



Comments on the Luxembourg tax circular

L.G.-A n° 55 dated 12 January 2010

The Luxembourg tax authorities issued a circular on 12 January 2010 (hereafter the “**Circular**”) concerning Islamic finance transactions and their tax treatment.

Firstly, the Circular analyses briefly the main principles of Islamic finance, and describes the main Islamic finance products¹. In the second stage, the Circular establishes certain criteria to be complied with in order for Murabaha and Sukuk transactions to benefit from the same tax treatment as conventional financing products.

Indeed, the current tax law provisions when applied to Islamic finance transactions lead to a double taxation of Murabaha transactions. The Circular aims, by defining specific requirements, at establishing a level-playing field between conventional and certain Islamic finance transactions, namely Murabaha and Sukuk.

We provide below some information on the Shariah compliance requirements of Murabaha in light of the information mentioned in the Circular².

Murahaha requirements:

Murahaha is the sale of a commodity for a deferred price which includes an agreed profit added to the cost.

According to the Circular, the agreed profit to be received by the financing party (hereafter the “**FP**”) shall benefit from the same tax treatment as conventional financing transactions (i.e. taxation over the period of the deferred payment), if the Murabaha contract fulfils the following conditions:

1. The contract between the parties must clearly state that the FP acquires the commodity in order to resell it, immediately or within a period not exceeding six months, to its client.
2. The contract must clearly distinguish between: (i) the remuneration of the FP for the intermediation service provided to the client (i.e. searching the requested commodity in the market); (ii) the FP profit constituting the compensation for the deferred payment facility offered to the client; (iii) the price for acquisition of the commodity by the client from the FP; and (iv) the price for acquisition of the commodity by the FP from the initial supplier.

¹ Murabaha, Mucharaka, Mudaraba, Ijara, Ijara-wa-Iqtina, and Istisna.

² Mainly in section 2.2.



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3. The FP's agreed profit must be clearly stated, known and accepted by the two parties to the contract.
4. The FP's agreed profit must be expressly designated as being payment for the service provided by the FP to the client which results from the effective deferred payment facility granted to the client. The parties could insert a clause presenting the profit as "compensation for the deferred payment granted to the purchaser by the seller, the purchaser undertakes to pay the profit to the seller until the date of final repayment".
5. From an accounting and tax point of view, the profit must be booked by the FP on the basis of a straight-line method over the period of the deferred payment, irrespective of the repayments actually made.

This specific tax treatment applies only to the profit (clause 2 (ii) above) to the exclusion of the remuneration paid for the intermediary service (clause 2 (i) above).

Assessment from a Shariah perspective:

Conditions 2, 3, 4, and 5 raise no issues from a Shariah point of view.

Nevertheless, the practical implementation of the first criterion is likely to trigger questions. In order to understand these potential questions, there is a need to briefly review the main characteristics of Murabaha contracts.

Murabaha has originally never been considered as a financing instrument, it is a newly developed product that has been derived in order to avoid the accrument of interest (the prohibited riba) in loan transactions which is a pillar of the modern financial system.

Shariah scholars have allowed Murabaha as a method of financing provided, however, that certain strict conditions are complied with. One of the main conditions is that the commodity must be in the ownership and physical possession of the seller at the time of sale. Therefore, when a potential purchaser of a commodity approaches a FP to finance such a commodity, the FP cannot enter into a sale contract simply because he is not yet the owner of that commodity.

As a result, one of the issues raised by the first condition mentioned hereabove from a Shariah perspective is: how the parties can state in the sale contract that the seller acquires the commodity in order to resell it to the purchaser?

In fact, the common procedures currently by the Islamic banks in order to set-up Murabaha transactions consist in the two following separate stages:

1. In a first stage, the client should sign a unilateral promise to purchase the commodity when purchased by the FP. All information mentioned in conditions 1, 2, 3, and 4 above could be mentioned in such a unilateral commitment, including a statement such as "I acknowledge that the FP is going to purchase the commodity in order to resell it to me".



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It is worth mentioning here that according to Shariah principles, such a promise is binding on the client and enforceable through the courts. As a consequence, if the client finally decides not to purchase the commodity, a judge will have to assess whether the client had a valid reason to do so in order to determine whether the FP can be granted damages in this context. However, in any case, such damages will be measured according to the real loss suffered by the FP, regardless of any prior fixed terms stipulated in the unilateral commitment promise.

2. In a second stage, when the FP has purchased the commodity, a sale contract should be entered into between the client and the FP, in which the information mentioned in conditions 2, 3, and 4 above could be included.

It follows that in Murabaha transactions, the first condition (the FP acquires the commodity in order to resell it to its client) should be included in the initial unilateral promise and not in the sale contract in order to ensure the overall Shariah compliance of such a transaction. Although the Circular is not really precise on this point, this should be borne in mind when structuring a Murabaha transaction.

Other issues could also arise in relation to the structuring of a Murabaha transaction but the Circular does not provide guidance as to the possible impact of such issues on the applicability of the aforementioned specific tax treatment. For instance, if the client decides not to fulfil his promise to purchase, can the FP resell the commodity to another client (possibly under different financial conditions) and benefit from the same tax treatment?

Conclusion:

Further clarification may be required from a Shariah perspective, to implement the Circular in practice.

However, the Circular is welcomed by all Luxembourg market players, including the Minister of Finance³, since it shall lift one of the hurdles which have, until now, prevented Luxembourg from being the leader in Islamic finance in Europe.

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³ Message dated 19.01.2010

http://www.mf.public.lu/actualites/2010/01/frieden_finances_islamiques_190110/index.html