Submission: Review of the Taxation Treatment of Islamic Finance

CPA Australia represents the diverse interests of 129,000 finance, accounting and business advisers worldwide. We are committed to working with governments and their agencies to ensure economic and social policies foster an environment that facilitates sustainable economic growth.

Our organisation is supportive of amending our tax laws to help attract Islamic investment and other forms of alternative finance to benefit the economy. Islamic Finance provides the opportunity to boost the Australian economy and help Australia achieve its objective of become a global financial services centre in the Asia Pacific region, being positive for both economic growth and jobs.

Australia has emerged from the GFC with a strong economic position and has a robust regulatory regime. And our geographic position Australia is in a unique position to service Muslims in the Asia-Pacific region and have the platform to attract this increasingly significant component of global finance.

In this light we welcome the opportunity to submit recommendations on the taxation treatment of Islamic finance set out in the Board's Discussion Paper.

This submission is presented in two related parts as follows:

Part 1: Response to four of the specific case studies (Case Studies 1, 3, 6 and 9), and

Part 2: Holistic tax issues.

Our key recommendations are as follows:

1. an economic substance approach is more appropriate for financial products for income tax purposes.

2. An 'integrative' approach as adopted by the United Kingdom would be more appropriate for Australia as it facilitates minor legal and regulatory reforms for alternative financing arrangements generally including Islamic Finance.

3. Regarding the possible options under the integrative method - the listing and exceptions methods – an amalgam of both approaches may be required.

4. Islamic and other alternative financing arrangements highlight the asymmetrical tax treatment of debt and equity in Australia (albeit not confined to Australia), it is noted that the dividend imputation system does ameliorate this problem to some extent and that this general issue is one which would need to be addressed in a broader context having regard to developments in other major jurisdictions.

5. While the accounting standards treatment of Islamic finance transactions in Australia is not entirely clear at present, it would be desirable for there to continue to be an alignment with the tax and accounting treatment of Islamic finance transactions going forward.

6. CPA Australia considers it preferable for legislative drafting to refer where necessary to alternative financing arrangements rather than something more specific such as 'Islamic financing arrangements or products'.

CPA Australia also acknowledges the contribution of Dr Brett Freudenberg from CPA Australia's Taxation Centre of Excellence to the preparation of this submission.

Please contact Garry Addison (ph. 03 9606 9771) in the first instance if you have any queries in relation to this submission.

Part 1 - Responses to specific case studies and questions

Please find below responses to the questions raised in Case Study 1, Case Study 3, Case Study 6 and Question 9.

We note that the 'case study' approached used in the Discussion Paper may lead to more of a 'specific provisions' approach. Rather than the specific questions raised about each case study, we suggest a more holistic approach may be appropriate. These holistic issues are considered in Part 2 of the paper.

Case Study 1: Cost plus profit sale (of a rental property)

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

In general, we agree with the tax consequences outlined in this case study. In our opinion however, the issues of timing, early settlement and client default may need to be considered using the worked example on page 28. Each of these issues are discussed below

Timing

There may be some potential problems with the recognition of the finance charge as income. For example, if the financier uses the 'fixed mark-up' profit calculation, the monthly profit to be included in assessable income (under TOFA tax timing rules and accruals method) would be spread evenly over the life of the financial arrangement – that is $1,601.42 per month (384,341/ 240) or a fixed total of $19,217.05 p.a. over 20 years. For a conventional financier using standard annuity modelling, the annual interest to be included in assessable under a conventional mortgage would (say, over the next 3 years) be: Y1: $29,965.02; Y2: $29,331.84; Y3: $28,643.38 and so on. The position outlined in paragraph 4.11, advocates that assessable amounts under both Islamic and conventional arrangements should be the same to maintain tax parity. There is the potential for some disparity, and consideration should be given as to whether the income treatment can be standardised.

Early settlement

Many Islamic institutions offer clients an *ibra* as an incentive for early settlement. Resolution 92 of the Shariah Advisory Council of Bank Negara (SACBN) regards ibra as 'giving discount on price or reducing the debt of the customer'. SACBN Resolution 88 regards ibra as surrendering a right over debt. In terms of the Asset sale Offer and Acceptance, a price reduction so conceived in substance is a reduction of debt. Consequently, the extent to which debt has been reduced has relevance to the CGT cost base for the client. Further if the profit component is not deductible to the client under s8-1 (see para 4.9) the extent of the debt reduction is also not assessable. This then raises GST issues if the home was a new dwelling and how this should be adjusted for.

Client Default

In the event that there is client default there may be problems with earned and unearned profit. Many debt defaults based on the BBA facility (the Malaysian equivalent to the case study in question) resulted in inconsistent judgements in Malaysian courts. From the various judgements, it seems that under the BBA facility, when there is a default by the borrower, it is not equitable to allow the financier to recover the ‘sale price’ when the tenure of the facility is prematurely terminated. That is, the financier is not entitled to the ‘unearned’ profit for the unexpired portion of the loan (*Affin Bank Bhd v Zulkifli Abdulla* [2006] 1 CLJ 438, High Court). Effectively, as the court construed the BBA facility as a loan, a claim for the unearned portion was denied. In the most recent case bank *Islam Malaysia Bhd v Azhar Bin Osman*, it was held ‘where the BBA contract is silent on issue of rebate or the quantum of rebate, by implied term I hold that the bank must grant a rebate and such rebate shall be the amount of unearned profit as practiced by Islamic banks,’ Given these developments and the associated problems with CGT and GST, it seems logical that default issues are addressed.

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?

We consider that Case Study One illustrates the biggest impediment to Islamic finance, that being the uncertainty surrounding the current appropriate tax treatment. In particular what is the current tax treatment of the Islamic financing charge as part of the instalments.

As mentioned in the Board’s Discussion Paper, the current income tax provisions may be adequate, although this is not certain. Accordingly it could be a matter for interpretation by the ATO or alternatively, appropriate legislative amendments to provide adequate clarification of the position for affected taxpayers, or even both if necessary. Without greater certainty in this area it is hard to envisage Islamic finance being broadly adopted.

1.3 How could tax neutrality be achieved in relation to: (a) income tax, (b) stamp duty; (c) GST?

Greater tax neutrality could be possible through greater utilisation of an ‘economic substance approach’ in applying Australia’s tax laws. Islamic finance highlights the fundamental problem of legal versus economic application of Australia’s tax laws. While a legal interpretation may be simpler, it can lead to anomalies and undesired complexities. In comparison, an economic approach can be more complex but lead to greater tax neutrality through taxing economically similar transactions the same. When it comes to financial products, it would appear that an economic substance approach is more appropriate for tax purposes as it would generally be consistent with the existing law.

It is therefore recommended that amendments to the relevant income tax assessment acts be based on an economic substance approach where appropriate such as in relation to financial products. The question in this context is whether economic ownership/ risk has essentially been transferred from the financier to the borrower or not.

We doubt, however, whether stamp duty should be based on an economic substance approach as it is essentially a transactions based tax and, in any event, any changes to it would be a matter for the relevant states. CPA Australia also considers there is also a strong argument that state duties are inefficient taxes and should be removed.

In the case of GST, there is a strong argument in our view for GST to apply directly to financial supplies in lieu of the current input-taxing approach if that is now feasible as it appears to be.

In ascertaining whether an economic substance approach should be applied more broadly at this stage, there would be a need in our view to have at least a 'whole of contemporaneous contract approach' to interpreting what will occur. This could build upon the concepts already in Division 974.[1] This is important because the difficulty is that to determine the precise 'nature' of what is occurring, one needs to look at a number of contemporaneous contracts/documents at the same time. It is only once all this documentation is considered that you can determine the true substance/economic effect of the transaction. Consequently, to ascertain the 'economic' substance, one needs to consider all contemporaneous documents concerning a transaction – it is only then that it can be truly ascertained what is really occurring economically.[2] Nevertheless, any further significant extensions of the economic substance approach beyond financial products would in our view warrant a separate review in its own right.

In the case study it was suggested that s 118-20 should reduce the capital gain of the financier to the extent an amount is already included in its assessable income due to the disposal. This should be correct provided that the 'financial charge' is recognised as income for the Islamic financier. If it is not recognised as income, then the receipt of capital proceeds by instalments would mean that the financier would have to take into account their exposure to CGT at an earlier date[3] even though the entire capital proceeds will not be received for an extended period.[4] We suggest that to ensure that the 'finance charge' is recognised as income, there should be the introduction of a generic term of 'financial charge' into the tax legislation. Such a financial charge would be assessable income for the financier – and would represent the 'cost' of finance for a borrower and would be deductible under the general notions of section 8-1 (if appropriate). This would be complimented by a requirement for financiers to disclose this finance charge in documentation and thus enable the borrower taxpayer to claim (if appropriate) a deduction. The notion of a finance charge could be similar to the finance charge already utilised in Division 240. This should also be complemented by introducing such a term into Australia's Double Tax Agreements and withholding tax provisions.

Also, Islamic finance products highlight the problematic treatment of 'financial supplies' for GST proposes as input taxed – as it is uncertain whether some of the Islamic financial products would not be regarded as financial supplies as per the GST regulations. In the

[1] *ITAA 1997* (Cth), subsection 974-10(3).

[2] *ITAA 1997* (Cth), subsection 974-10(3) Another object of this Division is that the combined effect of related schemes be taken into account in appropriate cases: (a) to ensure that the test operates effectively on the basis of the economic substance of the rights and obligations arising under the schemes rather than merely on the basis of the legal form of the schemes; and (b) to prevent the test being circumvented by entities merely entering into a number of separate schemes instead of a single scheme.

[3] Generally, date of contract for CGT event A1, ITAA 1997 (Cth), section 104-10.

[4] ITAA 1997 (Cth), section 103-10.

main, the GST treatment of financial supplies needs to be addressed and given the technological advances, the ability to subject financial supplies to GST as a taxable supply should be reviewed.[5]

In terms of the possible current GST treatment of a Cost-plus-profit sale, the Board is referred to the work of Penning who argues that the supply should be regarded as a Taxable Supply for both transactions: Penning, R. (2010). Islamic Finance : A GST Taster. In *22nd Annual GST and Indirect Tax Weekend Workshop*: ATAX UNSW, pp 11-11 to 11-14.

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

No different.

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

We understand that the Victorian Government is the only State/Territory Government that has to date introduced special duty exemptions for Islamic financing transactions effectively to remove double duty charges on a second dutiable transaction in a relevant property transaction.

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

Our understanding is that they have been favourably received.

[5] It should be noted that the Henry Report (2009) considered that the current GST treatment of financial supplies is inefficient, reducing competition and harms Australia's quest to become a finance hub.

Case Study 3: 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?

As previously stated, basing the tax treatment on the 'form' of a lease may provide greater certainty, but considering an economic substance approach is more appropriate.

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

As previously noted, we are broadly in agreement with the view that amendments to the income tax assessment acts in relation to financial products be based on an economic substance approach. What particularly needs to be considered in this context is whether economic ownership/risk has been effectively transferred from the financier to the borrower? If so, then it may be deemed for tax purposes that a transfer has occurred.

The Taxation of Financial Arrangements (TOFA) regime is, of course, another major example of the application of an economic substance approach to financial products.[6] Also,

[6] The TOFA regime is based on a more economic or substance based approach to taxation: (Australian Financial Centre Forum. (2009). Australia as a Financial Centre: Building on our Strengths. Barton: Commonwealth of Australia at p 71.) Also recognising the economic effect has been used by the Australian government as an integrity measure to restrict taxpayers manipulating legal forms. For example, to address the sheltering of income in a business entity, the personal services income provisions disregard the business form for tax purposes and allocate the income and or losses directly to the person performing the personal services (The operation of these provisions restrict taxpayer's ability to shelter personal services income in an entity taxed at a lower rate, to split income among a number of taxpayers, and the ability to access concessional fringe benefits and superannuation provided to employee-members. *ITAA 1997* (Cth), section 86-15. The personal services income provisions are contained in Division 84, 85 and 86). Another example of transparency as an integrity measure is the tax consolidations of corporate groups, as it disregards, for tax purposes, the separate legal entities (of corporations) and allocates all income and losses to the head corporation (*ITAA 1997* (Cth), Division 700). Tax 'consolidation' was introduced as an integrity measure to stop members of a corporate group manipulating transactions between them that could result, for example, in loss cascading Another example is the Controlled Foreign Companies and Foreign Investment Funds provisions which endeavour to address taxpayers sheltering income

if the item being financed is a ‘good’, then it is possible for tax purposes that Division 240 will treat the hire purchase as a sale immediately for tax purposes – even though legally this does not occur until the end of the arrangement.[7] When Division 240 applies, this allows the borrower to claim depreciation on the good, as well as interest deductions for the ‘notional finance charge’ embedded in the repayments. In these circumstances there is greater parity between conventional and Islamic finance arrangements. However, Division 240 only applies to ‘goods’, so the tax disparity would exist for the hire purchase of ‘land’.

In ascertaining the economic substance of an arrangement, a ‘whole of contemporaneous contract approach’ is recommended (refer to prior comments).

It is also recommended that Division 240 apply to all hire-purchase arrangements and not just ‘goods’. For CGT purposes, this can be complimented by CGT event B1.[8]

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

As previously outlined, complementary to the ‘economic’ approach is the introduction of a generic term of ‘financial charge’ into the tax legislation – which would represent the ‘cost’ of finance for a borrower and would be deductible under the general notions of section 8-1. This would be complemented by a requirement for financiers to disclose this finance charge in documentation and thus enable the borrower taxpayer to claim (if appropriate) a deduction. The notion of a finance charge could be similar to the finance charge already utilised in Division 240 which essentially equates to the difference between the sale and purchase price.[9] This would also be complemented by introducing such a term into Australia’s DTA and WHT provisions.

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overseas in a foreign legal entity by allocating the income to the member even though there has been no distribution (*ITAA 1936* (Cth), section 316: CFCs, and *ITAA 1936* (Cth), section 468 (Part XI): FIF.). Also luxury car leases are deemed to be sale and loan transactions – which thereby allow luxury car depreciation limits to apply (*ITAA 1997* (Cth), Division 242). Similar avoidance notions underpin Division 250 leases between taxpayers and tax preferred end users.

[7] Income Tax Assessment Act 1997 (Cth), Division 240.

[8] ITAA 1997 (Cth), section 104-15.

[9] However, further consideration needs to be given as to whether this would extend to the notions of ‘profits’, which if done, would achieve greater neutrality between debt and equity.

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

As previously outlined, Division 240 would not apply as the item being financed is not a 'good' and thereby currently would not apply to house purchase. Accordingly, for the financier it is not certain as to whether the finance component would be recognised as income or part of capital proceeds.

Furthermore, there is some doubt as to whether the main residence exemption would be available to the purchase of a home on a deferred payment arrangement that does occur under the Islamic financial product known as an *al-ijarah bit-tamleek* contract. [10] However, it is possible that CGT event B1[11] could apply to make the CGT event occur when the taxpayer first obtains the use and enjoyment of the asset. This is then complemented by section 118-130 which can allow the main residence exemption to apply from the date the taxpayer has the right to occupy even though ownership interest has not passed. This conclusion is supported by now withdrawn ATO ID 2004/58.

[10] Chotai, A. (2008). Tax and Religion. In *23rd National Convention*. Adelaide: Taxation Institute of Australia, at p 10. *Income Tax Assessment Act 1997* (Cth), section 118-110 provides the exemption for a main residence.

[11] Section 104-15 ITAA 1997 (Cth).

Case Study 6: Profit and loss sharing partnership (Musharakah)

In view of legal problems encountered in Malaysia surrounding the application of the 'cost plus' method, many Islamic financial institutions have resorted to the *musharika mutinaqisa* (diminishing partnership) financing model along the lines developed by the Arab Banking Corporation in the United Kingdom, Meezan Bank and various cooperatives in Canada. Although the abovementioned model is considered in Case Study Six, its tax implications in relation to home financing should also be considered.

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

The problems outlined in the Board's Report are similar to venture capital investments which saw the introduction of the flow-through treatment to try to bring about some parity between debt and equity investment.

In considering potential reforms, it is worthwhile reflecting upon the experience with venture capital in Australia. Breaches of tax neutrality were clearly implicated in the introduction of the venture capital incorporated limited partnerships (ILP). Tax transparency was to achieve the economic ideal of improved tax neutrality in terms of debt and equity funding and import–export neutrality. If an entity tax system or an imputation system applied to venture capital ILPs then this could tax equity funding more heavily than debt. This larger tax burden is due to equity and profit payments not being deductible, whereas the payment of interest on debt is. Also, non-resident members may not be able to claim foreign tax credits in their home jurisdiction for tax paid at the entity level. Additionally, tax transparency allows non-taxable entities to be members without tax being imposed at the entity level.[12] It is argued that tax transparency for venture capital investments is best understood in terms of trying to achieve improved tax neutrality between equity and debt funding for non-resident members rather than just the flow-through of losses and tax preferences.

[12] Barkoczy, S, and Sandler, D. (2007). *Government Venture Capital Incentives: A multi-jurisdiction comparative analysis*, Research Study No 46. Sydney: Australian Tax Research Foundation, at p 16: quoting Sandler, D. (2004). Venture Capital and Tax Incentives: A Comparative Study of Canada and the United States, Canadian Tax Paper No 108, Canadian Tax Foundation, Toronto, at p 9.

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

It is not clear to what extent there would be demand for Musharakah, although a report commissioned by the Menzies Research Centre recommended some better alternatives to home financing including one which was greater equity participation by financiers.[13] It is such an equity participation that occurs with a Musharakah.[14]

6.3 Should the income from the arrangement described in Case Study Six be treated, in substance as: (a) a repayment of principal and interest, or (b) income or loss from a partnership; or (c) ordinary business income.

When at the beginning of the arrangement it is the intention of the parties that the financier be bought out by the borrower, then it is suggested that the arrangement be treated as a repayment of principal and interest. Again, this conclusion requires a contemporaneous document approach to achieve this outcome.

[13] Menzies Research Centre. (2003). Innovative Approaches to Reducing the Costs of Home Ownership.

[14] Also some states such as Queensland and Victoria have granted favourable stamp duty concessions to housing cooperatives such as the Starr Bowket societies. It may be worthwhile that the Board consider the tax implications of Islamic housing cooperatives that are ideologically equivalent to Starr-Bowkett societies. According to Darnell (2007):'Starr-Bowkett Societies are, in essence a form of terminating Building Society but differ from building societies and co-operative housing associations in that Starr-Bowketts do not borrow money to fund loans and do not charge nor pay interest. All monies subscribed to the society are the only monies available for loan and it is this distinctive feature that gives Starr-Bowketts the appellation of the most pure form of co-operative finance.'

6.4 How could the appropriate income tax treatment be achieved?

Given the potential complex nature of these arrangements, it is suggested that a carve-out form the normal general and limited partnership tax rules apply. The position in the United Kingdom is to provide very prescriptive requirements for this carve out to occur – these conditions include:

- both a financial institution and other person acquire a beneficial interest
- eventual ownership must have exclusive right to occupy or use the asset;
- eventual owner must be required to make payments to the financial institution which will amount in aggregate to the price paid by the financial institution for its share of the asset, and must acquire the financial institution's beneficial interest as a result of those payments; and
- the eventual owner must be exclusively entitled to any income or growth in value from the asset. [15]

In such circumstances in the United Kingdom, the payments to the financial institution comprise an 'alternative finance return' (i.e. finance charge) unless they represent payments for acquisition of an interest in an asset or set-up costs.

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

No comment.

[15] Note there is some flexibility provided with this. See: Amin, Mohammed. 2008. Taxation of conventional and Shariah compliant mortgages, edited by P. LLP: PriceWaterhouseCooper LLP.

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

Amendments should be considered to CGT event B1 and section 118-130 to ensure that they would apply to such arrangements with the eventual owner treated as acquiring the asset at the date of first being able to use the asset (home).

6.7 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?

As described above, provided prescriptive measures were met then a carve-out from the normal partnership provisions could apply.

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

No comment.

Question 9: Comments about approaches other jurisdictions have taken

9.1 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.

A number of countries have adopted one or more (or a mixture) of approaches in implementing tax changes to facilitate Islamic finance based on necessity, convenience and other considerations. Collectively, these crystallise into a number of broad-based identifiable approaches that are dealt with below. An overview of the different approaches by the United Kingdom and Malaysia is presented in Table 3. A more detailed discussion of how this was achieved also follows.

Table: Islamic Finance: Tax and Regulatory Frameworks

Detail	Malaysia	United Kingdom
Models	Dual Islamic/Conventional banking and finance model Islamic Banking Act 1983 Banking & Financial Institutions Act 1989	Integrative model Finance Act (2005) (FA) Income and Corporation Taxes Act (1988)
Supporting institutions	Bank Negara Malaysia Malaysian Securities Commission Companies Commission Bursa Malaysia	
Special legislation to facilitate Islamic finance	Income Tax Act 1967 applicable to both Islamic and conventional finance Islamic Banking Act 1983 s124 of the Banking and Financial Institutions Act 1989 (BAFIA) provides for licensing of Islamic banking by non-Islamic banks and institutions s316 & 317 of the Capital Markets	Chapter 5, Finance Act 2005 dedicated to alternative finance arrangements Laws do not distinguish between Islamic and conventional finance

	and Services Act 2007 allow dealing in Islamic securities that require special types of agreements and legal documentations to facilitate securities dealing	
Tax implications for Islamic financial instruments	Income Tax Act 1967 (ITA) s2(7) Reference to interest also applies to 'gains or profits' received and expenses incurred in lieu of interest in shariah compliant transactions s18 Part III insurance premiums include 'instalment payments' under any Takaful scheme 'Profits' paid to depositors on	Chapter 5 of FA provides for appropriate tax treatment of Islamic finance transactions s47 defines 'alternative finance arrangements' (AFA) s47(1) and s52 sets out nature of arrangements contemplated as AFA 'Profits' in AFA in substance equal to return on investment of money at interest – s47(1)(d)

	Wadiah and *Mudarabah* deposit accounts treated as allowable deductions for banks 'Profits' part of gross income for depositors s55 to s58 Musharaka arrangements treated akin to partnership or JV's s33 and s39 Ijarah contracts treated as lease arrangements Assets acquired under BBA or Murabaha construed as 'qualifying capital expenditure' and capital allowances treated as if asset acquired under hire purchase contract	AFA only available to financial institutions s47(2)(a) 'Effective return' defined in s47(3) 'Alternative finance return' (AFR) defined in s47(5)
Treatment of 'Profit'	Equal treatment of Islamic & conventional finance:	Arrangements giving rise to 'profit share

	Profits from Islamic finance products taxable just as interest income Profits paid deductible if funding used to generate income Rules for interest withholding tax and interest exemptions apply to 'profits' as well Profit distributions not to be treated as dividends for tax purposes	returns' (PSR) defined in s49. That is, profits paid to depositors. Payments so made equate in substance to investment of money on interest For persons other than companies, payments of AFR and PSR deemed expenses. Available to persons engaged in trade, profession or vocation PSR not to be treated as a 'distribution' for purposes of Corporations Tax Acts – s209(2)(e)(iii) of ICTA
Tax Neutrality	s2(8) (ITA)meant to provide tax neutrality Tax excludes '...any disposal of an asset or lease by or to a person pursuant to a scheme of	Tax neutrality issues discussed in detail in Financial Services Authority paper 2007 Proposes a non-discriminatory regime or 'level playing field'

	financing...where such disposal is strictly required for the purpose of complying with those [shariah] principles but which will not be required in any other scheme of financing’	The FSA’s approach can be summed up as ‘no obstacles, but no special favours’
Stamp duty on reals estate transactions	Double stamp duty provisions removed in transactions falling within the definition of shariah complaint instrument	Stamp Duty land Tax (SDLT) on second transfer of property eliminated in relation to murabaha and diminishing musharaka transactions

1.1 Total absorption approach

Specifically a 'total absorption' model refers to the commitment by a country to initiate efforts to completely Islamise its banking systems.[16] Countries such as Sudan and Iran have adopted this approach and associated measures to completely supplant conventional finance law with shariah commercial law. Pakistan is another country that has adopted this approach which, although required to fully Islamise its banking system,[17] has avoided doing so for a number of economic and socio-political reasons.[18] The common concern of these countries is their preference for a financial system aimed at completely eliminating the use of interest economy-wide.

As a secular country, and to the extent that conventional finance is an extrinsic part of the financial system, it is not recommended that Australia adopt the total absorption approach.

1.2 A dual model approach

A 'dual model' approach is a departure from the 'total absorption' approach in that it recognises the integrative duality of financial systems in which Islamic finance exists parallel with conventional finance. That is, Islamic banks operate side by side with conventional banks. This model was first initiated in Malaysia and adopted by other countries such as Brunei, Indonesia and Bahrain. In relation to Malaysia, the dual Islamic/conventional financial model is recognised as one of the most mature in the world demonstrated by a well-developed dual Islamic and conventional banking and finance infrastructure. Much of this progress is attributable to its groundbreaking *Islamic Banking Act 1983* and the subsequent establishment of its first stand-alone dedicated Islamic bank (Bank Islam Malaysia Berhad). The maintenance of this dual model has added depth to the nascent Islamic banking industry. The extent of its reach now includes an Islamic capital market; an Islamic securities

[16] Securities Commission Malaysia (2009, pp. 32-33) *Introduction to Islamic Capital Markets*, Kuala Lumpur, Lexisnexis

[17] Recommended in the Council of Islamic Ideology (CII) *Report of the CII on Elimination of Interest* (June, 1980). Further, Article 29(f) of the Constitution of Pakistan (1956) provides that 'The State shall endeavour to …eliminate riba as early possible'.

[18] Mehmood, A (2002, pp.675-704) Islamisation of Economy in Pakistan: Past, present and Future

(sukuk) market and, a stock market with dedicated Islamic exchange traded funds, mutual funds and a shariah compliant stock market index.[19]

For this reason, the Malaysian government in collaboration with Bank Negara, the Securities Commission, the Inland Revenue Board of Malaysia and the finance industry are pursuing a strategy of developing the country as an international hub for Islamic banking and finance. Towards this end, the government has announced a range of tax initiatives, which include for instance a tax exemption until 2016 on the management fees received by fund managers for managing Islamic funds[20]; and withholding tax exemptions on profits received from Sukuk issued in Malaysia.[21] The Malaysian authorities' adoption of facilitating Islamic finance is set out in its Capital Market Masterplan.[22] While this broad thrust merely sets out the governments' intentions, the detailed regulatory, accounting, auditing and tax requirements were left to the Malaysian Securities Commission to address.[23]

While there is some benefit to the dual model approach it necessarily involves greater infrastructure (legal and regulatory) – and it is doubtful whether the potential of Islamic finance for Australia would warrant this. Also, characteristics unique to Malaysia (as opposed to Australia) mean that the investment infrastructure would not make this feasible or viable, particularly as Australia does not have the proportion of Islamic followers as Malaysia does.

1.3 An integrative approach

An 'integrative approach' is one that targets selective changes to tax law and financial regulations to facilitate the operationalisation of Islamic finance within the economy. As such,

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[19] Securities Commission, Malaysia. (2004). *Capital Market Development in Malaysia: History and Perspectives*. Kuala Lumpur: Author.

[20] A total of fourteen licences have been issued allowing international companies to establish Islamic fund management business and take advantage of tax exemptions. One of these companies is Saturna Sdn the Malaysian unit of Saturna Capital LLC – one of the biggest shariah-compliant stock fund in the U.S.
Permatasari, S. (2010, August 16). Islamic U.S. Mutual Funds Flocking to Malaysia: Islamic Finance. *Bloomberg BusinessWeek*, from http://www.businessweek.com/news/2010-08-16/islamic-u-s-mutual-funds-flocking-to-malaysia-islamic-finance.html

[21] (PwC, Malaysia, Asia's Islamic Finance Hub, August 2008, p 61). Doc 35 at p 35:

[22] Securities Commission Malaysia (2001) Capital Market Masterplan, Strategic Initiative 6.3 p. 112

[23] See the Securities Commission publication Regulatory Requirements, Legal Documentation, Accounting, Auditing and Taxation in the Islamic Capital Market (2009)

statutory impediments inherent in tax and financial regulations are separated out for special consideration to allow the seamless integration of Islamic financial practices within a conventional banking and finance architecture. In this process, selective tax law changes must maintain the integrity of existing prudential laws *ex ante*.

The United Kingdom tax authorities have adopted such an approach.[24] We also note that, in some ways the Malaysian approach also demonstrates some characteristics of an integrated approach. The UK response suggests that allowing minor legal and regulatory reforms would not fracture the existing regulatory regime in order to facilitate Islamic finance. The reason for the United Kingdom authorities opting for minimal tax changes is firstly, to allow the market to dictate future changes since novel ideas need to be thoroughly tested first before major statutory changes are enacted. Secondly, as evidenced in the collapse of the Islamic Bank of South Africa Ltd in 1997, absence of laws regulating alternative financing arrangements can create uncertainty.[25] Thirdly, the debt-equity problem that characterises Islamic finance contracts may lead to tax arbitrage through tax law lacuna[26] since, at the corporate level, tax entities will shift between tax-favoured alternative Islamic/conventional instruments to minimise tax obligations which effectively defeats the objective of tax neutrality.

For example, the United Kingdom's approach for treatment of *musharaka* (partnerships) profit is that it be treated as 'interest' for income tax purposes if the following occurs:

[24] Treasury, H. (2008a). The development of Islamic finance in the UK: the Government's perspective. Retrieved February 20, 2009. from http://www.hm-treasury.gov.uk/fin_islamic_finance.htm.

[25] Nathie, M. (2010). Islamic Bank Failure: A Case Study. *International Journal of Islamic Finance, 2*(1), 7-35.

[26] The OECD (2009, pp 9-11) defines arbitrage as referring 'to the earning of a relatively high after-tax rate of return through tax-favoured instruments, strategies or organizational forms, while financing this using a low-tax source. For example, a high tax bracket investor can borrow from a tax-exempt lender, with the result that the borrower deducts the interest cost while the lender is not taxed on the receipt of the interest. As a result of these behaviours, for any specific investor, the tax system is not neutral. This can lead to imperfections in the workings of capital markets and undesired distortions in the allocation of resources. Tax arbitrage can potentially eliminate tax, or even result in tax rates being negative. The globalisation of finance has expanded the opportunity for arbitrage by facilitating the exploitation of differences in tax treatments across jurisdictions.

One of the parties to the arrangement must be a Financial Institution[27]
The arrangements must be of the type and nature described in the legislation including that the eventual owner must 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
The alternative finance return or the profit share return must equate to, in substance, a return on an investment of money at interest.

Using the United Kingdom approach as a benchmark, a proposed Australian integrative model will require present tax and regulatory dispensations to be used as a benchmark platform. Then, as experienced in Malaysia, standardised Islamic banking and finance instruments and practices[28] are superimposed over the benchmark platform to establish a 'best fit' outcome. Admittedly, in this process some norms underlying Islamic finance will not fit well with Australian conventional banking and tax norms – such as the requirements for special Shariah Advisory Councils.[29] However, the United Kingdom and Malaysian approaches show there are many commonalities in tax treatment of Islamic finance instruments that may be emulated.[30] Where disparities are great, refinement in areas of 'least fit' may be identified and separated out for special attention. Through this process, it may emerge that Islamic finance instruments themselves may need to be redefined[31] to converge with conventional instruments and practices. Considering changes to United

[27] For United Kingdom purposes this includes a bank, a building society, a wholly-owned subsidiary of a bank/building society. Authorised consumer credit or hire purchase providers.

[28] One complying with standards set out by The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and adopting the prudential banking and risk management guiding principles established by the Islamic Financial Services Board (IFSB)

[29] See Irbil, Z., & Mirakhor, A. (2004). The development of Islamic financial institutions and future challenges. In S. Archer & R. A. Abdel Karim (Eds.), *Islamic Finance: Innovation and Growth*. London: Euromoney Books.

[30] Securities Commission Malaysia (2004). *Capital Market Development in Malaysia: History and Perspectives*. Kuala Lumpur: Author. See also Khir, Gupta & Shanmugam (2009)

[31] McMillen, M. J. T. (2001). Islamic Shari'ah-Compliant Project Financing: Collateral Security and Financing Structure Case Studies *Fordham International Law Journal, 48*. See also DeLorenzo, Y. T., & McMillen, M. J. T. (2007). Law and Islamic Finance: An Interactive Analysis. In S. Archer & R. A. Abdel Karim (Eds.), *Islamic Finance: The Regulatory Challenge* (pp. 132-197). Singapore: John Wiley & Sons (Asia); Iqbal, Z., & Mirakhor, A. (2004). The development of Islamic financial institutions and future challenges. In S. Archer & R. A. Abdel Karim (Eds.), *Islamic Finance: Innovation and Growth*. London: Euromoney Books.

Kingdom tax law thus far, the United Kingdom Financial Services Authority and Treasury taskforce entrusted with the facilitation of Islamic finance seem to have favoured 'minimal' changes through a 'gradual' implementation process.[32]

Minimal changes focus on minor revisions or amendments to tax law and regulations by resorting to new conceptualisations and definitions of 'conventionalised' Islamic financial practices, concepts and instruments. The reasons advanced for this treatment is the establishment and maintenance of the universality of comparative conventional and Islamic financial practices, even if these do not strictly meet all the requirements under shariah law. In other words, while the United Kingdom authorities are prepared to adopt a religiously neutral stance in tax treatment, it does not want to compromise the efficacy of stable conventional finance and tax law.[33] Further, by implementing changes gradually, the integrative process addresses time criticality in response to: market demand; innovative ideas to flourish without legal hindrance; preventing rushed changes and, ensuring plurality of financial alternatives through standardisation.[34] A number of methods have emerged in the implementation of the integrative approach such as: a listings method and the exceptions method.

Possible options under the integrative method

1.1.1 Listing method

One method used for the integrative approach involves identifying and then 'listing' all requirements that impede the introduction of Islamic finance. Tax and regulatory reform is then targeted in terms of priority and necessity. For instance, an impediment identified in Australian tax law that may require change with respect to *ITAA 1936* and *1997* (Cth) may include a broadening of the definition and meaning of 'interest' as expense or revenue. However, because of the economic definitions of debt and equity now in the ITAA 1997 there may be no need for changes – indeed all that may be required is clarification that Islamic 'rent' for instance will be treated as 'interest' for Australia tax purposes – somewhat similar to what the Malaysian authorities resorted to. While Islamic finance products sometimes

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[32] H M Treasury (2008a; 2008b; 2009)

[33] See www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/SP118.shtml comments by Howard Davies

[34] See AAOIFI

attempt to couch borrowing charges as an expense rather than 'interest' by characterising it as 'rental', from an economic standpoint it may be construed as retaining the substance of interest.[35] As this example illustrates, the rigorous process of tax reform would commence with appraising the economic substance of expense and revenue treatment of Islamic instruments. This allows for a comprehensive appraisal of what the tax treatment is intended to achieve instead of addressing minor changes on an ad-hoc basis. In practice, achieving tax reform through a listings method may be very tedious especially where changes straddle different pieces of legislation. Moreover, it must be acknowledged that there is no real 'list' of financial impediments and inhibitors. Moreover, the four major Islamic juristic schools are not in complete agreement with respect to areas of shariah compliance making it difficult to conceive an accepted list of impediments. One of the challenges with Islamic finance is the varying interpretation of Islamic law, leading to different banking and finance practices. Thus it is not unusual to find that Islamic financial products themselves vary greatly. However, it may be possible to identify key issues that are common in all Islamic instruments that require special tax and regulatory attention.

1.1.2 Exceptions method

Another method identified in the implementation of the integrative approach is the 'exceptions' method.[36] This method assumes that Islamic financial instruments and practices substantially conform to their conventional equivalents albeit with important *exceptions* that may require special attention. Legislators therefore, only need to address 'exceptional'

[35] For instance in an Islamic home finance lease *(al Ijara Thumma al-Bai)* it is not uncommon to find lease charges described as 'rentals' that effectively vary with home loan interest rates. The mathematics of these calculations appears in Khir, K., Gupta, L., & Shanmugam, B. (2009). *Islamic Banking: A Practical Perspective*. Kuala Lumpur: Pearson Longman (pp. 151-153). See especially Section 2(7) of the Malaysian Income Tax Act 1967 that provides the basis for the treatment of profits similar in nature to the treatment of interest for tax purposes (Securities Commission, *Regulatory Requirements, Legal Documentation, Accounting, Auditing and Taxation in the Islamic Capital Market* (2009, p. 214)

[36] First championed in management theory, the 'exceptions' approach is premised on the assumption that the firms' operations will not differ significantly from planned (normal) outcomes and that attention will be focussed on deviations from normality – i.e. deviations will require more investigation and attention.

issues and only in situations where deviations from acceptable norms and standards are significant. As an example, consider the Islamic *diminishing musharaka* home financing instrument whereby a client pays occupational rent on a home under a separate lease agreement. As joint owners, both client and bank are assessable as partners of the rental income in proportion to their respective capital contributions fashioned under a partnership agreement. In practice, the clients' share of rentals plus agreed periodic capital repayments are used to diminish the banks' equity in the partnership. Argued in terms of economic substance, the scheduled equity buy-back instalments mimic the conventional mortgage capital instalment schedule while the 'rental' portion mimics interest charges. Presently, the clients' share of rental income may constitute assessable income under s 6-5 of ITAA 1997 (Cth) unless the mutuality principle applies. If the mutuality principle does not apply, having to pay the occupational rent and receive a portion back as income, can the client offset one against the other? If not, paying both rental and instalments and being taxed on rental income financially disadvantages the client.

In dealing with this problem, the Malaysian tax authorities for example, treated this arrangement as an 'exception' as no specific tax legislation was in place. Consequently, it merely amended sections of its Income Tax Act 1967 (ITA) to restore neutrality. Thus, it simply regarded the *musharaka* financial arrangement as akin to a partnership – to be construed and taxed as such, thereby conveniently avoiding complicated changes to its ITA. The desired effect was achieved by simply changing the definition of a partnership to include musharaka. In relation to other Islamic financial instruments, the Malaysian tax law was amended and now defines instruments in terms of their equivalent Arabic connotations instead of settling for conventional equivalents as adopted by the United Kingdom authorities.[37] However, the United Kingdom's decision to avoid religious connotations to define financial instruments was meant to offset religious bias, maintain product tax neutrality and to ensure orderliness of product description under the United Kingdom Regulated Activities Order.

For the United Kingdom there was a free standing set of definitions for use in its tax law. For transactions which fall within these definitions, the legislation specifies how to determine the 'financial cost' and how that financial cost is to be treated by both the payer and the

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[37] Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., & Ravalia, A. (2007, pp. 12-13). *Islamic Finance in the UK: Regulation and Challenges*. Retrieved January 20, 2008, from http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf.

recipient. Broadly speaking the financial cost is brought within the same tax rules as those that apply to interest.[38]

Thus, the United Kingdom governments' decision to pursue Islamic finance through targeted reforms of tax rules may be construed as serving both the public interest and neutrality criteria without disturbing the prevailing tax regime.[39] Indeed, the approach advocated by the United Kingdom tax authorities increases the latitude of the legislature without in any way restricting its operationality. The Bank of England and the Financial Services Authority (FSA) adopted an 'open' approach[40] with emphasis on examining barriers and then legislating with complementary changes to preserve the tax neutral treatment of Islamic financial instruments.

The debate from the United Kingdom experience is that facilitating Islamic banking should be driven by principles of 'fairness'[41] and by factors that will create economic benefits to the country. The Malaysian government's approach was more broadly defined and driven by the desire 'to promote the harmonisation and convergence' of the financial markets with shariah issues (Securities Commission, 2004, p. 99).

As to the realities of Islamic financial practiced in the United Kingdom, Wilson (1999) shows how 'commodity mudaraba' prospered in early UK financial practices despite divergence with shariah norms. The contracting parties simply relied on the *maqasid* (the higher purpose) of the shariah to work out tax obligations in maintaining shariah and tax compliance. In Australia, the Muslim Community Cooperative of Australia (MCCA)[42] has partially succeeded in aligning tax obligations with Islamic financing instruments. It negotiated with the Victorian government for the removal of double stamp duty on shariah compliant financing contracts. Here, changes to state revenue law shows the integrative process at work – a fact acknowledged by Australian authorities.[43] Malaysian tax authorities went further by introducing selective changes to its *Income Tax Act 1967* (ITA) where for instance, under s 2(7) of ITA the definition of 'interest' was construed synonymous 'to gains

[38] PWC. (2008). Taxation of Conventional and Shariah Compliant Mortgages, November, at p 9.

[39] See the UK Financial Services Authority (FSA) Report *Islamic Finance in the UK: Regulation and Challenges* (November, 2007, pp. 10-15)

[40] See www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/SP118.shtml

[41] H M Treasury (2008, p. 3)

[42] A small shariah compliant quasi financial institution based in Melbourne

[43] Austrade, Islamic Finance

or profits received and expense incurred, in lieu of interest in transactions conducted in accordance with the shariah'.[44]

Changes such as these acknowledge that an integrative model is one persuaded by least inconvenience in terms of regulatory and legal challenges. This theme also seems to resonate with international financial bodies such as the International Monetary Fund (IMF)[45] although the emphasis is more on prudential supervision and the creation of supporting financial structures. Regulatory issues then will need to be addressed before, or at the same time, tax amendments are considered as a precursor to the full implementation of Islamic finance in Australia[46]

While the integrative approach is argued for here, there are some specific recommendations for the greater facilitation of Islamic finance which are referred to in Part 2 of this paper.

[44] The Securities Commission Malaysia (2009, p. 212), *Islamic Capital Market*. Kuala Lumpur, LexisNexis

[45] (Errico, Luca & Farrahbaksh, 1998; Solé, 2007)

[46] (Norman & Challoner, 2010, p. 186).

Part 2: Holistic Tax Issues – Key recommendations

Briefly, the key recommendations about how Islamic finance could be facilitated in Australia through tax reforms are canvassed below.

Debt v/s Equity

Historically, Australia has given tax concessional treatment of returns on debt (interest) as opposed to equity (profits). This in part is acknowledges that due to the mobility of capital (debt), it can be more sensitive to the level of tax imposed – particularly with encouraging foreign investment. However, Islamic finance highlights the fundamental issue of asymmetrical tax treatment of debt and equity in Australia and it is this key breach of tax neutrality that may need to be reviewed in the future to ensure a tax system is established that facilitates a diverse range of financial products, whether Islamic or not. While Australia continues to treat returns on equity different to debt, tax arbitrages may continue to unduly influence financial products (whether Islamic, conventional or otherwise). That said, however, Australia's dividend imputation system does partially address this problem and any further moves for increased neutrality between debt and equity would clearly need to be considered in a broader context and in the light of relevant developments in other major jurisdictions.

It should be appreciated that the current tax preferential treatment of debt may be encouraging taxpayers to over leverage. By bringing greater neutrality between debt and equity, it may encourage more alternative forms of financing for business and non-business taxpayers alike.

Economic v/s legal interpretation

Islamic finance highlights the fundamental problem of legal versus an economic substance application of Australia's tax laws. While a legal interpretation may be simpler it can lead to anomalies and undesired complexities. In comparison, an economic approach can be more complex but lead to greater tax neutrality through taxing similar transactions the same. When it comes to financial products it is argued that an economic approach is more appropriate for tax purposes. It is recommended, therefore, that amendments to the income tax assessment acts in respect to financial products should continue to be based on an economic substance approach where appropriate. Particularly in this context, has economic ownership/risk essentially transferred from the financier to the borrower? If so, then it may be deemed for tax purposes that a transfer has occurred (usually for Islamic finance this does not occur as it could breach shariah principles). .

In ascertaining this, there is a need to have a 'whole of contemporaneous contract approach' to interpret/understand what is occurring. This could build upon the concept already in Division 974.[47] This is important because the difficulty is that to determine the precise 'nature' of what is occurring, you need to look at a number of contracts/documents occurring at the same time. It is only once all this documentation is considered that you can determine the true substance/economic effect of the transaction. In other words, to ascertain the 'economic' substance, you need to consider all contemporaneous documents concerning a transaction. [48]

This would include the reform of extending Division 240 to apply to all hire-purchase items and not just 'goods' – in a way CGT event B1 extends to this.

Introduce generic 'financial charge'

Complementary to the 'economic substance' approach is the introduction of a generic term of 'financial charge' into the tax legislation – which would represent the 'cost' of finance for a borrower and would be deductible under the general provisions of section 8-1. This would be complimented by a requirement for financiers to disclose this finance charge in documentation and thus enable the borrower taxpayer to claim (if appropriate) a deduction.

[47] *ITAA 1997* (Cth), subsection 974-10(3).

[48] *ITAA 1997* (Cth), subsection 974-10(3) Another object of this Division is that the combined effect of related schemes be taken into account in appropriate cases: (a) to ensure that the test operates effectively on the basis of the economic substance of the rights and obligations arising under the schemes rather than merely on the basis of the legal form of the schemes; and (b) to prevent the test being circumvented by entities merely entering into a number of separate schemes instead of a single scheme.

The notion of a finance charge could be similar to the finance charge already utilised in Division 240. However, further consideration needs to be given as to whether this would extend to the notions of 'profits', which if done, would achieve greater neutrality between debt and equity.

This could also be complemented by introducing such a term into Australia's DTA and WHT provisions.

Concessions/ provisions for registered financial institutions

While it is recommended to implement 'generic' (broad) reforms that apply to allow transactions structured in certain ways specific for tax treatment (regardless of religious beliefs), with any amendments there are concerns that they could be subject to abuse/avoidance. One way to restrict this potential (rather than eliminate it altogether) would be to restrict any reforms to 'registered financial institutions'. This would reduce the entities that can take advantage of concessions and thereby the entities that the Australian Taxation Office has to audit/monitor. A similar restriction is used by the exemption from IWT for 'public offers' which are less likely to be abused compared to related party transactions or individual loans.[49]

To provide greater clarity, the use of the ATO's product rulings should be undertaken to allow different financial institutions to get clear indication of the appropriate tax treatment of their financial products.

Stamp duty

It is critical that there is not the imposition of multiple stamp duty on transactions pursuant to Islamic finance products. This is an issue that the Commonwealth may need to raise with the states via COAG.

[49] Board of Taxation. (2010). Review of the Taxation Treatment of Islamic Finance: Discussion Paper. Barton: Board of Taxation, at p 21.

GST

Islamic finance products highlight the problematic treatment of ‘financial supplies’ for GST proposes as input taxed – as it is likely that some of the Islamic financial products would not be regarded as financial supplies as per the GST regulations. In the main the GST treatment of financial supplies needs to be addressed and given the technological advances, the ability to subject financial supplies to GST as a taxable supply should be reviewed.[50]

Uncertainty

It should be acknowledged that one of the greatest inhibitors currently to Islamic finance is the uncertainty of treatment and rulings from the ATO about the current agreed tax treatment of common Islamic financing arrangements.

As recognised by the Board, it appears that France dealt with the uncertainty surrounding Islamic finance by issuing tax guidelines as the existing tax framework was found to be adequate.[51]

Double Tax Agreements (DTAs)

DTAs with countries in which Islamic finance is likely to be sourced from may be advanced by having a United Kingdom term like ‘financial charge’ rather than interest.

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[50] It should be noted that the Henry Report (2009) considered that the current GST treatment of financial supplies is inefficient, reducing competition and harms Australia’s quest to become a finance hub.

[51] Board of Taxation. (2010). Review of the Taxation Treatment of Islamic Finance: Discussion Paper. Barton: Board of Taxation, at p 65: in France ‘no legislative changes were found necessary. Instead the removal of tax barriers has been achieved through the release of the tax guidelines ensuring that ordinary French tax rules apply appropriately to Islamic financing arrangements that resemble debt instruments.

Accounting standards and Islamic finance

A key feature of the Taxation of Financial Arrangements regime is the compliance cost saving that comes from allowing eligible taxpayers to elect to more closely align the tax treatment of financial arrangements with the accounting standards treatment. What is the accounting standards treatment of Islamic finance transactions is an interesting question. The Asian-Oceanian Standard-Setters Group Research Paper 'Financial Reporting Issues relating to Islamic Finance' (the Report) paragraph 14 notes ‘the body of literature on accounting for Islamic financial transactions can be said to represent a spectrum of views, where towards one end there is a belief that such transactions can generally be accounted for using IFRS; while towards the other end, there are those who believe that a separate set of Islamic accounting standards would be required to report Islamic financial transactions.’. The accounting standard setters of Indonesia and Pakistan have produced their own Islamic Accounting Standards. In contrast, the Malaysian Accounting Standards Board (MASB) has concluded that the financial reporting principles in the IFRS are not in conflict with Shariah and as a recording function, financial reporting would neither sanctify nor nullify the Shariah validity of a transaction (The Report paragraph 25).

It is too early to know whether like Malaysia Australia will conclude that the IFRS equivalent Australian accounting standards treatment of Islamic finance transactions is not in conflict with Shariah. However, such a conclusion has an intuitive appeal.
