

The Luxembourg Islamic Finance Package: Direct tax aspects

In June 2009, the Luxembourg Ministry of Finance expressed a strong interest in the development opportunities presented by Islamic finance. It has since made a series of commitments (hereafter the "Islamic Finance Package" or the "Package"), aimed at reinforcing the attraction of Luxembourg to Islamic Finance.

The Islamic Finance Package includes (i) setting up a working group dedicated to making Luxembourg more attractive to Islamic finance, (ii) the issuance by the Luxembourg tax authorities of guidelines to clarify the Luxembourg tax environment for Islamic finance transactions, (iii) an audit regarding the benefits for the Luxembourg Government, or entities belonging to the Luxembourg Government, in using Islamic Finance instruments such as Sukuks as an alternative source of financing and (iv) an application by the Luxembourg Central Bank to become the first "non regional" associate member of the Islamic Financial Services Board, the international regulator of Islamic financial markets.

Implementation of the Package has already begun. On the 23rd November 2009, Luxembourg Central Bank became the first European Union Member State representative to be admitted to the Council of the Islamic Financial Services Board. This admission was approved at the 15th Meeting of the Council of the IFSB held in Kuala Lumpur. On the 18th December 2009, the Luxembourg Government published in the Official Gazette the dates on which the provisions of the double tax treaty and protocol concluded between Luxembourg and the United Arab Emirates on the 19th June 2009 were to become applicable (generally as from the 1st January 2010). On the 12th January 2010, a Luxembourg delegation attended a working seminar in Dubai, "to explore opportunities for greater collaboration in financial services between the Grand Duchy and the MENA region" according to a Luxembourg Finance report.

On the same day, the Luxembourg direct tax administration (administration des contributions directes, hereafter the "LDTA") released a circular (the "Circular") clarifying the tax treatment applicable to Murabaha and Sukuk under Luxembourg direct tax law. The Circular also describes the understanding by the LDTA of the main characteristics of Islamic Finance, as well as a description of so-called Islamic Finance investment instruments.

Current approach of Luxembourg tax law to Islamic Finance

The current Luxembourg direct tax legislation does not refer explicitly or implicitly to Shari'ah-compliant instruments or transactions. The Luxembourg direct tax treatment applicable to such instruments or transactions is governed by Luxembourg general direct taxation principles. The Luxembourg direct tax treatment applicable to Shari'ah-compliant instruments or transactions is generally based on an economic analysis of the transaction rather than on its legal qualification. This is particularly true when transactions or instruments are unknown both to conventional finance and to the Luxembourg legal system. On that basis, some Islamic Finance deals have already been implemented through Luxembourg vehicles, both regulated and non-regulated. The Circular issued by the LDTA provides clarity together with a much appreciated framework for investors and tax practitioners.

Même si les marchés connaissent une période de hausse, nombreux sont ceux qui restent toutefois dubitatifs. Face à la progression du prix des actions et à la relance économique, la prudence et le pessimisme restent cruellement de mise. Pourtant il y a de grandes chances qu'une nouvelle fois encore les sceptiques aient tort. Nous décrivons ci-dessous les sept idées reçues du négativisme ambiant.

Première idée reçue: nier qu'un redressement soit possible. Ce point de vue était commun au printemps dernier alors que le marché atteignait son plus bas niveau. Néanmoins, six mois plus tard, il était évident que la récession est terminée. La reprise est internationale et les études démontrent que l'amélioration se poursuit.

Deuxième idée reçue: le redressement sera faible. Ce point de vue est très répandu actuellement mais va à l'encontre des observations historiques affirmant que "les récessions profondes sont très souvent suivies de reprises rapides" - dit la règle de "Zarnowitz". Les récentes tendances illustrent mieux cette règle simpliste que les schémas de reprise en forme de U ou de L prévus par les experts.

Ces nouvelles données déroutent les pessimistes qui se tournent vers une **troisième idée reçue:** un scénario de reprise en W. Celle-ci consiste à prétendre que le redressement ne sera pas durable, emporté de nouveau par la faiblesse économique dès le retrait du soutien poli-



Scope of the Circular

Taxes covered by the Circular

The Circular aims at clarifying the Luxembourg direct tax treatment applicable to Murabaha transactions and Sukuks issuance. The Circular covers Luxembourg corporate income tax ("impôt sur le revenu des collectivités"), municipal business tax ("impôt commercial communal"), as well as withholding tax on payments relating to Sukuks. The Circular does not address VAT and other indirect taxes (stamp duties, transfer taxes, etc...) which could have significant implications on a given transaction. At present, no specific guidance has been issued by the Luxembourg VAT Authorities on this topic. The financial and administrative implications of a given transaction must therefore be analyzed with the utmost attention based on general concepts applicable to indirect taxes prior to closing the transaction and discussed with the Luxembourg indirect taxes administration (administration de l'enregistrement et des domaines) on a case-by-case basis. The scope of the Circular is limited to Luxembourg direct tax treatment and does not cover regulatory issues (such as business permit procedure in case of "Murabaha deals", etc...). It incidentally covers accounting treatment applicable to profit, as defined in the Circular, derived under a Murabaha transaction.

Islamic Finance instruments and transactions falling within the scope of the Circular

The Circular only focuses on the Luxembourg direct tax treatment applicable to Murabaha and Sukuks. However, the LDTA found it appropriate to introduce Luxembourg taxpayers and practitioners to Islamic Finance by providing a general description of Islamic Finance principles and techniques. In particular, the Circular describes Musharakha, Modaraba, Ijara, Ijara wa Iqtina and Istinah. It is important to note that these financing techniques often back the issuance of Sukuks. The fact that the LDTA does not provide for the Luxembourg direct tax treatment applicable to these transactions or financial products should not prevent investors from planning their implementation in Luxembourg. The economic analysis of these transactions or agreements allows for a tax treatment qualification under Luxembourg general direct tax principles. The understanding of the applicable tax treatment may be confirmed with the LDTA on a case-by-case basis.

Luxembourg taxable persons falling within the scope of the Circular

The Circular expressly excludes Luxembourg Undertakings for Collective Investments (hereafter "UCITS") from its scope. This may be explained by the fact that UCITS are exempt entities for Luxembourg corporate income tax purposes.

Luxembourg direct tax treatment applicable to Murabaha and Sukuks

Luxembourg tax spreading regime applicable to Murabaha transactions

It is generally known that Shari'ah law prohibits riba (for the sake of simplicity this is understood as the prohibition of earning interest under a conventional finance approach), gharar (uncertainty, unknown or hidden consequences incorporated in an agreement), investment in Shari'ah unlawful commodities or activities (alcohol, gambling etc...). This set of rules has led Shari'ah compliant economic operators to develop spe-

cific financing techniques. Among these techniques, Murabaha is a source of financing for customers lacking personal finances and wishing to purchase goods where an Islamic Bank intermediates between the goods seller and the final customer. Basically Murabaha consists in a purchase and re-sale on a cost plus agreement entered into by an Islamic Bank or its affiliate (hereafter the "Islamic Financing party") and the final customer. The Islamic Financing party purchases from a third party a good, which has been predefined with the final customer, and re-sells the good to the final customer. Under the Murabaha transaction, the final customer benefits from a price payment deferral granted by the Islamic Financing party. Instalments cover the acquisition cost paid by the Islamic Financing party to the initial supplier of goods, as well as the mark up.

Under Luxembourg accounting and tax law, transactions are taken into account on a commitment basis rather than on a settlement basis. As far as sale and purchase agreements are concerned, the sale is complete between the parties, and ownership is acquired by the buyer, as soon as the good or service subject to the agreement and the price have been agreed upon, although the item has not yet been delivered or the price paid. This means that the seller is generally taxable on the profit, if any, disclosed upon such a transaction once the sale is complete. The Circular states that under a Murabaha transaction, profit derived by the Islamic Financing party carrying on its activity from Luxembourg can benefit from the existing regime applicable to continuous or discontinuous services. Subject to the conditions listed below, the profit will be recognised for Luxembourg direct tax purposes on a linear basis during all the Murabaha payment deferral period, regardless of the effective instalments payments (hereafter the "Luxembourg tax spreading regime").

The profit of the Islamic Financing party derived from the Murabaha transaction may benefit from the Luxembourg tax spreading regime to the extent the following formal requirements are met:

- The Murabaha agreement clearly highlights that the Islamic Financing party acquires the good in order to resell it, either immediately or within a 6 month period, to the final customer;
- The fee for intermediation services provided by the Islamic Financing party, the profit derived by the Islamic Financing party from the price payment deferral, the acquisition price paid by the Islamic Financing party and the acquisition price paid by the final customer appear distinctly from the terms and conditions of the Murabaha agreement;
- The profit derived by the Islamic Financing party is clearly explained, known and agreed on between the parties to the Murabaha agreement;
- The profit derived by the Islamic Financing party is expressly designated as being in return for the price payment deferral in the Murabaha agreement.

Accounting wise, the Islamic Financing party is required to spread its profit on a linear basis during the price payment deferral period provided for by the Murabaha agreement. The Luxembourg tax spreading benefit is limited to the profit derived by the Islamic Financing party from the price payment deferral, and is not applicable to any other fee / income, e.g. for intermediation services, recognised by the Islamic Financing party. In a certain sense, the Circular only extends the existing "conventional" regime to Murabaha transactions. It remains to be seen whether the profit definition provided for by the Circular is compatible with Shari'ah scholars' views on "free from riba and gharar" Murabaha agreements.

Sukuks

The Circular defines Sukuks as securities, whose yield and principal depend on the performance of tangible assets or the usufruct of such tangible assets (hereafter the "Assets"). The Assets' cash flows are allocated to the Sukuks' yield and principal repayment. Based on these features, a risk exists that Sukuks' yield may be nil, and

Sukuks principal may not be totally repaid in the case the Assets are underperforming. Under the Circular, Sukuks are comparable to conventional finance debt instruments for Luxembourg direct tax purposes. Therefore, the yield on Sukuks qualifies as interest and is treated as tax deductible if incurred in the best interest of the Issuer. The Circular indicates that Luxembourg income tax law (hereafter "TIL") provisions relating to sleeping partners and participating bonds do not apply to the Sukuks' yield, which means that it is not considered as a dividend distribution for Luxembourg direct tax purposes and is not subject to Luxembourg withholding tax.

Contrary to its Murabaha approach, we understand the Circular's section on Sukuks is drafted in general terms and does not seem to provide stringent requirements. This position is particularly relevant in the light of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) statement on Sukuks issued in February 2008. The Sukuks' definition provided for in conventional finance countries tends to assimilate a Sukuk to a bond security. Under civil law, bond securities do not generally entitle their holder to any right of ownership of the assets which are legally owned by the bonds issuer. This does not appear to be in line with the Sukuks' characteristics as provided for in the AAOIFI statement, especially regarding the following features:

- "Sukuk [...] must be owned by Sukuk holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of Shari'ah"; and,
- "The Manager issuing Sukuk must certify the transfer of ownership of such assets in its (Sukuk) books, and must not keep them as its own assets."
- "Sukuk, to be tradable, must not represent receivables or debts," except in specific circumstances listed in the statement.

The general terms under which the Circular is drafted seem particularly flexible, which should allow for Sukuks as defined under the AAOIFI statement to qualify for the debt treatment for Luxembourg direct tax purposes. Again, the understanding of the applicable tax treatment may be confirmed with the LDTA on a case-by-case basis.

Perspective and opportunities

Major Islamic investors, especially those investing in pan-European real estate assets, have already experienced the Luxembourg tax and legal environment's compatibility with Shari'ah compliant financing techniques. More than 32 Shari'ah compliant UCITS have been launched or listed in Luxembourg and many more privately held investment structures were set up in accordance with Shari'ah compliant financing. The LDTA Circular is a further evidence of the Luxembourg Government's and the Luxembourg financial industry's will to implement the Islamic Finance Package. The Islamic Finance friendly environment so implemented is supposed to be as successful in attracting fundraisers seeking to broaden their investor base to Shari'ah compliant investors and Islamic Finance institutions willing to expand out of their natural geographical markets as it was in the past decade to attract the private equity and real estate fund industries to the Grand Duchy of Luxembourg. In this context, taking additionally into account its current legal, tax and regulatory environment, its track record in the above mentioned industries as well as in the UCITS implementation and bond listing industries, its steady political regime and favorable geographical location, Luxembourg is definitely a must-review jurisdiction in the globalizing Islamic Finance industry.

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Le scepticisme en sept étapes

tique. Un tel scénario n'est pas impossible mais reste toutefois peu probable. Les récessions en forme de W sont rares - seulement cinq reprises économiques sur 33 aux Etats-Unis se sont terminées après moins de 18 mois depuis les années 1800 et seulement une sur onze depuis la seconde guerre mondiale. Afin d'éviter l'année prochaine une récession en forme de W, deux conditions devront être satisfaites. Tout d'abord, le marché de l'emploi devra s'améliorer en 2010. Le nombre de chômeurs augmente toujours mais dans une moindre mesure, coïncident avec un minimum atteint en fin d'année 2009. Ensuite, la masse monétaire globale doit continuer de croître, ce qui a été le cas fin 2008, favorisant ainsi un redressement des marchés et de l'économie. Sa croissance s'est ralentie récemment mais demeure néanmoins positive.

Quatrième idée reçue: la croissance sera décevante à moyen terme. Il existe des raisons évidentes à ce pessimisme: une diminution des aides à la relance économique, des banques en difficulté ainsi que le surendettement des ménages. Cependant, la vraie question est de savoir quelle sera l'amplitude de ces phénomènes. Prenons l'exemple d'un durcissement des mesures fiscales. Les données historiques sur plusieurs pays montrent qu'une réduction du déficit est compatible avec une croissance économique solide à condition que l'augmentation des mesures fiscales s'étende sur plusieurs années. Les politiciens en sont conscients et feront preuve de prudence dans leur "stratégie de sortie". Les banques manquent actuellement de capitaux et l'offre de crédit est limitée. Cependant, en début de reprise, la demande de crédit est généralement faible. Parallèlement, les banques ont recommencé à faire des

profits, renflouant ainsi leurs fonds propres. Dans un an, les banques devraient être mieux positionnées pour fournir les crédits nécessaires à la reprise économique.

En ce qui concerne le surendettement des ménages, il s'agit d'un problème récurrent en Grande Bretagne, aux Etats-Unis et ailleurs - en générale, le ratio d'endettement est plus faible dans la plupart des économies émergentes. De plus, les taux d'intérêts excessivement faibles ont réduit la pression de la dette de façon plus gérable. Les freins à la consommation devraient être plus faibles qu'attendu, tant que les taux d'intérêt restent bas. Ces arguments en faveur d'une baisse des marchés négligent un élément qui a tendance à soutenir la croissance: les dépenses en investissement n'ont jamais été aussi faibles et présentent une marge d'augmentation significative. En résumé, les inquiétudes concernant la croissance à moyen-terme semblent trop alarmistes. Il est possible que les freins soient moins importants que prévus et qu'ils soient compensés par une reprise de l'investissement.

Cinquième idée reçue: le redressement de l'économie et des marchés pourrait être remis en cause du fait de l'instabilité des prix - qu'il s'agisse d'un mouvement déflationniste comme celui vécu au Japon ou d'une inflation plus forte qui nécessiterait une restriction monétaire plus importante. Les déflationnistes expliquent que la stagnation économique va provoquer une baisse des prix. La chute des prix est historiquement associée à une faiblesse monétaire, ce qui est contestable actuellement. Une augmentation de l'inflation semble être le risque principal, notamment parce que la croissance des économies émergentes devraient continuer à

être forte, entraînant une augmentation du prix des matières premières. De plus, les politiques monétaires ne devraient pas se durcir au préalable étant données la faiblesse du système bancaire et la pression politique pour soutenir la croissance.

Sixième idée reçue: qui concerne les valorisations des marchés plutôt que les prévisions économiques: les prix ont totalement intégré les "bonnes nouvelles". Cette idée n'est cependant pas applicable aux actions. Par exemple, le price to book ratio des indices mondiaux reste inférieur à sa moyenne à long-terme, même en excluant le secteur financier.

Dernière idée reçue: L'augmentation des taux d'intérêt stoppera instantanément la reprise économique et le rallye des marchés. Cependant par le passé, les taux ont habituellement atteint un niveau "acceptable" avant d'avoir un impact négatif - événement peu probable dans les douze mois à venir, voir à plus long-terme.

Les prévisions économiques et les perspectives de marché demeurent des sources d'inquiétude. Il en est toujours ainsi lors d'une reprise. Les risques d'investissement sont à leur paroxysme quand l'avenir semble radieux. Mieux vaut dès lors affronter les problèmes que de les ignorer.

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