Revenue Commissioners

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Islamic Finance

Introduction

Islamic finance covers any financing arrangement that is compliant with the principles of Shari'a law. Specifically, there are rules that forbid making or receiving interest payments. Islamic finance arrangements use familiar legal structures in an alternative way (insofar as debt is concerned) to achieve the financing objectives. For tax purposes, depending on the circumstances, transactions which are structured to be Shari'a compliant may or may not be treated similarly to mainstream financial transactions, which are similar in substance.

This article outlines the tax treatment of Shari'a compliant products and structures within the funds, leasing and insurance industries.

Funds

The primary characteristic that distinguishes Islamic fund management from conventional investing is its compliance with Shari'a law. A Shari'a Fund is required to appoint a Shari'a Board which provides guidance to the directors of the Fund and to the investment manager on matters of Shari'a law and in particular whether the proposed investments of the fund are Shari'a compliant.

The arrangement between a fund and its service providers can either be based on a service fee or a share in the profits of the fund or a combination of both. If the fund sustains a loss, the loss is borne by the investors.

Taxation of a fund and its service providers

The taxation of funds is governed by Part 27 of the Taxes Consolidation Act (TCA) 1997. Chapter 1A of that Part applies the gross-roll-up taxation regime to all funds set up after 31 March 2000. The regime does not impose an annual tax on the profits of the fund but requires the fund/fund manager to deduct and account for tax out of payments made to unit holders – except for certain classes of unit holder who can, by use of a declaration procedure, be paid gross. Provided the fund is constituted in accordance with Chapter 1A, these arrangements apply irrespective of whether the fund is a Shari'a compliant fund or a conventional fund.

Taxation of service providers

Income received by a service provider which is linked to the profits or performance of a fund should be treated as fee income where it relates to duties performed by the service provider.

VAT on funds

There is no specific VAT exemption for funds. The VAT analysis of a fund would depend on the activities of the fund.

Stamp Duty

A liability to stamp duty does not arise on the issuance or redemption of units/shares in a fund. In addition, the transfer of units/shares in a fund is not chargeable to stamp duty to the extent that the fund is an investment undertaking within the meaning of section 739B of the TCA 1997 or a common contractual fund within the meaning of section 739I of the TCA 1997.

Ijarah (Leasing and Hire Purchase) Arrangements

In principle, an Ijarah contract is similar to a conventional leasing arrangement. A normal Ijarah arrangement would generally refer to an operating lease. However, Ijarah arrangements can also be used to structure finance leases or hire purchase transactions.

Ijarah used for an operating lease

The key features of an Ijarah arrangement that is similar to an operating lease are set out below:

- Under an Ijarah contract, a person(s) (lessor) leases an asset to another person (lessee) for periodic rental payments (lease rentals). The lessor can be the owner of the asset or an intermediary lessor.
- During the lease period, the asset remains the property of the owner who would normally bear the burden of wear and tear.
- If the asset is to be insured, the lessor or the lessee may insure it but it must be at the lessor's expense. Such cost may however be implicitly factored into the calculation of the lease rental.
- The lease rentals are specified in the lease agreement and these can be fixed or variable amounts.
- Where a lease rental becomes overdue, the lessor does not charge any interest. However, the contract may require the lessee to make an additional payment towards a charitable cause.
- On the expiry of the lease term, the asset is handed back to the lessor.

Ijarah used for a finance lease

An Ijarah arrangement which is similar to a finance lease is commonly referred to as Ijarah Muntahia Bittamleek. Its features are broadly similar to a normal Ijarah arrangement (an operating lease). The key additional features of this arrangement are:

- In an Ijarah Muntahia Bittamleek, the lessor promises to transfer the title to the asset to the lessee for a consideration or at a token value or by way of a gift. The transfer is subject to instructions from the lessee and may be contingent upon a particular event, such as payment of the remaining lease instalments. The promise to transfer the ownership is binding on the lessor only and the lessee has an option not to proceed with the transfer.

- The arrangement relating to the transfer of title is set out in a document separate to the lease contract.

Ijarah used for a hire purchase

An Ijarah arrangement can also be used to structure a hire purchase transaction. The key features of this arrangement are set out below.

- The arrangement is broadly similar to a normal Ijarah arrangement (an operating lease). Additionally, the lessee promises to acquire the lessor's interest in the asset over the lease term for an agreed price.

- Normally, the lessor's interest in the asset is divided into a number of units and the periodic lease rental payments are split between (a) lease rental payment; and (b) payment for acquiring interest (units) in the asset. The lessee's interest in the asset therefore typically increases over time.

- Normally, the legal title in the asset remains with the lessor until the final lease rental is paid.

Taxation of an Ijarah arrangement

The provisions of the Taxes Consolidation Act 1997 will apply as if:

- the Ijarah arrangement in relation to operating leases, as described above, were a conventional operating lease arrangement;

- the Ijarah Muntahia Bittamleek in relation to finance leases, as described above, were a conventional finance lease. Accordingly, a company that accounts for the transaction as a finance lease under generally accepted accounting practice, may be taxed in accordance with the provisions of section 80A TCA 1997 in respect of relevant short term leases on making a claim; and

- the Ijarah arrangement in relation to hire purchase, as described above, were a conventional hire purchase arrangement.

However, it must be noted that this confirmation is limited to Ijarah that refers to the leasing of plant and machinery and other chattels. It does not apply to the lease of immovable property.

Where the lease contract requires the lessee to make an additional payment towards a charitable cause in the event of a lease rental becoming overdue, the transaction will be treated as if the lessee had made the payment directly to the lessor and the lessor made the payment towards the charitable cause (which is in fact the normal sequence of payments). The lessee will be entitled to a deduction and the lessor will be treated as having received the income but will be entitled to a deduction under section 848A TCA 1997, subject to the provisions of that section.

Stamp Duty

A charge to stamp duty will not arise in relation to Ijarah (Leasing and Hire Purchase) arrangements where the asset involved does not comprise immovable property or an interest in immovable property.

VAT

The VAT treatment of an Ijarah (Finance Lease and Hire Purchase) arrangement in relation to immovable property transactions will depend on the specifics of the agreements. Generally, such agreements are likely be regarded as the supply of a freehold equivalent interest by the lessor to the lessee at the time the agreement is entered into. As regards arrangements which cover goods other than immovable property, the normal VAT rules concerning leasing (a supply of services), transfer of title (supply of goods) or hire purchase (a supply of goods), as appropriate, would apply.

Previous guidance given by Revenue in relation to the taxation of conventional operating and finance leases and to hire purchase arrangements will, in substantially similar circumstances, also apply to the equivalent Ijarah transactions.

Takaful (Insurance) and Retakaful (Reinsurance) Arrangements

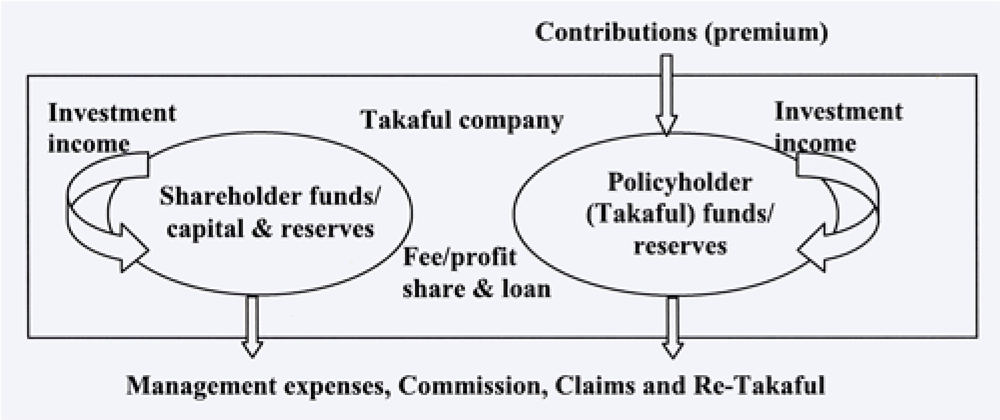
Takaful or ReTakaful arrangements are broadly equivalent to conventional insurance and reinsurance arrangements respectively.

Takaful arrangements

Takaful is an arrangement amongst a group of persons participating in a scheme under which the Takaful members (policyholders) jointly indemnify each other against any loss or damage that may arise to any of them. To this effect, Takaful members pool funds by way of contributions. The resulting fund is used to make compensation (claim) payments for any loss or damage arising to any Takaful member. The claim payments are generally restricted to actual damage or loss and the opportunity costs (such as loss of potential income) are generally ignored. The entire arrangement relating to the receipt of contributions, claim payments and the management and operation of a Takaful fund is managed by a Takaful company.

Broadly speaking, a Takaful arrangement is similar to a mutual insurance arrangement with the difference that Takaful members are typically not shareholders/unit-holders in the Takaful company which operates the arrangement for the Takaful members. The operator company is paid a fee for the services rendered and/or is entitled to a share in the return received on the fund's investments. The term General Takaful is normally used as a reference to a general insurance arrangement while the term Family Takaful would normally refer to a life assurance arrangement.

A Takaful arrangement can be illustrated as follows:



A Re-Takaful (reinsurance) arrangement also works in a similar way where the Takaful companies take the role of the Takaful members and the ReTakaful company takes the role of the operator of the scheme.

General Takaful Arrangement

The following are the key characteristics of a General Takaful arrangement.

- A company sets up a Takaful fund with contributions from the Takaful members (policyholders). The company records Takaful funds separately from its own share capital and reserves.

- The policyholders agree to compensate each other for any loss. This is normally set out in the insurance policy or other related documentation.

- The Takaful fund is used to make payments for any loss arising to a Takaful member (claim) and for any payments to a ReTakaful operator (reinsurance payments). The surplus funds are invested by the company. The return on investments creates a reserve in the Takaful fund.

- The company would normally charge a fee for its services relating to the management and the operation of the Takaful fund. The fee may be fixed or a share in the returns on Takaful investments. It is also possible that the company is paid a fixed fee and is also entitled to a share in the return received on Takaful investments. The arrangement is normally set out in the insurance policy or other related documentation.

- Normally marketing and management expenses and commission payments are paid by the company out of its own funds.

- A loss relating to Takaful funds is normally charged to the Takaful fund and ring-fenced from the company's reserves. Likewise, a loss relating to the company's investments/activities is normally borne by the company and ring-fenced from Takaful funds.

- In case there is a shortfall in the Takaful fund, the company would normally make an interest free loan to the fund. Generally, the loan is repayable only out of a future surplus arising in the Takaful fund.

- If there is a surplus in the Takaful fund, the surplus is used for repayment of any interest free loan owed to the company. Any remaining surplus can either be reserved for future losses or the company may decide to make a distribution to the policyholders. The distribution amount may be adjusted against the contribution payment relating to the following year.

- On dissolution or winding up of a Takaful fund, any surplus in the fund may be distributed amongst those who contributed to the Takaful fund or amongst those who are members (policyholders) of the fund on the day of dissolution or winding up. The surplus or any part thereof may also be given to charity. The Takaful funds cannot be diverted to the company.

Family (Life) Takaful Arrangement

A Family (Life) Takaful arrangement works in a broadly similar way to a General Takaful arrangement. It is similar to a conventional life assurance or a savings scheme wrapped in a life policy. The following are the key differences:

- The amounts received from the Takaful members (policyholders) are split between (a) a Contribution Account; and (b) an Investment Account. The split is agreed with the policyholder at the time of issuance of the policy and is generally based on the actuarial valuation of the associated risks. The Contribution Account is generally reserved for life assurance claims. If the Takaful member survives the policy term, the member is only entitled to receive the amount paid into the Investment account and any accumulated profits attributable to such amount.

- The profit made on Takaful investments is apportioned amongst the policyholders (Takaful members) or retained as a reserve for the future. The arrangement is normally set out in the insurance policy or other related documentation, as is the case with conventional life assurance.

ReTakaful (Reinsurance) Arrangement

A ReTakaful (Reinsurance) arrangement broadly works in a similar way to a conventional reinsurance arrangement. Various Takaful companies participate in a ReTakaful fund set up by a ReTakaful company. The ReTakaful company acts as the operator of the ReTakaful arrangement. The distinction between the company's capital and reserves and ReTakaful funds is maintained and both are ring-fenced from each other. The ReTakaful company may be paid a service fee and/or a share in the profit made on investments made out of ReTakaful funds. Where there is a shortfall in ReTakaful funds, the ReTakaful company would normally make an interest free loan to the ReTakaful fund which is generally repayable only out of a future surplus arising in the fund.

Taxation of Takaful and ReTakaful Arrangements

In relation to General Takaful and Re-Takaful arrangements-

- Contributions received by a Takaful company from policyholders (Takaful members) are to be treated as taxable income. Similarly, contributions received by a ReTakaful company from Takaful companies, as members of the ReTakaful arrangement, are to be treated as taxable income. Whether the income is on trading account will depend on the facts and circumstances of the case.

- The deductibility of expenses incurred by a Takaful company or a ReTakaful company for management, marketing, claims and commissions and any provisions in respect thereof should be treated in the same way as such expenses where incurred by a conventional insurance or a reinsurance company with the same level of activity.

- The deductibility of a contribution payment paid to a Takaful or a ReTakaful company is to be treated in the same way as an insurance or reinsurance premium for a conventional insurance policy or a reinsurance arrangement.

The provisions of sections 76 to 83 of the Taxes Consolidation Act 1997 apply in respect of the taxation of a Takaful or a ReTakaful arrangement as if such arrangements were conventional insurance or reinsurance arrangements respectively. In addition, the taxation of a Family (Life) Takaful company, which is an assurance company within the meaning of section 730A TCA 1997, and its members (policyholders) is to be determined under Chapters 4 and 5 of Part 26 of the Taxes Consolidation Act 1997. In this regard, an amount paid by an insured person is to be treated in the same way as a payment under a conventional life assurance policy is treated. Similarly, a maturity or claim amount paid by a Family (Life) Takaful company is to be treated in the same way as a claim or maturity payment under a conventional life assurance policy is treated.

As there are no existing Family (Life) Takaful arrangements in Ireland, the provisions relating to the taxation of old basis business should not apply to the Family (Life) Takaful arrangements.

For the purposes of the Value Added Tax Act 1972, Takaful (General and Family (Life)) and ReTakaful arrangements are to be treated in the same way as conventional non-life and life insurance and reinsurance arrangements, i.e. the services rendered will be exempt from VAT under paragraph (xi) of the First Schedule to the VAT Act to the extent provided in that paragraph.

A liability to stamp duty under the Stamp Duties Consolidation Act (SDCA) 1999 will arise in relation to policies of insurance or policies of life insurance issued under Takaful (General and Family (Life)) and ReTakaful arrangements where the risk is located within the State (section 61 of the SDCA).