



OUT10/20244

Review of the taxation treatment of Islamic finance products
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

Dear Sir/Madam

I am pleased to provide these comments as input to the Board of Taxation's *Review of the taxation treatment of Islamic finance products*.

Islamic finance is viewed as a business growth opportunity for NSW and as such NSW has and will continue to encourage and facilitate the development of Islamic finance locally.

Islamic finance will also contribute to the diversification of sources of funds which will in turn assist investment opportunities. I therefore welcome its development in Australia.

Should you require further information please contact Andrew Lowe on (02) 9338 6669 or by email at andrew.lowe@business.nsw.gov.au.

On behalf of NSW, our thanks for the opportunity to comment.

Yours sincerely

KERRY DOYLE
Acting Deputy Director General

COMMENTS TO THE BOARD OF TAXATION DISCUSSION PAPER ON ITS 'REVIEW OF THE TAXATION TREATMENT OF ISLAMIC FINANCE PRODUCTS'

INTRODUCTION

NSW appreciates the opportunity to assist the Board of Taxation's *Review of the taxation treatment of Islamic finance products*, consistent with the NSW Government's aim of ensuring that NSW taxes do not inhibit the expansion of Islamic finance products. NSW provides these comments to assist the Board making findings on state tax laws that will ensure, wherever possible, that Islamic finance products have parity of tax treatment with conventional finance products.

POSITIONING SYDNEY AS A CENTRE OF EXCELLENCE IN ISLAMIC FINANCE

The NSW Government's *Business Sector Growth Plan* outlines the actions and initiatives that the NSW government, together with industry, will undertake to promote long-term economic growth in the State. The Plan has identified developing Sydney as a centre of excellence in Islamic finance as a key action to support growth in the finance, insurance and professional services sector. This Plan was launched by the Premier of NSW, the Hon. Kristina Keneally MP, on 28 September 2010.

Along with addressing possible tax issues, the *Business Sector Growth Plan* sets out that the NSW Government will: continue to work with Austrade and Dubai Export Development Corporation (and others from the Middle East region and the Malaysia Islamic Finance Centre (MIFC)) to develop investment opportunities, including bringing Islamic finance trade and investment missions to Sydney; encourage and facilitate the first corporate and sovereign Islamic bond (Sukuk) issuances in Australia; encourage and facilitate the establishment of Islamic finance studies at NSW-based universities; and develop NSW-specific Islamic finance indices.

LEVEL TAX PLAYING FIELD

The NSW Government supports in-principle a level playing field in the way state taxes apply to Islamic financial products compared to conventional financial products. The difficulty with achieving this lies in identifying: Islamic financial retail transactions (e.g. residential property) and, more significantly, the more complex wholesale commercial transactions; how they interact with state taxes; what amendments are necessary to achieve parity with conventional finance products; and potential revenue impacts – with the need to maintain the integrity of the tax base and not open up opportunities for tax avoidance. Submissions to the Review should assist consideration of at least some of these issues.

Achieving a neutral outcome is unlikely to be straightforward. NSW understands that the United Kingdom experienced some revenue leakage following its initial amendments to achieve tax parity, with its initial amendments opening up opportunities for tax avoidance, but that this has now been rectified. As the Discussion Paper identifies, other jurisdictions have taken a variety of approaches in achieving parity of tax treatment for Islamic finance products.

Islamic financial products are often structured very differently from conventional financial products. This can result in adverse tax treatment of them. For example, under common Islamic finance arrangements, we understand that the legal title in the purchase of real estate is first transferred to the financial institution, and then transferred to the customer following full payment. Under current NSW law, both these transfers attract stamp duty. This could present an impediment to the take-up of Islamic finance products in the residential and commercial sectors in NSW.

NSW is aware that Islamic finance products can potentially face different tax liabilities compared to conventional finance products under the NSW *Duties Act 1997* (and potentially other tax laws).

ABOLITION OF CERTAIN TRANSACTION-BASED TAXES

NSW has already abolished several taxes that may have been applicable to Islamic finance transactions. For example, hiring duty and lease duty were abolished from 1 July 2007 and 1 January 2008 respectively. These taxes were abolished as part of the reforms associated with the *Intergovernmental Agreement on Reform of Commonwealth-State Financial Relations*.

Mortgage duty on owner occupied residences was abolished in NSW from 1 September 2007 and mortgage duty on non owner occupied residences was abolished on 1 July 2008.

Duty on unquoted marketable securities, mortgage duty on business transfers and transfer duty on non-land business assets are legislated to be abolished from 1 July 2012.

NSW STAMP DUTY ISSUES IN DISCUSSION PAPER CASE STUDIES

The Board's Discussion Paper sets out eight case studies and invited responses to various questions concerning those case studies. Possible NSW stamp duty implications of those case studies have been examined and are presented below, along with a brief comparison of NSW Treasury's understanding of Victoria's stamp duty provisions (*Victorian Duties Act 2000*), as sought by the Board's Discussion Paper.

Case Study One: Cost Plus Profit Sale (known as Murabahah)

It is understood that this structure is commonly used for motor vehicle and equipment financing but may be used to finance real property.

The contract for sale of the house from the vendor to the financier for purchase price of \$360,000 would be liable to transfer duty in NSW.

The agreement for the sale of the house on deferred terms would be liable to transfer duty in NSW, applying at the date of the agreement on the consideration for the transaction being \$744,341 (i.e. \$360,000 plus \$384,341).

No first home stamp duty exemption/concession or first home owner grant benefit on the purchase by the financier would apply under the NSW *Duties Act 1997* and the NSW *First Home Owner Grant Act 2000* on the purchase by the financier where the house was to be the first home of the client.

NSW Duty on a traditional structured transaction: Commonly used for motor vehicle finance however not common for home purchases.

Victoria: Provides an exemption for the second agreement where the client is a natural person – see section 57B of the Victorian *Duties Act 2000*.

Case Study Two: Interbank Finance (known as Tawarruq)

It is understood that this structure is used to provide non asset-specific finance and is commonly used as a permissible alternative to a conventional personal loan.

As the transactions relate to commodities there are no stamp duty implications in NSW.

Victoria: No implications.

Case Study Three: Finance Lease (known as Ijarah)

It is understood that this structure is used to provide tangible asset financing and is most commonly used to finance real property as well as motor vehicles and equipment.

If the asset was land or other dutiable property such as a “business asset” transfer duty would be payable in NSW on the initial purchase by the financier. If the asset purchased was a motor vehicle, motor vehicle duty would be payable on the application to register the vehicle in NSW.

No first home stamp duty exemption/concession or first home owner grant benefit provided for in NSW law would apply where a house was to be the first home of the client because title is with the financier.

When the financier leases the asset to the client no duty is payable under the NSW *Duties Act 1997* where the amounts paid are rent.

When the financier gifts or sells the asset to the client transfer duty would be payable in NSW if the asset was land or other dutiable property such as a business asset. If the asset sold was a motor vehicle duty would be payable if the registration of the vehicle was to be transferred into the client's name.

NSW Duty on a traditional structured transaction: In terms of real property, tenants of either the Department of Housing, the Community Tenancy Scheme or the Aboriginal Housing Office are eligible for exemption from duty on purchase of the home where certain criteria are satisfied (s.278 of the NSW *Duties Act 1997*).

Victoria: Provides an exemption for the sale from the financier to the client where the client is a natural person – see section 57A of the Victorian *Duties Act 2000*. Implications for Victorian motor vehicle duty not known.

Case Study Four: Purchase Order (known as Istisna)

Contractual arrangements can be used to finance building and construction projects.

Duty payable in NSW would depend on how the transaction is structured. Duty would be payable where the title to the land changes, and also on transfer of title to the construction where it constitutes a fixture.

Alternatively transfer duty would be payable in NSW on the transfer of the completed project (land and buildings) from the financier to the client. Duty would be calculated by reference to the value of the property at the transfer date.

There is also a suggestion in the case study that a mortgage may be executed, however in this case there would not appear to be a dutiable advance as understood within the NSW legislation.

NSW Duty on a traditional structured transaction: As traditional structures vary the same results with purchase orders are likely.

Victoria: Duty payable as per NSW.

Case Study Five: Pre-paid forward sale (known as Salam)

A forward sale can be used to finance the manufacture of goods.

As the transactions relate to commodities there are no NSW stamp duty implications.

Victoria: No implications.

Case Study Six: Profit and Loss Sharing Partnership (known as Musharakah)

It is understood that this structure is used to provide asset financing and is most commonly used (in Torrens title jurisdictions) for real property financing, but occasionally also used for financing other commercial assets, such as taxi-cab licences. Under NSW duties law:

1. The client and financier form a partnership and the partners purchase assets. Duty would be payable on any acquisition of the assets where they are dutiable property, e.g. land, business assets.
2. When there is a change in the partners, duty would be payable on the change of interest in the dutiable property of the partnership.
3. The client's purchase of the financier's interest would be dutiable on the value of the financier's interest in the dutiable property.

Q6.6 Where this arrangement is used to finance the purchase of real property, the NSW position would be:

1. The financier and the customer contract to purchase the real property from the vendor as tenants in common. The ownership is in proportion to their contributions to the purchase.

2. At settlement the financier sells its interest in the real property to the customer over time. There are at least three ways this may be achieved.
 - i) An agreement for sale of the real property. NSW transfer duty would be payable on the total consideration/property value at the time of the agreement.
 - ii) On each repayment to the financier there would be a small change in beneficial interest in the property which would each be liable to NSW transfer duty.
 - iii) The customer would declare a trust over the interest of the customer in the real property in favour of the financier. The declaration of trust would be liable to NSW transfer duty on the value of the interest.
3. The financier leases its interest in the real property to the customer - nominal duty payable.
4. The financier registers an interest free mortgage over the real property to secure the customer's future repayments. No duty payable.
5. At the end of the arrangement the title is transferred to the customer. Where transfer duty is paid under point 2 above the title transfer would attract nominal duty only.

Where the purchase is of a first home of the customer, the share equity first home concession under section 78B of the *NSW Duties Act 1997* may apply. The first home owner grant would not be payable as the financier is the title holder.

NSW Duty on a traditional structured transaction: The purchasers of most residential property take title to the property with a mortgage taken by the financier to secure the monies advanced to purchase the property. NSW transfer duty is payable on the property purchased.

The case study six structure is akin to shared equity arrangements which are used to finance some affordable housing purchases. The *NSW Duties Act 1997* provides a concession for shared equity arrangements under section 78B which allows the first home duties concession to apply where the first home buyer's interest in the property is at least 50 per cent.

Victoria: One of the possible structures, 2(ii) above, is partly addressed by section 57D of the *Victorian Duties Act 2000* where there is a declaration of trust and the customer is a natural person.

Case Study Seven: Islamic Bond backed by finance lease (known as Sukuk)

An Islamic bond is asset backed with the certificate representing an undivided share in the underlying asset.

Normally transfers by way of mortgage or discharge of mortgage of property other than *NSW Real Property Act 1900* land are exempt from duty. However, depending on the form of the arrangements:

1. Duty could be payable on any transfer of dutiable property from the vendor to the SPV; or
2. Duty could be payable on the transfer of assets which are dutiable property from the SPV to the vendor.

NSW Duty on a traditional structured transaction: As traditional structures vary the same results with Islamic bonds are likely.

Victoria: As per NSW.

Case Study Eight: Islamic Risk Sharing Arrangements (known as Takaful)

The contract parties invest in a pooled investment vehicle where they joint-guarantee each other against specified events, and profits are paid out to investors upon the occurrence of a specified event. The fund does not seek to make profits but to mitigate its losses, but may invest surplus funds in Shariah-compliant assets or financing arrangements.

This is an insurance type of product but would not be dutiable under the insurance duty provisions of the *NSW Duties Act 1997*.

NSW Duty on a traditional structured transaction: Traditional insurance products attract insurance duty at the rate of 9 per cent.

Victoria: As per NSW.

CONCLUSION

The above comments on the stamp duty impact on the case studies should be taken as a guide only of the application of NSW tax law. From the analysis of the case studies, it is apparent that the same economic outcome may be achieved by different transaction forms which would in turn affect the stamp duty liability.

The NSW *Business Sector Growth Plan* states that the NSW Government will respond to the Board's review after it is completed in mid 2011 and the Commonwealth responds. It will be necessary to examine how the structure of transactions would be affected by changes to Commonwealth tax laws to address Islamic finance and their impact on stamp duty outcomes.

NSW will continue to work with the Board of Taxation and consider its final report in 2011.