To the Board of Taxation

I would like to make the following submission to the Board of Taxation (the "Board") in relation to its Review of the Tax Treatment of Islamic Finance - Discussion Paper ("the review").

1. HIGH LEVEL OBSERVATIONS ON ISLAMIC FINANCE IN AUSTRALIA

1.1 My experience in the Islamic finance sector has involved consulting closely with Shariah scholars and structuring Islamic finance products in a manner which the market dictates. This experience is essential to appreciate how Islamic finance in practice is different from that described in the textbooks. Unfortunately, it appears the Board has not consulted practitioners who actually have practical market experience.

1.2 The Australian Government supports the *Johnson Report's* recommendation to "*remove any regulatory barriers to the development of Islamic financial products in Australia, guided by the principle that there should be a level playing field for such products*" This is a very naive stance when it does not even understand what Islamic finance is yet. None of Austrade's *Islamic Finance*, the *Johnson Report* or *Demystifying Islamic Finance* (produced by a Malaysian law firm who wants work in Australia) have a single objective source or a brief to review Islamic finance similarly.

1.3 Contrary to the Government's claims, there is no transparency, clarity and integrity in our financial system when people are pretending there's no interest, pretending there are leases, pretending there's investment joint ventures, pretending there's a real economic benefit in instantaneously selling metal housed in an LME warehouse and pretending that parties own property they don't really own.

1.4 It was disappointing to hear Mr. Dick Warburton dismiss Senator Cory Bernardi's submission to the Board as "emotional". It is far too simplistic to label genuine political, security and social concerns as such. Tax laws may have been changed to accommodate new financial products before but they have never been changed to accommodate Shariah law, there is a vast difference in the resulting implications for Australian society.

1.5 It is unfortunate that the Australian public were not consulted as to their legitimate concerns with Islamic finance yet the Australian Government have been free to dissimilate all manner of incorrect information on the sector. It is also offensive and ridiculous to be told that Islamic finance is not part of a broader "Islamisation" process and for these concerns to be labelled "emotional". Prior to their full review and understanding of the sector, how can anyone determine someone else is wrong?

2. ISSUES WITH THE TERMS OF REFERENCE

2.1 The Terms of Reference go beyond a review of ensuring Islamic finance products receive parity of tax treatment with conventional finance products. Whilst parity of treatment is the third point of reference, the first point of reference is to "*identify impediments in current Australian tax laws (at the Commonwealth, State and Territory level) to the development and provision of Islamic finance products in Australia.*" It would appear therefore that there is scope for amending tax laws to favour and encourage Islamic finance as there is no connection between the first point and the third point dealing with parity.

2.2 Clause 4.115 of the review states "*The Board has been asked to review Australia's tax laws to ensure that, wherever possible they do not inhibit the expansion of Islamic finance, banking and insurance products*" with chapter 4 elsewhere referring to "*impediments.*" Again, there is no "equivalence" or "parity" connection, just a stand alone mandate to remove undefined "*inhibitors*" or "*impediments*" to allow "*expansion*". Please clarify exactly what sort of expansion the Board is facilitating.

2.3 Where required to consider Islamic finance's tax treatment based on "economic substance" and "economic equivalence", the Board has made fundamental conceptual errors (as outlined below) that will result in the review being flawed and unsound.

3. ISSUES WITH THE PRINCIPLES OF ISLAMIC FINANCE

3.1 The review is based on the "*principles of Islamic finance*" as described in clauses 2.5 to 2.20 however these principles do not underpin the transactional basis and economic substance of Islamic finance in the marketplace. The following examples illustrate this:

(a) In clause 2.5, the reference to "*the right of property should come from a persons own labour*" is far too narrowly described and irrelevant in Islamic finance.

(b) The statement "*the sanctity of contracts are core principles of Islamic finance*" is also a misleading statement as, under Shariah law, contracts and the promises made in them are generally less binding than under common law principles. In any event, Islamic finance contracts will be governed by Australian contract law so this statement is confusing and also irrelevant.

(c) Clause 2.5 goes on to state that "*risk sharing, prohibition of interest (a prohibition of pure debt security) and the elimination of contractual ambiguity and other forms of exploitation are some of the implications of these core principles*". This is fine in theory, however, as Islamic finance contracts are manipulated and structured to reflect exactly the same economic outcome as conventional products and hence very often contain these said elements, relying on such a statement as a core principle will result in an incorrect analysis.

In particular, "*risk sharing*" and "*uncertainty*" elements in a transaction are commonly dealt with through structural enhancements, innovative contract terms or side arrangements to achieve a "conventional" outcome. As you can imagine, Islamic banks are more than just the Shariah-compliance scholars, there is a credit department and other stakeholders who have a say in determining the final structure of a product and its economic characteristics. If particular Shariah scholars don't oblige or an innovative solution can't be found, bankers often go "scholar shopping" to achieve the conventional outcome.

(d) In clause 2.6, the Board should not be relying on the "*Islamic economic system*" as a basis of the review. This is not the system that Islamic finance operates in and is partly why Islamic financial products must replicate conventional products. As Islamic finance operates in a conventional system and Islamic finance principles adapt to accommodate this system, in substance Islamic finance principles are conventional principles. Thus, the assumption that Islamic finance products are based on Islamic finance principles, operating in an Islamic economic system has no worth in a practical exercise to determine the appropriate tax treatment of Islamic finance products.

(e) The statement that "*Islamic banking and finance provides equivalent functionality to conventional finance but the underlying arrangement is based on the trading of assets, profit and loss sharing investments or leasing arrangements*" is incorrect. Islamic financial products are less functional, inefficient, inflexible and more costly than conventional products, they do not provide "equivalent functionality". They are rigid structures and poor substitutes for their conventional counterparts. Whilst trading of assets and leasing arrangements may occur, albeit in contrived and modified structures, profit and loss sharing is not a relevant component of Islamic finance, with counterparty risk being identical to conventional products.

(f) The "Musharaka" structure in clause 2.13 (and elsewhere in the review) refers to losses having to be shared on the basis of equity participation. This is not how the market drafts these structures and this assumption is wrong. Upon usual defaults, an undertaking provided by the borrower requires it to purchase the banks share of the

musharaka (defined by "units"), or an underlying asset of the musharaka, at a price equal to the bank's outstanding principal and "profit".

(g) The "Mudarabah" and "Wakalah" are also defined without regard to market reality. Again, the bank will always have a right to "put" a purchase undertaking back to the borrower in order to reclaim its full outstanding amount. The English court case of *The Investment Dar v Blom Bank* will make this perfectly clear to the Board and relevant case law should be considered in the review.

3.2 In a workshop on 26 February 2009 as part of the "*Islamic Finance Project*" conducted by Harvard Law School and the London School of Economics, the world's leading Islamic finance experts including Shariah scholars, bankers, academics and economists agreed that "*the Islamic Finance industry was simply mimicking conventional products*". Accordingly, any review of the economic substance of Islamic finance transactions must take into account there being no difference in the financier's risk profile, the characteristics and movement of interest or the bank's rights to accelerate and enforce.

3.3 Whatever the structure, a synthetic and contrived contractual framework must be adhered to in Islamic finance in order to comply with Shariah law as well as Australian law. Conventional finance contracts only need to follow Australian law and thus are a lot simpler. Following additional law will create a slower, more restrictive financial system and impede a bank's ability to create appropriate financing solutions as times and circumstances change.

4. ISSUES RAISED BY AUSTRALIA'S CURRENT APPROACH TO FINANCE TAXATION

4.1 Chapter 4 details case studies to determine the "*economic substance*" of a transaction under "*principles of Islamic finance*". As noted above, these principles are usually ignored in application, making the case studies essentially worthless. I note the following:

(a) Case Study One: Cost Plus Profit Sale

Whilst the review notes there are different ways to structure an Islamic home loan, the most common way is by an ijara structure and it is disappointing that the review utilises a largely irrelevant structure to create a case study. When would "cost-plus" ever be used given the rate must be fixed for the entire term? Islamic banks I know don't give fixed rate home loans.

The ijara structure operates as follows:

(i) The bank acquires a co-ownership interest in the house to the extent of its loan and takes a mortgage.

(ii) The borrower leases the bank's portion of the house from the bank, each month paying "Fixed Rental" (principal) and "Variable Rental" (interest). The Variable Rental is calculated by reference to a "Profit Rate" which fluctuates based on the same movements of cash rates or the way any bank wants to charge variable interest.

(iii) Upon usual default, the leasing agreement is terminated and the mortgage can be utilised. The bank can accelerate the principal upon default by obliging the borrower to purchase its interest in the house at the price of the outstanding amount.

(iv) A new "lease" is entered into each month to allow Variable Rental (and satisfy Shariah-compliance certainty of cost issues as the rent stays the same for the 1 month lease). The borrower undertakes to constantly renew the lease each month until the principal is all paid back.

(v) To circumvent the "Islamic principle" that a tenant can't undertaken major maintenance and insurance obligations, a "servicing agency agreement" is entered into to appoint the borrower as agent of the bank to do so.

There are no "Islamic principles" here, these are conventional principles. The new lease every month is a perfect example of a structural innovation which makes the "Variable Rental" uncertain over the term of the loan.

(b) Case Study Two: Interbank Finance

The structure described is a "commodity Murabaha" and is utilised for most general purpose loans. More than half of all Islamic finances are commodity Murabaha, its ultra-synthetic structure making a mockery of supposed "real economy" and "tangible asset" principles of Islamic finance.

(c) Case Study Four: Purchase Order used for construction finance

The structure described is uncommon in the market. The asset is usually constructed by the borrower for the bank pursuant to an "istisna(s)" and then leased back to the borrower under a "forward ijara" (for similar reasons as above). Under the forward ijara, "rental" can accrue before the lease starts on account of additional rental after the lease starts and such amounts are set-off. This market utilised structure has the economic substance of a project finance and the analysis undertaken of the review's structure is largely pointless.

(d) Case Study Six: Profit and Loss sharing partnership

As noted above, this case study is flawed because a bank will not share risk and losses. It is wrong to suggest that banks do not fix returns in these structures, this is the norm.

5. RELEVANT ISSUES FOR THE BOARD TO CONSIDER

To further illustrate the assumed myths and marketing hype that flaw the review, I comment as follows:

5.1 Islamic finance does not limit speculation or excessive risk taking and massive losses have been made by the sector across all product offerings, most notably the many sukuk failures. Whilst Islamic Banks may have had limited exposure to collateralised debt obligations, they did not survive the financial crisis relatively better off and any such claim (which Austrade's *Islamic finance* publication makes) is wrong. Given their relative lack of options regarding risk-hedging and asset diversification, Islamic banks found themselves over-exposed and over-concentrated in particular asset classes, particularly property (which *Islamic Finance* does note).

Asiamoney stated in August 2008: "*But the fact that Islamic banks were prohibited from the riskier assets of the moment does not automatically mean that they follow best practice in terms of risk management, credit research or investment processes.*"

5.2 Islamic finance does not prohibit or shun derivatives or hedging products. These products are common and are structured to generate similar economic profiles to conventional derivatives. The contracts used are inflexible and cumbersome, with trading in the secondary market costly and time-consuming. While some Islamic scholars are not agreeable to all forms of Islamic derivatives, they are used speculatively (the scholars control the product, not its use).

5.3 The Board should appreciate that Islamic finance encourages the same greed culture and to suggest that it is somehow based on more ethical standards is ludicrous. The fact is that Islamic finance is more expensive than conventional products, due to:

(a) The structuring costs arising from the many additional contracts for the same deal and the various metal brokers, agents or other participants required to make the structure work. In particular, commercial structures like sukuk accrue large shariah board approval costs, extra legal fees and various other fees associated with their often complex structures.

(b) Banks will charge for "Shariah risk". This risk is from:

(i) There is a risk that secular courts may start reviewing the Shariah-compliance of a deal for enforceability as we have seen recently in *The Investment Dar v Blom Bank*. If courts start reviewing contracts for Shariah-compliance, banks will have more risk (which must be priced).

(ii) The bank's Shariah board may determine a transaction under a contract is not Shariah-compliant and donate any profits made from it to Islamic charities. The Islamic banks don't give up this money, they get it back through increased margins, particularly in the case of late payment fees which are not Shariah-compliant. The Islamic bank customer pays the full late payment fee anyway (as the Islamic bank wants to keep the deterrence) and the additional pricing. (Note how "*Islamic principles*" are ignored).

(c) There being fewer participants and a captive market that may feel obligated or even pressured to use its products.

5.4 It is illogical to promote the "*expansion*" of a finance system that we know is already more expensive and does not increase competition.

6. LEGAL ISSUES

6.1 The last couple of years have been very difficult for the Islamic finance industry from a litigation perspective. The following is just some of the legal issues that are to be expected:

(a) Trade Practices Act breaches, particularly "deceptive and misleading conduct".

(b) Corporations Act financial product disclosure requirement breaches.

(c) Insolvency law issues when determining the precise nature, rights and liabilities of Islamic finance stakeholders in the winding-up of a company.

(d) A "best of both worlds" position complicates matters when "risk sharing" inevitably doesn't fall the consumers' way.

For example: *"Mudaraba contracts, which are the basis of the relationship between banks and their account holders, specify that the account holders, as owners of capital, have what's called a mudarib relationship with the bank – that is, an agency agreement. In other words, they are sharing risks and rewards with the bank, and effectively providing a form of equity to it in a way that is not the case in conventional banking. "As a result, investment account holders are liable to incur unexpected losses in the same way as shareholders because there is effectively no cushion, as provided by equity from the shareholders in conventional institutions,"* states Mark Stanley of Ernst & Young in Bahrain.

But will Islamic finance "depositors" accept the risks if the bank goes bust or expect to be treated like a conventional account holder and demand any government guarantees that might be in place? I suspect the latter.

We've already seen in the failed sukuks, investors claiming to be "asset owners" in the underlying sukuk assets (and thus take priority in insolvency proceedings) when the deals were structured to be "asset based" not "asset backed" for various reasons to begin with including avoiding liability in relation to those assets. These sorts of issues will only add confusion and uncertainty to our laws.

6.2 *Shari'ah's Black Box: Civil Liability and Criminal Exposure Surrounding Shari'ah-Compliant Finance* by David Yerushalmi, 2008 is a superb analysis of other legal risks associated with Islamic finance. It details issues including common law tort actions for deceit or fraud, securities laws, consumer protection and anti-fraud laws, sedition, anti-competition and racketeering. Whilst it is based on an analysis of US law, Yerushalmi's analysis mostly applies to Australia as well.

6.3 Whilst the Board may only "tweak" some tax laws, this is merely the beginning. Besides Tax law changes, real property law changes, securities law changes, consumer credit law changes, changes to our financial regulatory system including prudential standards and changes to our accounting standards, as the industry grows all sorts of issues will arise and require changes to our law. *Demystifying Islamic Finance* (which Senator Nick Sherry launched) states: "*In countries where a comprehensive review and reform of the whole legal and regulatory framework is not undertaken, they will find their Islamic finance industry to be surrounded by legal landmines*" and "*it is incorrect to assume that Islamic finance requires only minimal changes to the financial laws and regulations, as indeed this is only the first step in what should be a long journey*".

The "long journey" is about slowly moving a legal system and economy to "Shariah-compliance", including Australian courts applying Shariah law jurisprudence in contract and commercial matters. Of course, it is fanciful to suggest that the conventional system will be replaced overnight but every law change, every regulatory change, every concession given by Government is a concession to the Islamic system - a dumbing down of law and regulation to accommodate ancient and retrograde techniques. I am happy to provide evidence of this being exactly the intention of Islamic finance as described by many prominent Islamic political leaders, Shariah scholars and, of course, the creator of Islamic finance, the Muslim Brotherhood.

6.4 The above is relevant to illustrate that Islamic finance does not operate today in an "*Islamic economic system*" and that assumptions like those relied upon in the review are wrong. Does facilitating "*expansion*" of Islamic finance mean moving closer to the Islamic economic system? Certainly there is no neutrality in the review as the "*principles of Islamic finance*" and the "*Islamic economic system*" are clearly being held up as superior.

7. REGULATORY ISSUES

7.1 Changes to prudential standards to accommodate Islamic finance may jeopardise the integrity of the Australian financial services industry.

The issue is that Islamic finance is selling itself as conceptually different and, in theoretical terms, it is. Accordingly, regulatory changes will seek to address these differences. While some regulatory changes are required to "make sense" of current regulation, other changes actually demand a loosening of high standards to accommodate "Islamic principles" despite the sector not operating under them. In any case, as Islamic banks operate effectively as conventional banks, provide what are in reality conventional banking products and are, in the eyes of the consumer, banks, the entire industry will be adversely effected by altering regulatory regimes.

7.2 Islamic finance regulatory institutions like AAOIFI are already asserting their control over Australia's regulatory framework with the adoption of their accounting, auditing, governance, ethics and Shariah-compliance standards.

What's wrong with that? AAOIFI Chairman, Mufti Muhammad Taqi Usmani, who sits on many Western and Islamic bank Shariah boards says that offensive, aggressive military jihad must be waged by Muslims "*to establish the supremacy of Islam worldwide*" and "*Killing is to continue until the unbelievers pay jizyah (subjugation tax) after they are humbled or overpowered.*" He also advises Muslims to only live peacefully in the West until they gain enough power to carry out jihad.

So is this who should be dictating regulatory regimes in Australia? His influence on the Islamic finance industry and its scholars is immense. It was Usmani who personally declared that over 80% of all sukuk were not Shariah-compliant in 2008 and globally sukuk issuance took a battering for it, downturn and recent defaults notwithstanding.

When Australia enables Islamic finance, AAOIFI members will be actively pursued for Shariah boards as the world of senior and "respected" Shariah finance scholars is very small (perhaps

as little as 30 worldwide) and many sit on over 50 boards at the one time. AAOIFI also encourages the appointment of its board members to Shariah boards to ensure its standards are implemented and scholars' conduct regulated. Many of these members trained at hard-line Islamic schools in Pakistan or Saudi Arabia and do have jihadist objectives.

8. THE TERROR FUNDING ASPECT AND THE ROLE OF ISLAMIC CHARITIES

8.1 Despite denials, many Islamic finance institutions have been a conduit for financing terror and the sector must be monitored very closely. The key issue is that, unlike a conventional bank, the very foundations, structures and contracts that form Islamic financing facilitate the provisioning of money to Islamic "charities", many of which have been proven to channel money, often through complex laundering, to terrorists.

8.2 Pro-active analysis and monitoring of Islamic finance institutions and their unique operations must be undertaken. Moreover, the Financial Action Task Force (FATF) Guidelines states in relation to terror financing and money laundering that members and financial institutions should be "*recognising the existence of the risk(s), undertaking of assessment of the risk(s) and developing strategies to manage and mitigate the identified risk(s)...Countries will need to identify the main vulnerabilities and address them accordingly*".

8.3 Laws and guidelines specifically combating "terror financing" tend to focus on financial institutions servicing terrorists (like strict KYC and account monitoring requirements), not the institution being (directly or indirectly) the terror funder. All Islamic finance participants' donate to Islamic charities, be it through formal *zakat* donations, informal *zakat* donations which a Western bank may provide for marketing purposes or through contractual and non-Shariah compliance obligations (for example, late payment fees). This is a "main vulnerability" that I am not aware of being addressed by the Australian Government.

8.4 Current anti-money laundering laws are generally unhelpful for combating Islamic bank terror financing as the practice refers to the cleaning of illegal gains, not legitimate income financing illegal activity, the reverse process.

8.5 The uncomfortable fact is that Islamic finance has had a lot to do with terrorism financing. Loretta Napoleoni (who is favourable to Islamic finance) states: "*Islamic banks, not charities, are the life-line of Wahhabi insurgency, they are the feeder of Islamist armed groups", without them "terror-donations" could not reach the end users scattered around the world.*" Many promoters of Islamic finance point to a lack of convictions for Islamic finance participants but do not acknowledge the evidence that has been presented by reliable sources, problems with international will, co-operation or jurisdiction to make a case successful, the settlements reached and the many banks being shut down and their assets confiscated. An analysis of Islamic finance and terror funding is easily researched and has been well established.

8.6 Australian financial institutions may unknowingly fund terror:

(a) If they use foreign Shariah advisory consultants for a particular transaction or product (it may be a cheaper option than having their own board initially or if the "fatwa provider" is important to secondary marketing).

(b) As Banks will often participate in Islamic financings as part of a syndicate which includes a foreign Islamic bank. The Islamic bank will want to be the "Investment Agent" and its Shariah Board will provide the *fatwa* (only 1 needed for the syndicate) and all other Shariah related services, including choosing Islamic charities.

The Australian bank may therefore have no idea where their Islamic charity donations are going. And even if they do enquire, the complex laundering of donations makes it difficult to keep track of end beneficiaries.

8.7 Yusuf al Qaradawi is a "reputable" and prominent Islamic finance scholar who sits on many Islamic and Western bank Shariah boards. In relation to offensive jihad he has stated: "*It thus needs to be financed from the money of Zakah, the amount of which is to be decided based*

on the total sum of the charity, the requirements of Jihad as well as the degree of the need of other potential recipients of charity. Qaradawi believes Islamic finance is "*Jihad with money*" and should replace capitalism. Will he be allowed on Australian Shariah boards?

8.8 The above is indirectly in the Board's scope as it should base any tax exemptions on a financial institution's willingness to comply with terror prevention obligations. I certainly am not saying all participants are there to fund terror, it may be a small fraction, but to assert (as Senator Nick Sherry has) that Islamic finance is no greater a vulnerability to a conventional bank is disingenuous. There is no point putting your head in the sand about such matters.

9. PROPOSALS TO THE BOARD

The following are my suggested proposals to the Board:

9.1 Advise the Australian Government to undertake a full, unbiased and commercially and politically neutral analysis of Islamic finance's effect on, and operations within, the Australian financial services industry.

9.2 First determine the commercial structuring which underpins Islamic finance in the marketplace and then consider what tax or (where in the Board's scope) other legal and regulatory changes are required or acceptable.

9.3 ASIO must screen, approve and monitor all Shariah advisers. The Islamic finance sector must be free from both terror funding and any perceived risk of terror funding.

9.4 Ensure participants fully disclose all Islamic charities they donate to and their end beneficiaries. Some Islamic finance participants in the Middle East, on their initiative, name the charities in relevant contracts (where the contract is the source of the donation).

9.5 Ensure full transparency by participants of all Islamic charity payments to the end beneficiary.

9.6 Request the Australian Government to comply thoroughly with FATF Guidelines, taking into account the unique nature and characteristics of the Islamic finance industry.

9.7 Require that all "charities" receiving donations from Islamic finance participants be Australian based and are inclusive of all of the community (notwithstanding *zakat* rules that exclude non-Muslims, which is clearly discriminatory).

9.8 Request the Australian Government implement practical and sector specific changes to anti-terror and anti-money laundering laws.

9.9 Contrary to the review's mandate, any tax law changes should be "Islamic finance" specific and not just deal with the economic substance of a transaction. In this case, parity of tax treatment must only be available upon satisfaction of, and to ensure compliance with, points 9.3, 9.4, 9.5 and 9.7 above. If Islamic finance participants want tax changes in order to be treated equally, then they should operate on an equal basis to conventional participants, ie their operations should be confirmed as only that of a finance provider.

In the interests of the Board's time I have made this correspondence as brief as possible. I am happy to clarify and expand on any aspect or assertion as requested.

David Clark

15 December 2010