# Economic and Social Council

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# I. Introduction

1. Following a presentation made by Moftah Jassim al-Moftah and Salah Gueydi on the treatment of Islamic financial instruments under the United Nations Model Double Taxation Convention between Developed and Developing Countries (ST/ESAIPAD/SER.E/21) during the second session of the Committee of Experts on International Cooperation in Tax Matters, held in Geneva from 30 October to 3 November 2006, it was decided that further work was needed to obtain a better understanding of the issues involved. To that end, a new working group on the treatment of Islamic financial instruments (was formed under the coordination of Mr. al-Moftah (expert, Qatar) and the membership of Andrew Dawson (expert, United Kingdom) and observers from Malaysia (Khodijah Abdullah), Qatar (Salah Gueydi), the Sudan (Gabir Saad el-Din), the Organization for Economic Cooperation and Development (OECD) (Jacques Sasseville) and the International Monetary Fund (Victor T. Thuronyi).

2. Members of the working group were requested to submit their contributions on the subject taking into account the need to cover the following items:

(a) The main Islamic financial instruments available in the country they represent (if any);

(b) Tax treatment of those instruments in their countries, or, if they do not represent a country, provisions of the model that would apply to the instruments.

3. Most members of the working group submitted a contribution in keeping with the above. The present note, which is based mainly on these contributions, proposes to present the main contracts and transactions used in Islamic finance (see sect. II) and to discuss tax issues related to these contracts and transactions, taking into account the provisions of the United Nations Model (and its commentary) on one hand, and the tax provisions dealing with the subject in countries where Islamic finance is practised, on the other hand (see sect. III). The concluding section discusses whether or not to recommend that the United Nations Model and/or commentary (and/or negotiation manual) include language to deal with Islamic finance (see sect. IV).

# II. Main Islamic financial instruments

4. The following types of contracts and instruments are addressed below: *musharaka*,

## D. *Ijara*

12. *Ijara* means literally to rent. It covers, in Islamic jurisprudence, the usufruct of assets and property (rental) and the hire of services of a person for a wage.

13. As a financing mode, *ijara*

(totally) any losses arising from the *mudaraba* operations. The returns to the holders are dependent on the revenue generated by the underlying investment. *Sukuk* holders are not registered owners and cannot attend or vote at the general assembly. One of the main features of *mudaraba sukuk* is that the *mudarib* (entrepreneur) does not guarantee the capital at maturity, but scholars recommended that such a guarantee should be "a voluntary commitment".

# III. Tax issues related to Islamic financial instruments

39. These issues are mainly related to the characterization of the income derived from Islamic financial instruments. Tax treatment of those instruments will be a direct consequence of such characterization.

40. Two approaches can be adopted in this respect: a legal approach based on the form of the contract or transaction, and an economic approach based on the substance or the economic reality of the contract or transaction.

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***Murabaha, salam and istisna'a***

47. In *murabaha, salam and istisna'a* contracts, the profit consists in a markup over a cost price of an asset, commodity or product. Therefore, most likely, it will be business income taxable by the source state only when the activity qualifies for the permanent establishment test.

***Ijara***

48. In *ijara* contracts, the income is derived from the lease of the asset subject matter of the contract. Therefore, it would be taxable under article 6 of the Model if the asset was an immovable property. If the asset was an aircraft or ship used in international traffic, then article 8 would apply. Otherwise, the income would be taxed as business income (if the permanent establishment test is met).

49. Note, however, that countries that, for domestic law purposes, regard finance leases in the same way as operating leases would most likely characterize the payments under the lease as payments of business profits or as royalties. Which of these applies will depend on the precise wording of the treaty (some treaties treat them as royalties payments for the use of equipment; this language is in the United Nations Model, but has been removed from the OECD Model).

***Sukuk***

50. Characterization of income from *sukuk* will follow, in principle, the characterization of the main contract on the basis of which *sukuk* were issued (

C would be analysed as reimbursement of a loan. Each payment would be composed of two elements: a capital (equal to a portion of *k*') and a profit element (equal to a portion of the difference (*k*-*k*')). The latter would be analysed as interest and taxed accordingly, under article 11 of the Model, in the hands of IS and deductible at the level of C.

(d) *Ijara*: under United Kingdom law, *ijara* contracts are subject to the ordinary tax rules applicable to finance and operating leases. As to *ijara waktina* (see sect. II.D), which can be decomposed into a pair of contracts — one for the hire

# IV. Conclusions

72. There is a variety of Islamic financial arrangements, and the tax consequences of any given arrangement may depend on the specific facts of the case and on the details of the tax laws of the country concerned. Therefore, it is very difficult to draw general conclusions as to the taxation of Islamic financial instruments. But, as a general remark, we may distinguish between two approaches in this respect, a legal approach, which looks at the form of (Islamic financial) transactions, and an economic approach, which looks at the substance thereof.

73. Most countries where Islamic finance is practised seem to have adopted the economic approach to assure an equal treatment for tax purposes of Islamic instruments as compared to their conventional counterparts. Even countries that generally follow the legal approach to taxation (e.g. the United Kingdom) have enacted special legislation to treat Islamic instruments according to their substance, following thereby the economic approach in this area. The adoption of the legal approach would lead to “anomalies” in the tax treatment of Islamic instruments that adversely affect their development. The economic approach suggests the application of article 11 of the Model to Islamic financial instruments.

74. It is not clear whether or not there is a need for the United Nations Model or the commentary to deal specifically with Islamic financial transactions. But, generally speaking, there seems to be a consensus (within the working group) that the Model, as currently drafted, is capable of covering Islamic financial transactions. Any difficulties in their characterization would arise more from the approach of the domestic law of each treaty partner rather than from the Model itself. As to the commentary, although it is difficult to propose a solution that covers all possible cases in the light of the variety of transactions and the diversity of their treatment under domestic laws, some are of the opinion that we should add some language in the commentary of article 11 of the Model to say that the definition of interest would include income from some types of Islamic financial instruments that are deemed to be debt relations (although, legally, they are not). More details could also be included in the negotiation manual to give some guidance in bilateral situations, in order to decide whether or not some language on Islamic finance is needed to be included in the treaty.