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17 December 2010

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Dear Ms Chaplain

Review of the taxation treatment of Islamic finance

Thank you for the opportunity to comment on the discussion paper relating to the Board of Taxation's review of the taxation treatment of Islamic finance (**Discussion Paper**). We support the views expressed in the Johnson report in relation to Islamic finance in the context of Australia becoming a financial services hub in the region and the ideal of ensuring parity of treatment of Islamic finance structures for tax purposes.

We set out our responses to the specific questions raised in the Discussion Paper below.

Unless otherwise indicated, legislative references in this submission are to the *Income Tax Assessment Act 1936* or the *Income Tax Assessment Act 1997*, jointly or as applicable.

1. Case study one: cost plus profit sale

1.1 Do you agree with the issues identified in the summary? Do you have any further comments in relation to the issues identified?

We agree with the issues identified in the summary.

1.2 What are the tax impediments in addition to those summarised to the development of the home financing product described in case study one?

Cost base v deductibility

We agree that there is uncertainty as to whether the profit component is deductible under section 8-1 or whether it should be added to the cost base of the asset for CGT purposes. We recognise that from a policy perspective:

(a) it is undesirable for the client to obtain an outright deduction upon acquisition of the asset; and

(b) it is undesirable for parties to a bai bithaman ajil (**BBA**) transaction not to be given the same treatment as parties to a conventional mortgage product.

Section 110-25(2) states:

110-25(2) The first element is the total of:

> **(a)** the money you paid, or are required to pay, in respect of acquiring it; and
>
> **(b)** the *market value of any other property you gave, or are required to give, in respect of acquiring it (worked out as at the time of the acquisition).
>
> Note 1: There are special rules for working out when you are required to pay money or give other property: see section 103-15.
>
> Note 2: This element is replaced with another amount in many situations: see Division 112.

If the contract executed in respect of the repayment by the Client is drafted in a manner which does not break down the sale price and the profit component (in other words only discloses the repayment amount), prima facie the repayment amount (including the profit component) should be considered to be the first element of the cost base of the asset.

We submit that this the profit component should not be included in the cost base of the asset held by the client and should be treated as interest.

Classification of profit component as interest for the interest withholding tax (IWT) provisions

There is current uncertainty as to whether the profit would be assessable to a non-resident financier (not resident in a treaty country) under subsection 6-5(3) on the basis of source or whether it would be considered to satisfy the definition of interest under subsection 128A(1AB) and be subject to IWT. Subsection 128A(1AB) defines interest as:

> **interest** includes an amount, other than an amount referred to in subsection 26C(1):
>
> (a) that is in the nature of interest; or
>
> (b) to the extent that it could reasonably be regarded as having been converted into a form that is in substitution for interest; or
>
> (c) to the extent that it could reasonably be regarded as having been received in exchange for interest in connection with a washing arrangement; or
>
> (d) that is a dividend paid in respect of a non-equity share; or
>
> (e) if regulations under the Income Tax Assessment Act 1997 are made having the effect that instruments known as upper tier 2 capital instruments, or a class of instruments of that kind, are debt interests - that is paid on such a debt interest and is not a return of an investment;
>
> but does not include an amount to the extent to which it is a return on an equity interest in a company.

The fact that the agreement between the client and the non-resident financier is documented by a BBA consisting of a number of contracts which need to be executed in a particular order to avoid *riba*, poses issues as to whether the profit component is interest or in the nature of or "in substitution for" interest for the purposes of the IWT provisions.

In order to determine whether the profit component paid to the non-resident financier is subject to IWT, it is necessary to determine whether the profit component paid to the non-resident financier satisfies the ordinary meaning of the word "interest" or meets the extended definition of interest set out in subsection 128A(1AB).

In *Re Farm Security Act 1944 (Sask)* [1947] SCR 394 at 411-412, which has received approval from a number of Australian Courts including *FCT v The Myer Emporium Ltd* 87 ATC 4363, Rand J stated:

> Interest is, in general terms, the return or consideration or compensation for the use or retention by one person of a sum of money belonging to, in a colloquial sense, or owed to another...
>
> But the definition, as well as the obligation, assumes that interest is referable to a principal in money or an obligation to pay money. Without that relational structure in fact and whatever the basis of calculating or determining the amount, no obligation to pay money can be deemed an obligation to pay interest.

In *FCT v Century Yuasa Batteries* 98 ATC 4380, the Full Federal Court provided a definition of "interest:

> The parties to the appeal accept that interest is to bear its ordinary meaning, which is the return, consideration or compensation for the use or retention by one person of a sum of money belonging to, or owed to another, and that interest must be referable to a principal.

In *Steele v DFC of T* 99 ATC 4242, Gleeson CJ, Gaudron and Gummow JJ described the character of interest as being a recurrent payment to secure the use of a limited term of loan funds:

> As was explained in *Australian National Hotels Ltd v FC of T*[1], interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd v FC of T*[2] it is therefore ordinarily a revenue item. This is not to deny the possibility that there may be particular circumstances where it is proper to regard the purpose of interest payments as something other than the raising or maintenance of the borrowing and thus, potentially, of a capital nature.[3] However, in the usual case, of which the present is an example, where interest is a recurrent payment to secure the use for a limited term of loan funds, then it is proper to regard the interest as a revenue item, and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset.

We would submit that in the case of the BBA, the profit component should be regarded as a "return, consideration or compensation" for the non-resident financier. In *Re Rouse; South Australian Gas Co* v *Official Receiver* (1966) 8 FLR 122, Paine J treated the difference between the "extended credit price" that was payable by instalments over time and the lesser cash price as interest for the purposes of section 84(5) of the *Bankruptcy Act* 1924-1965 (Cth). Cooper J at first instance in *FCT v Century Yuasa Batteries* 97 ATC 4299, took the view that the circumstances in *Re Rouse*; *South Australian Gas Co* v *Official Receiver* would fall within the extended definition of section 128(1) (the predecessor to section 128A(1AB)).[4] We submit that based on the case law, the better view is that the profit component could be regarded as interest for the purposes of the IWT provisions.

However, in the context of Shariah-compliant products such as the BBA, there will be a number of contractual arrangements between the Client and the non-resident financier to reflect the different legal relationships required to ensure that the profit component derived by the non-resident financier is not considered *riba*. Any conditionality between the contractual arrangements could together create uncertainty as to whether the profit component does in fact satisfy the definition of interest in section 128A(1AB). However, if the definition of interest was amended to explicitly include the profit component, this should provide sufficient certainty (please refer to our comments in section 1.3).

If the profit component is not considered to be interest, or in the nature of interest of, or in substitution for interest, for the purposes of the IWT provisions, it is our view that the asset would have an Australian source if the property was located in Australia (and in any event, Division 855 would apply in default) and would be included in the non-resident financier's assessable income under subsection 6-5(3).

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[1] (1988) 19 FCR 234 at 239-241; 88 ATC 4627 at 4632-4633 per Bowen CJ and Burchett J.

[2] (1938) 61 CLR 337 at 359-363; (1938) 5 ATD 87 at 93-96.

[3] See, for example, Parsons, *Income Taxation in Australia*, (1985) at par 6.111.

[4] *Century Yuasa Batteries v FC of T* 97 ATC 4299 at 4315

PAYG withholding for interest paid to non-resident, non-treaty financiers

A tax impediment that has not been considered is the impact of Subdivision 12-F of Schedule 1 to the *Taxation Administration Act 1953* (Cth) which deals with the collection of withholding tax in respect of dividend, interest and royalty payments. Where the Client has entered into a BBA with a non-resident, non-treaty financier (that does not have a PE in Australia) and the profit component is considered to be interest, the Client will *inter alia*, need to register for PAYG withholding, collect IWT on behalf of the Commissioner and issue PAYG summaries to the non-resident Islamic financier. We note that if the BBA was instead a conventional loan, the same issues would also arise. However, in practice, it would be more likely (given the absence of other, including religious, constraints) that a Client would enter into a conventional loan agreement with a resident financial institution. This creates an additional practical burden on a Client and increases the distortion of treatment between the economically similar arrangements.

1.3 How could tax neutrality be achieved in relation to:

(a) **Income tax (including IWT)**

In order to achieve tax neutrality between the Islamic mortgage product and a conventional mortgage, it will be essential to provide certainty from both the non-resident financier's perspective and the Client's perspective.

Non-resident Financier

One option that may achieve this tax neutrality would be to expand the definition of interest to make it unequivocally clear, that the profit component satisfies the definition of interest under subsection 128A(1AB).

If the definition of interest was expanded to include the profit component derived by a non-resident financier IWT would apply. This would ensure that section 128D operates so that the profit component is not assessable income and is not exempt income of the non-resident financier.

If IWT applies to the profit component, it will also be necessary to consider the application of the IWT exemptions such as the "public offer test" and the financial institution exemption in some of Australia's double tax treaties.

Application of the IWT exemption

The availability of exemptions from IWT appears to be more problematic. In relation to section 128F and the public offer test, it is not clear whether a BBA would be able to be structured as a:

(i) "debenture" within the extended meaning of section 6(1); or

(ii) "syndicated loan facility" within the meaning of section 128F(11) or (12).

It seems unlikely that the BBA would be treated as a non-equity share.

We would recommend that the scope of section 128F and section 128FA be expanded to ensure that BBAs (and other similar Islamic finance products) are able to have the same treatment as debentures.

In relation to whether a BBA could be treated as a "syndicated loan facility", it should be confirmed whether or not the requirement for the agreement to describe itself as a "syndicated loan facility" or as a "syndicated facility agreement" is acceptable under Islamic principles. If this is acceptable, the exemption is only available in limited circumstances, including where over $100 million is being

financed and there are at least two "lenders" (as required by the definition of "syndicated loan"), notwithstanding that the public offer test may have been met. Accordingly, it is important that both the debenture and syndicated loan facility exemptions are available to ensure parity of tax treatment. If using the current nomenclature of "syndicated loan facility" or "syndicated facility agreement" is unacceptable, then consideration could be given to including " bai bithaman ajil" in the list of document titles that are required to be used to qualify for the "syndicated loan facility" exemption.

Double Tax Agreements

Some of Australia's double tax agreements contain an IWT exemption for interest that is paid to an unrelated financial institution. Assuming the financial institution is a resident of the DTA (and other requirements are met e.g. in the US DTA, the resident also satisfies the qualified person requirement), the financial institution exemption may apply. The typical article of the DTA, sets out the financial institution exemption and states:

> Notwithstanding paragraph (2), interest arising in [Australia] to which a resident of the [other DTA country] is beneficially entitled may not be taxed in [Australia] if:
>
> ...
>
> (b) the interest is derived by a financial institution which is unrelated to and dealing wholly independently with the payer. For the purposes of this Article, the term "financial institution" means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.

Accordingly, the key issue is to determine whether an Islamic financial institution satisfies the definition of a financial institution for the purposes of the DTA by analysing whether or not it substantially derives its profits by:

(i) raising debt finance in the financial markets; or

(ii) taking deposits at interest and using those funds in carrying on a business of providing finance.

Taxation Ruling 2005/5 sets out the ATO's view as to the definition of a "financial institution" for the purposes of the US and UK double tax agreements. We have set out below, paragraphs 17 and 18 of the ruling, which sets out what activities constitute raising debt finance in the financial markets and would enable an Islamic finance institution to satisfy the "financial institution" definition.

> 17. The meaning of the term 'debt finance' has regard to the approach applied in Division 974 of the Income Tax Assessment Act 1997 (ITAA 1997) of analysing the economic substance of the rights and obligations arising under a financing arrangement rather than the mere legal form. This recognises that the basic indicator of the economic character of the debt is the non-contingent nature of the returns. Applied in the context of the Conventions, a US or UK resident is raising debt finance where the funds obtained result in an 'effectively non-contingent obligation' to return an amount at least equal to the amount received. The term 'effectively non-contingent obligation' takes its meaning from section 974-135 of the ITAA 1997.
>
> 18. The term 'financial markets' in the expression 'raising debt finance in the financial markets' takes on its ordinary commercial meaning. It means a facility through which:
>
> - offers to acquire or dispose of debt finance products are regularly made or accepted (including offering loans); or
>
> - offers and invitations are regularly made to acquire or dispose of debt finance products that are intended to result or may reasonably be expected to result in the making (or acceptance) of offers to acquire or dispose of such debt finance products (including offering loans).

> The linkage between the meaning of debt finance above, and the requirement that the enterprise obtains its debt finance in the financial markets, means that these funds must be raised on normal commercial terms.

We have set out below, paragraphs 19 and 20 of the ruling, which sets out what activities constitute taking deposits at interest and would enable an Islamic finance institution to satisfy the "financial institution" definition.

> 19. The term 'taking deposits at interest' takes on its ordinary meaning. The CCH Macquarie Business Dictionary defines 'deposit' as:
>
> a sum of money placed into an account with a financial institution. Deposits can range in maturity from a deposit in a passbook account, able to be withdrawn on demand (or on call), to a deposit made for a fixed period of time. [3]
>
> 20. As such, the term, 'taking of deposits at interest' refers to the receipt of a sum of money into an account by a financial institution which pays interest thereon. In the above dictionary definition the term 'financial institution' is used in its ordinary sense, as an institution authorised under a regulatory regime to take deposits, rather than in the defined sense used in the Conventions. For the purposes of this Ruling, the enterprise must be authorised under the regulatory regime of either the US or the UK, to take sums of money to be placed in an account.

Based on the above, it will be necessary to ensure the exemption for financial institutions equally applies to Islamic financiers notwithstanding that they may not be regarded as "raising debt finance" or "taking deposits at interest" due to the nature of Islamic finance products. It may be possible that an Islamic finance institution satisfies the "raising debt finance" aspect, but it is our view that in order to achieve neutrality between conventional products and Islamic finance products, the financial institution exemption should be specifically extended to Islamic finance institutions. If possible, an administrative approach could be taken by ATO ruling rather than seeking to amend the relevant DTAs (at least until relevant DTAs are renegotiated).

Resident Client

Based on the above, it is our view that there is a possibility that the profit component forms part of the cost base of the asset and would not be deductible. To ensure a resident client who is a party to a BBA is entitled to similar tax treatment if it had been a party to a conventional mortgage product, we offer the following comments:

(i) exclude BBA and other Islamic finance products which are in substance the same as conventional products from the application of section 110-25(2); and

(ii) insert an extended definition of interest which only has effect within Subdivision 110-A of Part 3-1 of the ITAA 1997, which would include the profit component under a BBA and other similar Islamic finance products. As a consequence, the profit component would be considered interest for the purposes of the cost base rules and would be a third element cost of the asset. Section 110-45(1B) would apply to exclude the interest from the cost base of the asset under section 110-45(1B) (provided that the profit component was deductible under section 8-1 or another deduction provision).

(b) Stamp duty

We consider that section 57B of the *Duties Act 2000* (Vic) works effectively in this case study to achieve tax neutrality.

Section 57B provides that:

> (1) This section applies if a natural person and a financial institution enter into an arrangement under which—
>
> (a) a third party and the natural person acting as agent for the financial institution enter into a contract of sale for an estate in fee simple in land; and
>
> (b) in accordance with the contract of sale referred to in paragraph (a), the estate in fee simple in land is transferred from the third party to the financial institution (the first transaction); and
>
> (c) at the same time as the first transaction, the financial institution and the natural person enter into a contract of sale for the estate in fee simple in land; and
>
> (d) in accordance with the contract of sale referred to in paragraph (c), the financial institution transfers the estate in fee simple to the natural person for a determined consideration (the second transaction).
>
> (2) No duty is chargeable under this Chapter in respect of the second transaction.

The effect of this section is that duty is only payable once on the transfer of land from the Vendor to the Financier. The Financier would pass this stamp duty cost on to the Client. This is the same result as the purchase of a residential property by the Client financed by a loan from the Financier and secured by a mortgage. This model could be used by the other jurisdictions.

GST

We consider it to be difficult to obtain tax neutrality (ie the same GST outcome as a conventional fixed interest loan backed by a mortgage) under the home financing product described in Case Study One, if the supply is not considered to be a "financial supply" for GST purposes, particularly in relation to the ability to claim a 75% reduced input tax credit on related costs.

The ability to claim a 75% reduced input tax credits is a unique aspect of the Australian GST law. A prescriptive list of "reduced credit acquisitions" is set out in the *A New Tax System (Goods and Services Tax) Regulations 1999* (**GST Regulations**). If an acquisition relates to making financial supplies and is a reduced credit acquisition, a 75% reduced input tax credit can be claimed on those acquisitions.

As the home financing product involves the sale and transfer of an asset, the supply being made by the Financier is the asset itself. This is not a financial supply. Therefore, costs that relate to the sale of the asset are not costs that relate to a financial supply and the 75% reduced input tax credit is not available on these costs.

It is possible that the "profit" component is considered to be:

(i) a debt, credit arrangement or right to credit (item 2 of GST Regulation 40-5.09(3)) or

(ii) a charge or mortgage over real or personal property (item 3 of GST Regulation 40-5.09(3)),

either of which is a financial supply, for GST purposes. This means that costs incurred by the Financier may relate to both the sale of the asset as well as the

profit component. As the profit component is a financial supply, the Financier may retain the ability to claim a 75% reduced input tax credit on any relevant costs.

If the profit component is not a financial supply, to obtain tax neutrality, the reduced credit acquisition provisions in the *A New Tax System (Goods and Services Tax) Act 1999* (**GST Act**) will need to be extended to apply to these kind of arrangements. Alternatively, the home financing product could be deemed to be a financial supply for GST purposes, which will then allow 75% reduced input tax credit to be claimed on costs that are reduced credit acquisitions that relate to the making of the financial supply. Either option requires legislative change and amendments.

1.4 How would your answer be different if the property were a commercial property?

(a) Income tax

We do not expect the Australian income tax implications to be different if the property was a commercial property.

As discussed above, from the perspective of the client, it will be necessary to ensure that the interest does not form part of the cost base of the commercial property. We refer to our comments in section 1.3(a)(ii).

(b) GST

From a GST perspective, the supply of commercial property is a taxable supply and subject to GST. As the Financier is selling the asset, the Financier would typically request that it be able to gross up the sale price, including the profit amount, an extra 10% to recover the GST amount from the Client. The Financier would remit the GST amount to the ATO. Assuming that the Client is purchasing the commercial property for business/enterprise purposes, we would expect that the Client would be registered or required to be registered for GST. Generally, the Client would be able to claim the GST amount back as input tax credits. The Financier would also be able to claim back any GST it incurs on its own costs that relate to making the supply of the commercial property.

This is different from if the Financier were providing a loan to finance the purchase of the commercial property, as the provision of a loan is an input taxed supply and not subject to GST. Hence, the Client would not pay an additional amount in respect of GST to the Financier and would not have any GST to claim back from the ATO. The Financier would ordinarily not be able to claim back any GST on its costs that relate to providing the loan.

There are further flow on effects from the treatment of the supply of commercial property as being a taxable supply from the Financier's perspective, if the Financier uses a revenue apportionment methodology to claim back input tax credits on its overhead costs. As the revenue from this supply is now taxable, when it was previously considered to be input taxed, the input tax credit recovery on its overhead acquisitions could improve substantially.

(c) Stamp duty

We consider that a stamp duty exemption should apply to the transfer from the Financier to the Client, regardless of whether the property is a commercial property or a residential property.

Section 57B of the *Duties Act 2000* (Vic) only requires that the Client is a natural person and does not require that the land is used for residential purposes.

However, in New South Wales, mortgage duty would also be payable on a mortgage over a commercial property in New South Wales. Where a loan is only secured by property in New South Wales, duty would be payable at 0.4% of the loan amount.[5]

Therefore, in order to achieve tax neutrality, between this case study and the purchase of a commercial property financed by a loan and secured by a mortgage over New South Wales property, it would necessary to ensure that an equivalent amount to this mortgage duty amount is payable. This could be achieved by deeming that this arrangement gives rise to an advance secured by a mortgage for the purposes of the mortgage duty provisions.

1.5 Please consider the application of stamp duty in the context of Islamic mortgage funds.

The stamp duty consequences in relation to Islamic mortgage funds would vary depending on whether the fund holds the relevant land or would only hold the right to the deferred payment of the cost plus profit.

If the fund holds the relevant land, stamp duty could be payable in relation to the transfer of the land into the fund. Land rich duty, landholder duty or trust acquisition duty could also be payable in relation to investment in the fund, depending on the percentage interest acquired.

If the fund holds only the right to the deferred payment of the cost plus profit, duty would only be payable in South Australia[6] and Queensland[7] on the transfer of this right into the fund if the central management and control of the Client is in these jurisdictions.

See our comments in section 7.5(c) in relation to potential exemptions that could be included for these types of transactions such that there is equivalent stamp duty treatment as in relation to more traditional securitisation arrangements.

1.6 Have the Victorian amendments to the Duty Act worked effectively to provide a level playing field?

See our comments above at paragraph 1.3(b).

2. Case study two: interbank finance

2.1 Can the potential cost to the Financier from lost entitlement to reduced input tax credits be quantified?

Case study two states that the Financier (the resident Investment Agent) has an investment agency agreement with the non-resident Syndicated Financiers. Hence, any supplies made to the non-resident Syndicated Financiers should be GST-free. The Financier will also make supplies of the commodity to the Client. This is a taxable supply.

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[5] *Duties Act 1997* (NSW) s 210

[6] *Stamp Duties Act 1923* (SA) Schedule 2 Part 1 Item 3.

[7] *Duties Act 2001* (Qld) section 35.

This is a different GST outcome for the Financier from a conventional debt instrument, as set out in the table below:

	Conventional debt instrument	Case Study Two arrangement
Supplies	GST-free supply to the non-resident Syndicated Financiers	GST-free supply to the non-resident Syndicated Financiers
	Input taxed financial supply to Client (not subject to GST)	Taxable supply of commodity to Client (subject to GST)
Entitlement to claim input tax credits on costs	Entitled to full input tax credits on costs related to supply to non-resident Syndicated Financiers	Entitled to full input tax credits on costs related to supply to non-resident Syndicated Financiers
	No entitlement to claim input tax credits on costs that relate to input taxed financial supply, unless a 75% reduced input tax credit is available	Entitled to full input tax credits on all costs related to making taxable supply of commodity to Client, including any GST incurred on acquiring the commodity

As can be seen from the above table, the GST implications will be same for the Financier in relation to supplies made to non-resident Syndicated Financiers under either a conventional debt instrument or the arrangement set out in this Case Study Two. However, the GST implications will be different in relation to supplies made to the Client.

Further, the entitlement of the Financier to claim input tax credits on costs related to making supplies to the Client will also differ under the arrangement set out in Case Study Two from a conventional debt instrument. It is difficult to compare the difference between the two arrangements as typically, a Financier would not actually acquire a commodity under a conventional debt instrument. Hence, the actual costs incurred by the Financier are different under the arrangement in Case Study Two. However, generally, a Financier would have a limited entitlement to claim input tax credits on costs that relate to making supplies of the debt instrument, unless a 75% reduced input tax credit can be claimed on some costs, whereas a Financier would be able to claim full input tax credits on all costs under the Case Study Two arrangement.

In this regard, a Financier would actually increase its recovery of GST under the Case Study Two arrangement compared to if it only made supplies of the conventional debt instrument.

2.2 Should the profit component payable by the resident Client be subject to IWT and how could certainty be achieved?

As discussed in section 1.2, we submit that a reasonably arguable position can be made that the profit component satisfies the definition of interest for the purposes of the IWT provisions. Accordingly, we consider that if the profit component is paid outside of Australia, it should be subject to IWT.

We would not expect section 12-245 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) to apply, on the basis that the Client pays the interest to the resident Investment Agent. Section 12-250 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) states:

> **SECTION 12-250 INTEREST PAYMENT RECEIVED FOR FOREIGN RESIDENT**
>
> **12-250(1)** An entity that receives a payment of interest (within the meaning of Division 11A of Part III of the *Income Tax Assessment Act 1936*) must withhold an amount from the payment if:
>
> (a) the entity is a person in Australia or an *Australian government agency; and
>
> (b) a foreign resident is or becomes entitled:
>
> > (i) to receive the interest or part of it from the entity, or to receive the amount of the interest or of part of it from the entity; or
> >
> > (ii) to have the entity credit to the foreign resident, or otherwise deal with on the foreign resident's behalf or as the foreign resident directs, the interest or part of it, or the amount of the interest or of part of it.

As pointed out in paragraph 4.22 of the Discussion Paper, the resident Investment Agent would have the obligation to withhold IWT in respect of repayment of the Sale Price to the non-resident Syndicated Financiers (if the profit component is interest).

Unless section 128F, section 128FA or an applicable double tax treaty applies, the IWT should be collected by the resident Investment Agent rather than the Client. Our comments in section 2.3 below, set out our recommended drafting changes to enable the IWT exemptions to apply.

Certainty

The definition of interest should be expanded to make it clear that the profit component derived by the non-resident Syndicated Financiers satisfies the definition of interest under subsection 128A(1AB) of the ITAA 1936. This would lead to IWT being imposed.

As a consequence, section 128D would operate so that the profit component is not assessable income and is not exempt income of the non-resident Syndicated Financiers.

2.3 Bearing in mind the Government's policy intent (that Australian business does not face a restrictively higher cost of capital, or constrained access to capital, as a result of the IWT burden being shifted from the non-resident lender to the Australian borrower):

(a) **What are the specific withholding tax exemptions that, in principle, should be available in the circumstances described in case study two?**

The exemptions in section 128F, 128FA and the DTAs should apply in the circumstances described in case study two.

(b) **What element of the test is problematic?**

In summary, the key issues associated with satisfying the IWT exemption under section 128F (or section 128FA) with respect to this form of Islamic finance product are:

(i) whether the purchase of a commodity is a non-equity share, a syndicated loan or transaction prescribed by the regulations;

(ii) whether it is a debenture or syndicated loan facility.

To address this problem, changes would be required to include a product of this type in the scope of transactions to which the interest withholding tax exemptions in section 128F and section 128FA could apply.

(c) **Why should the exemption be available in this case?**

The exemptions reflect Australia's policy of encouraging flows of capital from outside of Australia which have the intended effect of reducing borrowing costs for Australian business. The section 128F (and section 128FA) exemption (and the financial institution exemption in the relevant DTA) should also be made available in the circumstances described in case study two, as the substance of the transaction is substantially the same as conventional inter-bank financing.

The Johnson Report emphasised that Islamic finance transactions should get parity of treatment to conventional transactions. We note that the circumstances in case study two warrant the application of the exemption.

(d) **How could the IWT provisions be amended to ensure the policy intent of the exemption is not compromised?**

The changes suggested in part 2.3 above, specifically the expansion of the scope of arrangements to which section 128F and section 128FA can apply, are able to be made without compromising the policy intent of the exemption.

Expanding the scope of the form of documents to which whose section would apply would extend the exemption from IWT to transactions similar to case study two. This would decrease the costs of funding to Australian borrowers because there would be no IWT and consequently Australia would become a more attractive destination for foreign lenders. This would also ensure that transactions that are the same in substance are not treated differently or prejudicially merely because of the form in which the arrangement is documented. Extending the exemption to create parity between arrangements having the same substance, but in different forms may have some revenue impact. However, as stated in the Johnson report:

> "Australia is, and is likely to remain, a capital importing country. As such, Australia needs access to a diverse range of offshore savings pools to finance domestic investment needs. Any tax measures which raise the cost of imported capital thus warrant close scrutiny. Sensible policy changes that improve access to offshore pools of capital at competitive rates are clearly in Australia's interest, as they lower investment financing costs."[8]

Moreover, the ATO's loss of a potential revenue stream would be offset by gains to the Australian economy by creating:

> "Access to offshore savings pools (which) is not only desirable and sensible for Australia as a capital importing country, it can also help to further the Government's objective of greater international engagement of our financial sector."[9]

The Johnson Report also stated:

> "When the exemption in section 128F was introduced in 1971, the then Government referred to 'the importance it attaches to flows of capital from abroad for the development of our resources and the economy generally."[10]

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8 The Johnson Report - "Australia as a Financial Centre, Building on our Strengths, Report by the Australian Financial Centre Forum November 2009"

9 The Johnson Report - "Australia as a Financial Centre, Building on our Strengths, Report by the Australian Financial Centre Forum November 2009"

10 The Johnson Report - "Australia as a Financial Centre, Building on our Strengths, Report by the Australian Financial Centre Forum November 2009"

Similar comments to those above can be made with regard to the suggested expansion of the exemption under section 128F. The suggested amendments would not only ensure the policy intent of the exemption is not compromised, but it would also contribute towards the attainment of the policy by increasing Australia's attraction as a lending destination and consequently reduce the constraints currently felt in relation to the availability of capital.

The suggested change to the definition of debenture accords with changes the Government is already making. In a joint media release on 11 May 2010[11], the Government released proposed amendments to the IWT regime, outlining a stagged reduction in IWT with an aspirational target of nil IWT in a number of circumstances.

For completeness we note that integrity measures may be required in order to ensure that only appropriate financing arrangements, specifically where Islamic Finance products are used rather than conventional loan arrangements to achieve the same substantive result, are able to access any expanded exemption

2.4 How is the tax treatment of the resident "agent" different to the conventional equivalent? How should the resident "agent" be taxed in principle?

How is the tax treatment of the resident "agent" different to the conventional equivalent?

Practically, the resident Investment Agent and a conventional agent should have the same tax outcome. The difference is that the resident Investment Agent has additional responsibilities in the form of:

(a) purchasing the commodity on behalf of the Syndicated Financiers; and

(b) selling the commodity to the Client.

There should be no gain or loss in relation to the purchase and sale of the commodity for the resident Investment Agent as:

(a) the commodity will be sold to the Client at the same price as the purchase price (assuming the resident Investment Agent does not retain a margin) with the profit component treated as interest for the Client; and

(b) any transactional costs are likely to be borne by the Client.

How should the resident 'agent' be taxed in principle?

A resident Investment Agent who derives fees and other related income should be taxed under the normal assessment provisions.

2.5 What security might be required for this type of arrangement? What happens in the event of default? Does this cause any tax impediments?

It would be possible to use security similar to a covered bond for this type of arrangement. This would mean that the Client (resident bank in case study two), would be required to provided a pool of similar or equivalent assets (or pool of income producing assets) to cover any potential default.

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[11] Joint Media Release with The Hon Chris Bowen MP Minister for Financial Services, Superannuation and Corporate Law and Senator The Hon Nick Sherry Assistant Treasurer; http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/035.htm&pageID=003&min=wms&Year=&DocType=0

In the event of default the Syndicated Financiers could access the security set aside by the Client to recover the debt due. This recovery should not have any additional tax implications and would merely be regarded as recovery of the debt owed to the Syndicated Financiers.

3. Case study three: finance lease and hire purchase

3.1 Is the differential treatment of leases (based on the form of the leasing arrangement) an impediment to the development of Islamic finance?

There are a number of Islamic Finance leasing products such as:

- Ijarah (operating lease equivalent); and
- Al-Ijarah-Thummal Al Bai or Ijaraah Muntahia Bittamleek (finance lease equivalents).

These products have been established in the international marketplace and have a number of similar characteristics to conventional operating leases and finance leases in the marketplace. It is our view that commercial factors (such as the profit margin and leasing rates) are more relevant as factors to the development of Islamic Finance leasing products than the differential Australian tax treatment.

3.2 Should the income tax treatment of leases be more broadly determined by the economic substance of the arrangement?

The income tax treatment of leasing arrangements is well established and has been the subject of many reviews and much consideration, including judicial consideration, over time. It is not appropriate to adjust the taxation of leasing to align with other taxing regimes, as there are many commercial and legal differences between general leasing arrangements and finance transactions.

Any changes developed to accommodate Ijarah and Al-Ijarah-Thummal Al Bai or Ijaraah Muntahia Bittamleek should not be to the detriment of preserving and retaining the different tax treatment that applies to general leasing arrangements. Given the different transactions available to fund asset acquisition, any deemed finance treatment of any of the Ijarah and Al-Ijarah-Thummal Al Bai or Ijaraah Muntahia Bittamleek products should only be on the basis that the paramount intention of the transaction is one of acquisition, and not mere use of an asset. This would be likely to indicate that the current treatment of Ijarah arrangements should remain unchanged and should continue to reflect the existing lease tax treatment.

We consider that finance treatment of Al-Ijarah-Thummal Al Bai or Ijaraah Muntahia Bittamleek would only be appropriate in cases where there is a purchase option (which would currently reflect the treatment under Division 240).

3.3 How can the interest equivalent and the principal be isolated if Division 240 does not apply?

Implicit rates of return can generally be identified in leasing arrangements by reference to the value of the principal asset and the overall lease payments. As noted in point 3.2, the fact that an implicit rate of return may exist in a leasing arrangement does not provide a rationale for a general or widespread change to the taxation of leasing.

If customers enter into an arrangement where the acquisition of the asset is paramount (like a Division 240 hire purchase agreement), then the current deemed loan treatment should apply. Where there is no purchase option, or no intention of acquisition of an asset (such that the paramount purpose of the arrangement is one of lease or right to use), then

the current rules that apply to the taxation of leasing arrangements should continue to apply, and there would be no need to calculate an interest and principal equivalent.

3.4 How would your answer be different if this arrangement was used for home financing?

There should be no difference in treatment as between home financing and other-asset financing. If there is a demonstrated paramount purpose of acquisition of an asset, evidenced by a purchase option that is reasonably likely to be exercised, the arrangement should be treated as a notional loan and notional principal and interest components of payments should be relatively easily identified.

Where there is no purchase option, then there should be no deemed loan treatment and ordinary rules relating to tenancy arrangements should be respected.

In any case, there should be no impact on the ordinary principles relating to deductibility (namely, the "negative limb" of section 8-1, which precludes deductibility for expenses that are private or domestic in nature).

4. Case study four: purchase order

4.1 What is the equivalent conventional product?

Under a purchase order:

(a) the Client approaches the Financier regarding the construction of an asset/project;

(b) the Financier enters into an agreement with a third party (eg a contractor/developer) to construct an asset/project according to certain specifications. As the contractor/developer constructs the asset/project, the develop receives progress payments from the bank; and

(c) the Client enters into a separate loan facility with a Financier to fund the asset/project construction. The Client would repay the principal and interest over an agreed period of time after completion of construction of the project.

The purchase order is in effect a combination of a loan agreement and a forward contract (in which the construction and payment obligations are settled in the future).

4.2 Will the application of ordinary income tax rules be an impediment to the development of this type of Islamic finance product?

The following table summarises some of the Australian tax issues that affect the Financier and Client and are associated with the development of the purchase order product:

	Financier	
Australian tax issue	**Resident Financier**	**Non-resident Financier**
Ordinary income	If the Financier makes a profit (being the difference between the Sale Price and the Purchase Price) on the sale of the asset to the client, the profit component may be taxable on revenue account. If the profit component is characterised	If the non-resident Financier makes a profit (being the difference between the Sale Price and the Purchase Price) on the sale of the Asset to the Client, the profit component may be taxable on revenue account. If the profit component is characterised as revenue,

	as revenue, then the profit component will be included in the Financier's assessable income under section 6-5(1) and taxed under the TOFA provisions (in respect of the Financier/Client leg of the purchase order transaction).	then the profit component will be included in the non-resident Financier's assessable income under section 6-5(3) if it has an Australian source (although we note that if the non-resident Financier is resident in a double tax treaty country, the non-resident Financier would be taxed only if it has a permanent establishment in Australia but could nonetheless be taxed under the CGT provisions). If the profit is assessable at a rate of 30% (rather than 10%) to the non-resident Financier this would be an impediment to the development of Islamic finance purchase order products, given that in substance the purchase order is akin to a loan arrangement (in respect of the Financier/Client leg of the purchase order transaction).
Capital Gains	If the profit on the sale of the Asset to the Client is treated as a capital gain, Australia's current capital gains rules are likely to impact on resident Financiers. A Financier in a purchase order arrangement will hold an ownership interest in the asset and then transfer the asset to the Client. Accordingly, the disposal of the asset by the Financier to the Client will give rise to a CGT event A1. The Financier will be required to include any capital gains made on the sale in its assessable income. If the capital gain is already included in the Financier's assessable income, the capital gain will be reduced under Division 118. If the purpose of the purchase order is to raise finance to construct the asset, it is not appropriate to assess the Financier on any capital gain made by the Financier in transferring the asset to the client. A preferred approach would be to treat the Client as the notional owner so that the Client would be required to include any capital gains on a future sale of the asset in its	For non-resident Financiers, the disposal of the asset to the Client may give rise to a CGT liability. Under Division 855, a non resident will be subject to capital gains if the CGT asset is taxable Australian property or the non-resident Financier is carrying on a business through a PE. The non-resident Financier will be subject to the same CGT consequences that would apply to a resident Financier. However, a preferred approach would be to treat the Client as the notional owner so that the Client would be required to include any capital gains on a future sale of the asset in its assessable income.

	assessable income and the Financier would be taxed on the profit component under the TOFA provisions (provided payments are made to the Client after construction has completed).	
IWT	N/A	We refer to our comments in section 1.3. We submit that the definition of interest should be expanded to make it clear that the profit component of the repayment satisfies the definition of interest under subsection 128A(1AB) of the ITAA 1936. If the definition of interest was expanded to include the profit component derived by a non-resident Financier, this would ensure that section 128D of the ITAA 1936 operates so that the profit component is not assessable income and is not exempt income of the non-resident financier.
	Client	
Deductibility of Interest	This Islamic finance product is unlikely to be attractive to clients if the profit component of the purchaser order forms part of the cost base and cannot be deductible under the general deduction provisions in section 8-1. If the purpose of the arrangement is to raise finance for the construction of an asset/project, then the substance of the purchase order is akin to a conventional loan arrangement. If the borrowings are used for an income producing purpose, the profit component of the Sale Price should be deductible for the Client in the same way that interest would be deductible on an ordinary loan.	

4.3 Will GST apply appropriately?

The supply of the asset by the Financier will be a taxable supply and subject to GST. If the Client is registered, or required to be registered, for GST, the client will be able to claim the GST amount back as input tax credits. The net direct GST outcome of the supply of the asset is neutral when compared to the provision of a conventional loan, as the supply of a loan is an input taxed financial supply, and not subject to GST.

Even if the Client is a resident individual and not entitled to claim back any GST incurred as input tax credits, the GST outcome under this case study could be similar to provision of a conventional loan. Under the arrangement in this case study, the Client will incur a GST amount that will form part of the cost base of the asset it purchases from the Financier. Under a conventional loan product, while the Client will not incur any GST on the loan, as the loan is an input taxed financial supply, the Client will be acquiring the construction and building costs directly. Construction and building costs are typically costs that would include an amount in respect of GST. The Client would not be able to claim back these

GST amounts. Hence, under either arrangement, the Client will incur a GST cost. However, the quantum of the GST cost could differ if the purchase price of the asset from the Financier is different from the building and construction costs that the Client would otherwise have incurred directly.

There is also a difference in relation to the costs incurred by the Financier in relation to the supply of the asset. Typically, a Financier does not incur building/construction costs under a loan arrangement. While the Financier should be entitled to claim back any GST incurred on these costs under the arrangement in this case study, it is difficult to compare and assess the appropriateness of the application of GST where such costs are not typically incurred by the Financier.

In relation to other costs, such as overhead costs, that the Financier would incur regardless of whether the Financier makes a supply of the asset or a conventional loan, there will be a difference in the entitlement to claim back any GST as input tax credits depending on the supplies made. If the Financier were to make a supply of a conventional loan, the Financier would not be entitled to claim any GST incurred on its costs back as input tax credits, unless a 75% reduced input tax credit is available. Under the arrangement in this case study, the Financier would be entitled to claim back all GST incurred on its costs as input tax credits. Hence, the arrangement under this case study provides the Financier with a more favourable GST outcome compared to a conventional loan product. The "in built" GST cost in providing a conventional loan could result in a cost differential being passed on the client.

4.4 Is there an additional duty cost compared to the conventional equivalent?

Duty would not apply to the construction of an asset financed by a conventional loan in any jurisdiction, except in New South Wales where mortgage duty would apply if the loan was secured by a charge over the asset and/or the land on which it is located.

Duty would apply in this case study if the Financier acquired the land under an arrangement similar to case study one and sold both the land and the asset to the Client. Duty would apply to the greater of the amounts paid to the Financier by the Client and the market value of the land and the asset.

However, if the Financier does not hold any interest in the land and sells only the asset to the Client, duty may not be payable. The nature of the asset sold by the Financier and whether it would constitute an interest in land, goods or something else is unclear in these circumstances.

Where the asset is fixed to the land (eg a building), based on the decisions in *Mr Espresso Group Pty Ltd v Chief Commissioner of State Revenue* [2009] NSWADT 291 and *McDonald's Australia Ltd v Chief Commissioner of State Revenue* [2005] NSWSC 6, we consider that the transaction should be characterised as the surrender by the Financier of a right to remove the asset from the land owned by the Client. In *McDonald's Australia Ltd v Chief Commissioner of State Revenue* [2005] NSWSC 6 the Court found that the sale of the fixtures by franchisees to a franchisor on land leased by the franchisee was the surrender or abandonment of the right to sever the fixtures and was not the sale of an interest in land or the sale of goods. Similarly, in *Mr Espresso Group Pty Ltd v Chief Commissioner of State Revenue* [2009] NSWADT 291, the Court found that the transfer of fixtures from an outgoing tenant to an incoming tenant was neither the sale of an interest in land nor the sale of goods and was the surrender of a right to sever the fixtures. This surrender would not attract duty in any jurisdiction in Australia other than South Australia, to the extent that the surrender of this right involves a conveyance.[12]

[12] *Stamp Duties Act 1923* (SA) s 60

Where the asset or part of the asset is not fixed to the land, we consider that the Financier would be taken to transfer goods to the Client. This transfer would not attract duty in any jurisdiction other than South Australia unless it was aggregated with the transfer of another type of dutiable property such as land.

We do not consider that the transaction can be characterised as the sale of an interest in land. However, if the asset was characterised as an interest in land, duty would be payable in all jurisdictions.

4.5 What are the PAYG withholding and IWT issues caused by the Financier's relationship with the Contractor?

There should ordinarily be not IWT issues associated with any payments between the Financier and the Contractor.

Foreign resident withholding tax

Withholding tax is imposed on payments made under a contract for works or related activities if the payments are made to, or received for foreign entities (sections 12-315 and 12-317 of Schedule 1 of *Taxation Administration Act 1953*). Under regulation 44C of the *Taxation Administration Regulations 1976* (Cth), a payment under a contract for works or related activities will include activities associated with the construction, installation and upgrading of buildings, plant and fixtures.

If the contractor/developer is resident in Australia, a resident Financier would not be required to withhold foreign resident withholding tax (**FRWT**). However, if the progress payments are made to a non-resident contractor/developer, the resident Financier would be required to withhold unless the contractor/developer has obtained a variation or exemption from the ATO.

Section 12-315(1)(c)(ii) of Schedule 1 to the *Taxation Administration Act 1953* (Cth) provides that to the extent that the payments are subject to IWT, the payment will not be subject to FRWT. It is our view that with respect to the contract between the Financier and the Contractor, FRWT should apply, rather than IWT.

4.6 How could any tax impediments be resolved?

There do not appear to be any obvious tax impediments in this scenario as between the Financer and the Contractor. To the extent to which the payments made by the Client to the Financier include an identifiable interest component, that component should be eligible for deductibility (to the Client), rather than forming part of the capital cost of the ultimate asset (assuming the asset is used for income producing purposes and otherwise would qualify for deductibility).

5. Case study five: pre-paid forward sale

5.1 What is the equivalent conventional product?

The substance of the pre-paid forward sale arrangement will depend on the intention of the parties. If the purpose of the arrangement is to raise finance, the tax treatment of the pre-paid forward sale should be equivalent to a prepaid commodity sales agreement.

For the remainder of this case study, we assume the purpose of the pre-paid forward sale is to raise finance for the client.

5.2 Will the application of ordinary income tax rules be an impediment to the development of this type of Islamic finance product?

Trading Stock Provisions

This Islamic finance product is in many ways, similar to a pre-paid gold forward sale agreement. The client will include in its assessable income, the proceeds from the sale of trading stock to the bank. Based on the example in the case study five example, this should occur in the income year in which the trading stock is delivered to the Financier.

One issue that may arise is whether the disposal of the trading stock is considered to be outside the ordinary course of the client's business. Under section 70-90, the client may be required to include in its assessable income, the market value of the trading stock (rather than the price agreed upon with the Financier). This would be an impediment to the introduction of this Islamic finance product.

TOFA

The TOFA rules are unlikely to apply on the basis that the arrangement is for less than 12 months and the arrangements will not be cash settlable (although this will depend on the particular arrangement).

IWT

The profit from the pre-paid forward sales arrangement attributable to a non-resident Financier should be treated as interest or in the nature of interest for the purposes of subsection 128A(1AB). Therefore, if the Financier is not a resident of Australia, the client will be liable to deduct withholding tax from the profit component.

5.3 Will GST apply appropriately?

If the arrangement is intended to be equivalent to a standard loan, the GST consequences will be different under this arrangement. This is because GST will apply to the supply of the commodity by the Financier. The Financier should be able to claim back any GST incurred in acquiring the commodity as input tax credits. As the provision of a standard loan arrangement is an input taxed financial supply for GST purposes, no GST would ordinarily apply to the supply by the Financier. The Financier would not be entitled to claim back any GST incurred on its costs that relate to the loan.

However, if this arrangement is characterised as an ordinary trading arrangement, in which the Financier acts in the capacity as a broker, the supply of broking services would typically be a taxable supply and subject to GST. If this is the intended equivalent product, the application of GST should be appropriate.

5.4 Is there an additional duty cost compared to the conventional equivalent?

If the conventional equivalent is an ordinary trading arrangement, the stamp duty consequences of this case study would be the same, except for possibly in South Australia. The transfer of goods without any other type of dutiable is not dutiable property in any jurisdiction in Australia other than South Australia. Therefore, in both a pre-paid forward sale and an ordinary trading arrangement, duty would not be payable.

In South Australia, the transfer of goods is generally dutiable. There is an exemption from duty for the transfer of goods, wares or merchandise sold in the ordinary course of trade.[13] However this exemption may not apply to the transfer of goods from the Client to the

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[13] *Stamp Duties Act 1923* (SA) s 31.

Financier in the case of the pre-paid forward sale. This exemption would be likely to apply, however, to an ordinary trading arrangement where the Financier acts in the capacity as a broker.

If the conventional equivalent is a loan, duty would only be payable in New South Wales if security is provided for the loan over New South Wales property. Duty would not be payable in any other jurisdiction.

5.5 How could any tax impediments be resolved?

Client

One option that should be considered is amending the application of section 70-90 which deems a transaction involving this type of Islamic finance product from being considered a disposal of trading stock outside the ordinary course of business. This would eliminate any uncertainty that the market value replaces the value agreed upon by the client and the non-resident Financier.

Non-resident Financier

As discussed above, if section 70-90 applies, section 70-95 would apply to deem the non-resident Financier to have acquired the trading stock at market value. This issue is two-fold:

- cause uncertainty as to the amount of IWT that should be withheld by the client; and
- it may cause an additional IWT liability for the Financier.

IWT

Given, the uncertainty as to whether the profit is interest, in the nature of interest or in substitution for interest it may be worthwhile expanding the definition of interest to ensure that the profit satisfies the definition of interest under subsection 128A(1AB), for certainty. If the definition of interest was expanded to include the profit derived by a non-resident financier, IWT would apply.

If IWT applies to the profit, it will also be necessary to consider the application of the IWT exemptions such as the "public offer test" and the financial institution exemption in some of Australia's double tax treaties. Ultimately, whether these type of arrangements attract the IWT exemption in section 128F (and section 128FA) will depend on the agreement itself and the circumstances of its offer. It is unlikely that substantively equivalent transactions would qualify for an exemption under section 128F or section 128FA, due to the nature of the arrangement and the fact that it appears that the public offer test component of those sections would be unlikely to be satisfied, even if the form of the arrangement could be included (as noted in our responses above). In this case, it would not seem appropriate to seek to have the section 128F and section 128FA exemptions apply, as that would create an imbalance in tax treatment between conventional arrangements and the pre-paid forward sale arrangement, which could distort general commercial behaviour.

The availability of exemptions from IWT appears to be problematic. In relation to section 128F and section 128FA) Some of Australia's double tax agreements contain an IWT exemption for interest that is paid to an unrelated financial institution. Assuming the financial institution is a resident of the DTA (and other requirements are met e.g. the qualified person requirement in some DTAs), the financial institution exemption may apply. The typical article of the DTA, sets out the financial institution exemption and states:

> Notwithstanding paragraph (2), interest arising in [Australia] to which a resident of the [other DTA country] is beneficially entitled may not be taxed in [Australia] if:

...

(b) the interest is derived by a financial institution which is unrelated to and dealing wholly independently with the payer. For the purposes of this Article, the term "financial institution" means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.

Based on the above, it will be necessary to ensure the exemption for financial institutions equally applies to Islamic financiers notwithstanding that they may not be regarded as "raising debt finance" or "taking deposits at interest" due to the nature of Islamic finance products. It may be possible that an Islamic finance institution satisfies the "raising debt finance" aspect, but it is our view that in order to achieve neutrality between conventional products and Islamic finance products, the financial institution exemption should be extended to Islamic finance institutions. If possible, an administrative approach could be taken by ATO ruling rather than seeking to amend the relevant DTAs (at least until relevant DTAs are renegotiated)

6. Case study six: profit and loss sharing partnership

We have only considered the Australian tax impacts on Foreign Financiers and not considered implications for local financiers.

6.1 What is the conventional equivalent to the arrangement described in Case Study Six?

A key feature of the Profit and Loss Sharing Partnership in case study six is the sharing of not only profits, but also losses between the Client and Financier. This is generally a feature of a tax or general law partnership rather than a standard loan arrangement.

The diminishing Musharakah is a product that is offered by Islamic financial institutions for the purchase of equipment, machinery, factory buildings and other tangible assets.[14] From a commercial perspective there is potential for the diminishing Musharakah to be used in Australia as an alternative form of debt financing to leasing and hire purchase arrangements. A diminishing Musharakah (ie a diminishing profit and loss sharing partnership) is in substance, a loan arrangement with an equity profit component, whereby the Client acquires the Financier's share of the assets over time.

6.2 What is the potential demand for this product in Australia? Can the potential demand be quantified?

We make no comment on the question.

6.3 Should the income from the arrangement described in Case Study Six be treated, in substance, as:

- **a repayment of principal and interest; or**
- **income or loss from a partnership; or**
- **ordinary business income?**

We consider that the income from a diminishing Musharakah arrangement **should** be treated as a repayment of principal and interest, rather than an income or loss from a partnership, but only in certain circumstances. Based on current Australian tax law

[14] Dawood Islamic Bank Ltd, *Diminishing Musharakah* <http://www.dawoodislamic.com/DiminishingMusharakah.aspx> at 15 November 2010

principles, the profit will not satisfy the definition of interest or the extended definition of interest for the purposes of the IWT provisions and consequently these definition will require modification.

Notwithstanding the above comments, if the current law was applied the income from a diminishing Musharakah would be likely to be treated as income or loss from a partnership. The definition of partnership under section 6(1) of ITAA 1936 is broader than the definition of a partnership at general law and includes "an association of persons carrying on business as partners or in receipt of income jointly". Accordingly, for tax purposes, it is not necessary that the parties are carrying on a business to be treated as a partnership. The parties will fall within the definition of "partnership" for income tax purposes if they are in receipt of income jointly. Accordingly, a diminishing Musharakah would fall within the definition of "partnership" for income tax purposes on the basis that there is a sharing of profits in accordance with an agreed profit ratio.

The profit derived by the partnership would be assessed on an assessment basis if the amount was considered to have an Australian source. There are no prescriptive legislative rules for determining the source of the profit and the determination of the source of the profit is a "practical, hard matter of fact"[15] and can only be determined at the time the profit is paid to the non-resident Financiers.

If the arrangement was treated as an income or loss from a partnership or ordinary income, we do not expect non-resident Islamic Financiers to participate in a diminishing Musharakah given the commercial and Australian taxation red tape (ie lodging and submitting partnership tax returns).

6.4 How could the appropriate income tax treatment be achieved?

To achieve the result that the profit from the arrangement is considered interest (and not income from a partnership), specific amendments would need to be made to the legislation. We consider that significant attention would need to be given to integrity measures surrounding any amendment o this nature, as it would be a significant distortion to the current treatment of partnership income and would appear to differentiate the treatment between other partnership arrangements and diminishing Musharakah arrangements to the extent that distortion in commercial practices could arise.

What security might be required for this type of arrangement? What happens in the event of default? Does this cause any tax impediments?

We would expect that typical financier security measures would be required to support a transaction of this kind, but that the provision of security should not cause any particular income tax impediment.

6.5 How would your answer be different if the purpose of the arrangement is to finance the purchase of a residential property?

Our answer would not be different if the purpose of the arrangement was to finance the purchase of a residential property.

[15] *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183 per Isaacs J (at p 189-190)

6.6 If you believe the arrangement described should be taxed as if it is a loan, how could an exception to partnership taxation or the application of ordinary income tax concepts, GST and stamp duty laws be provided?

(a) **Income tax**

An exception to partnership taxation could be provided by requiring certain conditions (akin to those required in the UK) to be met before the profit share return, in an arrangement similar to case study six, could be treated like interest for income tax purposes. The following conditions would need to be satisfied:

(i) one of the parties to the arrangement would need to be a Financial Institution;

(ii) the arrangement would need to be of the type and nature described in the legislation including that the eventual owner would be required to have the exclusive right to occupy or otherwise use the asset and be exclusively entitled to the income, profits or gain arising from or attributable to the asset; and

(iii) the alternative finance return or the profit share return would be required to equate to, in substance, a return on investment of money at interest. To the extent the profit component is in excess of the interest component, the Financial Institution cannot treaty shop to avoid taxation under the source rules.

(b) **GST**

As stated in paragraph 4.81 of the Discussion Paper, for GST purposes, if this arrangement is treated as the acquisition of a share in a partnership, this is an input taxed financial supply. This would result in the same treatment as if a conventional loan product was supplied, as this is also an input taxed financial supply.

While there may be some compliance costs as a result of the arrangement being treated as a partnership, these costs will be difficult to quantify. However, regardless of whether there is a partnership or not, there will always be some compliance costs in relation to the reporting and administration of GST. Hence, it is possible that any additional compliance costs will be small or negligible.

We also do not think that there will be any substantial loss in relation to claiming reduced input tax credits, as long as identical or similar costs are incurred by the Financier. As the Financier will be making an input taxed financial supply under either arrangement, the Financier will retain its ability to claim reduced input tax credits on the relevant costs.

(c) **Stamp duty**

Mortgage duty would only be payable in New South Wales in the case of a conventional loan if security is provided for the loan over New South Wales property. Duty would also be payable in all jurisdictions on the acquisition of the business asset if it is dutiable property.

In the profit and loss sharing partnership arrangement, duty could be payable on both the acquisition of the business asset in all jurisdictions and again on the incremental transfers of the Financier's interest to the Client. If the asset is dutiable property, these incremental transfers would be dutiable, either as the acquisition of an interest in a partnership or the acquisition of an interest in the relevant business asset.

Therefore, in order to achieve tax neutrality between these scenarios, an exemption would need to be included in the relevant stamp duty legislation for the transfer of a partnership interest or the transfer of an interest in dutiable property from a financial institution to a person where the financial institution acquired the interest jointly with that person for the purposes of providing finance for the acquisition and duty was paid for that acquisition.

6.7 What other approach could be implemented to achieve tax neutrality?

There do not appear to us to be any obvious alternative approaches that would achieve tax neutrality, without creating a potentially commercially distorting new taxing regime.

7. Case study seven: lease backed Islamic bond

7.1 What are the impediments in current Australian tax laws (at the Commonwealth, State and Territory level) to the development and provision of this Islamic finance product in Australia?

(a) **Income tax**

There is significant uncertainty about how a lease backed Islamic bond would be treated for Australian tax purposes. This uncertainty is likely to be a significant impediment to the development and provision of this type of product in Australia, particularly when specific steps have been taken by other nearby countries (eg Malaysia, Singapore) to avoid such uncertainty in the tax outcome for Islamic finance products issued in those countries. This would tend to make issuing such a product in Australia less attractive relative to a similar product issued in Malaysia or Singapore. The availability of Islamic finance products may be particularly beneficial to Australia because, as identified in the Johnson Report, it is a capital importing country and the ability to utilise financial products that comply with Islamic finance principles, may increase the available capital pool and cost of capital for Australian businesses and other consumers.

As a general principle, we note that it may be necessary to treat the arrangements between the Originating Entity and the Issuer and the Issuer and the Certificate Holders as separate arrangements (ie as two separate loan arrangements), particularly if the Issuer is deriving a margin as a result of the arrangements. This may necessitate amendments to Division 240 to ensure that it can apply to the lease leg of the arrangement, even if the relevant assets being transferred and leased are not goods, to recharacterise this leg of the arrangement as a loan. Alternatively, the Issuer might be treated in a similar way to a dealer under a conventional product.

Debt/equity test

As you have identified, it is unclear how a lease backed Islamic bond will be treated for the purposes of Division 974. In particular, it is unclear whether:

(i) the arrangement will be treated as a single arrangement, related schemes or two separate arrangements;

(ii) the arrangement may be excluded from being a financing arrangement for Division 974 purposes on the basis that it is a lease (see section 974-130(4)); and

(iii) the tests relating to whether:

(A) there is an effectively non-contingent obligation to provide financial benefits; and

(B) it is substantially more likely than not that the value provided will be at least equal to the value received,

can be met, particularly given that the amount to be paid in respect of the Islamic bonds is generally linked to the sale price of the asset and it may not be possible to include a guaranteed residual value feature.

In addition to considering the potential assistance of section 25-85 (as discussed below), whether or not the Islamic bonds are treated as debt interests will be relevant to IWT and thin capitalisation issues.

It is worth noting that if the Issuer is a trust, the equity test will not apply, and it will be necessary to revert to the common law to determine the treatment of the arrangement if it does not meet the debt test.

Deductibility of return on certificates issued

As you have identified, to ensure parity with a conventional bond, the return on the certificates would ordinarily need to be treated in the same manner as interest. This should mean that, provided the relevant tests have been met, the payments should be deductible.

Deductibility of the return under section 8-1 may be problematic, notwithstanding that the return is likely to be based on an implicit interest rate, on the basis that the return may be characterised as a distribution of profits rather than an expense or outgoing incurred in deriving the SPV's lease income. This is because it reflects the return on the certificate holders' equity share in the assets being leased. To the extent that the arrangement is treated as a debt interest under Division 974, section 25-85 may assist, although deductions would be limited to the benchmark rate of return plus 150 basis points, which may not ensure parity with a conventional bond issue, depending on the circumstances.

Application of TOFA rules

As you have identified, it will be important to monitor the impact of the discussion paper on the application of Division 230 in relation to securitisation vehicles that is being prepared by the TOFA Working Group to the Finance and Investment Sub Committee of the National Tax Liaison Group. Until this is released, there remains considerable uncertainty as to how Division 230 will apply to securitisation structures.

If Division 230 does apply, and is not restricted due to the arrangement being treated as an equity financial arrangement, it may be of significant assistance in ensuring parity of tax treatment in relation to the Islamic bond issue component of the arrangement. This is because the nature of the return becomes less important than whether a gain or loss arises in relation to the arrangement.

However, it is important that lease backed Islamic bonds are able to access parity of tax treatment outside of the TOFA regime given that many taxpayers are not compulsorily within the regime and it may not be appropriate for them to elect into the regime, depending on their other arrangements.

Application of the IWT provisions

As you have identified, the return on the certificates, or at least a portion of it, may be characterised as "interest" within section 128A(1AB) or deemed to be interest under section 128AC. This should particularly be the case where the implicit interest rate that determines the rental payments on the leases is disclosed in the documentation as the return will be more clearly characterised as being "in the

nature of" or "in substitution for" interest. However clarity on this point should be provided.

The availability of exemptions from IWT appears to be more problematic.

In relation to the public offer test, it is not clear whether an Islamic finance bond would be able to be structured as a:

(i) "debenture" within the extended meaning of section 6(1); or

(ii) "syndicated loan facility" within the meaning of section 128F(11) or (12).

It seems unlikely that the Islamic bond would be treated as a non-equity share.

In relation to whether an Islamic bond could be treated as a "syndicated loan facility", it should be confirmed whether or not the requirement for the agreement to describe itself as a "syndicated loan facility" or as a "syndicated facility agreement" is acceptable under Islamic principles, or whether an additional category could be added to the required nomenclature of agreements to which that element of the exemption may apply. Even if this is acceptable, a very broad interpretation of the phrases "borrower" and "lender" would need to be adopted in order to allow the participants in the lease backed Islamic bond arrangement to meet the definition of "syndicated loan facility". While this may not be insurmountable, this also only provides the exemption in limited circumstances, including where over $100 million is being financed and there are at least two "lenders" (as required by the definition of "syndicated loan"), notwithstanding that the public offer test may have been met. Accordingly, it is important that both the debenture and syndicated loan facility exemptions are available to ensure parity of tax treatment.

In relation to the exemption from IWT that applies to interest paid to certain financial institutions under some double tax treaties, it would be necessary to ensure that the return on the certificate be characterised as "interest" and that the relevant certificate holder can meet the definition of "financial institution". It may be particularly problematic if the certificate holder is an Islamic financier, but is not a bank and, due to the nature of Islamic financing, is unable to be treated as an entity "raising debt finance" or "taking deposits at interest". These issues should be clarified.

Tax treatment of the transfer of the underlying assets

You have identified a number of issues relating to the transfer of assets, including the application of the CGT provisions and their interaction with Division 240 (if applicable). However, it may also be necessary to consider other provisions including whether a balancing adjustment under Divisions 40 or 43 may apply and whether the Originating Entity would still be the "holder" under section 40-40 and would be able to claim capital allowance deductions, which will depend on the nature of the assets and the agreement entered into (noting that pricing of the debt may assist in correcting this treatment if the tax treatment is not corrected). For parity of tax treatment, the transfer of the assets should be ignored for tax purposes and the Originating Entity should continue to be entitled to capital allowance deductions.

(b) **Stamp duty**

The stamp duty payable in relation to a lease-backed Islamic bond would be likely to be a significant impediment to the development of this product.

If the relevant assets are dutiable property, both the transfer of the assets to the SPV and the transfer of the assets back to the Vendor would attract duty.

Duty could also be payable on the issue or transfer of the Certificates depending on how the Certificates can be characterised. If the issue of the Certificates is characterised as the transfer of an interest in the assets held by the SPV and these assets are dutiable property, duty would be payable in all jurisdictions. If the issue of the Certificates is characterised as the transfer of the right to a payment stream, duty would be payable in Queensland[16] and South Australia[17] if the central management and control of the Vendor in one of these jurisdictions.

By contrast, duty is generally not payable in relation to more conventional securitisation arrangements as the underlying assets are often not transferred or a securitisation exemption applies. The securitisation exemptions such as exemptions in relation to asset backed securities are unlikely to apply in relation to the lease-backed Islamic bond.

It should also be noted that Islamic bonds may be issued backed by other forms of Islamic finance structures, and not only leases. The issues raised in respect of such structures may differ from those described above and should be separately considered.

7.2 What can we learn from overseas jurisdictions?

We have not undertaken an extensive review of the treatment of similar transactions in overseas jurisdictions.

7.3 Is legislative change required to address the impediments, uncertainty or complexity in the application of the current law?

While administrative solutions or ATO rulings might address some of the areas of uncertainty outlined above, legislative change is generally preferable as it provides greater certainty than a mere ATO ruling, which may be withdrawn or amended at some time in the future. Additionally, there is no certainty that the ATO would be comfortable in adopting a particular view (eg that the return on Islamic bonds should be treated as in the nature of or in substitution for interest) in relation to a particular issue that would ensure parity of tax treatment, given that they are limited to their interpretation of the legislation.

Accordingly, if ATO rulings will be included as part of the recommendations to be made by the Board of Taxation, we consider that this should only be done if the ATO is able to confirm that it is able to issue a ruling that assists to ensure parity of tax treatment for lease backed Islamic bonds and will provide certainty for potential participants in this market. Additionally, this should only be adopted as a recommendation if the ATO is able to confirm that they are in a position to finalise any required rulings promptly.

7.4 Are there other options such as administrative solutions or ATO rulings?

As outlined at part 7.3, we consider that legislative change is generally preferable to ensure parity and certainty of tax treatment for Islamic bonds. However, ATO rulings or other administrative solutions may be of assistance to the extent they are able to be given promptly, in a manner which ensures parity of tax treatment where legislative change is determined not to be desirable.

7.5 What are the specific provisions or aspects of the law that should be amended?

While the introduction of a specific code to address the taxation of Islamic finance products such as lease backed Islamic bonds, with other tax provisions "switched off" might seem

[16] *Duties Act 2001* (Qld) section 35.

[17] *Stamp Duties Act 1923* (SA) Schedule 2 Part 1 Item 3.

like the simplest option, we understand that the Board of Taxation has been asked to consider whether adjustments can be made to existing tax frameworks to allow parity of tax treatment for Islamic finance products. If this is to be achieved, changes or clarification (by way of legislative change, ATO ruling or similar) should be made in relation to the following provisions/aspects of the law:

(a) **Income tax**

(i) the operation of Division 974 to ensure that the arrangement can be treated as debt;

(ii) the operation of section 8-1 to ensure that the return on the certificates is deductible, notwithstanding that it may be treated as a distribution of profits (which could be achieved using a similar provision to section 25-85, without the restrictions as to the amount of any deduction);

(iii) the definition of "interest" in section 128A(1AB) to ensure the return on certificates is treated as interest;

(iv) the definition of "debenture" in section 6(1) to ensure that the certificates issued are able to be treated as "debentures";

(v) the definition of "syndicated loan facility" in section 128F(11) and (12) to ensure that the bond arrangement can meet the definition (or an extended definition) if it is not a "debenture";

(vi) the operation of the exemption for financial institutions under certain double tax agreements to ensure that Islamic financiers can meet the definition notwithstanding that they may not be regarded as "raising debt finance" or "taking deposits at interest" due to the nature of Islamic finance products to the extent that they would otherwise meet the definition if they utilised the conventional equivalent finance products (noting that this may need to be done by ATO ruling rather than seeking to amend the relevant double tax agreements);

(vii) the operation of the CGT provisions and other provisions that could give rise to gains or losses on the transfer of the assets (eg Divisions 40, 43 and 240) to ensure that the transfer of the assets are ignored for tax purposes; and

(viii) to the extent it is necessary to treat the arrangement between the Originating Entity and Issuer separately from the arrangement between the Issuer and the Certificate Holders, the operation of Division 240 may need to be amended to ensure it applies to the lease leg of the transaction (even if the assets are not goods) to recharacterise this leg of the transaction as a loan.

(b) **Stamp duty**

An exemption should be included in the stamp duty legislation for the transfer of the assets to the SPV and from the SPV back to the Vendor. An exemption should also be included for the issue and subsequent transfer of the Certificates. Such an exemption could be included by extending the application of the current securitisation exemptions so that they apply to the issue of a leased-backed bond and the transfer of the leased assets to the issuer for the purposes of issuing such bonds and from the issuer of the bonds back to the transferor.

7.6 What are the integrity issues?

Integrity issues may arise, in particular, where religion-neutral and/or principles based drafting is used to address impediments or uncertainty around the taxation of Islamic finance. Religion-neutral and principles based drafting is generally preferable because they are non-discriminatory and more likely to allow the development of new Islamic finance products without requiring further legislative or administrative changes to ensure parity of tax treatment compared with conventional western finance products. However, it may also allow opportunities for western finance products to be structured in a manner that would achieve favourable results compared with conventional tax treatment. While it is not intended that any amendments designed to enable parity of tax treatment for Islamic finance products would give rise to concessional tax treatment, the drafting of the provisions would need to be closely considered before and after implementation to ensure that they are not open to abuse by other forms of financing structures.

7.7 Would there be any other tax issues if the Islamic bonds were issued by a sovereign entity such as a state government?

If the Originating Entity was a sovereign entity, such as a state government, Division 250 may apply to recharacterise the arrangement between the Originating Entity and the Issuer [and possibly the Certificate Holders if they would otherwise be entitled to capital allowance deductions] as a loan arrangement, disallowing any capital allowance deductions to which the Issuer may otherwise have been entitled. This may be a less problematic outcome than if Division 250 were not to apply.

8. Case study eight: Islamic risk sharing arrangements

We make no comment on this case study.

9. Considering the terms of reference for this review, please provide any comments you may have on the approaches taken to the taxation of Islamic finance in other jurisdictions.

We have not undertaken an extensive review of the treatment of Islamic finance transactions in overseas jurisdictions. However, we consider that it would be appropriate for the Board of Taxation to consider the treatment adopted in overseas jurisdictions and, in particular, to focus on any lessons that can be learned from the adoption of any changes in those jurisdictions. In particular, any anti-avoidance schemes that have been developed should be considered, along with any measures adopted to restrict such schemes.

Please feel free to call Teresa Dyson on (07) 3259 7369 in relation to income tax or Geoff Mann on (03) 9679 3366 in relation to GST and stamp duty if you would like to discuss any aspect of this submission.

Yours faithfully