

# An important first step

## Executive summary

- Sukuk are a form of Islamic financial instrument that have similar characteristics to corporate bonds.
- Given the large amounts of liquidity in the Muslim world, corporate treasurers should consider issuing sukuk to diversify their funding sources.
- New tax rules should be welcomed as an important first step enabling UK companies to issue sukuk and putting on a firm foundation the taxation of investors in sukuk.

MOHAMMED AMIN

EXPLAINS THE NEW  
SUKUK RULES IN THE UK.

Sukuk are a form of Islamic financial instrument whose popularity has grown rapidly over the past decade. As described in the article "Islamic Finance" in the December 2005 issue of *The Treasurer* (page 34), they have similar characteristics to corporate bonds. Given the large amounts of liquidity in the Muslim world, corporate treasurers may be considering whether they can issue sukuk to diversify their funding sources.

Figure 1 shows a possible structure for a modaraba sukuk. The modaraba agreement can be thought of as a kind of limited partnership. XYZ Trading Company Ltd (the modarib) operates the purchased assets rather like a general partner, while the trust (the rab al-maal) receives 99% of the economic benefits, rather like a limited partner, subject to an overall cap of 6%, so that the trust receives only sufficient funds to make the periodic payments to the investors. If 99% of the modaraba profits are insufficient to fund the investor payments, they lose their entitlement to the balance, so the investors have some downside risk, which is considered necessary to comply with Islamic law.

Prior to any changes in UK tax law, there were three significant areas where taxation issues could arise:

### Potential treatment of the modaraba agreement as a partnership

The issuing vehicle XYZ Sukuk Ltd would be taxable on its share of the income from the modaraba agreement.

**Distribution treatment** The issuer XYZ Sukuk Ltd would not be given tax relief for its payments to the sukuk investors. These payments represented an ownership entitlement to the receipts from the assets contributed to the modaraba agreement and would not be seen as a financial expense of the issuer. Furthermore, even if they were seen

as a financial expense, under section 209(2) (e) (iii) of the Income and Corporation Taxes Act 1988, interest paid on "securities under which... the consideration given... is... dependent on the results of the company's business" is treated as distribution, which means that the payment would not be tax-deductible.

The overall result would be that XYZ Sukuk Ltd would be taxed on the profits received, and only the lower post-tax amount would be available to pass on to the sukuk investors. This outcome would be considerably less favourable than the treatment of a conventional interest-paying bond.

**Transaction taxes** Finally, there was scope for transaction taxes. The sponsor XYZ Trading Company Ltd first sells the assets to XYZ Sukuk Ltd acting as a trustee, and eventually there will be a sale of the assets to back to the sponsoring company. With UK land and buildings there could be significant charges in stamp duty land tax at a rate of 4% on transaction values which exceed £500,000.

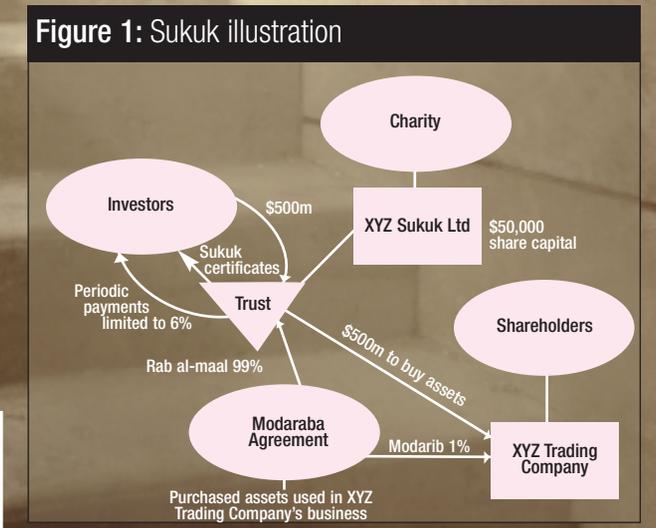
Sometimes sukuk are convertible and any new UK tax legislation needed to recognise this. Furthermore, sukuk structures could be designed to issue sukuk with unlimited participation rights. Such sukuk would have the economic characteristics of equity rather than debt and needed to be appropriately treated by any new tax rules.

**THE NEW UK TAX LAW** The relevant legislation is contained in the Finance Act 2007 s53. However, a reader searching the Act will not find any reference to sukuk or Islamic finance. There are instead detailed rules applicable to something called an alternative finance investment bond.

Since the UK began legislating for Islamic finance in the Finance Act 2003, it has scrupulously avoided any reference in the legislation to Islamic finance or to the Arabic names of any specific Islamic finance structures. Tax law needs to apply equally to all taxpayers, irrespective of their religious beliefs. Accordingly, the UK approach is to define certain types of transactions, give them descriptive names for ease of reference, and then set out a tax treatment which applies to those transactions. The tax legislation applies regardless of whether the transactions are sharia-compliant or not.

The Finance Act 2007 contains a detailed set of requirements for

Figure 1: Sukuk illustration



arrangements which give rise to an alternative finance investment bond. Some of the more important requirements are that:

- one person (the bondholder) pays a sum of money (the capital) to another (the bond issuer);
- bond assets which the bond issuer will acquire to generate income or gains are identified;
- a period when the arrangements will end (the bond term) is specified;
- the bond issuer undertakes to dispose of any remaining bond assets at the end of the bond term, to make repayments of capital during or at the end of the bond term, and to make other payments to the bondholder (additional payments);
- the additional payments must not exceed what would be a reasonable commercial return on a loan equivalent to the capital;
- the bond issuer undertakes to manage the bond assets;
- the bondholder is able to transfer his rights to other persons who thereby become bondholders;
- the arrangements are listed on a recognised stock exchange as defined in the Income Tax Act 2007 s1005. This mirrors the requirement for Eurobonds to be listed if interest is to be paid gross without withholding tax; and
- the arrangement would be treated as a financial liability of the bond issuer if accounted for under international accounting standards.

Having set out a prescriptive set of definitional requirements, the legislation then contains a number of relaxations:

- The issuer can acquire the bond assets before or after the arrangements take effect;
- Bond assets may be property of any kind, including rights in relation to property owned by another person;
- A declaration of trust may be used but is not mandatory;
- Bondholders are allowed to have early termination rights;
- The additional payments can be fixed or variable. However, if they are not fixed, then the test of whether they exceed a reasonable

commercial return on a loan equivalent to the capital is made by reference to the maximum amount of additional payments. This may cause difficulty if the maximum amount cannot be determined;

- The redemption payment may be reducible if there is a decline in the value of the bond assets or their income; and
- It is permitted to satisfy the redemption payment by the issue or transfer of shares or securities.

It is possible to designate a stock exchange for the purposes of the alternative finance investment bond rules, without having to designate it for other purposes. This power has now been used to designate certain foreign stock exchanges where existing sukuk are listed without the UK having to recognise those exchanges for all other tax purposes.

If the detailed requirements set out in the Finance Act 2007 are satisfied, then XYZ Sukuk Ltd is taxed in the same way as it would be if the alternative finance investment bond were a debt instrument issued by it. Accordingly, although XYZ Sukuk Ltd remains taxable on the income received from the modaraba, it will now receive tax relief for the income payments made to the sukuk investors. Overall, the sponsor and XYZ Sukuk Ltd together now receive tax relief equivalent to the relief due if the sponsor had issued a conventional interest paying bond.

Also, if the alternative finance investment bond is listed on a stock exchange that is recognised for tax purposes generally, income payments can be made without withholding income tax in the same way no income tax is withheld on interest paid on listed Eurobonds.

The Finance Act 2007 also specifies that investors in alternative finance investment bonds will receive the same tax treatment that would have applied if the alternative finance investment bond had been a debt security issued by the special purpose vehicle. The legislation is careful not to say that the alternative finance investment bond is a debt instrument; it merely applies the same tax treatment that would have applied if the alternative finance investment bond had been a debt instrument.

**HOW WELL DOES THE NEW LEGISLATION WORK?** From the investor's perspective, the Finance Act 2007 rules governing the taxation of investments in alternative finance investment bonds appear satisfactory.

The rules acknowledge that convertible sukuk may be issued as the legislation allows the redemption payment to be satisfied by the issue of shares (normally issued by the sponsoring company) or by the transfer of shares. That would be the case with an exchangeable sukuk where the sponsor undertook to deliver the shares of another company such as one of its subsidiaries. An exchangeable sukuk structure has been used at least twice in Malaysia by a holding company to monetise its investments in subsidiary companies.

In the case of issuing companies, the rules are workable and in straightforward cases will enable UK companies to issue sukuk and to obtain tax relief for the income payments on them. However, the new rules are not entirely satisfactory for issuers and there is not yet a level playing field between companies seeking finance through issuing sukuk and companies issuing conventional bonds.

In particular, transfer taxes have not been addressed by the new rules. For example, if a UK building is transferred to the sukuk issuer (XYZ Sukuk Ltd) as part of the arrangements, stamp duty land tax at a rate of up to 4% is payable. Similarly, if the building has appreciated since the owner originally acquired it, the sale will crystallise a taxable capital gain without any provisions in the legislation providing relief.

Conversely, if the owner merely issued a conventional bond

secured on the building, there would be no stamp duty land tax or taxable capital gain since the conventional bond could be issued without requiring a transfer of the building.

**AN IMPORTANT FIRST STEP** The new legislation should be welcomed as an important first step enabling UK companies to issue sukuk and putting on a firm foundation the taxation of investors in sukuk. The remaining difficulties mentioned above can be addressed by future legislative changes as the UK government is continuing to consult on the technical aspects of this legislation.

The UK government is also carrying out a study to decide whether it should become an issuer of wholesale Islamic financial instruments and a separate study to determine whether National Savings & Investments should provide retail savings products designed for

sharia-compliant investors. The pre-Budget report on 9 October gave an interim report, and explained that the government was considering a range of issues including the features that a sukuk would need in order to be issued at the same price as a gilt or Treasury bill.

If the UK government does decide to issue Islamic financial instruments, its actions will be closely watched by governments across the world.

Mohammed Amin is a tax partner at PricewaterhouseCoopers and leads its Islamic finance practice in the UK. He is a member of HM Treasury's Islamic Finance Experts Group.

[mohammed.amin@uk.pwc.com](mailto:mohammed.amin@uk.pwc.com)  
[pwc.blogs.com/mohammed\\_amin](http://pwc.blogs.com/mohammed_amin)  
[pwc.com/uk](http://pwc.com/uk)

## THE RISE AND RISE OF ISLAMIC FINANCE

Although a young segment of the financial industry, Islamic finance has gone through an exceptional growth period, *write Humphrey Percy and Natalie Schoon*. Over the past 10 years, it has grown at a rate of 15%-20% a year to more than 300 Islamic financial institutions in over 75 countries. At the end of 2006 the estimated size of the total market, including banking, mortgages, equity funds, fixed income, insurance, project finance and private equity, was \$400bn.

The Islamic banking sector in the UK, though still relatively small, is growing fast. London has more banks providing Islamic financial products than the rest of Europe combined, making it the largest centre for Islamic finance outside the Muslim world. This level of growth is expected to continue and far exceeds the rate of growth in conventional finance.

The key drivers behind this trend are:

- The increase in wealth (and resulting investment needs) in oil-producing countries resulting from the rise in oil prices;
- Greater understanding and acceptance of sharia'a-compliant offerings by issuers, investors and borrowers;
- Growth in Islamic capital market products, particularly the sukuk;
- Continued development of Middle Eastern capital markets and the predicted growth of project finance and Islamic structured finance, driven by infrastructure development projects.

**ESTIMATING THE SIZE OF THE SUKUK MARKET** Although \$400bn appears to be a reasonable estimate, the actual size of the market is difficult to determine. Not all Islamic banks are required to make their annual reports public, which results in a lack of publicly available data. In addition, Islamic windows of conventional banks do not report the contribution of Islamic finance to their overall balance sheet. By the end of 2004, total assets with Islamic financial institutions were estimated to be in excess of \$260bn<sup>1</sup>, which is 91% bigger than the estimated \$137bn in 1994. Although the increase of 91% over a period of 10 years is significant, this has been eclipsed by a growth of 53% between 2004 and 2006, a large portion of which is associated with sukuk issuance.

Large conventional banks have a key advantage over Islamic banks because of the backing of a big balance sheet and structuring capabilities. This becomes clear when comparing the total assets of the largest Islamic bank with total assets of the large conventional banks. At the end of 2006, the largest Islamic bank (Al Rajhi) had total assets of \$28.1bn. The likes of HSBC, Barclays and Citi each had a total asset base close to \$2 trillion. As a result it is much easier at present for conventional banks to underwrite large sukuk

issues and to structure sizeable project finance structures than it is for Islamic banks.

The majority of sukuk issued between June 2006 and June 2007<sup>2</sup> has been managed by Malaysian institutions. However, with the exception of the Malaysian government and Abu Dhabi Investment Bank, conventional banks have managed by far the largest individual issues during this period.

**OTHER ISLAMIC FINANCE PRODUCTS** During the first half of 2006, the total volume of non-sukuk Islamic deals<sup>3</sup> stood at \$9.1bn, exceeding the \$9.05bn total deals in the whole of 2005, up from \$1.275bn in 2004. Even though information about these deals is scarce, the growth between 2004 and the first half of 2006 indicates the potential. Murabaha constituted the largest share (59%), followed by ijara (25%) and project finance (10%). Middle Eastern borrowers took the major share, with more than 90%.

The infrastructure investment in the Gulf region alone is estimated to exceed \$500bn by the end of 2008, and although some of this might be financed conventionally, a number of deals will be financed using Islamic financial structures.

As with the sukuk market, a gap exists between the share of Middle East-based borrowers and conventional issue managers, with the share of Middle Eastern borrowers close to 90% versus the share of Middle Eastern lead managers at only 47% for the first half of 2006<sup>4</sup>.

**RAPID GROWTH EXPECTED** Islamic finance is expected to continue to grow rapidly for some time to come. Although at the moment a large part of Islamic financial products is offered by Islamic windows of conventional banks, the number of fully Sharia'a-compliant banks is increasing, and are successfully winning at least part of the business that is currently the preserve of the Islamic windows of conventional banks.

*Humphrey Percy is the CEO of Bank of London and the Middle East, and Natalie Schoon is Head of Product Development at the bank.*  
[info@blme.com](mailto:info@blme.com)  
[www.blme.com](http://www.blme.com)

### Footnotes

<sup>1</sup> *Islamic Banking & the Halal Economy*, presentation by CIMB Banking Group, May 2006

<sup>2</sup> *Islamic Financial News*

<sup>3</sup> *Islamic Finance Information Service (IFIS) website*

<sup>4</sup> *Islamic Finance Information Service (IFIS) website*