taxnotes® international

Volume 82, Number 7 ■ May 16, 2016

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by Mohammed Amin

Reprinted from *Tax Notes Int'l*, May 16, 2016, p. 687

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FEATURED PERSPECTIVE

How Should VAT Systems Treat Islamic Finance Transactions?

by Mohammed Amin

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This article is an output from the research work on international tax aspects of Islamic finance transactions being conducted by the International Tax and Investment Center (www.iticnet.org), with the financial support of the Qatar Financial Centre Authority (http://www.qfc.qa/en).

In this article, the author discusses VAT issues regarding Islamic finance transactions and how some countries have addressed those challenges.

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Most countries developed their tax systems in an environment of conventional finance. However, while Islamic finance has similar economic objectives to conventional finance, it usually involves transactions that are very different. Accordingly, unless tax systems properly accommodate Islamic finance transactions, prohibitive tax costs can arise.

That applies to direct taxes as well as indirect taxes such as the VAT, which some countries call a goods and services tax. This article illustrates some VAT concerns, using a hypothetical VAT rate of 20 percent for simplicity.

When all parties to a transaction are registered for VAT and carry on businesses that qualify for full recovery of VAT on costs, any VAT charges that arise represent no more than a short-term cash flow problem at worst. However, if a party is not in business (for example, a retail consumer) or is conducting a business unable to recover VAT on all its costs (for example, a bank), there is a risk of prohibitive VAT costs arising.

This article also looks at how some countries have addressed those challenges and proposes a conceptual framework to assist VAT policymakers.

VAT and Conventional Financial Services

VAT is by definition a tax on ''value added.'' When implemented, it effectively operates as a form of consumption tax on final consumers.

In most cases, tax authorities require businesses to compute VAT by totaling the VAT charged on all sales during the period (output tax), deducting the aggregate VAT paid on all purchases during the period (input tax), and paying the net amount to the tax authority. If the net amount is negative, the tax authority normally pays a cash refund to the business.

Conceptually, finance costs are excluded when computing the value added of a business. Accordingly, VAT logic requires that there be no VAT charged on interest payments. In VAT language, lending money with interest does not involve making a taxable supply. A consequence is that banks cannot deduct input tax on the costs of their lending-related activities. Instead, that input tax represents a cost.

For example, a $1,000 computer will cost a regular business just $1,000, because the $200 VAT charged by the computer supplier is recoverable input tax. However, a $1,000 computer actually costs a bank $1,200 because the $200 VAT it has to pay to the computer supplier is not recoverable.

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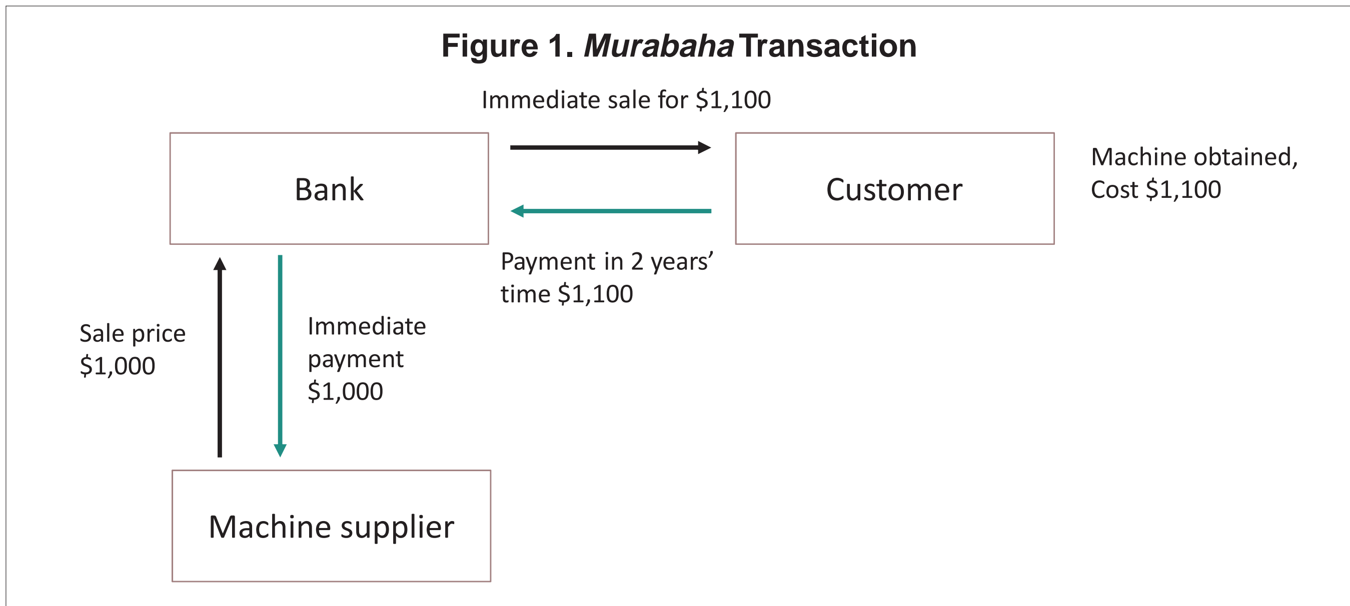

Figure 1. *Murabaha* Transaction

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Governments sometimes deviate from that simple treatment to encourage the location of some types of banking activity in their jurisdiction. For example, New Zealand allows banks to recover input VAT on the provision of financial services to a business 75 percent of whose supplies are taxable. Similarly, the U.K. enables banks operating there that provide financial services to persons outside the European Union to recover VAT on overhead costs stemming from the provision of those services.

Islamic Finance Transactions and VAT

While many different types of transactions take place in Islamic finance, this section uses just two relatively simple and common ones to illustrate the difficulties that can arise.

Murabaha (Purchase and Resale)

If the customer of a conventional bank requires finance to purchase a $1,000 machine, the conventional bank will lend $1,000 to the customer who then purchases the asset. In, say, two years, the customer will repay the $1,000 loan plus, say, $100 accumulated interest.

The analogous Islamic finance transaction is *murabaha*, in which the bank will purchase the $1,000 machine, resell it to the customer at a higher price, say, $1,100, with the markup being disclosed. The sale price is payable in two years in one lump sum. No interest is charged (see Figure 1).

VAT Analysis

In a conventional bank loan, there is a $1,000 taxable supply of the machine by the supplier to the customer with $200 VAT charged. If the customer carries on a business making taxable supplies, it can recover the $200 VAT, so the customer's final machine cost is $1,000 plus $100 of interest, or $1,100. (For simplicity, the customer's cash flows relating to the $200 VAT payment and its recovery, if allowed, are ignored in both examples.)

In a *murabaha* transaction, there are two supplies of the machine. The first is Machine Supplier to Bank for a price of $1,000, on which $200 VAT is charged. The second is Bank to Customer for a price of $1,100. As a supply of goods, that should be subject to VAT of $220. That has a few potential implications:

- Bank should be able to recover the $200 VAT it paid on the purchase of the machine, because it has used the machine to make a taxable — that is, nonexempt — supply. Accordingly, Bank would pay $20 to the tax authority, or the $220 output VAT it has charged the customer less the $200 input VAT.
- In most VAT jurisdictions, when a business incurs costs that are partly used to make exempt supplies and partly used to make taxable supplies, the costs must be apportioned on a reasonable basis to determine what part relates to making taxable supplies. VAT on that portion of the costs is then recoverable. Accordingly, Bank may be able to recover VAT on part of its overhead costs, because it is making a taxable supply of the machine. VAT recovery does not arise in a conventional bank loan.
- If Customer carries on a taxable business, it can recover the VAT, so the $220 VAT represents merely a cash flow issue. However, if Customer cannot recover the VAT (either because it is a retail customer or is a customer engaged in a business making exempt supplies), the VAT of $220 becomes a cost. In that case, the aggregate cost to Customer of using Islamic finance is higher than

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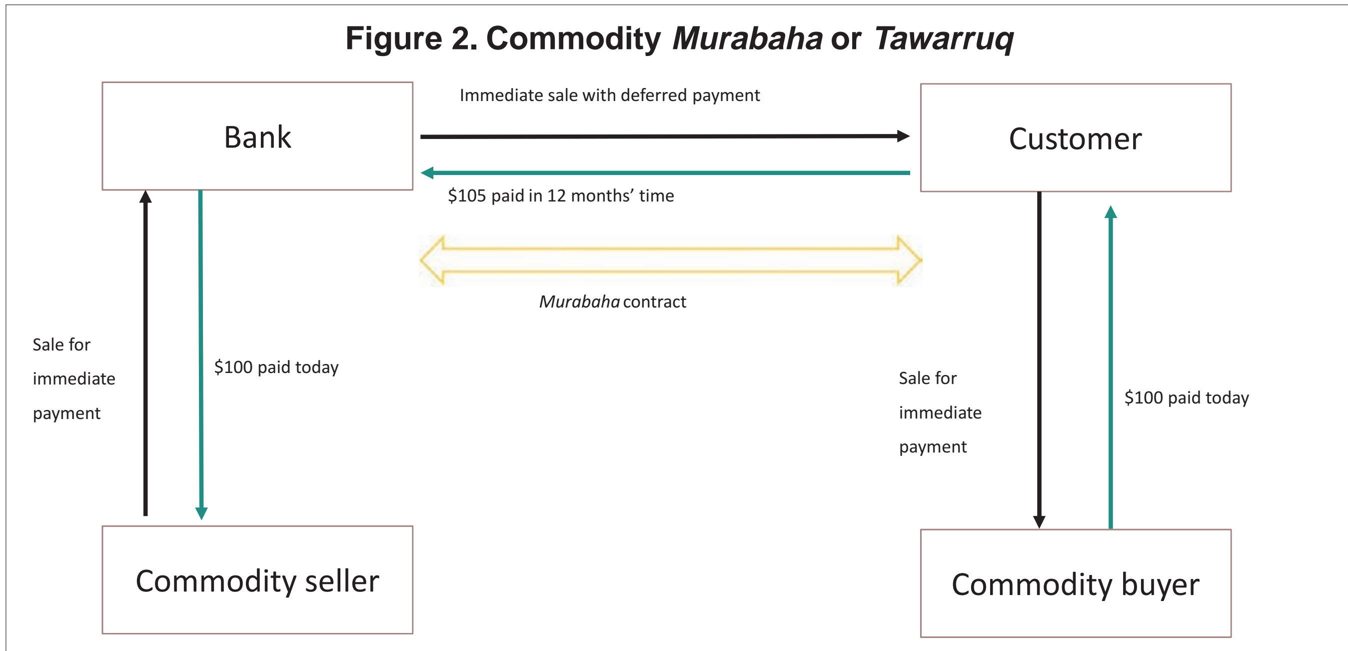
Figure 2. Commodity *Murabaha* or *Tawarruq*



it would have been with conventional finance. The aggregate cost with conventional finance is $1,300, or $1,000 machine + $200 VAT + $100 interest. The aggregate cost with a *murabaha* transaction is $1,320, or $1,100 machine + $220 VAT. The difference represents VAT at 20 percent on the $100 implied finance cost being the *murabaha* transaction's uplift in the purchase price of the machine.

Commodity *Murabaha*

Often customers require finance from banks not for the purchase of specific assets but for other business purposes such as the payment of wages. A conventional bank will simply lend money to the customer and charge interest. For example, it might lend $100 today at 5 percent simple interest, with $105 repayable in 12 months.

A common way for Islamic banks to provide cash to customers is a commodity *murabaha* transaction, also known as *tawarruq*. The bank purchases a commodity (for example, copper) for $100, making immediate payment. The bank then sells the copper to the customer for $105, with immediate delivery but deferred payment. The $105 deferred price is payable in 12 months. As soon as the customer owns the copper, it sells it for its open market value of $100 (ignoring any small bid/offer spread) for immediate delivery and immediate payment.

After the above transactions, the customer owns no copper but has $100 in cash. It must pay the bank $105 in 12 months. Ignoring transaction costs, the economics for both the bank and the customer are identical to a $100 one-year loan at 5 percent simple interest (see Figure 2).

VAT Analysis

There are three copper sales, each a supply of goods, subject to VAT in the absence of any special provisions. The first is a sale from the commodity seller to the bank, a straightforward taxable supply of $100 of copper on which $20 VAT is charged. The bank then sells the copper to the customer for $105 plus VAT of $21. The bank and the customer must agree whether the $21 VAT is to be paid by the customer to the bank immediately, or whether it is also to be deferred for 12 months. The VAT treatment of the customer's sale of the copper to the commodity buyer for $100 depends on whether the customer is in business or is a retail customer.

If the customer is in business, the sale of copper for $100 should be a taxable sale subject to 20 percent VAT. The customer will collect $20 of VAT from the commodity buyer, but can offset the $21 of VAT paid on purchasing the copper from the bank. That results in a net refund of $1 VAT by the tax authority to the customer.

If the customer is not in business, the sale of the copper for $100 to the commodity buyer does not appear to be a sale in the course of a business. Accordingly, no VAT would be chargeable. Critically, the customer then has no way of recovering the $21 VAT it paid on its purchase of the copper. That $21 cost does not arise on a conventional bank loan and in practice makes the transaction prohibitively expensive.

VAT on Islamic Finance Transactions

Several countries with VAT systems have considered how Islamic finance transactions should be treated, and their approaches are relatively consistent.

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South Africa

The South African VAT regime is set out in the Value-Added Tax Act, 1991 (Act No. 89 of 1991). Section 8A addresses Islamic finance.

For a *murabaha* transaction, the client is deemed to have acquired the goods from the original seller for the original sales price and can recover (or not recover, depending on the client's circumstances) VAT accordingly. The *murabaha* markup received by the bank is treated as an exempt supply of financial services.

In the murabaha example discussed earlier, the customer would be treated as purchasing the machine from the original seller for $1,000 (with $200 VAT) and would be in the same economic position as if it had taken out a conventional bank loan. No VAT would arise on the bank's $100 markup under the *murabaha* transaction.

The definition of *murabaha* used is in section 24JA of the Income Tax Act, 1962 (Act No. 58 of 1962).

Singapore

The VAT law of Singapore is in the Goods and Services Tax Act, originally legislated in 1993 and revised in 2005.

The Fourth Schedule addresses exempt supplies, including financial services, and there are provisions within it for Islamic finance. For *murabaha* financing, paragraph 1(ra) treats the provision of the financing as an exempt financial service. The effective return earned by the bank is an exempt supply. Accordingly, in the example above, the customer would not face VAT being charged on the $100 markup earned by the bank, and the bank would charge only VAT of $200, equalizing the Islamic finance and conventional finance transaction.

Malaysia

The Malaysian Goods and Services Tax Act (GSTA) 2014 came into force relatively recently, on April 1, 2015.

GSTA 2014 Schedule 2 is called "Matters to Be Treated as Neither a Supply of Goods nor a Supply of Services," and paragraph 5 is called "Supply of Goods or Services Under Islamic Financial Arrangement." It states:

> Where any person makes a supply of goods or services under an Islamic financial arrangement, any supply made in such arrangement other than the provision of financing shall be treated as neither a supply of goods nor a supply of services.

The apparently straightforward consequence is that those supplies are ignored for GST purposes. However, the statute does not detail how to ascertain which supplies are excluded from being supplies of goods or services.

Royal Malaysian Customs has issued a series of guides to the GST, one of which is called "Guide on Islamic Banking." It goes through several Islamic finance transactions, itemizing the supplies that take place and explaining how the provision quoted above is applied in practice.

The overall consequence in Malaysia is that the GST consequences to the customer and the bank from using Islamic financing should be the same as using conventional finance, because the intermediate supplies that take place within the Islamic finance transaction are ignored for GST purposes.

Identifying Islamic Finance Transactions

The legislation in South Africa, Singapore, and Malaysia refers to Islamic finance transactions, with a relatively detailed definition. Strictly speaking, it introduces a religious test into secular tax law, which might not be acceptable to other countries. As seen below, the U.K. takes a different approach. U.K. tax law proceeds by looking only at the economic implications of the transaction, without any concern for whether it qualifies religiously as Islamic finance, so religious tests do not enter into the U.K. tax system.

United Kingdom

VAT is a harmonized tax in the EU. However, the EU has not accounted for Islamic finance in EU VAT law. Consequently, unlike with direct taxes, the U.K. cannot deviate from EU VAT by legislating for Islamic finance transactions.

However, on its website, HM Revenue & Customs has set out its views on how U.K. VAT law applies to several common Islamic finance transactions. The treatment of *murabaha* transactions is outlined in HMRC leaflet VATFIN8200, which states:

> Where goods are sold with title to the asset passing "from the bank to the customer the sale is treated in the same way as a credit sale (see paragraph 4.3 of Notice 701/49 Finance). There are two supplies being made by the bank — one of the goods and one of the facility to defer payment. Consideration for supply of the goods will follow the normal liability rules. The 'profit' element will be treated as consideration for the facility to defer payment and will be exempt under the VAT Act 1994, Schedule 9, Group 5, item 3."

Consequently, in the example, the bank that sells the machine to the customer charges the customer VAT on only $1,000, leaving the customer in the same VAT position as with a conventional loan.

To analyze the commodity *murabaha* transaction above, one must refer to HMRC leaflet "VAT Notice 701/9: Commodities and Terminal Markets." As discussed above, commodity *murabaha* becomes problematic if the customer is not engaged in a business that makes taxable supplies because significant VAT costs can arise. The U.K. VAT regime for commodities and terminal markets, taken together with the U.K.'s special warehousing regime, significantly reduces, and in most cases eliminates, those potential problems.

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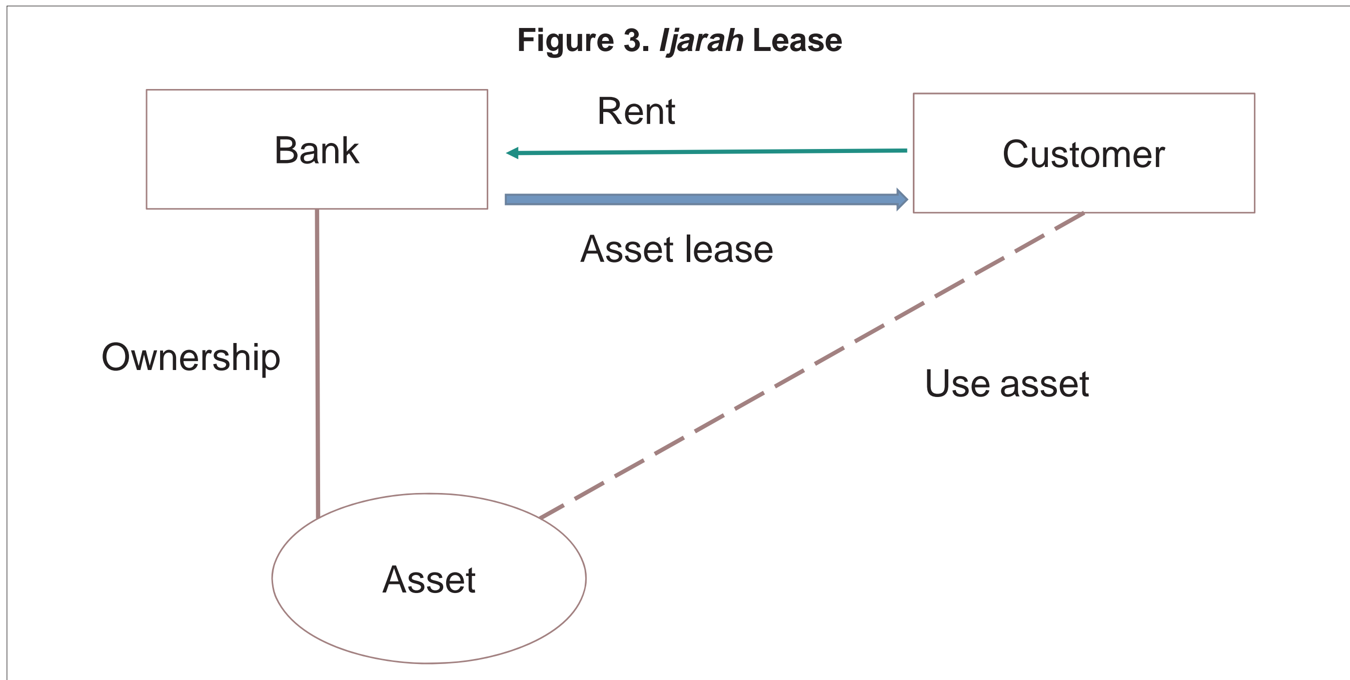
Figure 3. *Ijarah* Lease



While VAT Notice 701/9 covers many types of transactions, the one most likely to be encountered in Islamic finance is the sale of an identifiable commodity. For example, the subject of the commodity *murabaha* transaction could be copper in which individually numbered bars of pure copper are bought and sold to achieve the desired economic consequences. Those kinds of copper transactions would take place on the London Metal Exchange (LME), which is one of the terminal markets listed in VAT Notice 701/9 section 4.

As a result of that provision, in the commodity *murabaha* example, if the commodity seller and buyer are LME members, and if the bank and the customer engage LME members to buy and sell the copper on their behalf, all the transactions legally will be between LME members, either as principals or agents with the copper never leaving the warehousing regime that allows sales of the copper to be treated as if they were taking place outside the U.K. The result is that no VAT will be charged on any of the copper sales, leaving the customer in the same position as with a conventional bank loan.

The fact that the U.K. has not needed to legislate for the VAT treatment of Islamic finance demonstrates that by and large its VAT regime (and indeed that in the EU) is capable of handling many Islamic finance transactions without giving rise to excessive VAT costs compared with the equivalent conventional finance transactions.

Conceptual Framework

Transactions Similar to Conventional Transactions

Some Islamic finance transactions are almost identical to their conventional counterparts. An example is *ijarah* (leasing that complies with rules set by Shariah scholars), which does not look any different from a conventional asset lease (see Figure 3).

Accordingly, an *ijarah* lease contract should not raise any significant VAT problems that are not raised by a conventional leasing contract. The same will be true for other Islamic finance transactions that are virtually identical to their conventional counterparts, in terms of the entities involved and their roles in the transaction and the cash flows.

Peripheral Transactions

An Islamic finance transaction might have an ''inner core'' that is similar to a conventional finance transaction but requires many peripheral transactions to allow it to happen. For example, multinational groups often issue interest paying bonds to investors from bond-issuing special purpose vehicles (SPV) that then lend the money borrowed to a group operating company. Similarly, *sukuk* (often colloquially called ''Islamic bonds'' even though they are not debt instruments) are issued by an SPV that passes the money raised to a group operating company.

However, as illustrated by the *sukuk* transaction in Figure 4, several peripheral transactions are needed to enable the income stream on the sukuk to arise.

It might be that existing VAT law is adequate to allow those peripheral transactions to be carried out with adverse VAT costs in the form of irrecoverable VAT. Otherwise, it will be necessary to draft legislation to ensure those peripheral transactions do not cause additional VAT costs.

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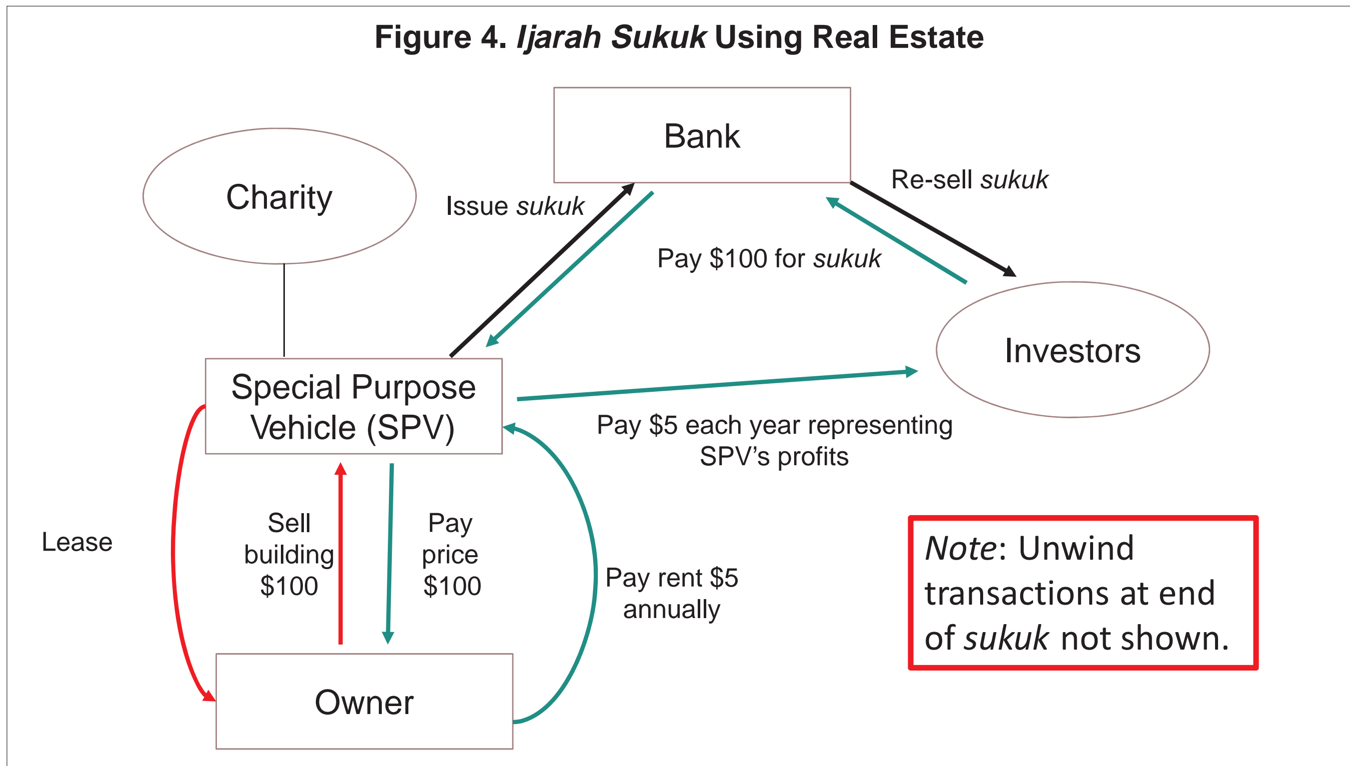
Figure 4. *Ijarah Sukuk* Using Real Estate



Different Islamic Finance Transactions

One example of an Islamic finance transaction that is not structurally similar to its conventional counterpart is the commodity *murabaha* or *tawarruq* transaction discussed earlier. That arrangement achieves the same economic outcome as a fixed-term, interest-bearing loan, but the transactions are different. It can involve multiple supplies of goods or services, which would not exist in an equivalent conventional finance transaction.

As illustrated above, that situation creates the greatest risk of the Islamic finance transaction giving rise to VAT costs, which would not arise in an equivalent conventional finance transaction. Unless existing tax law (such as the U.K. rules for commodities and terminal markets) already operates to avoid additional VAT costs, legislation will be needed to create parity of tax treatment between conventional and Islamic finance. ◆

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