17 December 2010

Review of the Taxation Treatment of Islamic Finance Products
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

BY POST & EMAIL: *taxboard@treasury.gov.au*

Dear Sir / Madam

REVIEW OF THE TAXATION TREATMENT OF ISLAMIC FINANCE PRODUCTS

The Financial Services Council (FSC) welcomes the opportunity to comment on the Discussion Paper regarding the Review of the Taxation Treatment of Islamic Finance Products released by the Board of Taxation on 13 October 2010. We also appreciate the opportunities to participate in the consultation phases of these reforms.

We appreciate your support and commitment towards reviewing Australia's taxation system to assist the funds management industry in developing Islamic finance products.

The FSC is the peak body representing the retail and wholesale funds management, superannuation and life insurance industries. The FSC has over 135 members who are responsible for investing over $1.4 trillion on behalf of more than ten million Australians.

Most of the issues raised in the Discussion Paper relate to Shariah compliant financing arrangements and their conventional banking equivalents. This submission does not address the banking and finance aspects of such arrangements as they are better addressed by the banking industry. Even so, in our view, the successful development of a Shariah compliant investment and finance market in Australia will require a combination of measures across both banking investment and insurance markets. Accordingly the FSC has the following observations in respect of investment products.

In our view, investing into Australia through a Shariah compliant trust is permitted under the Corporations Act. This is evidenced by several existing Shariah compliant funds already operating in Australia. We therefore do not believe there is a need to change the Corporations Act to facilitate the growth of these investment funds in Australia. We note that the disclosure obligations under the Corporations Act that apply to retail funds will require disclosure of the nature and role of the Shariah Board of Shariah compliant funds. In our view, this is appropriate as the Shariah Boards play a critical role in these funds.

In addition to their Shariah Boards, the other distinguishing features of Shariah compliant funds are their prohibitions on making certain types of investments and receiving certain types of distributions.

The FSC understands that Shariah principles prohibit investments involving alcohol, gambling, certain animal products, pornography, weapons production and distribution and some other activities. From a funds management perspective, this is relatively simple to accommodate by ensuring the investment mandate specifically excludes these from the list of permissible investments. In a practical sense, this is similar to the way "ethical funds" currently operate with restrictions on certain investments.

From the FSC's perspective, the critical focus of the law reform is to ensure that there is a level playing field for financing undertaken by Shariah compliant funds. Where a series of transactions are undertaken by a Shariah compliant fund which are, in substance, a financing arrangement, then it is important to ensure that the transactions produce an equivalent economic outcome to the equivalent conventional financing transaction.

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As the Board of Taxation has identified, it will be necessary to either amend, or change the administration of, certain Commonwealth and State legislation in order to achieve this outcome. In this regard the FSC makes the following suggested changes:

1. Alterations to the eligible investment list. Australian unit trusts and Managed Investment Trusts (MITs) are restricted in their investment list to those items listed in section 102M of the *Income Tax Assessment Act 1936*. Some types of investment structures that have been developed to mimic conventional financing structures in a manner that is Shariah compliant. Such structures will not always be within the eligible investment list even though a more conventional finance structure might be. For example, a sukuk arrangement would probably not fall within s. 102M but its equivalent, a bond, would fall within s.102M. Similarly, an Ijara arrangement would probably not fall within that section but a loan to buy a chattel would fall within that section. It is therefore suggested that the list of eligible investment business be expanded to include items prescribed by regulation. The Government could then prescribe certain types of Islamic financing arrangements as being eligible investments. This would allow flexibility in this developing area without a need to continually refer the matters to Parliament. In addition, such a list of prescribed Islamic finance items could also be referred to for the purposes of other changes to income tax legislation adopted to facilitate Islamic finance to ensure consistent application of income tax laws to Islamic finance arrangements.

2. Islamic investors are prohibited from receiving interest (Riba). An Australian MIT making distributions to unit holders will split the distribution into various components reflecting the underlying origin of the distribution. Thus the distribution will typically be split into interest, dividends, capital gains, foreign income (which may include interest) and other income. The possibility of receiving an interest component may be unacceptable to Islamic investors. One way to overcome this is to allow MITs the ability to make an irrevocable election to the effect that expenses that do not directly relate to a particular class of income be allocated against interest income in the first instance. This would remove the interest component of a distribution for most diversified funds. Such a provision could be modelled on the now repealed s. 50 of the *Income Tax Assessment Act 1936.* We note that, as a practical matter, Islamic finance often allows some interest income being earned within approved structures, as long as the business is not that of money lending and the amount of interest is not excessive. Accordingly, the proposed changes will serve to accommodate this practical matter.

3. A further mechanism for overcoming the issue identified in 2 above, would be to allow Islamic investors to elect that the interest component of any distribution be donated to a charitable organisation rather than be distributed to them. The charity would need to be registered as a tax deductible gift recipient however this proposal will depend on a number of factors, including the type and country of residence of investors.

4. Mortgage trusts are a common form of MIT. One Shariah equivalent of a mortgage is an Ijara with a diminishing Musharaka (or partnership). Under such arrangements, the “financier” owns the property in the first instance and then sells it in agreed fixed instalments to the “occupier” over time. This can result in two liabilities to conveyancing duty. Firstly, when the financier buys the property and secondly when the occupier pays the last instalment. Some Australian jurisdictions, such as Victoria, do not levy Stamp Duty on the second acquisition. This needs to be clarified across all Australian jurisdictions.

5. Australian MITs and mandate clients of an Australian Fund Manager may also undertake borrowing, or ‘gearing’, against its investments in order to enhance returns for investors. In order to offer the benefits of such products to Islamic investors, an MIT may be required to enter into a cost plus profit sale arrangement, or ‘Murabahah’ under which the MIT sells to a financier, or arranges for the financier to purchase, an asset or portfolio of assets which may consist of, for example, listed or unlisted equity investments or real property – and repurchase the asset/s at cost plus profit on a deferred payment basis. As the Board of Taxation notes, uncertainty may arise in this situation as to whether the MIT would be required to treat the arrangement as a disposal and acquisition of the asset/s for CGT purposes (where it is not otherwise within the Taxation of Financial Arrangements regime),

or as an 'in-substance' financing arrangement under which the 'profit' component of the repurchase would be deductible under section 8-1 of the ITAA 1997. The latter treatment could be clarified by enacting tax legislation similar to the existing securities lending tax provisions, to allow for the legal sale and repurchase to be disregarded for CGT purposes and the 'profit' on repurchase to be deductible to the MIT as a financing cost.

If you have any questions regarding the FSC's submission, please do not hesitate to contact Pravin Madhanagopal or myself on (02) 9299 3022.

Yours sincerely

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