

# The Luxembourg Islamic Finance Package – Direct Tax Aspects

By Jamal Afakir

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 “Package”), aimed at reinforcing the attraction of Luxembourg to Islamic finance.

The 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 Sukuk 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 (IFSB), the international regulator of Islamic financial markets.

Implementation of the Package has already begun. On the 23<sup>rd</sup> 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 15<sup>th</sup> Meeting of the Council of the IFSB held in Kuala Lumpur.

On the 18<sup>th</sup> December 2009, the Luxembourg government published in the official gazette the dates when the provisions of the double tax treaty and protocol concluded between Luxembourg and the UAE on the 19<sup>th</sup> June 2009 were to become applicable (generally as from the 1<sup>st</sup> January 2010). On the 12<sup>th</sup> 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 (Middle East and North Africa) region” according to a Luxembourg finance report.

On the same day, the Luxembourg Direct Tax Administration (LDTA) released a circular (the “Circular”) clarifying the tax treatment applicable to Murabahah 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.

## Approach of Luxembourg tax law towards Islamic finance

The current Luxembourg direct tax legislation does not refer explicitly or implicitly to Shariah 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 Shariah 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.

## Scope of the Circular

### Taxes covered by the Circular

The Circular aims at clarifying the Luxembourg direct tax treatment applicable to Murabahah transactions and Sukuk issuance. The Circular covers Luxembourg corporate income tax, municipal business tax, as well as withholding tax on payments relating to Sukuk.

The Circular does not address VAT and other indirect taxes such as stamp duties, and transfer taxes, 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 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 the case of Murabahah deals. It incidentally covers accounting treatment applicable to profit, as defined in the Circular, derived under a Murabahah transaction.

### Islamic finance instruments and transactions within the Circular

The Circular only focuses on the Luxembourg direct tax treatment applicable to Murabahah and Sukuk. 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 Musharakah, Mudarabah, Ijarah, Ijarah wa Iqtina and Istisna. It is important to note that these financing techniques often back the issuance of Sukuk.

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

It is generally known that Shariah law prohibits riba (the prohibition of earning interest under a conventional finance approach), gharar

*continued...*

## The Luxembourg Islamic Finance Package – Direct Tax Aspects (continued)

(uncertainty, unknown or hidden consequences incorporated in an agreement), investment in Shariah unlawful commodities or activities such as alcohol and gambling.

This set of rules has led Shariah compliant economic operators to develop specific financing techniques. Among these techniques, Murabahah 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, Murabahah consists of 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, goods that have been predefined with the final customer, and re-sells the goods to the final customer.

Under the Murabahah 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.

### “The Circular indicates that Luxembourg income tax law provisions relating to sleeping partners and participating bonds do not apply to the Sukuk yield”

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 Murabahah transaction, profit derived by the Islamic financing party operating from Luxembourg can benefit from the existing regime applicable to continuous or discontinuous services. Subject to the conditions listed below, the profit will be recognized for Luxembourg direct tax purposes on a linear basis during all the Murabahah payment deferral period, regardless of the effective instalment payments (hereafter the “Luxembourg tax spreading regime”).

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

- The Murabahah agreement clearly highlights that the Islamic financing party acquires the goods in order to re-sell it, either immediately or within a six-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 Murabahah agreement;
- The profit derived by the Islamic financing party is clearly explained, known and agreed on between the parties to the Murabahah agreement;
- The profit derived by the Islamic financing party is expressly designated as being in return for the price payment deferral in the Murabahah 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 Murabahah 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, such as for intermediation services, recognized by the Islamic financing party.

In a certain sense, the Circular only extends the existing “conventional” regime to Murabahah transactions. It remains to be seen whether the profit definition provided for by the Circular is compatible with Shariah scholars’ views on “free from riba and gharar” Murabahah agreements.

### Sukuk

The Circular defines Sukuk 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 Sukuk yield and principal repayment. Based on these features, a risk exists that Sukuk yield may be nil, and Sukuk principal may not be totally repaid in the case the Assets are underperforming.

Under the Circular, Sukuk are comparable to conventional finance debt instruments for Luxembourg direct tax purposes. Therefore, the yield on Sukuk 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 “ITL”) provisions relating to sleeping partners and participating bonds do not apply to the Sukuk 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 Murabahah approach, we understand the Circular’s section on Sukuk 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 Sukuk issued in February 2008.

The Sukuk 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 *continued...*

## The Luxembourg Islamic Finance Package – Direct Tax Aspects (continued)

not appear to be in line with the Sukuk 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 Shariah”; 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 Sukuk 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 Shariah compliant financing techniques. More than 32 Shariah compliant UCITS have been launched or listed in Luxembourg and many more privately

held investment structures were set up in accordance with Shariah compliant financing.

The LDTA Circular is 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 successful in attracting fundraisers seeking to broaden their investor base to Shariah compliant investors and Islamic financial institutions willing to expand out of their natural geographical markets. As successful 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 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.<sup>(9)</sup>

The author would like to thank Samantha Nonnenkamp (Director, Atoz) and Tim Birch (FIAD) for their valuable help.

**Jamal Afakir**  
**Director**  
**Atoz Tax Advisers, Member of Taxand**  
**Email: Jamal.Afakir@atoz.lu**



## Islamic Finance: Opportunities for Tomorrow

25<sup>th</sup> - 28<sup>th</sup> October 2010, Kuala Lumpur

**GLOBAL ISLAMIC FINANCE FORUM**

The Global Islamic Finance Forum (GIFF) 2010, themed “Islamic Finance: Opportunities for Tomorrow”, will be held in Kuala Lumpur from the 25<sup>th</sup> to the 28<sup>th</sup> October 2010. GIFF 2010 is a platform to discuss and exchange views and insights on the growth potential and opportunities in Islamic finance.

**Lead Media Partners**




**Media Partners**






Sponsors for IFN Asia Forum 2010

**Lead Sponsors**








**Associate Sponsors**




**Research Partner**



**Technology Partner**



**Booth Sponsors**





**Takaful Associate**



**For further information on GIFF 2010 or to register, please visit [www.GIFF2010.com](http://www.GIFF2010.com)**