands of tins of food to retailers with 30 days credit allowed for the payment of each sales invoice.

Section 47 limits its impact by requiring the involvement of a financial institution in subsection (3). This ensures that only transactions where finance is provided by or to a financial institution fall within the new rules. Accordingly, the food manufacturer and its customers should not be impacted by these new rules. (One drawback of this approach is that it is currently impossible for two non-financial companies to transact Islamic finance with each other and receive the tax treatment given by the new legislation.)

Financial institution is defined in section 46(2) as:

- (a) a bank as defined by section 840A of Income and Corporation Taxes Act (ICTA), 1988;
- (b) a building society within the meaning of the Building Societies Act, 1986;
- (c) a wholly-owned subsidiary of a bank within paragraph (a) or a building society within paragraph (b);
- (d) a person authorised by a licence under Part 3 of the Consumer Credit Act, 1974 to carry on a consumer credit business or consumer hire business within the meaning of that act; or
- (e) a person authorised in a jurisdiction outside the UK to receive deposits or other repayable funds from the public and to grant credits for its own account.

Tracing through the definitions establishes that they cover all banks licensed in the European Economic Area, and also persons licensed to take deposits in other countries, which is the key practical definition of a bank. However many other bodies engaged in financial activities, such as hedge funds, fall outside these definitions.

Legislation should not be longer than it is necessary

Section 47 (reproduced above) demonstrates how complex it can be to legislate for an apparently straightforward transaction. Drafting the new legislation would have been very arduous if it was then necessary to legislate specifically for all the tax consequences flowing from *murabaha* or *tawarruq* transactions.

The legislation avoids this burden by assimilating the tax consequences of Islamic finance transactions into the existing tax legislation. For example,

where a company undertakes a *murabaha* or *tawarruq* transaction, the tax consequences are governed by FA, 2005 section 50 (1): Where a company is a party to arrangements falling within section 47, Chapter 2 of Part 4 of FA, 1996 (loan relationships) has effect in relation to the arrangements as if:

- (a) the arrangements were a loan relationship to which the company is a party;
- (b) any amount which is the purchase price for the purposes of section 47(1)(b) were the amount of a loan made (as the case requires) to the company by, or by the company to, the other party to the arrangements; and
- (c) alternative finance return payable to or by the company under the arrangements were interest payable under that loan relationship.

The FA, 1996, which governs loan relationships, contains a very extensive and complex set of provisions which apply to companies engaging in the lending or borrowing of money and paying interest or other finance costs. Section 50 (1) is not saying that section 47 involves the making of a loan; instead it taxes the company as if a loan had been made and as if the alternative finance return (the profit or loss under the *murabaha* or *tawarruq* transaction) were interest.

Addressing specific obstacles to Islamic finance

Tax legislation in the UK has grown steadily since income tax became a permanent feature of the tax system in 1842, and was of course developed long before Islamic finance was contemplated in the UK. Not surprisingly, it happened to contain specific provisions which would impact upon Islamic transactions, even though the equivalent conventional transaction was not affected. These were addressed by specific legislation.

For example, the UK has long had a provision to counter companies disguising equity finance in the form of debt, in order to obtain tax relief for payments that are economically equivalent to dividends to risk bearing shareholders. This can be found in the ICTA, 1988, section 209 (2) (e) (iii).¹ This provision would preclude Islamic banks offering investment accounts to their customers, since the profit share paid to the customer would be treated as a distribution. This means that the payment would not be tax deductible for the bank.

This problem is addressed specifically by FA, 2005, section 54, which states: “profit share return (*defined in FA, 2005, section 49 in a form that corresponds to profit share return on investment account deposits of Islamic*

¹ In the Corporation Tax Acts, “distribution,” in relation to any company, means ... (e) any interest or other distribution out of assets of the company in respect of securities of the company (except so much, if any, of any such distribution as represents the principal thereby secured and except so much of any distribution as falls within paragraph (d) above), where the securities are ... (iii) securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company’s business or any part of it.

banks) is not to be treated by virtue of section 209(2)(e)(iii) of ICTA as being a distribution for the purposes of the Corporation Tax Acts.

Conclusion

The approach taken by the UK has been a success in enabling Islamic banks to set up and operate while maintaining a tax system that applies equally to all taxpayers irrespective of their religious practices. As a pioneer, the UK has been closely watched by other countries considering how to develop Islamic finance in their own territory.