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17 December 2010

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Islamic Finance Unit
The Treasury
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By email: taxboard@treasury.gov.au

Dear Annabelle

SUBMISSION: Review of the Taxation Treatment of Islamic Finance

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

Given the tenor of the terms of references our submissions considers the broader issues that Islamic finance raises and how amendments may be made to existing tax framework. Our submission canvasses:

- Appendix **A**: Holistic Issues - Key recommendations; and
- Appendix **B**: The 'constitutionality' of tax reforms to facilitate Islamic finance.

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. In comparison, an economic approach can be more complex but lead to greater tax neutrality through taxing economically similar transactions the same. In relation to financial products it is argued that an economic approach is more appropriate for tax purposes. However this needs to be synchronized with CGT provisions and the State's duty legislation.

We would welcome the opportunity to discuss with you this submission in more detail.

Yours sincerely

Dr Brett Freudenberg & Dr Mahmood Nathie
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Appendix A: Holistic Issues – Key recommendations

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

1.1 Debt vs 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 needs to be resolved to ensure a tax system is established that facilitates a diverse range of financial products, whether Islamic or not. For it is while Australia continues to treat returns on equity different to debt that tax arbitrages will unduly influence financial products (whether Islamic, conventional or otherwise).

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.

1.2 Economic vs 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 economically 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 that amendments to the income tax assessment acts be based on 'economic notions' in respect of financial products continue. 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). These rules need to be complemented by the CGT provisions (and stamp duty) to ensure that economic principles apply there as well.

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 974.1 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 – it is only then that you can truly ascertain what is really occurring economically.2

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[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

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.

1.3 Introduce generic 'financial charge'

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

1.4 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 WHT for 'public offers' and are less likely to be abused compared to related party transactions or individual loans.[3]

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.

1.5 CGT

As previously, described it needs to be considered whether a 'contemporaneous document' approach could be implemented to determine whether (and at what time) a CGT event has occurred. Also, whether there should be some adjust to the 'timing' of a capital gain when the capital proceeds are received over an extended period of time, for example greater than 12 months.

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

1.6 Stamp duty

It is critical that there is not the imposition of multiple stamp duty on transactions pursuant to Islamic finance products. Again this reform should consider a 'contemporaneous document' approach to determine what is the effective economic transaction occurring to determine the duty payable.

1.7 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.[4]

1.8 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/Treasury about the current agreed tax treatment of common Islamic financing arrangements. (to decrease the uncertainty cost)

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.[5]

1.9 DTAs

DTA 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.

[4] 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.

[5] 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.

Appendix B: Constitutionality of tax reforms to facilitate Islamic finance

Interpretation of section 116 Constitution

To what extent does the Australian Constitution fetter or enable the Commonwealth parliament to enact tax laws to facilitate faith-based financial transactions?

In terms of the Australian constitution, s 116 is the pivotal section in setting out the relationship of state (being the Commonwealth of Australia) and religion Section 116 specifies:

> The Commonwealth shall not make any law for establishing any religion, or for imposing any religious observance, or for prohibiting the free exercise of any religion, and no religious test shall be required as a qualification for any office or public trust under the Commonwealth.

On a closer reading, this section provides four guarantees in relation to religion – three of which are influenced by the First Amendment of the United States' Constitution.[6] However, only two of the four guarantees have been subjected to interpretation by the High Court, they being: (a) The Commonwealth shall not make any law for establishing any religion; and (b) The Commonwealth shall not make any law for prohibiting the free exercise of any religion. However, both interpretations have narrowed the potential operation of s 116 which is dealt with separately below. It is argued that the forth guarantee, religious test for public office, would not be infringed with the introduction of tax reforms to facilitate faith based transactions. The second guarantee, imposing religious observance, will be considered with the 'free exercise' guarantee.

(a) The Commonwealth shall not make any law for establishing any religion

In terms of the first guarantee against the Commonwealth 'establishing' any religion, the High Court has interpreted this to mean that the Commonwealth is prohibited from enacting laws to set up a religion as the official religion of the country.[7] This means that even if the Commonwealth makes laws that favour one religion over another, this will not necessarily breach s 116.[8]

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[6] GV Puig and S Tudor (2009) 'To the advancement of thy glory? A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 61.

[7] GV Puig and S Tudor (2009) 'To the advancement of thy glory? A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 63.

[8] *Attorney-General (Vic); Ex re Black v Commonwealth* (1981) 146 CLR 559 while s 116 may prohibit the Commonwealth Parliament from constituting a 'particular religion or religious body as a state religion or state church', it does NOT stop the Commonwealth Parliament supporting religion generally: per p 597 Gibbs J, at p 582: Barwick CJ, Stephen J: at p 608-609, Mason J: at p 616, Wilson J: at p 653.

Barwick CJ framed what the prohibition on 'establishment' means in *Attorney-General (Vic): Ex re Black v Commonwealth* (1981) 146 CLR 559:[9]

> Establishing a religion involves the entrenchment of a religion as a feature of and identified with the body politic ... It involves the identification of the religion with the civil authority so as to involve the citizen in a duty to maintain it and the obligation of ... the Commonwealth.[10]

In the same decision, Stephen J explained it in the following way:

> [T]o speak of a religion being established by laws of a country may well be to include much more than the act of according material recognition and status to a set of beliefs, a system of moral philosophy or particular doctrines of faith; it would certainly include the recognition of a particular religion or sect, with its priestly hierarchy and tenets, as that of the nation.[11]

It appears that in interpreting s 116 the use of the word 'for' has been seen as critical as observed by Sundberg J in *Halliday v the Commonwealth of Australia* [2000] FCA 950:

> In *Attorney-General (Vic); Ex re Black v The Commonwealth* (1981) 146 CLR 559 several members of the court considered the import of the word 'for' in the expression 'for establishing any religion'. Barwick CJ (at 583) thought that the word indicated that the law must be intended and designed to set up the religion as an institution of the Commonwealth. Gibbs J (at p 598) said the word 'for' looked to the purpose of the law rather than to its relationship with a particular subject matter...Mason J (at p 615-616) was of the view that 'for' connoted a connection by way of purpose or result with the subject matter which was not satisfied by the mere fact that the law touches or relates to the subject matter.....There is no reason to think that the meaning attributed to 'for' in the expression 'for establishing any religion' should not apply to the word in the expression 'for prohibiting the free exercise of any religion.[12]

However, some see the use of the word 'for' more of grammatical necessity in the initial drafting of the provision rather than imposing a particular meaning.[13]

(b) The Commonwealth shall not make any law for prohibiting the free exercise of any religion

In terms of the second guarantee considered by the High Court, the 'free exercise' provision has also been interpreted narrowly. The provision was specifically considered by Griffith CJ in *Krygger v Williams* (1912) 15 CLR:[14]

> To require a man to do a thing which has nothing to do with religion is not prohibiting him from a free exercise of religion. It may be that a law requiring a man to do an act which his religion forbids would be objectionable on moral grounds, but it does not come within the prohibition of s116.[15]

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[9] Referred to as the DOGS Case.
[10] Attorney-General (Vic): Ex re Black v Commonwealth (1981) 146 CLR 559, per Barwick CJ, at p 582.
[11] Attorney-General (Vic); Ex re Black v Commonwealth (1981) 146 CLR 559, per Stephen J at p 606.
[12] *Halliday v the Commonwealth of Australia* [2000] FCA 950, per Sundberg J at p 463.
[13] GV Puig and S Tudor (2009) 'To the advancement of thy glory? A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 67.
[14] This case concerned the provision of the *Defence Act 1903* (Cth) imposing obligations on all make inhabitants of the Commonwealth in respect of military training do not prohibit the free exercise of religion.
[15] *Krygger v Williams* (1912) 15 CLR, per Griffith CJ, at p 369.

It was observed in *Adelaide Company of Jehovah's Witnesses Inc v Commonwealth* (1943) 67 CLR 116 that all religions are potentially covered by the provision:

> Section 116 applies in express terms to "any religion", any "religious observance", the free exercise of "any religion" and any "religious test". Thus the section applies to all religions.[16]

The courts in interpreting s 116 have also tried to reconcile and balance religious freedom with ability of governments to govern and maintain an ordered society. This is clearly evident in the sentiment expressed by Latham CJ in the *Jehovah's Witnesses* case:

> Can any person, by describing (and honestly describing) his beliefs and practices as religious exempt himself from obedience to the law?...The complete protection of all religious beliefs might result in the disappearance of organized society, become some religious beliefs...regard the existence of organized society as essentially evil...[17]

Latham CJ referred to the jurisprudence that had already been established in the United States concerning the free exercise of religion which did not allow religious practices to excuse breaches of the criminal law.[18] An example referred was that a Mormon could not use his religious beliefs of polygamy to excuse himself from the criminal law against such acts.[19]

The approach of the High Court is that this right of 'religions freedom' is not absolute, the reasoning being 'religion is so broad a political and ethical concept that it is liable to be misinterpreted to include objectionable, if not otherwise illegal, rituals and practices'.[20] To this end the High Court may 'take the general interest into account', and that if a law has general application then that law is not likely to infringe the right of free exercise.[21] That is, the court has balanced the competing public interests of freedom of religion and the regulation of an organised society.[22] Justice Williams framed this balancing act as:

> [T]he meaning and scope of the [the Constitution, s116] must be determined, not as an isolated enactment, but as one of a number of sections interned to provide in their inter-relation a practical instrument of government, within the framework of which laws can be passed for organising the citizens of the Commonwealth in national affairs into a civilised community, not only enjoying religious tolerance, but also possessing adequate laws relating to those subjects upon which the Constitution recognises that the Commonwealth Parliament should be empowered to legislate in order to regulate its internal and external affairs.[23]

For example it has been held (in obiter) that a law overriding the confidentiality of religious confessions is not a law prohibiting the free exercise of religion.[24] In *Kruger v Commonwealth* (1997) 190 CLR 1 Chief Justice Brennan stated that for a law to breach the right of freedom

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[16] Adelaide Company of Jehovah's Witnesses Inc v Commonwealth (1943) 67 CLR 116, per Latham CJ, at p 123.
[17] Adelaide Company of Jehovah's Witnesses Inc v Commonwealth (1943) 67 CLR 116, per Latham CJ, at p 132.
[18] Adelaide Company of Jehovah's Witnesses Inc v Commonwealth (1943) 67 CLR 116, per Latham CJ, at pp 131–132.
[19] Reynolds v United States (1878) 98 US 145.
[20] GV Puig and S Tudor (2009) 'To the advancement of thy glory?: A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 61
[21] GV Puig and S Tudor (2009) 'To the advancement of thy glory? A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 61.
[22] *Adelaide Co of Jehovah's Witnesses Inc v Commonwealth* (1943) 67 CLR 116, Latham CJ at p 132, and Starke J at p 155.
[23] Adelaide Co of Jehovah's Witnesses Inc v Commonwealth (1943) 67 CLR 116, per Williams J, at p 159.
[24] SDW v Church of Jesus Christ of Latter-Day Saints [2008] NSWSC 1249: Simpson J.

expressed in s 116 that there had to be a clear intent. That is, '[t]o attract invalidity under s 116, a law must have the purpose of achieving an object which s 116 forbids'.[25] Consequently, a law which just 'incidentally affects that freedom' will be not be invalid due to s 116.[26] By way of example, the refusal of permanent resident status to a person who had come to Australia to take up the position of the Imam of a mosque was held not to be a decision to prohibit the free exercise of religion – even though it was acknowledged there would be some 'disruption of worship'.[27] Indeed it appears that s 116 has been interpreted more as proclaiming tolerance for different religions, as well as the right for an absence of religious belief.[28]

Hogan has observed that:

> The constitutional standing of the relationship between church and state in Australia is a unique mixture of elements derived from a British Constitution and tradition of law, from a superimposed American principle of separation, and from the evolving pattern of Australian federalism and judicial interpretation.[29]

It is argued that the guarantee against imposing 'religious observance' would be interpreted in a similar manner – that is – 'incidental' observance would be valid.

Due to the interpretation the High Court has accorded to s 116 it may be concluded that it is not a guarantee of an individual civil right, instead it should be seen as a regulator of Commonwealth power.[30] Even though the distinction may seem to be a mere syntax, the result is profound, as noted by Stephen J in *Attorney-General (Vic); Ex re Black v Commonwealth* (1981) 146 CLR 559:

> [that s116 did not comprise] some broad statement of principle concerning the separation of church and state, from which may be distilled the consequences of such separation.[31]

However, Latham CJ in the *Jehovah's Witnesses* case did specify the importance of s 116 for minority religions – as 'the majority ...can look after itself':

> Section 116 is required to protect the religion (or absence of religion) of minorities, and, in particular, of unpopular minorities.[32]

Kirby J (dissenting) in *Federal Commissioner of Tax v World Investments Ltd* (2008) 236 CLR 204 while acknowledging the narrow interpretation given to s 116 stated:

> ... for clear historical reasons, the secular character of the Commonwealth and its laws and the separation of the governmental and religious domains constitute settled features of constitutionalism in this country...[33]

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[25] *Kruger v Commonwealth* (1997) 190 CLR 1, per CJ Brennan, at p 40.
[26] *Kruger v Commonwealth* (1997) 190 CLR 1, per Gaudron J, at pp 133-134.
[27] Minister for Immigration and Ethnic Affairs v Lebanese Moslem Association 17 FCR 373, Fox, Burchett and Jackson JJ.
[28] GV Puig and S Tudor (2009) 'To the advancement of thy glory? A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 67.
[29] M Hogan (1981) 'Separation of Church and State: Section 116 of the Australian Constitution'53(2) *AQ* 214, p 214.
[30] GV Puig and S Tudor (2009) 'To the advancement of thy glory? A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 64.
[31] Attorney-General (Vic); Ex re Black v Commonwealth (1981) 146 CLR 559, per Stephen J, at p 609.
[32] *Adelaide Company of Jehovah's Witnesses Inc v Commonwealth* (1943) 67 CLR 116 Latham CJ at p 124. The learned judge further identified that s116 protects not only opinion, but also acts done in pursuance of religious beliefs.
[33] *Federal Commissioner of Tax v World Investments Ltd* (2008) 236 CLR 204, per Kirby J (dissenting), at p 249.

Nevertheless the extent of the reach of s 116 is clearly articulated by Rich J in *Church of New Faith v Commissioner for Payroll Tax (Vic) (1983)* 154 CLR 120:

> Freedom of religion is not absolute. It is subject to powers and restrictions of government essential to the preservation of the community. Freedom of religion may not be invoked to cloak and dissemble subversive opinions dangerous to the Commonwealth.[34]

Having established that s 116 has been interpreted narrowly in terms of separating state and religion, for tax reforms to occur to facilitate Islamic finance, would the Commonwealth's power to tax be sufficient?

Power to 'tax' under section 51

A key issue to facilitate Islamic finance in Australia is, amongst other things, the need for tax reform. The primary power that the Commonwealth would rely on would be s 51(ii) which specifies that:

> The [Commonwealth] Parliament shall ... have power to make laws with respect to ... (ii) Taxation; but not so as to discriminate between States or parts of States".[35]

The taxing power given to the Commonwealth has been described as being very broad. Indeed, Isaacs J (dissenting) in *R v Barger (1908)* 6 CLR 41 described it in the following way:

> The unlimited nature of the taxing power is ... incontestable. Its exercise upon all persons, things and circumstances in Australia is, in my opinion, unchallengeable by the Courts, unless ... a judicial tribunal finds it repugnant to some express limitation or restriction.[36]

Barton J identified that it was possible for such a taxing power 'when exercised to the full it may destroy the interest or the industry taxed'.[37] Due to its width, the Commonwealth can select any criteria it chooses to impose tax. Indeed cases have indicated that the purpose or motive of the legislature or even the economic consequences of tax legislation have no relevance.[38]

The broad interpretation of the Commonwealth's power to tax has been stated as part of the reason for the Commonwealth's dominance over finance, including the federal government's assumption of control over income taxation in 1942,[39] which confirmed that the Commonwealth could give itself priority for payment of tax over the states.[40]

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[34] Church of New Faith v Commissioner for Payroll Tax (Vic) (1983) 154 CLR 120, per Rich J, at pp 149-150.
[35] Commonwealth of Australia Constitution Act (Cth), section 51(ii).
[36] *R v Barger* (1908) 6 CLR 41, per Isaacs J (dissenting), at pp 94-95.
[37] *Osborne v Commonwealth* (1911) 12 CLR 321, per Barton J, at p 345.
[38] MacCormick v Federal Commissioner of Taxation (1984) 158 CLR 622.
[39] Scott Guy (2010) *Constitutional Law*, Pearson Australia, p 314 referring to *South Australia v Commonwealth (First Uniform Tax Case)* (1942) 65 CLR 373.
[40] Scott Guy (2010) *Constitutional Law*, Pearson Australia, p 318: 'Similarly the court held [in the First Uniform Tax Case] that section 221 of the Income Tax Assessment Act 1936 (giving priority to the Commonwealth in the payment of income tax) was also a law with respect to taxation and therefore supported by s 51(ii)'.

The early High Court decision of *R v Barger (1908)* 6 CLR 41 construed the power subject to the 'reserve powers' doctrine.[41] This meant that an Act imposing a tax on the products of a manufacturer (unless the manufacturer offered its employees fair conditions of employment) could be constitutionally invalid. However this reserve power doctrine has been subsequently repudiated by later High Court decisions.[42] For example, later the High Court upheld the validity of Commonwealth laws which used land tax to break up large concentrations of land.[43]

In the *Fairfax* case,[44] Kitto J endorsed the opinion expressed in the United States Supreme Court in *US v Sanchez* (1950) US 42 at p 44:

> that a tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed...Nor does a statue necessarily fall because it touches on activities which Congress might not otherwise regulate.

This is because the High Court traditionally focuses upon a law's direct legal effect, rather than its indirect or economic consequences in characterising laws for constitutional purposes.[45] The decision in *Fairfax* has been stated as recognising that the taxation power is not limited to the raising of revenue for government purposes. Indeed a wide range of objectives – fiscal, social and economic may be achieved through 'tax' legislation.[46] For example, the High Court has upheld the validity of a scheme designed to encourage higher levels of investment in Commonwealth securities.[47]

In *MacCormick v FCT* (1984) 158 CLR 622, Brennan J held that the s 51(ii) power:

> extends to any form of tax which ingenuity may devise' [and] 'the Parliament may select such criteria as it chooses, subject to any express or implied limitations prescribed by the Constitution, irrespective of any connection between them.[48]

Indeed 'politics' has been stated as a greater practical restriction on tax legislation rather than legal, provided the constitutional boundaries are not infringed:[49]

> under s51(ii) the Parliament has, prima facie, power to tax whom it chooses ... exempt whom it chooses ... [and] impose such conditions as to liability or as to exemptions as it chooses.[50]

Guy argues that an expansive approach in the exploitation of its limited legislative powers is illustrated by Kitto J invoking the seminal proposition of Dixon J in *Melbourne v Commonwealth* (1947) 74 CLR 31:[51]

> Speaking generally, once it appears that a federal law has an actual and immediate operation within a field assigned to the Commonwealth as a subject of legislative power, that is enough. It will be held to fall within the power unless some further

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[41] Scott Guy (2010) *Constitutional Law*, Pearson Australia, p 294.
[42] Scott Guy (2010) *Constitutional Law*, Pearson Australia, p 294.
[43] RE Krever and G Kewley, eds (1987) *Australian Taxation: principles and practice*, Longman Cheshire Pty Ltd, p 38: *Osborne v Commonwealth* (1911) 12 CLR 321.
[44] *Fairfax v FCT* (1965) 114 CLR 1, per Kitto J, at p 13.
[45] Australian Trade Commission (2010) *Islamic Finance*, Australian Trade Commission, p 68 quoting *South Australia v The Commonwealth* (1942) 65 CLR 373, per Latham CJ at p 424-425.
[46] RE Krever and G Kewley, eds (1987) *Australian Taxation: principles and practice*, Longman Cheshire Pty Ltd, p 39.
[47] *Fairfax v FC of T* (1965) 114 CLR 1.
[48] *MacCormick v FCT* (1984) 158 CLR 622, per Brennan J, at p 655.
[49] RH Woellner, S Barkoczy, S Murphy, C Evans, and Dale Pinto (2010) *Australian Taxation Law*, 20 ed, CCH Australia Limited, pp 67-68.
[50] *Fairfax v FC of T* (1965) 114 CLR 1, at p 16 Taylor J, and Kitto J at pp 12-13.
[51] Scott Guy (2010) *Constitutional Law*, Pearson Australia, p 300.

reason appears for excluding it. That it discloses another purpose and that the purpose lies outside the area of federal power are considerations which will not in such a case suffice to invalidate the law.[52]

Or put another way:

> If a law, on its face, is one with respect to taxation, the law does not cease to have that character simply because Parliament seeks to achieve, by its enactment, a purpose not within Commonwealth legislative power.[53]

Nevertheless, to fall within this broad head of power the legislation must be enacting a 'tax'. Tax has been stated to be 'a compulsory exaction of money by a public authority for public purposes enforceable by law'.[54] An earlier interpretation referred to tax as 'the process of 'raising money for the purposes of governments by means of contribution from individual persons.'[55]

In *MacCormick v FCT; Camad Investments Pty Ltd v FC of T* (1983-1984) 158 CLR 622, Gibbs CJ, Wilson, Deane and Dawson JJ in the High Court identified the following six characteristics of a 'tax'. Firstly, it is a compulsory payment and secondly, the moneys are raised for government purposes. Thirdly, the moneys do not constitute fees for services rendered and next the payments are not penalties. Fifthly, the exactions are not arbitrary or capricious; and finally, the exaction should not be incontestable.

The importance of classifying whether a law involved a 'tax' – as opposed to a fee for service – was illustrated in *Air Caledonie International v Commonwealth* (1988) 165 CLR 462 which concluded that immigration fees for arriving passengers in Australia was a tax and not a fee for service.

However there are some direct constitutional restrictions on the Commonwealth's taxation power, and they relate to the non-discrimination of states;[56] the non-preference of states;[57] laws imposing tax should only deal with tax and not other matters;[58] the senate is not to introduce or amend tax legislation;[59] and, the Commonwealth cannot impose tax on state

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[52] *Melbourne v Commonwealth* (1947) 74 CLR 31, per Dixon J, at p 79. Known as the 'State Banking Case'.

[53] *Northern Suburbs General Cemetery Trust v Commonwealth* (1993) 176 CLR 555 at p 589 per Mason CJ, Deane, Toohey and Gaudron JJ.

[54] *Matthews v The Chicory Marketing Board (Vic)* (1938) 60 CLR 263; at p 276 Latham CJ; applied by Gibbs J in *The State of Victoria v The Commonwealth* (1971) 122 CLR 353, at p 416.

[55] R v Barger (1908) 6 CLR 41, at p 68 per Griffith CJ, Barton and O'Connor JJ.

[56] *Commonwealth of Australia Constitution Act* (Cth), s 51(ii). Wo RH Woellner, S Barkoczy, S Murphy, C Evans, and Dale Pinto (2010) *Australian Taxation Law*, 20 ed, CCH Australia Limited, p 60: section 51(ii) has been interpreted as prohibiting direct legal discrimination, not indirect/consequential discrimination in the law's operation: it does not matter that is practical operation will disadvantage some taxpayers in particular locations. *WR Moran Pty Ltd* (1940) 63 CLR 338.

[57] *Commonwealth of Australia Constitution Act* (Cth), 99. RH Woellner, S Barkoczy, S Murphy, C Evans, and Dale Pinto (2010) *Australian Taxation Law*, 20 ed, CCH Australia Limited, p 61: section 99 of the *Commonwealth of Australia Constitution Act* (Cth) complements s 51(ii) by prohibiting the giving of a tax preference, and there is unlikely to be a significant difference in practical operation between discrimination and preference: *James v Commonwealth* (1928) 41 CLR 442.

[58] *Commonwealth of Australia Constitution Act* (Cth), section 55: "Laws imposing taxation shall deal only with the imposition of taxation, and any provision therein dealing with any other matter shall be of no effect" This provisions seeks to protect the Senate due to its restricted powers in terms of taxation and section 55 is designed to ensuring that 'tacking' does not occur. Laws relating to the assessment and collection of tax, such as the ITAA, are not 'laws imposing taxation' in the sense that is used in s 55: *Osbourne v Commonwealth* (1911) 12 CLR 321 and confirmed in *FCT v Munro* (1926) 38 CLR 153.

[59] *Commonwealth of Australia Constitution Act* (Cth), section 53 provides that laws imposing taxation may not be introduced or amended by the Senate – although the Senate may return such laws to the House of Representatives with a request of amendments or ommittances.

property.[60]Other provisions that are in part relevant is that the Commonwealth must acquire property on just terms,[61] that the Commonwealth has exclusive power in property acquired by it,[62] and that states are prohibited imposing duties of excise, customs and bounties.[63]

What is the relationship between s 116 and s 51?

Accordingly, for tax reforms to facilitate Islamic finance to be constitutionally valid it is critical to determine the relationship between the religious freedom of s 116 and the Commonwealth's power to tax in s 51. Even though s 116 has been interpreted narrowly, there is judicial commentary to indicate that s 116 is an 'overriding provision applicable to all instruments of laws'.[64] As Latham CJ in the *Jehovah's Witnesses* case phased it:

> It [section 116] prevails over and limits all provisions which give power to make laws. Accordingly, no law can escape the application of s 116 simply because it is a law which can be justified under s51 or s52 ...[65]

Consequently the Commonwealth's power to tax pursuant to s 51(ii) would be subject to s 116. However, to what extent s 116 will invalidate tax law is questionable given how the courts have interpreted it. There are a number of cases that have considered the interplay between s 116 and 51(ii).

In *Halliday v The Commonwealth of Australia* [2000] FCA 950 the applicants sought declarations to set aside the validity of the *A New Tax System (Goods and Services Tax) Act* 1999 (Cth) ('GST')[66] insofar as it related to the imposition of tax collection by persons to forward it to the Commonwealth. One of the taxpayer's assertions was that the Acts used to establish the GST contravened s 116 of the Constitution, in that they 'force certain citizens to impose on others measures and demands contrary to their religion'.[67]

Regardless of the interpretation of Islamic ethics by the taxpayer Sundberg J dismissed the validity of this plea on grounds of an erroneous interpretation of s116.[68] Sundberg J held that

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[60] *Commonwealth of Australia Constitution Act* (Cth), section 114: the states are prohibited from imposing tax on property of any kind belonging to the Commonwealth without the Commonwealth's prior consent, and the Commonwealth is not to impose any tax on property of any kind belonging to a state.

[61] *Commonwealth of Australia Constitution Act* (Cth), section 51(xxxi): Commonwealth power to acquire property 'on just terms from any State or person in respect of which the Parliament has power to makes laws'.

[62] *Commonwealth of Australia Constitution Act* (Cth), section 52(i): gives the Commonwealth Parliament exclusive power to make laws with respect to the seat of government and all places acquired by the Commonwealth for public purposes.

[63] *Commonwealth of Australia Constitution Act* (Cth), section 90: prohibits the states (and territories) from imposing duties of excise, customs and bounties on the production or export of goods.

[64] GV Puig and S Tudor (2009) 'To the advancement of thy glory? A constitutional and policy critique of parliamentary prayers' 20 *PLR* 56 – 78, p 67.

[65] Adelaide Company of Jehovah's Witnesses Inc v Commonwealth (1943) 67 CLR 116, per Latham CJ, at p 123.

[66] The plaintiff raised six grounds in its pleadings challenging the inoperability of the New Tax System (then foreshadowed by the Howard government) citing breaches of a number of Acts as well as the Australian Constitution.

[67] (2000) 45 ATR 458, at p 460.

[68] It is interesting that the plaintiff chose to raise ethical concerns of a minority religious group (Muslims) in its pleadings for, in doing so, it is respectfully argued that this misinterpreted the role of taxation in Islamic law as well as conferring preference on Muslim beliefs, contrary to what the Constitution had intended under s116. The more serious aspect of that case is the impression that somehow Islam encourages tax evasion quoting a dubious dictum 'to not tax, tithe' attributed to Muslims in its pleading.

collecting GST does 'not prohibit the doing of any act in the practice of religion.'[69] Furthermore the Justice held that the relevant part of s116 which precludes the Commonwealth from making a law prohibiting the free exercise of any religion did not constitute a valid ground for not collecting taxes [by Muslims] for payment to the tax authorities.

Sundberg J in the *Halliday* held further that:

> The GST laws (including the withholding provisions) do not prohibit the doing of acts in the practice of religion any more than did the military service law in *Krygger v Williams*. At most they may require a person to do an act that his religion forbids. But that is not within s116. The matter may be approached by asking whether the law is a law "for prohibiting the free exercise of any religion", in the sense that it is designed to prohibit or has the purpose of prohibiting that free exercise, the answer must be in the negative. It is plainly a law of general application with respect to taxation. There is no hint of a legislative purpose to interfere with the free exercise of a Muslim's or anyone else's religion.[70]

The decision in *Halliday* is consistent with the earlier case of *Re Burrowes* where Heerey J rejected arguments of taxpayer in that the taxpayer should be excused from any liability to pay tax because they held a conscientious objection to paying taxes which might be used for military expenditure.[71]

Consequently, it appears that while the power to tax would be subject to an overriding prohibition of religious freedom, provided that the tax law is of general application then s 116 will not invalidate it.

Religion and reform

Having established that it would be possible for tax reforms to be introduced to facilitate faith-based transactions, the observations of Sundberg J in *Halliday* are insightful in determining the extent to which tax reform should take account of religion. Sundberg J quoted *United States v Lee 455* US 252 (1982), a case which involved an Amish person who did not withhold social security taxes because they believed that the payment of the taxes and receipt of benefits would violate the Amish faith:

> The difficulty in attempting to accommodate religious beliefs in the area of taxation is that "we are a cosmopolitan nation made up of people of almost every conceivable religious preference" [*Braunfield v Brown* 366 US 599 at p 606]. The Court has long recognised that balance must be struck between the value of the comprehensive social security system, which rests on a complex of actuarial factors, and the consequences of allowing religiously based exemptions. To maintain an organized society that guarantees religious freedom to a great variety of faiths requires that some religious practices yield to the common good. Religious beliefs can be accommodated ..., but there is a point at which accommodation would 'radically restrict the operating latitude of the legislature'..... Because the broad public interest in maintaining a sound

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If Sundberg's dismissal was based solely on the operative aspect of s116, it is argued that the dismissal is justified even under Islamic law. Refer to the prior historical analysis of Islam and tax.

[69] (2000) 45 ATR 458, at p 465.

[70] *Halliday v The Commonwealth of Australia* [2000] FCA 950, (2000) 45 ATR 458, per Sundberg J, at p 464.

[71] RH Woellner, S Barkoczy, S Murphy, C Evans, and Dale Pinto (2010) *Australian Taxation Law*, 20 ed, CCH Australia Limited, p 57: *Re Burrowes; Ex parte DFC of T* 91 ATC 5021.

> tax system is of such a high order, religious belief in conflict with the payment of taxes affords no basis for resisting the tax.[72]

The essence of Sundberg's judgement goes to the heart of the question posited in the introduction namely; that tax reforms may be appropriate to consider financial transactions structured in a manner to ensure religious compliance. However, the law cannot structure acts to accommodate what a persons' religion forbids – such as for instance the avoidance of interest in contracts – that is a matter for people to exercise personally to which the law is not averse. That way some religious practices must yield to the common good as a way to enable the broad public interest to be maintained.

The *Halliday* case is very instructive to lawmakers seeking legal reforms to facilitate Islamic finance in that it clarifies constitutional tolerance parameters namely, avoiding the furtherance of religious convictions. This position (though strictly not dealing with legal reform) is supported by two English common law cases that established the extent to which English courts will tolerate religious convictions due to the non operability of Islamic tenets in contractual disputation. In *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* (No.1),[73] the defendant failed in its principal defence of upholding shariah law relating to its [defendant's] default in payments, as enforceability could only be determined under English common law and not shariah law. The court of appeal simply set aside the defendants' religious convictions in deciding the merits of the case. The second case of *The Investment Dar Company KSCC v Blom Developments Bank Sal*[74] demonstrated that the plaintiff was not absolved from its obligations to make payments that closely resembled interest payments despite raising the *riba* (interest) prohibition under shariah law.

Furthermore, the necessity for tax and regulatory reform to be binding and comprehensive in relation to Islamic finance was demonstrated in the South African High Court case *Registrar of Banks v Islamic Bank of South Africa Ltd* (in liquidation) (Case No 25286/97) in October, 1997.[75] The regulator approved the granting of a banking licence to the respondent based on shariah principles in the absence of appropriate banking and tax law. In the liquidation proceedings, the court-appointed Inspectors' Report revealed serious misunderstanding and lack of consistency over the tax treatment of so-called 'shariah compliant' financing contracts. Thus, following the bank's collapse, the liquidator simply set aside the shariah construction of depositors' claims as well as clients' debt obligations to the bank and applied conventional banking law in the liquidation proceedings. This demonstrates the necessity for a comprehensive set of laws for regulatory authorities to apply in their governance duties and that religions tenets will not override [secular] tax law.

Thus it is argued that even though s 51(ii) is subjected to s 116, this would not prevent the Commonwealth introducing tax reforms to provide greater faith based transactions, particularly Islamic finance. This is because such tax reforms are not likely to 'prohibit the doing of any act in the practice of religion.'[76] Furthermore, the Commonwealth's power to tax would appear to be broad enough to enable the reforms to facilitate greater Islamic finance. It should be recalled that in the *Fairfax* decision the taxation power was not limited to the raising of revenue for government purposes – but a wide range of objectives – including fiscal, social and economic may be achieved through 'tax' legislation.[77] It has been stated that the Commonwealth cannot favour one religion over another in tax law without necessarily

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[72] *Halliday v The Commonwealth of Australia* [2000] FCA 950, (2000) 45 ATR 458, per Sundberg J, at p 464

[73] [2004] EWCA Civ 19; [2004] 1 WLR 1784.

[74] [2009] EWHC 3545 (Ch).

[75] Nathie (2010) Islamic Bank Failure: A Case Study

[76] *Halliday v The Commonwealth of Australia* [2000] FCA 950, (2000) 45 ATR 458, per Sundberg J, at p 465.

[77] RE Krever and G Kewley, eds (1987) *Australian Taxation: principles and practice*, Longman Cheshire Pty Ltd, p 39.

breaching s 116.[78] Indeed, 'imagination' may be the only effective limit given Brennan J's statement that s 51(ii) power:

> extends to any form of tax which ingenuity may devise' [and] 'the Parliament may select such criteria as it chooses, subject to any express or implied limitations prescribed by the Constitution, irrespective of any connection between them.[79]

Accordingly, the Commonwealth's desire to see Australia emerge as a financial hub in South East Asia through, amongst other things, facilitating greater Islamic financial transactions appears to be constitutionally possible. To this extent it has been stated that Australian reforms for Islamic finance should be 'responsive and enabling' but not 'preferential'.[80]

An interesting parallel to the introduction of Islamic finance emerges in the evolution of faith-based equity funds[81] in the United Kingdom. Sparkes recalls it was the pioneering role of the Quakers, the Methodists and people such as John Wesley that introduced faith-based ethics in investments.[82] He argues that faith-based principles were already in vogue in Wesley's 1760 ethical investment model. Put simply, those principles were reflective of the church's desire to employ its capital to earn profit according to its religious tenets. That transformation led to divergent ethical positions adopted by concerned groups such as those advocating South African Apartheid sanctions in sports.[83] But here's the important observation: changes in the market effectively re-characterised faith-based investments since the ethical stance was strictly no longer representative of any religious doctrinaire. On this basis it seems that while accepting the religious underpinning of Islamic finance, the position adopted by the both the United Kingdom Financial Services Authority and HM Treasury in their desire to promote London as the international financial hub for Islamic finance is one based on 'access to good financial services' and not religion.[84]

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[78] *Attorney-General (Vic); Ex re Black v Commonwealth* (1981) 146 CLR 559 while s 116 may prohibit the Commonwealth Parliament from constituting a 'particular religion or religious body as a state religion or state church', it does NOT stop the Commonwealth Parliament supporting religion generally: per p 597 Gibbs J, at p 582: Barwick CJ, Stephen J: p 608-609, Mason J: 616, Wilson J: 653.

[79] *MacCormick v FCT (1984)* 158 CLR 622, per Brennan J, at p 655.

[80] Australian Trade Commission (2010) *Islamic Finance*, Australian Trade Commission, p 6.

[81] That later morphed into Socially Responsible Investments (SRI's)

[82] R Sparkes (2005) A Historical Perspective on the Growth of Socially Responsible Investment, Greenleaf Publishing.

[83] R Sparkes (2005) A Historical Perspective on the Growth of Socially Responsible Investment, Greenleaf Publishing, pp 52–58.

[84] See the comments by Ian Pearson MP, Economic Secretary to the Treasury: "The Government wants to ensure no one in the UK is denied access to good financial services on account of their religious beliefs. We value the contribution Islamic finance makes to London's position as an international financial centre and we want to see this sector continue to grow and prosper in this country." http://www.hm-treasury.gov.uk/press_136_08.htm.