Dear Sir/Madam

Review of the Taxation Treatment of Islamic Finance

The Taxation Institute of Australia (Taxation Institute) and the Australian Financial Markets Association (AFMA) (together, the Professional Bodies) appreciate the opportunity to provide comment to the Review of the Taxation Treatment of Islamic Finance. We welcome the Review and the Government’s commitment to facilitate a level playing field for the provision of Islamic finance alongside conventional financing.

Our submission provides general commentary on the income tax, goods and services tax (GST) and state tax issues that arise. We also provide specific commentary on the impact of these taxes on the case study examples describing transactions that our members consider are most commercially viable in the near to medium term, namely:

- Case study 2: interbank finance (Tawarruq);
- Case study 3: finance lease and hire purchase (Ijarah); and
- Case study 7: lease backed Islamic bond (Sukuk al Ijarah).

We have also included GST analysis of the following case study examples:

- Case study 1: cost plus profit sales (Murabahah);
- Case study 4: purchase orders (Istisna);
- Case study 6: profit and loss sharing partnership (Musharakah); and
- Case study 8: Islamic risk sharing arrangements (Takaful).

This submission is not an exhaustive analysis of potential issues, but is intended to illustrate some of the issues that may be relevant in meeting the stated objectives.
If you require any information or assistance in respect of this submission, please contact the Taxation Institute’s Tax Counsel, Tamera Lang on (02) 8223 0059 or AFMA’s Associate Director of Policy, Denise Hang on (02) 9776 7994.

Yours sincerely

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# TABLE OF CONTENTS

1. **General Comments** ..............................................................4  
   1.1. Income Tax Issues......................................................................................... 5  
   1.2. GST Issues...................................................................................................... 6  
   1.3. State Tax Issues............................................................................................. 8  

2. **Case Study One: Cost Plus Profit Sale (Murabahah)...........12**  
   2.1. Scope of our Analysis.................................................................................. 12  
   2.2. GST Issues.................................................................................................... 12  

3. **Case Study Two: Interbank Finance (Tawarruq)..............15**  
   3.1. Income Tax Issues....................................................................................... 15  
   3.2. GST Issues.................................................................................................... 18  
   3.3. State Tax Issues........................................................................................... 19  

4. **Case Study Three: Finance Lease and Hire Purchase (Ijarah)**  
   21  
   4.1. Income Tax Issues....................................................................................... 21  
   4.2. GST Issues.................................................................................................... 21  
   4.3. State Tax Issues........................................................................................... 22  

5. **Case Study Four: Purchase Order (Istisna)......................23**  
   5.1. Scope of our Analysis.................................................................................. 23  
   5.2. GST Issues.................................................................................................... 23  

6. **Case Study Six: Profit and Loss Sharing Partnership**  
   (Musharakah) ....................................................................................................24  
   6.1. Scope of our Analysis.................................................................................. 24  
   6.2. GST Issues.................................................................................................... 24  

7. **Case Study Seven: Lease Backed Islamic Bond (Sukuk) ....26**
7.1. Income Tax Issues ................................................................. 26
7.2. GST Issues ........................................................................... 27
7.3. State Tax Issues ................................................................. 28

8. Case Study Eight: Islamic Risk Sharing Arrangements (Takaful) ................................................................. 29
   8.1. Scope of our Analysis .......................................................... 29
   8.2. GST Issues ........................................................................ 29
1. General Comments

The development of an Islamic finance capital market has great potential to make a significant contribution to the economy over the near term, as described in the Discussion Paper. It has also been recognised that, whilst Islamic finance has been developed as a solution for Shariah compliant financing and investing, it is a market that may have wide appeal to a range of non-Muslim constituents. Certainly, Islamic finance has a place within the growing movement of ethical investment and socially responsible investment.

The Report of the Australian Financial Centre Forum notes Australia’s reliance on foreign capital as a key feature of the economy.1 The role of the financial sector in channelling these offshore funds into Australia, either by borrowing the funds offshore and lending directly to business and individuals, or by arranging and underwriting debt issuance on the capital market, has supported investment in the economy. The opportunities presented by the excess of funds in the Gulf region, an increasing part of which is seeking Shariah compliant investments, has been well documented.2

Australia provides an attractive venue for foreign investors looking for asset diversification. The resilience of the Australian economy, the good international reputation of the regulatory environment and low country and market risks are factors attractive to many investors. Funds obtained through Islamic financing increase the pool of funds available to Australian businesses and individuals, and have the potential to reduce the cost of these funds through increased competition.

Furthermore, the Australian equities market provides attractive opportunities for Shariah compliant investors to diversify their investments into a range of sectors (including mining and resources) that fall outside the portfolio domain of many other jurisdictions seeking to promote Islamic finance.3

We agree with the objective of facilitating a parity of tax treatment between Islamic finance and conventional products, by ensuring that the tax treatment of Islamic finance products is based on their economic substance. We also agree that this should be facilitated, where possible, through adjustments to existing tax frameworks. Our comments are provided within this context.


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1 Australian Financial Centre Forum, Australia as a Financial Centre, 2009.
2 See for example: Austrade, Islamic Finance, 2010.
3 Such as Ireland, Luxemburg and Hong Kong.
1.1. Income Tax Issues

There is clearly uncertainty as to the precise income tax treatment under current law of the various Shariah compliant financing techniques considered in the Discussion Paper.

Indeed, this submission raises some further technical points that add to the level of uncertainty, rather than reducing it.

Where uncertainty exists, it can reasonably be assumed to be a disincentive to Shariah compliant investments being made.

It may be possible to resolve those uncertainties by seeking rulings from the Australian Taxation Office (ATO). However, seeking administrative solutions is likely to be an unsatisfactory approach because:

- it is inherently piecemeal;
- it is likely to be a lengthy process; and
- some uncertainties would be expected to be resolved in a way that is inconsistent with Shariah compliant financing techniques having comparable tax treatment to their conventional financing counterparts.

Accordingly, the Professional Bodies consider that some legislative change is required to both remove uncertainty and to achieve parity of income tax treatment.

The Professional Bodies consider it reasonable to expect that the Australian demand for capital provided via Shariah compliant financing techniques will be driven by financial sector and other large business entities. These entities would be expected to already be subject to Division 230 of the ITAA 1997.

As noted by the Discussion Paper, the income tax frameworks introduced as part of the taxation of financial arrangements (TOFA) reforms – and Division 230 in particular - are generally intended to operate by reference to the substance of financial products and transactions, rather than their legal form.4

Accordingly, it would appear that legislative changes would be most productively targeted towards ensuring that Division 230 extends appropriately to Shariah compliant financing techniques.

However, amending Division 230 is not a panacea. Other aspects of the income tax law (such as CGT and interest withholding tax) are more reliant upon the form of a transaction, and so can result in different (and distortionary) tax outcomes for Islamic financing products and their economically similar conventional financing products.

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4 Refer to the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009 (TOFA EM) at paragraphs 1.13 to 1.15.
A number of the interactions between Division 230 and such provisions are in the process of being worked through (eg, TOFA and withholding tax) – and so perhaps some of these distortionary tax outcomes may be eliminated over time without further targeted legislative changes for Shariah compliant financing techniques. However, it must be acknowledged that uncertainty would remain in the interim – and so there remains a policy basis for extending legislative changes to Shariah compliant financing techniques in the relevant technical areas.

1.2. GST Issues

We note the Terms of Reference for the Review include the making of recommendations to ensure, wherever possible, that Islamic finance products have parity of tax treatment with conventional finance products. We support the goal of GST parity for equivalent Islamic finance products “wherever possible”, but suggest that complete GST parity is effectively unachievable, and even substantive GST parity will require careful drafting of legislative amendments to avoid inappropriate or undesirable application to other transactions. Some examples are given in this submission.

There are inherent difficulties in seeking to apply the current legislative provisions to achieve an economically equivalent result for arguably equivalent finance products given that the GST law is supply-driven, rather than outcome-focused. As the Courts have observed:

“In economic terms it may be correct to call the GST a consumption tax, because the effective burden falls on the ultimate consumer. But as a matter of legal analysis what is taxed, that is to say what generates the tax liability (and the obligations of recording and reporting), is not consumption but a particular form of transaction, namely supply.”

The Discussion Paper acknowledges at paragraph 3.65 that even within the conventional finance sector, products that are arguably economically equivalent to each other may be treated differently for GST purposes if the nature and structure of the product are different, eg. a loan and a finance lease. Taxpayers are currently able to choose which arrangement they want and bear the GST consequences of that arrangement (or the effect of the GST consequences on the cost structure of the financier).

There are additional complexities when considering the appropriate application of GST to Islamic finance transactions. The task of determining the equivalent conventional transaction to an Islamic finance transaction may not always be straightforward. Consider for example what the conventional equivalent of a Murabahah for goods is – a chattel mortgage or hire purchase?

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5 Sterling Guardian Pty Ltd v Commissioner of Taxation [2006] FCAFC 12 at [15], cited with approval by the High Court in Commissioner of Taxation v Reliance Carpet Pty Ltd [2008] HCA 22 at [3]
The Courts in recent GST cases have focused on applying the specific words of the GST legislation to the facts and have extensively debated the legal substance of transactions and arrangements between parties to determine the appropriate application of the GST legislation, rather than attaching significance to outcome-focused social or economic considerations if the meaning of the legislation can be determined from the words of the legislation.\textsuperscript{6} The approaches to interpreting the GST legislation have evolved over the 10 years since implementation, and can be expected to continue to evolve. If considered essential, a policy intent of economic equivalence or tax parity then needs to be enshrined in the words of the GST legislation itself either by overriding principles or specific amendments.

In the report from the Board’s “Review of the Legal Framework for the Administration of the Goods and Services Tax” dated December 2008, recommendation 23 was that:

\textit{“The Government should undertake a review of the financial supplies provisions with a view to reducing their complexity and introducing more principled rules, while maintaining the existing policy.”}

Treasury then issued the Consultation Paper for the “Review of the Financial Supply Provisions” on 12 May 2009. In this Paper “Option 1” was presented, which suggested replacing the existing legislative framework (ie. the prescriptive lists of items which were or were not financial supplies) with a principle or set of principles which describe the fundamental characteristics which should be financial supplies according to the underlying policy. It was commented on page 10 of that Treasury Paper that:

\textit{“Replacing the existing law with a set of clear principles would ensure the classification of financial supply is sufficiently flexible to cater for the introduction of new innovative financial products and services not specifically dealt with by the present list-based approach.”}

Most of the submissions by industry and professional bodies which responded to the Treasury Paper however strongly rejected the “principles-based” overhaul of the financial supply provisions, as it was considered that from a practical perspective it would decrease certainty and stability of the financial supplies regime. Retention of the existing legislative structure was instead favoured. The prescriptive list is already based on principles and practical experience from GST/VAT regimes around the world.

It is noted that the subsequent announcements of proposed amendments to the GST legislation in the 2010 Federal Budget did not include extensive structural changes to the financial supply provisions. The Discussion Paper entitled “Implementation of the recommendations of Treasury’s review of the GST financial supply provisions” dated June 2010 does refer to “principles-based law

\textsuperscript{6} See for example Travelex Ltd v Commissioner of Taxation [2010] HCA 33, Commissioner of Taxation v Glaxinia Investments (Trustee) [2010] FCAFC 46, Commissioner of Taxation v American Express Wholesale Currency Services Pty Ltd [2010] FCAFC 122
design” in respect of these specific proposed amendments, with carve-outs and add-ons where necessary. We are yet to see how such specific “principles-based” amendments will be framed.

We do not support an overhaul of the current financial supply provisions with overriding principles-based rules as a solution to achieving the desired economic equivalence for Islamic finance products. Nor do we consider it appropriate for amendments to be made to the GST legislation that ignore the fundamental building blocks of the GST regime, eg. ascertaining the supplies that are made and the consideration for those supplies.

To achieve, as far as possible, GST parity for Islamic/conventional products, amendments to the lists (or defined terms) in the GST Regulations would however be required, potentially also with amendments to the GST Act as well to deal with specific issues, some of which are noted later in this submission.

In summary, as a supply-based transaction tax, in the absence of over-arching “principles-based drafting”, taxation based on economic substance rather than form would require careful specific legislative drafting to achieve.

1.3. State Tax Issues

We note that the Terms of Reference for the Board include the development of findings for State and Territory tax laws that will ensure Islamic finance products have parity of tax treatment with conventional finance products. In our view, Islamic finance transactions currently would not receive parity of tax treatment with conventional finance products under State and Territory tax laws. We consider this to be the case in all States and Territories, including Victoria.

At paragraphs 3.71 to 3.75 of the Discussion Paper, it is suggested that changes to Victorian stamp duty laws in 2004 have eliminated distinctions in treatment between Islamic and conventional finance products. However, the exemptions that were introduced to the Duties Act 2000 (Vic) do not apply to wholesale transactions because of the prescriptive nature of the provisions.7

These provisions require the relevant Islamic finance product to involve a ‘natural person’ as the effective borrower and a ‘financial institution’ as the effective lender. The former requirement effectively limits the exemption to retail transactions so that it will not have any material impact on Australia developing as a financial hub, an outcome that is highly dependent on promoting wholesale financial transactions. The latter requirement also limits the nature of financiers: to ADIs, co-operatives, co-operative housing societies and bodies approved by a gazetted order. For example, in the absence of an appropriate order, the mortgage fund contemplated in Question 1.5 would not qualify for any exemption; this operates as a commercial disadvantage for these financiers and for Islamic finance.

See AFMA submission to the Victorian Competition & Efficiency Commission (VCEC), May 2010.
Each State and Territory has exemptions which could apply to appropriate Islamic finance transactions (as well as conventional transactions):

<table>
<thead>
<tr>
<th>State</th>
<th>Legislation</th>
<th>Provisions</th>
</tr>
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<tbody>
<tr>
<td>NSW</td>
<td>Duties Act 1997</td>
<td>ss51, 163E</td>
</tr>
<tr>
<td>VIC</td>
<td>Duties Act 2000</td>
<td>ss32, 89</td>
</tr>
<tr>
<td>QLD</td>
<td>Duties Act 2001</td>
<td>ss32, 33, 190</td>
</tr>
<tr>
<td>SA</td>
<td>Stamp Duties Act 1923</td>
<td>ss60C, 101</td>
</tr>
<tr>
<td>WA</td>
<td>Duties Act 2008</td>
<td>ss120, 167</td>
</tr>
<tr>
<td>TAS</td>
<td>Duties Act 2001</td>
<td>ss34, 77</td>
</tr>
<tr>
<td>ACT</td>
<td>Duties Act 1999</td>
<td>ss53, 95</td>
</tr>
<tr>
<td>NT</td>
<td>Stamp Duty Act 1978</td>
<td>s56C(15)</td>
</tr>
</tbody>
</table>

By way of example:

*Duties Act 1997 (NSW) s51:*

(1) The mortgagor and the mortgagee are jointly and severally liable to pay the duty chargeable on a transfer by way of mortgage of dutiable property that is land under the *Real Property Act 1900*.

(2) If the Chief Commissioner is satisfied that:

(a) duty has been paid in accordance with this section on a transfer of dutiable property to which this section applies, and

(b) the dutiable property has been re-transferred to the mortgagor (or a person to whom the land has been transmitted by death or bankruptcy) and the mortgagor (or person) is the registered proprietor of the land,

the Chief Commissioner must refund the ad valorem duty paid on the transfer less the amount of duty that would have been payable on the mortgage under Chapter 7 (Mortgages).

*Duties Act 1997 (NSW) s163E:*

(1) If the person lodging an acquisition statement under this Chapter in relation to the acquisition of an interest in a landholder:

(a) informs the Chief Commissioner at the time the statement is lodged that the acquisition is effected for the purpose of securing financial accommodation, and

(b) the Chief Commissioner is satisfied that the acquisition is effected for that purpose,

the statement, in so far as it relates to that acquisition, is not chargeable with duty, except as provided by subsection (2).
(2) The statement is chargeable with duty at the expiration of the period of 5 years after the date of the acquisition (or such longer period as may be determined by the Chief Commissioner in the particular case) if the interest concerned is not:

(a) re-acquired by the person from whom it was acquired, or

(b) in the case of an acquisition by way of mortgage, conveyed by the mortgagee to a third person in exercise of the mortgagee’s power of sale,

within that period (or that longer period).

(3) A person is not required to lodge an acquisition statement with the Chief Commissioner in respect of a re-acquisition by the person of the interest concerned.

The exemptions in each State and Territory can be generically categorised as:

- a refund of conveyance/transfer duty upon exercising the equity of redemption, following a legal mortgage of dutiable property (this exemption is not available in the Northern Territory); and

- an exemption from land-rich duty in relation to a transfer and retransfer of shares or units by way of security (generally within a 5 year term).

We have not considered (but are not aware of) any corresponding exemption that would apply to transfers of motor vehicle registration. However, in at least some States we note that a transfer of ownership of a motor vehicle does not require a transfer of registration (and therefore need not incur stamp duty). That is because in those States registration relates to legal responsibility for the operation of a motor vehicle, rather than ownership of the vehicle. In those States, it is likely that an exemption from motor vehicle registration duty would be unnecessary; conventional financing transactions, such as novated motor vehicle leases, operate without incurring additional motor vehicle registration duty.

There are a number of generic problems with the existing exemptions mentioned above:

- the conveyance/transfer exemption operates only when a financial transaction is completed, not when it starts. This means that transactions at the commencement of a financing arrangement can incur stamp duty and that a refund may not be made for a number of years. In the context of a commercial transaction, this could commonly be 5 to 10 years; in the context of retail transactions, it could be 25 to 30 years. This delay results in a significant cost in terms of the time value of money paid as duty (albeit potentially refunded, without interest, at completion of the transaction).
• it is not clear whether the conveyance/transfer exemption applies to both the refund of duty on the original transfer and the duty that would be payable on the retransfer. This means that a transaction may still be disadvantaged compared with a conventional financing transaction (where even mortgage duty has recently been abolished in all States except NSW).

• the financial transaction is effectively limited to a 5 year term, to ensure commercial certainty. The parties cannot be certain that the relevant Commissioner will extend the term for which an exemption will be available.

AFMA proposed, in its submission to the Victorian Competition and Efficiency Commission (VCEC) in May 2010, that exemptions drafted in similar terms to the land-rich exemption should be included in relation to transfers of dutiable property and transfers of motor vehicle registration. We consider this form of exemption to be preferable to exemptions like the existing Victorian ‘Islamic finance’ exemptions in ss.57A-57F of the Duties Act 2000 (Vic), which are based on specific forms of transaction involving parties of a specific character rather than transactions for a specific purpose.

As a revenue integrity measure, rather than the exemptions being limited in time to 5 years, they could be drafted to contain a periodic review mechanism so that the revenue authority can disqualify (and therefore recover duty on) avoidance transactions. The exemption should be clear that the review period could be set by the revenue office at the commencement of the transaction, based on the terms of the underlying transaction.
2. Case Study One: Cost Plus Profit Sale (Murabahah)

2.1. Scope of our Analysis

The potential income tax implications of Cost Plus Profit Sales are largely addressed under case study two at 3.1 below.

We note that we have chosen not to comment on the potential stamp duty implications of Cost Plus Profit Sales.

2.2. GST Issues

We agree with the analysis in the Discussion Paper that a simple Murabahah should be seen to involve two separate supplies of the asset, one to the Financier and the second (immediately or shortly after the first supply) by the Financier to the Client. It is submitted that the better view is that there is no input taxed financial supply of an interest in a credit arrangement for example, as that is not the legal arrangement and viewing it in that manner would appear to offend the prohibition against interest or “Riba”.

At least in respect of real property financing, we also agree that the economic substance is broadly equivalent to a conventional loan backed by a mortgage. In most cases the sale by the Financier would be input taxed as a sale of residential premises that are not “new residential premises”, so we agree with the conclusion that the current law would disadvantage the Financier of the Islamic finance product due to it being unable to claim 75% reduced input tax credits (RITCs) for various outsourced services which a loan financier could claim.

A proper legislative fix to this disparity would however require careful drafting. Simply adding to, or amending, the listed RITC items in the GST Regulations would not be sufficient. The RITC items in the GST Regulations only apply to those listed acquisitions where they relate to making financial supplies. They do not apply to acquisitions where they relate to any other types of input taxed supplies. If the Financier under a Murabahah arrangement was not making a financial supply, then some amendment would be needed to allow for an RITC which did not relate to making a financial supply. If this is not expressed narrowly then other suppliers of input taxed residential premises may also be able to claim RITCs which they could not presently claim, and if the amendment was narrow it would need to be considered whether it would discriminate against other suppliers (eg vendors selling on deferred terms).

Where commercial property is financed through a Murabahah arrangement different GST issues arise. Sales of commercial property are either taxable supplies or GST-free supplies.

Where the sale is taxable, the Financier will account for GST on the sale of the property but will be able to claim full input tax credits for GST incurred on the acquisition of the property and on associated costs. In this sense the Financier is

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8 Section 70.05(1), GST Act
in a theoretically economically superior position to that of a conventional commercial lender which would have been denied some input tax credits on associated costs. However, like a hire purchase, the GST liability for the Financier would be likely to arise upfront rather than spread over the periodic payments. From a practical perspective the Financier will need to have this covered in the payment arrangements, eg an upfront payment by the Client which the Client may not have under a conventional loan.

Potential problems also arise with respect to the application of the GST-free provisions, eg the going concern and farm land rules.

GST-free treatment as a going concern is common for sales of tenanted commercial buildings. One of the conditions for GST-free treatment under section 38-325 of the GST Act is that the supplier carries on, or will carry on, the enterprise until the day of the supply.

If the Financier acquires the property subject to existing leases and then immediately on-sells it to the Client, in accordance with the current ATO published position in GSTR 2002/5, the sale by the Financier to the Client should be able to be GST-free as long as the leasing continues uninterrupted (assuming all of the other criteria in section 38-325 are satisfied).

Where the leases continue over the brief period the Financier has legal title in the property in a Murabahah transaction, it is relatively easy to see that the enterprise is continuing to be carried on by the Financier so that the going concern rules are satisfied. However, the going concern provisions are also commonly used for other commercial property sales, such as sales of partly completed property developments or as part of sales of other commercial businesses. In these cases it may be more difficult to establish that the Financier is carrying on the enterprise relating to the property and other assets transferred. While in most instances the Client should be entitled to claim a full input tax credit for the GST charged by the Financier, a GST liability is created that would not otherwise arise had the sale been financed via a conventional loan product with the cash implications that may bring. Section 38-325 could be amended to prevent this anomaly.

The conditions for GST-free treatment of sales of subdivided farm land under section 38-475 of the GST Act include that the supply is made to an associate of the supplier. If under a Murabahah arrangement a financier is effectively interposed into the supply chain of the property then the sale may not be GST-free under section 38-475. In addition, in accordance with the views expressed by the ATO in ATO ID 2004/631, a sale of farm land to the financier using Murabahah may not be able to be GST-free under section 38-480. These potential non-applications of the farm land rules where a Financier is inserted into the supply chain could be rectified by specific legislative amendment.

In respect of sales of real property to a property developer under the Division 75 margin scheme (typically vacant residential land but other types of real property can be sold under the margin scheme), the effective insertion of the Financier
into the supply chain of the property significantly changes the timing of the GST payable to the ATO, as the Financier will be liable to pay the GST in respect of the margin on its purchase and on-sale even though its only “value-add” is essentially term financing. The Financier will be required to pay this GST amount in its next Business Activity Statement. This amount of GST the Financier must account for would have been included in the Client’s GST liabilities to the ATO possibly many years into the future. From a practical perspective the Financier will need to have this covered in the payment arrangements, eg an upfront payment by the Client which the Client would not have under a conventional loan. The GST legislation could be amended to defer the Financier’s GST liability to a later event, or remove the GST liability from the Financier and deem the Client’s margin to be based on the consideration for the acquisition by the Financier.

The Discussion Paper only refers to Murabahah arrangements for financing real property. Murabahah is however commonly used in other jurisdictions for financing acquisitions of goods, generally being distinct from Ijara Muntahiah Bi Tamlik discussed in Case Study Three in that title passes immediately. The GST treatment should then just typically follow the nature of the goods (ie, taxable or GST-free). If, however, the supplier was not GST-registered then that will not prevent the Financier’s subsequent sale from being taxable, although the second hand goods scheme contained in Division 66 of the GST Act could apply to give the Financier a notional credit to reduce this additional GST cost as is presently the case with hire purchase arrangements.

Further issues arise with respect to precious metals as the GST treatment can change as through the supply chain, although these are dealt with in the discussion of Case Study Two.

It can be seen that in respect of Murabahah the current GST legislation will in some instances provide a less favourable economic outcome than its conventional equivalent, but in others a more favourable economic outcome. Specific legislative amendments could be made to address all or some of these.
3. Case Study Two: Interbank Finance (Tawarruq)

3.1. Income Tax Issues

3.1.1 Trading stock or revenue asset?

The analysis in the Discussion Paper applicable to the Client appears to assume that the commodity is not trading stock or otherwise on revenue account.

If the Client regularly financed its operations through Tawarruq transactions, it may be said that the commodities are acquired for the purpose of sale in the ordinary course of the Client’s business, and so constitute trading stock.

If the commodities constitute trading stock of the Client, then the Client should have an overall deductible loss of $102,746,849 in the year in which the transactions occur as follows:

- $102,746,849 deductible pursuant to s.70-15(2)
- $100,000,000 assessable pursuant to s.70-80(1)/s.6-5
- no adjustment required under s.70-35 as there would be no trading stock “on hand” at the start/end of the relevant income year.

If the commodity is otherwise on revenue account, then the client should equally realise a deductible loss in the income year in which the transactions occur. Although the commodities are not acquired with the purpose of resale at profit, where the Client is a bank, issues will arise in practice as to whether the commodities are revenue assets.

3.1.2 Section 8-1 deductibility to Client of the profit element

The main issue in a Tawarruq is ensuring the deductibility of the profit element to the Client.

The Professional Bodies consider it highly preferable for the profit element to be clearly deductible pursuant to s.8-1 or, alternatively, a specific deduction provision.

The Discussion Paper concludes at paragraph 4.29 that the profit component “should be deductible”. However, it is not clear whether this is a statement of the preferred outcome (as is the case in paragraph 4.20) or a statement of the outcome that the Board considers applies under current law.

The Professional Bodies consider that under current law, deductibility under s.8-1 would be impacted by the terms of the transaction documents. This will shape the characterisation of what the purchase price is paid “for”.

On the one hand, the transaction document might clearly stipulate that the profit element is a financing charge. However, on the other hand, the document might record the two amounts, but not sufficiently make clear that the profit element is a
financing charge – and not simply part of the total consideration for the acquisition of the commodities.

That is, where one lump sum amount is paid, in order to secure a s.8-1 deduction, as an initial step it would be necessary under current law for there to be, on the face of the transaction documents, a permissible basis for apportioning that amount between the acquisition cost of the commodities and the financing charge.

In this regard, the following observation of Hill J in FC of T v Firth (2002) ATC 4346 is pertinent:

“No doubt where parties to an agreement do contract for severable advantages and for separate considerations an apportionment will be possible with the result that a deduction will only be available for that consideration or that part of the consideration which relates to an advantage of a revenue nature which fulfils the criteria for deductibility under s.8-1. But whether the contract is severable or indivisible and thus whether an apportionment is required or not will depend upon the terms of the contract and the nature of the advantage sought to be gained under it.” [emphasis added]

The Professional Bodies consider it instructive if the Board were to form a view on whether a basis for apportionment between the financing element and the acquisition cost for the commodities is likely to be present in typical Tawarruq transaction documents.

However, even if this were the case for “typical” Tawarruq transaction documents, there would obviously still be scope for transaction risk, thereby compromising the deductibility of the financing element under s.8-1. This risk should be considered undesirable.

3.1.3 Section 25-85 deductibility to Client of the profit element

If the profit element were not deductible under s.8-1, it may potentially be deductible under s.25-85, operating in concert with s.8-1.

However, s.25-85 is only activated if the arrangement is a “debt interest”.

Moreover, s.25-85 caps the amount that may be deductible. Thus, there would not be complete equality of outcome if the Tawarruq profit element were deductible pursuant to s.25-85 (ie, subject to a cap) rather than under s.8-1 alone (ie, not subject to a cap).

In any case, there is a real issue as to whether s.25-85 can operate to assist in securing deductibility of the profit element. In this regard, s.25-85 does not provide that all returns on debt interests are deductible. Rather, it set out certain circumstances that do not prevent a s.8-1 being available.
Relevantly, s.25-85(2) provides that a return on a debt interest:

“… is not prevented from being a general deduction for an income year under s.8-1 merely because … the return secures a permanent or enduring benefit for the entity or a connected entity of the entity”.

It is considered that there may be some difficulty in concluding that buying a commodity necessarily answers this description.

3.1.4 Division 230

Were Division 230 to apply to a Tawarruq entered into by a Client that is a bank, it could potentially achieve an appropriate spreading of the financing element (ie, the loss) on an accruals basis – on the same basis as conventional financing.

The first issue is whether the relevant “arrangement” is the single six-month commodity contract – or whether aggregation with any subsequent Tawarruq arrangements with the same counterparty is appropriate.

Where aggregation is not permitted, it is likely that the 12 month short term financing exception in s.230-440 applies – in which case Division 230 does not apply to the arrangement.

Paragraph 4.32 of the Discussion Paper posits that “… where the main purpose of the arrangement is financing (for instance if the trade of goods, property or services is to facilitate financing) there may be an argument that the 12 month rule should not apply”.

The 12 month rule is a mechanical “bright line” test. It is not, on its face, a purpose based test – despite assumptions as to the purpose likely to be present in such circumstances being relevant to the development of the rule. In this regard, the TOFA EM states at paragraph 2.117:

“Division 230 will not apply to gains and losses arising from certain short-term financial arrangements. A key feature of financing is where one party to an arrangement performs its part in advance of another party. However, where the delay in performance is relatively short it could be said that the financing component is usually subservient to the purpose of providing goods or services. For compliance and administrative reasons, Division 230 will not apply to the gains and losses that arise from financial arrangements which satisfy all of the items listed below.” [emphasis added]

Restated, it is dubious that a financing purpose could preclude the operation of the 12 month short term financing exclusion.

It would be instructive if the Board could seek accounting input as to whether the fair value election could potentially apply to the arrangement. If so, this may form a more ready basis upon which the 12 month short term financing exclusion could be rendered inoperative.
3.1.5 Interest withholding tax

The issue of whether interest withholding tax applies raises similar considerations to those considered in the context of s.8-1 deductibility. If the contract were to clearly split out the $2,746,849 financing element, that element would be expected to fall within the expanded definition of “interest” in s.128(1AB) - which relevantly includes amounts that are in the nature of interest.

We note that the observation in the final sentence of paragraph 4.22 should be qualified – if the profit component has an Australian source then the observation only applies if the non-resident financier is resident of a treaty country. In this regard, it is noted that Australia does not have double tax treaties with many countries that are traditional sources of Islamic finance. Restated, Australia may have taxation rights over the profit component even where the non-resident financier does not have an Australian permanent establishment.

It is recommended that further thought be given to whether a Tawarruq can be properly characterised as a debenture, in which case s.128F may potentially be engaged. In this regard, a Tawarruq would seem to involve a corporate acknowledgment of indebtedness. See further, Handevel Pty. Ltd. v. Comptroller of Stamps (Vic.) (1985) 157 CLR 177, Taxation Ruling IT 2652 and Private Binding Ruling Authorisation Number 39849.

Paragraph 4.25 of the Discussion Paper states that it is unlikely that the exemption from withholding tax in relation to offshore borrowing of an Offshore Banking Unit (OBU) would be available for a Tawarruq.

However, it is considered possible to interpret s.128GB as applying – especially if it is the case that the arrangement is a debt interest.

Accordingly, it is recommended that the Board liaise with the ATO. If it appears that a favourable interpretation cannot be achieved, then it is recommended that s.121GB be amended to ensure that it applies to the Tawarruq profit component.

Finally, we note that there are interest withholding tax exemptions available for offshore lenders that are financiers and are resident in the US, UK, Japan, France, Norway and South Africa. It would be highly desirable for such an exemption to be included in Australia’s tax treaties that have been concluded with countries with a high Muslim population (eg, Malaysia).

3.2. GST Issues

Similar to the Murabahah in Case Study One, we agree with the analysis in the Discussion Paper that a Tawarruq will involve separate supplies of the commodities for GST purposes.

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9 The final paragraph of 4.22 states that “Alternatively, if the profit component is not in the nature of interest, it may not be taxed in Australia unless the non-resident Financiers have a permanent establishment in Australia”.

We however do not understand the comment at paragraph 4.27 that “there may be a GST cost to the Financier in relation to lost entitlement to reduced input tax credits” which then forms the basis of Question 2.1. Subject to the discussion below about specific issues for precious metals (which was not raised in the Discussion Paper), full input tax credits should be available to the Financier in the circumstances described.

Under section 38-385 of the GST Act the first supply of precious metal after its refining by or on behalf of the refiner, to a dealer in precious metal, is GST-free. Any other supply of precious metal is input taxed under section 40-100. Precious metal is defined in section 195-1 as gold, silver and platinum (and any substance prescribed by regulation) in investment form of specified fineness.

If an acquisition of precious metals was financed by Tawarruq then the sale by the Financier would be input taxed under section 40-100. As the Financier’s supply is not an input taxed financial supply, under the existing legislation RITCs would not be available whereas a conventional financier could claim RITCs on various outsourced acquisitions. As discussed above in Case Study One in respect of residential property, a proper legislative fix to this disparity would however require careful drafting as the RITC items in the GST Regulations only apply to those listed acquisitions where they relate to making financial supplies. They do not apply to acquisitions where they relate to any other types of input taxed supplies. If the supply by the Financier under a Tawarruq arrangement is not itself to become a financial supply, then some amendment would be needed to allow for an RITC for the Financier which did not relate to making a financial supply.

3.3. State Tax Issues

We generally agree with the Board’s assessment that there should be equivalent stamp duty treatment for the Tawarruq arrangement described in this case study to a conventional inter-bank financing arrangement.

However, a different and unusual stamp duty outcome can result if the underlying commodity is located in South Australia. In that case, the contract for sale of the commodity between the Investment Agent and Client, and the contract for sale of the commodity between the Client and the Commodity buyer will both be chargeable with conveyance duty at approximately 5.5% on the greater of the contract price and the value of the commodities. In relation to the contract between the Investment Agent and the Client, the price will include the financing costs; this means that not only will stamp duty be payable (unlike on a loan secured over assets in South Australia), but it will be payable twice on a single transaction and one of those payments will include duty on the finance costs (that is, equivalent to charging duty on the interest, not merely the principal).

This result is a consequence of section 31 of the Stamp Duties Act 1923 (SA). It is anticipated that that section will be removed (or at least significantly ameliorated) in July 2012 when stamp duty on the sale of business assets is currently proposed to be abolished in South Australia. Until the removal of that
provision, the stamp duty costs associated with such transactions will preclude Tawarruq arrangements involving South Australian commodities and therefore hinder the development of Islamic finance.
4. Case Study Three: Finance Lease and Hire Purchase (Ijarah)

4.1. Income Tax Issues

4.1.1 Division 230

Division 230 would not be expected to apply to an Ijarah arrangement because of the various relevant carve outs in s.230-460(2).

4.1.2 Division 240

Step 4 of the case study states that upon termination of the lease, the financier will sell the asset to the Client at a pre-determined price which “will normally be equivalent to the cost of the asset”.

It would be appreciated if the Board would confirm, in relation to a typical Ijarah:

- whether the pre-determined sale price is cost – as opposed to the expected market value at termination of the lease; and
- what degree of compulsion as opposed to optionality is associated with the sale.

These considerations are relevant to the potential application of s.240-115, which precludes depreciation deductions in certain circumstances where Division 240 operates.

Question 3.3 asks how the interest equivalent and the principal be isolated if Division 240 does not apply. We consider that if the terms of Division 240 were not to apply to the Ijarah (eg, a lease over land, rather than goods), then the ordinary rules about assessable income and allowable deductions should apply – being the outcome applying for a conventional finance lease that did not fall within Division 240 (eg, a lease over land, rather than goods).

Section 240-10 sets out a table of the types of arrangements that will be subject to Division 240. The table currently only includes one type of arrangement, being a “Hire purchase arrangement” (with that term defined in s.995-1(1)). If it were intended that Division 240 should apply to all Ijarah arrangements (whether or not confined to arrangements with respect to goods) it would be a relatively discrete change to include Ijarah arrangements in that table.

4.2. GST Issues

From a GST perspective we expect that the existing application of the GST legislation to finance leases and hire purchases (particularly following the proposed hire purchase amendments) will appropriately apply to the economically equivalent Ijara and Ijara Muntahiah Bi Tamlik products.
4.3. State Tax Issues

We note the Board’s statement at paragraph 4.38 of the Discussion Paper that this case study is ‘not different to the duty treatment of conventional finance leases’.

While we accept that proposition in some circumstances, we note that a finance lease in a conventional context and an Islamic finance context are not appropriately compared against each other as equivalent products in ascertaining tax neutrality, but should be compared against their base alternative of a conventional loan financing.

Since an Islamic finance lease is commonly proposed as an alternative transaction to a loan, the Client will usually acquire the Asset at completion of the transaction. In a conventional context, the Client would typically acquire the Asset upon completion of the transaction only if the transaction was intended as off-balance sheet financing of an asset originally owned by the Client, or in the case of a hire purchase; that is, many conventional operating leases do not involve any acquisition of the Asset by the Client at completion. Where the Asset is land this finance lease will incur significant duty if the exemptions outlined earlier in our submission do not apply, and will typically involve significant cost associated with the time value of the duty payment during the term of the financing transaction even if the exemption is available. A corresponding transaction involving shares or units in a ‘land rich entity’ is more likely to be exempt from duty, so that the choice of form of the transaction (land, directly versus indirectly) results in significantly different stamp duty outcomes.

In the context of a home financing, it is unlikely that the transaction could be structured so that the Asset is shares or units in a ‘land rich entity’ that holds the home, rather than the home itself. This means that duty is more likely to be imposed on a home financing than in financing a commercial property. In addition, given the typical home financing term of 25 or 30 years (compared to a typical commercial financing term of 5 to 10 years), the time value of the stamp duty that is paid will be very significant even if a refund is ultimately obtained when the transaction completes.

If the home is located in Victoria then the exemptions in ss57B, 57C or 57D may apply, depending upon the specific documentation used in relation to the transaction. However, the exemption will only be available if the Financier is an ADI, co-operative, co-operative housing society or body approved by a gazetted order. The exemption would not be available if finance is provided by a mortgage originator or mortgage fund.
5. **Case Study Four: Purchase Order (Istisna)**

5.1. **Scope of our Analysis**

We note that we have chosen not to comment on the potential income tax and stamp duty implications of Purchase Orders.

5.2. **GST Issues**

We do not agree with all of the analysis of the GST implications discussed in this Case Study, or the facts may not be clear.

In particular, in paragraph 4.53 it is commented that “if the payments are made after construction or after delivering the asset to the Client … GST will be payable on the taxable component and input taxed for the debt component”. In the Istisna scenario provided, we would expect that the Financier’s supply would be wholly taxable, in the same way that a Murabahah for the acquisition of a completed warehouse would be fully taxable. It is expected that there would be no supply of an interest in a credit arrangement or other financial supply made by the Financier in these circumstances.

There should then be no input tax credit denial for the Financier, which is a potentially advantageous economic position for it over other financing methods. The timing of the GST payable by the Financier may be subject to the periodic or progressive supply rules in Division 156 of the GST Act, or (according to current ATO views) on transfer of title, depending upon the terms of the arrangement.
6. Case Study Six: Profit and Loss Sharing Partnership (Musharakah)

6.1. Scope of our Analysis

We note that we have chosen not to comment on the potential income tax and stamp duty implications of Profit and Loss Sharing Partnerships.

6.2. GST Issues

There is some uncertainty in the GST analysis of Musharakah arrangements in the Discussion Paper in relation to the nature of the relationship between the parties.

A partnership is defined in section 195-1 of the GST Act by reference to the definition in subsection 995-1(1) of the ITAA 1997. That definition includes an association of persons carrying on business as partners or in receipt of ordinary income or statutory income jointly. This is generally considered to constitute two separate limbs, referred to as a “general law partnership” and “tax law partnership” respectively. The distinction is often referred to as relating to a sharing of profit as opposed to a sharing of income. In accordance with ATO public rulings the GST implications of transactions involving the two different types of partnerships can be very different.

Paragraph 4.71 of the Discussion Paper indicates that the arrangement may be a tax law partnership. Paragraphs 4.74, 4.75 and 4.81 refer to each change in interest in the asset amounting to a dissolution and reconstitution of the partnership (subject to a continuance clause), with a series of input taxed supplies of the shares of equity for GST purposes, which indicates that it is considered to be a general law partnership. The ATO view in GSTR 2004/6 is that “partners” in a tax law partnership do not hold equity interests but instead have interests in the income-producing assets. The GST treatment of disposals of interests in those assets then depends upon the nature of the assets themselves (and GST-free going concern treatment may also be available), and they will not be input taxed financial supplies.

We submit that whether a particular Musharakah arrangement is a general law partnership or a tax law partnership will depend upon the nature of the asset and the terms of the arrangement. For example, a Musharakah for residential property financing is likely to be a general law partnership, whereas a Musharakah for leased commercial property may be a tax law partnership.

Where the arrangement is that of a general law partnership, we agree with the comments at paragraph 4.81 of the Discussion Paper that there may be a loss of RITCs for the Financier compared with its position under a conventional loan arrangement. The RITC items for loan-related acquisitions in items 11 to 15 of regulation 70-5.02(2) would not apply and, in accordance with the ATO views in GSTR 2004/1, item 9 dealing with securities-related acquisitions transactions
does not apply to partnership interests. To provide GST parity items 11 to 15 may need to be amended.

Alternatively, if the arrangement is that of a tax law partnership for non-residential property, the Financier may however suffer no input tax credit recovery restriction so (from a GST perspective) is in a better economic position than a conventional lender.
7. Case Study Seven: Lease Backed Islamic Bond (Sukuk)

7.1. Income Tax Issues

7.1.1 Division 974 characterisation

The first consideration is to clarify whether all Sukuk involve a trust relationship for Australian general law purposes. (There is a subsidiary question of whether sukuk are units in a unit trust which is relevant to the CGT analysis discussed below).

This outcome would be consistent with step 2 of the Case Study Seven facts (page 53 of the Discussion Paper) which describes the certificate holder as holding a proportionate beneficial interest in the underlying assets held by the SPV and entitlement to income generated through the asset.

At step 4, it is stated that the certificates are sold back to the SPV by the investors for their face value. It would be instructive in terms of the debt/equity characterisation of the Sukuk to receive clarification as to whether this “capital protection” is a result of the pre-determined asset sale price – or whether it is typically a term of the Sukuk themselves.

7.1.2 Division 230

As noted in the Discussion Paper, the TOFA Working Group to the National Tax Liaison Group Finance and Investment Sub-Committee (TOFA Working Group) is considering the application of Division 230 to securitisation arrangements, and this may impact upon the treatment of Sukuk structures.

As at the time of writing, the TOFA Working Group’s paper has not been released.

The debt/equity characterisation of Sukuk will be relevant to the analysis contained in paragraphs 4.93 to 4.95 of the Discussion Paper.

If the Sukuk are equity interests, the tax consequences for the SPV issuer will not be governed by Division 230 – and Division 230 would likely have no practical application for non-resident Sukuk holders.

7.1.3 Withholding tax

It is noted that if interest withholding tax did not apply (ie, the facts did not lead to an application of s.128A(3) and s.128AC as contemplated in the Discussion Paper), then managed investment trust (MIT) withholding could potentially apply.  

As many Islamic financiers will be located in countries that do not currently have an Exchange of Information (EOI) agreement with Australia, the default 30% rate of withholding would apply.

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10 It is assumed for these purposes that the SPV in the case study would satisfy the definition of a MIT.
It is recommended that Australia seek to conclude EOI agreements with traditional Islamic financing jurisdictions. This is also relevant to Shariah compliant investors investing in managed funds more generally.

7.1.4 CGT

We have the following observation on paragraph 4.103 of the Discussion Paper: there are carve outs from CGT event D1 for the borrowing of money and for the trustee of a unit trust issuing units in the trust.

7.2. GST Issues

Looking at the case study example provided, we submit that the GST treatment of the sale and the lease-back is relatively straightforward as discussed in the Discussion Paper.

The more difficult GST questions relate to the issuance of the Islamic bonds to investors. It is understood that the certificate constitutes a share in the underlying asset rather than the right to an income stream or other conventional security. To achieve GST parity (particularly where the investors are Australian residents) it is necessary to characterise the supplies made by the SPV to the investors as financial supplies. It is possible that they could be considered to fall within item 2, 10 or 11 of regulation 40-5.09(3), but that is not certain.

We recommend that the regulations be amended to include Sukuks within the list of items in regulation 40-5.09(3). One possibility is to amend the definition of “securities” either in the text of item 10 or in the Dictionary to the GST Regulations. This is essentially the approach adopted recently in Ireland.

In looking at the manner in which this amendment should be achieved, it is noted that the issue of bonds, debentures and other documents evidencing indebtedness constitute a “borrowing” within section 995-1 of the ITAA 1997, which by virtue of section 195-1 of the GST Act is also the meaning of that term for the purposes of the GST Act. Where funds are raised by a financial supply which is a borrowing, associated acquisitions are not denied input tax credits to the extent that the borrowing relates to making supplies that are not input taxed, ie. the creditable purpose test is applied on a “look-through” basis. In addition, acquisitions relating to a borrowing are not “financial acquisitions” so are excluded from the financial acquisitions threshold calculations. To achieve GST parity the issue of a Sukuk should also be treated as a borrowing, either by amending the ITAA 1997 or GST Act definitions.

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11 Section 11-15(5), GST Act
12 Section 189-15, GST Act
7.3. State Tax Issues

We note the Board’s statement at paragraph 4.85 of the Discussion Paper that:

“There should be no practical tax consequences associated with the establishment of the SPV and the transfer of assets to the SPV as this would not occur in the case of conventional bonds.”

However, it is our observation that it is not unusual to involve a special purpose vehicle as the issuer of conventional bonds; in some cases that special purpose vehicle may even be a bankruptcy remote ‘orphan’. Accordingly these conventional bond financings may incur the same tax consequences as the Islamic finance transaction.

In the case where the real underlying asset is land, stamp duty may be payable on the transfer and retransfer of the assets between the Originating Entity and the Issuer. The exemptions outlined earlier in our submission, and their limitations, are potentially relevant to these transactions (both in connection with a conventional transaction and its Islamic finance equivalent).

However, in relation to the Islamic finance transaction there is the potential for additional duty to apply in relation to the issue and redemption of the Sukuk. This is because the Sukuk represent equity interests in the assets of the Issuer (in contrast to the purely debt interest of a conventional bond).

If the Issuer is a unit trust so that the Sukuk are actually units in the trust, then the ‘land rich’ provisions of each State and Territory may apply to the issue, transfer and redemption of the Sukuk. In this case, the exemptions outlined earlier in our submission, and their limitations, should apply.13

If the Issuer is not a unit trust but the Sukuk represents some equitable interest in the assets held by the Issuer, then the issue and redemption of the Sukuk may attract conveyance/transfer duty, or at least cost the time value of the duty paid. Our proposed exemption would alleviate that cost. In addition, the transfer of the Sukuk would be chargeable with conveyance/transfer duty and the exemptions considered above would not apply; however, even our proposed exemption would not apply to such a transaction.

Where the Issuer is a sovereign entity, there are more likely to be stamp duty exemptions available (which either apply to the sovereign entity generally, or which are introduced specifically for the transaction).

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13 We note that this structure of using a unit trust may result in reducing stamp duty compared to an alternative structure, but may also result in the Issuer being regulated as a managed investment scheme under the Corporations Act.
8. Case Study Eight: Islamic Risk Sharing Arrangements (Takaful)

8.1. Scope of our Analysis

We note that we have chosen not to comment on the potential income tax and stamp duty implications of Islamic Risk Sharing Arrangements.

8.2. GST Issues

It is noted that the brief analysis of Case Study Eight contains no comments in relation to GST. There are however a number of GST issues with such arrangements.

The specific terms of each arrangement may differ, but we expect that most Takaful, or Islamic insurance, arrangements would have the character of a mutual co-operative then subject to the operation of the principle of mutuality.14 It may be that others have the nature of a special purpose trust or some other structure.

In any event, there will be a separate entity for GST purposes, eg as an “unincorporated association or body of persons”.15 It is noted that the principle of mutuality is effectively overridden for GST purposes by s.9-15(2B) of the GST Act, allowing supplies by associations to their members to be treated as supplies made for consideration and subject to the normal GST rules. Furthermore, s.9-20(3) makes it clear that that an entity may carry on an enterprise even though it can only make supplies to members of the entity.

The GST Act contains special rules for supplies relating to insurance policies in Division 78. Our preliminary observation is however that the supplies made by the association or other GST entity in return for the contributions are unlikely to be supplies of insurance policies for the purposes of Division 78 of the GST Act. Section 195-1 defines an insurance policy for these purposes as follows:

"insurance policy" means a policy of insurance (or of reinsurance) against loss, damage, injury or risk of any kind, whether under a contract or a law. However, it does not include such a policy to the extent that it does not relate to insurance (or reinsurance) against loss, damage, injury or risk of any kind.

There is some doubt as to whether there is a contract of insurance in the common law sense in a Takaful arrangement. Essentially the co-contributors are jointly liable in respect of each claim, and each claim is paid out of the pooled funds. If they are not supplies of insurance policies then Division 78 cannot apply, including all the deeming rules about excesses, claims payments, adjustment mechanisms, etc, which would then simply be subject to the general GST rules.

For example, if the contribution paid by a non GST-registered participant is taxable, and there is no decreasing adjustment for the Takaful provider on payment of a cash

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14 Similar to the mutual insurance associations discussed in cases such as New York Life Insurance Co v Styles (1889) 14 AC 381 and Faulconbridge v National Employers' Mutual General Insurance Association Ltd (1952) 33 TC 103

15 Refer section 184-1(1), GST Act
settlement, then there is a clear difference in claims costs between a Takaful and conventional insurer due to GST.

Insurance settlements can involve three or more parties (eg insurer, insured, repairer, third party claimant, third party insurer). Where Division 78 applies many potential supplies between the parties are specifically deemed to not be taxable supplies. If Division 78 does not operate for a Takaful arrangement then the GST implications of a settlement and recovery could be very complex and open to alternative interpretations.

If there is not a “contract of insurance” in a Takaful arrangement then if private health insurance is structured in this manner the supplies to contributors may not qualify for GST-free treatment under section 38-55 of the GST Act. Life insurance structured in this manner similarly may not be input taxed through item 6 of regulation 40-5.09(3).

It may be that the supplies by the association (or other GST entity) to the contributors fall within item 7 of regulation 40-5.09(3) as the provision of an interest in or under “a guarantee, including an indemnity” and so are input taxed. A detailed examination of this is beyond the scope of this submission. We note that the Government is already proposing to amend item 7 to better distinguish between the legal concepts of guarantees and indemnities.16

In summary, a number of difficult interpretative issues arise in trying to apply the current GST legislation to Takaful arrangements. The GST treatment of contributions and the claims costs of conventional versus Islamic insurance arrangements could be very different. If a clear policy position and/or GST parity for equivalent products is desired, then proper analysis of the issues is required along with legislative amendments, e.g. broadening the definition of an “insurance policy” in section 195-1 to include the supply of an interest in such a common fund (and definitions of other terms as necessary) so that Division 78 can operate.

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16 Refer Treasury Discussion Paper “Implementation of the recommendations of Treasury’s review of the GST financial supply provisions” dated June 2010