

# *Embracing Sharia-Compliant Products through Regulatory Amendment to Achieve Parity of Treatment*

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## *Abstract*

This article recognises the potential importance of Islamic finance products in Australia, along with the current regulatory impediments preventing Australia from becoming a leader in the Asia-Pacific Islamic finance market. Taking into account the potential importance of, and impediments to, Islamic finance, this article highlights, through the historical development and contemporary state of Islamic finance, its economic, social and political benefits to Australia. Once a case for embracing Islamic finance is made, the main current regulatory impediments to Australia becoming a key player in the Islamic finance market within the Asia-Pacific region are highlighted. This article then argues that, rather than requiring any separate regulatory regime, the current regulatory impediments may be overcome through amendments to existing laws to ensure parity of treatment in Australia between the Islamic finance market and the conventional finance market. The Australian income tax regime is utilised as a case study demonstrate how parity of treatment could be achieved via amendment by taking two frequent and separate Islamic finance transactions. This article concludes that the economic, social and political benefits potentially warrant Australia embracing Islamic finance and that, with the right regulatory measures, Australia could lay the foundation to become a leader in the Asia-Pacific Islamic finance market.

## **I Overview**

Over the last two years, there has been a concerted effort on the part of the federal government to ensure that Australia is well positioned to meet the financial needs of the international Muslim community. To this end, it has been suggested that 'Islamic financing is a crucial plank in the Government's strategy

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to make Australia a financial hub in the Asia Pacific region'.<sup>1</sup> The potential benefits of Islamic finance have been highlighted in various recent reports and media releases, such as the Report by the Australian Financial Centre Forum entitled *Australia as a Financial Centre: Building on our Strengths* ('Johnson Report'), released by the federal government in January 2010.<sup>2</sup> It identified that 'the greatest opportunity for Australia in terms of accessing offshore capital pools at competitive rates would appear to be in the area of developing sharia-compliant wholesale investment products'.<sup>3</sup> The Johnson Report also recommended 'the removal of any regulatory barriers to the development of Islamic financial products in Australia, guided by the principle that there should be a 'level playing field' for such products.'<sup>4</sup> In that same report, in addition to the general recommendation, it was recognised that specific impediments may exist within the Australian taxation regime which result in complexity and uncertainty 'surrounding the interaction of the Australian taxation provisions and Islamic finance'.<sup>5</sup> The current federal government has embraced the notion of Islamic finance and on Budget night 2010, announced that it would establish an interdepartmental committee to examine and provide advice on regulatory barriers to Islamic finance.<sup>6</sup>

Despite the recent surge in interest in being able to offer Islamic finance products and meet the needs of both Australian and international Muslims, Australia is a late entrant into the Asia-Pacific Islamic finance market with countries such as South Korea, China, Hong Kong, Japan, Singapore and Thailand already part of this growth.<sup>7</sup> It is essential that Australia act in a timely manner. It has been suggested that the lack of regulatory support is what continues to hamper the rapid expansion and acceptance of Islamic finance in Australia.<sup>8</sup> Taking into account the potential importance of, and impediments to, Islamic finance, this article highlights, through the historical development and contemporary state of Islamic finance, the economic, social and political benefits of Islamic finance to Australia. Once a case for embracing Islamic finance is set out, the main regulatory impediments to Australia becoming a key player in the Islamic finance market

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<sup>1</sup> Australian Government, Austrade, 'Landmark Islamic Finance Publication Ministerial' (Media Release, 12 February 2010) <<http://www.austrade.gov.au/Landmark-Islamic-finance-publication-Ministerial/default.aspx>>.

<sup>2</sup> Australia's interest in becoming a player in the Islamic finance market is also evidenced by government body delegations to the Gulf Cooperation Council (GCC) as well as recent visits from GCC delegations: see, Abdul Rahim Ghouse 'Islamic Finance: How serious is Australia?' (2010) 124(2) *InFinance* 24.

<sup>3</sup> Australian Financial Centre Forum, Australian Government, *Australia as a Financial Centre: Building on our Strengths* (November 2009) 70.

<sup>4</sup> *Ibid* 98.

<sup>5</sup> *Ibid* 71.

<sup>6</sup> Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law and Senator The Hon Nick Sherry, Assistant Treasurer, 'Government Responds to Australia as a Financial Services Centre Report' (Media Release, No 050, 11 May 2010) <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/050.htm&pageID=&min=ceba&Year=&DocType=0>>.

<sup>7</sup> Mushtak Parker, 'Australian Initiative to boost Sharia-compliant projects' *Arab News* (online), 28 June 2010 <<http://arabnews.com/economy/islamicfinance/article74620.ece/>>.

<sup>8</sup> Abu Umar Faruq Ahmad, Noor Mohammad Osmani and Mohd Fazlul Karim, 'Islamic Finance in Australia: The Potential Problems and Prospects' (Paper delivered at Seventh International Conference – The Tawhidi Epistemology: Zahat and Waqf Economy, Bangi, 2010) 221.

within the Asia-Pacific region are highlighted. This article then argues that, rather than requiring any separate regulatory regime, the current regulatory impediments may be overcome through amendments to existing laws to ensure parity of treatment in Australia between the Islamic finance market and the conventional finance market. The Australian income tax regime is utilised as a case study demonstrating how parity of treatment could be achieved via amendment by taking two frequent and separate Islamic finance transactions.

This article is divided into several parts. Following this overview, Part II considers what constitutes Islamic finance, specifically explaining 'riba', which is examined in the taxation case study. Part III then examines the key economic, social and political reasons why Australia should embrace Islamic finance. This is done from both an historical and contemporary narrative, taking into account key principles surrounding Islamic finance. Part IV considers the key impediments to Australia becoming a key player in the Islamic finance market within the Asia-Pacific region. Part V uses the income tax regime, focussing on the recent Discussion Paper of the Board of Taxation,<sup>9</sup> to demonstrate that where a 'substance over form' approach is adopted, minor legislative changes may ensure parity of treatment between the Islamic finance market and conventional finance market. Finally, this article concludes that the economic, social and political benefits potentially warrant Australia embracing Islamic finance and that with the right regulatory measures Australia could lay the foundation to become a leader in the Asia-Pacific Islamic finance market.

## II Islamic Finance Defined

Islamic finance is not a new phenomenon and can be traced back to the 7<sup>th</sup> century.<sup>10</sup> However, its commercial implementation is relatively new. Despite this newness, prohibitions feature prominently in any analysis of Islamic finance. Specifically, Islamic finance is the overarching term used to describe investments which comply with the principles of sharia.<sup>11</sup> Within the sharia, 'law, finance, economics, and business form a single dimension only'.<sup>12</sup>

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<sup>9</sup> Australian Government, 'Review of the taxation treatment of Islamic Finance (Discussion Paper, Board of Taxation, October 2010). It should be noted that the Board of Taxation has completed its review and provided its report to the Assistant Treasurer. However, to date this has not been made publicly available.

<sup>10</sup> Hussain Gulzar Rammal and Ralf Zurbrugg, 'Awareness of Islamic banking products among Muslims: The Case of Australia' (2007) 12 *Journal of Financial Services Marketing* 65, 66.

<sup>11</sup> Tina Savona and Shahriar Mofakhami 'Structuring Islamic Finance Transactions: Interaction with the Law of Secured Finance' (2009) 20 *Journal of Banking and Finance Law and Practice* 306, 308. Australian Government, 'Review of the taxation treatment of Islamic Finance (Discussion Paper, Board of Taxation, October 2010) 7.

<sup>12</sup> Abu Umar Faruq Ahmad and M Kabir Hassan 'Legal and Regulatory Issues of Islamic Finance in Australia' (2009) 2 *International Journal of Islamic and Middle Eastern Finance and Management* 305, 305. It should be recognised that Islam is a 'complete code for all fields of human existence' and not just a religion: Abu Umar Ahmad and A B Rafique Ahmad 'Islamic Microfinance: The Evidence from Australia' (2009) 25 *Humanomics* 217, 219. Abdullahi A An-Na'im describes the sharia as the 'whole Duty of Mankind', so in addition to the realms of moral and pastoral theology and ethics, detailed ritualistic and formal observances, it encompasses 'all aspects of public and

Standard and Poor's has succinctly summarised the five pillars of Islamic finance as: the ban on interest, the ban on uncertainty or speculation, the ban on financing certain economic sectors, the profit- and loss-sharing principle,<sup>13</sup> and the asset-backing principle.<sup>14</sup> To these could be added the ban on monopoly ('*ihtikar*') and the prohibition on deception and misrepresentation ('*ghish*').<sup>15</sup> Despite a general acceptance of these underlying principles, there is still ambiguity among the broader Muslim community as to what constitutes an Islamic financial product.<sup>16</sup> Guidance is often sought from sharia scholars as to the interpretation of these principles and those interpretation may themselves vary between Islamic schools of thought.<sup>17</sup> While the interpretation may sometimes be disputed, Islamic finance essentially adheres to sharia — subscribing to higher ethical ideals. This means that within the Qur'an

there are specific injunctions that call for honest fulfilment of all contracts (5: 1); prohibit the betrayal of any trust (8: 27); forbid the earning of income from cheating, price manipulation dishonesty or fraud (4: 29); shun the use of bribery to derive undue advantage (7:188); as well as promote clarity in contracts to minimise manipulation from dubious ambiguity (7: 282).<sup>18</sup>

The most well-known and significant of the prohibitions contained in Islamic finance is the prohibition of *riba*.<sup>19</sup> The two specific transactions analysed in the taxation case study in this article deal with the issues surrounding *riba*. In essence, what is known as '*riba*' must not be charged or paid on any financial transaction. Today, most typically, the word '*riba*' is translated as the charging or paying of interest (or the intrinsic value of the money) which is deemed unlawful by sharia.<sup>20</sup> Since the time of Caliph Umar,<sup>21</sup> exactly what amounts to *riba* has

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private law, hygiene and even courtesy and good manners': see, Abdullahi Ahmed An-Na'im, *Towards an Islamic Reformation* (Syracuse University Press, 1990) 11.

<sup>13</sup> This profit and loss sharing which involves risk taking by the financier is in stark contrast with conventional financing: Savona and Mofakhami above n 11, 329.

<sup>14</sup> Standard and Poor's, *Islamic Finance Outlook 2010* (2010) <[http://rihb.files.wordpress.com/2007/08/islamic-finance-outlook-2010-standard-poor\\_s.pdf](http://rihb.files.wordpress.com/2007/08/islamic-finance-outlook-2010-standard-poor_s.pdf)>

<sup>15</sup> Gopala KK Sundaram, 'How crisis resistant is Islamic Finance?' in Mario Devos (ed) *International Monetary and Financial Law* (Oxford University Press, 2010) 397. Other scholars also add the provision of *zakat* (a charity tax) and *takaful* (Islamic insurance) as pillars; see Mervyn K Lewis and Latifa M Algaoud, *Islamic Banking* (Edward Elgar, 2001) 28.

<sup>16</sup> Ahmed, Osmani and Karim, above n 8, 230.

<sup>17</sup> For a discussion on the difficulties in determining the prescriptive moral content of the teachings of Islam in relation to Islamic finance due to the different schools of interpretation see, Judith Thomson 'Developing Financial Law in Conformity with Islamic Principles: Strict Interpretation, Formalism or Innovation?' (1997-2000) 4 *Deakin Law Review* 77.

<sup>18</sup> In order these are the verses from the *Qur'an* 5: 1; 8: 27; 4: 29; 2: 188, 282. Zaid Ibrahim & Co, *Demystifying Islamic Finance: Correcting Misconceptions, Advancing Value Propositions* <<https://www.zaidibrahim.com/wp-content/uploads/2010/05/Demystifying-Islamic-Finance-soft-copy.pdf>>

<sup>19</sup> The *Qur'an* mentions *riba* in four different revelations; see verses 2: 275, 2:276, 2:278; 3:130; 4:161 and 30:39.

<sup>20</sup> *Riba* translates from Arabic as 'an increase, growth or accumulation': Ahmad and Ahmad above n 10, 220. Prior to the 1970s most translations of the *Qur'an* into English used 'usury' but today 'interest' has been substituted; see, Mahmoud A El-Gamal, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press, 2006) 17.

<sup>21</sup> Umar, the second Caliph, regretted that the prophet died before giving a more detailed explanation of *riba*. Hadith contained in Bukhari 7/493=5160, Muslim 5360-61, Abu Da'ud 3184.

been debated by Islamic scholars, jurists and economists. More recent Islamic revivalism has meant it has been 'the subject of protracted jurisprudential debate in the Arab and Muslim world in the twentieth century'.<sup>22</sup> Abdullah Saeed has recently examined the jurisprudential issues pertaining to *riba* in some detail<sup>23</sup> and while he endorses a modernist interpretation which places the *riba* injunction in its humanitarian and moral context<sup>24</sup> he accepts that, today, the traditional, legalistic interpretation of *riba* as interest prevails. Thus, any increase (negligible, nominal or substantial) over and above the principal in a loan accruing to a creditor is prohibited, as are all fixed financial instruments. Given this is the dominant interpretation<sup>25</sup> and underpins modern Islamic finance, it is the interpretation adopted for the purpose of this article.

Apart from explaining what Islamic finance is, it is worth noting what it is not. Within Western society, the Islamic faith is often shrouded in negative connotations and misconceptions. As part of that faith, Islamic finance often suffers from the same misconceptions, particularly the mistaken belief that 'Islamic finance is used to spread terrorism, that it is a vehicle to promote world domination of Islam over other faiths, or that it is designed to replace conventional financing.'<sup>26</sup> In a recent publication, launched by the then Assistant Treasurer Senator Nick Sherry,<sup>27</sup> the 15 most common misconceptions along with the 10 main value propositions of Islamic finance are outlined. *Demystifying Islamic Finance: Correcting Misconceptions, Advancing Value Propositions* is a publication which aims 'at encouraging the growth of Islamic finance in Australia by dispelling the misconceptions about this important sector of global finance.'<sup>28</sup> These 15 misconceptions<sup>29</sup> can be seen as falling into four categories: rationale; users of the product; outcomes and performance; and attributes of Islamic finance.

<sup>22</sup> Chibli Mallat, 'The Debate on Riba and Interest in Twentieth Century Jurisprudence' in Chibli Mallat (ed) *Islamic law and Finance* (Graham & Trotman, 1988) 69; see also, Waqar Masood Khan, *The Transition to a Riba Free Economy* (International Institute of Islamic Thought, 2002) 2. Khan writes: 'Although we have no dearth of doubters, we [the expert panel] are placed in a far superior position with respect to the theological understanding of what *riba* means.'

<sup>23</sup> Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretations* (Brill, 1999). For analysis of the debate as it played out in Egypt see Mallat, above n 20, 69–88.

<sup>24</sup> Saeed, above n 23, 142.

<sup>25</sup> Muhammad Uzair, 'The impact of Interest Free Banking' (1984) 3 *Journal of Islamic Banking and Finance* 39, 40: 'there is a complete consensus that interest in all forms, and of all kinds, and for all purposes is completely prohibited in Islam'. Similarly, Kettell writes there now appears to be consensus of opinion among Islamic scholars that the term extends to all forms of interest' see: Brain Kettell, *Islamic Finance in a Nutshell* (John Wiley & Sons, 2010) xvii. While Haider agrees that 'riba has come to be synonymous in the modern era with interest of any kind on a loan and jurists in Islamic finance routinely dismiss any alternative conclusion based on the employment of alternative modalities as "apologetic" or "defeatist"', he foreshadows this 'will haunt Islamic finance for as long as it continues to cling to its Langdellian ways'; see, Haider Ala Hamoudi, 'Muhammad's Social Justice or Muslim Cant: Lagdellianism and the Failures of Islamic Finance' (2007) 40 *Cornell International Law Journal* 89, 113.

<sup>26</sup> Parker, above n 7.

<sup>27</sup> Australian Government, The Treasury, 'Launch of Demystifying Islamic Finance' (Media Release, 27 May 2010) <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/120.htm&pageID=003&min=njsa&Year=&DocType=0>>.

<sup>28</sup> Ibid.

<sup>29</sup> The 15 misconceptions have been summarised in Zaid Ibrahim & Co, above n 18, 7–22.

In its publication, Ibrahim and Co dispels these misconceptions, providing a strong case for embracing Islamic Finance.

### III Embracing Islamic Finance

Austrade reports that Islamic finance is one of the fastest growing areas of the financial services industry, with sharia-compliant assets held globally by financial institutions estimated to be worth US\$822 billion in 2009 and projected to be US\$1 trillion in 2010.<sup>30</sup> It also reports that this growth is being driven by four fundamental factors: petrodollar liquidity, Muslim population, low penetration levels and the ethical character and financial stability of Islamic financial products.<sup>31</sup> It is generally accepted that the predominant reason for the growth in recent years is the high price of oil, leading to increased wealth in the Gulf Cooperation States.<sup>32</sup> Currently, the United Arab Emirates, Bahrain and Malaysia are the predominant Islamic finance centres<sup>33</sup> with places like the UK and Indonesia, along with European and African jurisdictions, also market participants.<sup>34</sup> In particular, the UK after introducing regulatory changes, including changes to the taxation of Islamic finance products, has become the leading non-Muslim Islamic finance centre.<sup>35</sup> More recently, the global financial crisis has highlighted the instability of the conventional financial industry and, while not completely unscathed, it is generally reported that the Islamic finance market has fared better than its conventional counterpart.<sup>36</sup> Standard and Poor's reports that in 2009, while many of the world's financial systems were deleveraging, assets of the top 500 Islamic banks expanded by 28.6 per cent.<sup>37</sup> Given such statistics, it is suggested that Islamic finance promotes cross-border trade and flow of funds and can enhance economic and financial linkages around the world,<sup>38</sup> and that Islamic finance can contribute to global financial stability.<sup>39</sup>

Other benefits include the unlocking of the value of idle assets. Generally, real estate provides the underlying asset but, as Islamic finance grows, there are potential idle assets such as commodities, ships and aircraft, as well as receivables by companies in the services sector.<sup>40</sup> Arguably, Islamic finance also offers closer support to the real economy. Because Islamic finance products must be supported by an underlying economic activity, there is a close link between financial and

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<sup>30</sup> Austrade, *Islamic Finance* (Australian Government, 2010) 11.

<sup>31</sup> *Ibid.*

<sup>32</sup> Justin Dabner 'Eliminating Income Tax Barriers to Inbound Islamic Investment into Australia' (2008) 62 *Bulletin for International Taxation* 238, 240. Savona and Mofakhmi above n 11, 306.

<sup>33</sup> Savona and Mofakhmi above n 11, 306. Austrade, above n 30, 17.

<sup>34</sup> The top 10 countries by value of Sharia compliant assets are Iran, Saudi Arabia, Malaysia, UAE, Kuwait, Bahrain, Qatar, UK, Turkey and Bangladesh: Austrade, above n 30, 17.

<sup>35</sup> Savona and Mofakhmi, above n 11, 307.

<sup>36</sup> Ahmad and Hassan, above n 12, 305. Savona and Mofakhmi above n 11, 307.

<sup>37</sup> Standard and Poor's, above n 14, 9.

<sup>38</sup> Zaid Ibrahim & Co, above n 18, 26, quoting H E the Governor of Bank Nigeria Malaysia, Tan Sri Dr Zeti Akhtar Aziz.

<sup>39</sup> *Ibid.* 34.

<sup>40</sup> *Ibid.* 30.

productive flows.<sup>41</sup> Islamic finance may also create jobs as there is a shortage of professionals specifically trained and qualified to deal directly with Islamic finance. Further, there are complementary positions in areas such as trust administration, business succession, corporate wealth, inheritance and estate planning, philanthropy and independent financial advising.

In addition to the potential benefits outlined above, it has been suggested that demand is currently outstripping supply, providing opportunities for countries like Australia to take advantage of the increasing demand by proactively engaging in Islamic finance. While Australia's Muslim population alone — approximately 1.7 per cent of the general population<sup>42</sup> — is insufficient reason to develop Australia as an Islamic finance centre, being part of the Asia-Pacific region means Australia is in close geographic proximity to the majority of the Muslim population, and specifically a number of Muslim majority countries.<sup>43</sup> Australia also has banks with an established global presence.<sup>44</sup> Coupled with Australia's strong and stable financial market providing an attractive option for inbound investment, there are significant opportunities for Australia to embrace Islamic finance products and take advantage of this current opportunity.<sup>45</sup> Australia is also viewed internationally as financially stable and is ranked by the World Economic Forum as second among the world's financial centres behind the UK.<sup>46</sup> In global terms, there are 1.57 billion Muslims making up 23 per cent of the global population, while Islamic finance constitutes only one per cent of global financial assets.<sup>47</sup> The opportunities are wide ranging, from attracting foreign banks who wish to establish operations in Australia, to Australian-based banks offering sharia-compliant products.<sup>48</sup> The specific opportunities for Australia identified by the federal government have been highlighted as attracting foreign Islamic banks, and banks with Islamic windows into Australia, as well as attracting investment in Australian assets and businesses, Australian banks providing sharia-compliant products (particularly in the wholesale market) and fund managers establishing sharia-compliant funds.<sup>49</sup> These opportunities also potentially complement the existing 'halal'<sup>50</sup> manufacturing industry, allowing the whole process to comply with sharia.<sup>51</sup> There may also be synergies in relation to Australia's current trade,

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<sup>41</sup> Ibid 33.

<sup>42</sup> Department of Immigration and Citizenship, Australian Government, *The People of Australia: Statistics from the 2006 Census* (2008) 48 <[http://www.immi.gov.au/media/publications/research/\\_pdf/poa-2008.pdf](http://www.immi.gov.au/media/publications/research/_pdf/poa-2008.pdf)>.

<sup>43</sup> It is estimated that 62 per cent of the world's Muslim population live in the Asia-Pacific region, with Indonesia being the largest Muslim nation; see, Nick Sherry 'The Future of Islamic Finance in Australia' Australia' (Speech delivered at the 2010 Islamic Finance Conference, Rendezvous Hotel Melbourne, 8 June 2010).

<sup>44</sup> Ahmad, Osmani and Karim, above n 8, 233.

<sup>45</sup> Austrade, above n 30, 6.

<sup>46</sup> Sherry, above n 43.

<sup>47</sup> Austrade, above n 30, 14, citing Pew Research Centre, *Mapping the Global Muslim Population — A Report on the Size and Distribution of the World's Muslim Population*, (October 2009).

<sup>48</sup> Austrade, above n 30, 21

<sup>49</sup> Sherry, above n 43.

<sup>50</sup> 'Halal' means 'permissible'. In Islam, all human conduct is categorised, with 'haram' used for that which is prohibited or forbidden, and *halal* for that which is permissible. The other three other categories are obligatory, recommended, and reprehensible.

<sup>51</sup> Dabner above n 32, 240.

tourism and educational links<sup>52</sup> which can be utilised to promote Australia as an Islamic finance centre.<sup>53</sup> Currently, there are few Islamic finance products offered in Australia.

From a fiscal perspective, while the relatively small Australian Muslim population alone does not justify Australia expanding into Islamic finance products, there is a growing domestic market. The Muslim Community Cooperative Australia ('MCCA'), established in 1989, was the first Australian Islamic finance provider in Australia and currently meets the majority of the needs of the domestic community.<sup>54</sup> A second Islamic financial institution, Islamic Cooperative Finance Australia ('ICFA'), established in 1998, has also entered the domestic market, although, as neither holds a banking licence, neither operates as a bank as such.<sup>55</sup> The first Islamic credit union, the Muslim Community Credit Union ('MCCU') commenced operations in 2000 but was ultimately unsuccessful and ceased operating in 2002.<sup>56</sup> Another organisation, Iskan Finance Pty Ltd, established in 2001, aims to meet the home financing needs of the Australian Muslim community.<sup>57</sup> Ahmad, Osmani and Karim argue that despite the relatively small size of the Muslim community in Australia and the lack of a strong asset base, there is reason to cater to the domestic market as demand outstrips supply.<sup>58</sup> Despite the availability of sharia-compliant finance products in Australia from these service providers, there has been limited success, with empirical evidence suggesting that this is due to a lack of awareness of the principles of Islamic finance amongst the Islamic community.<sup>59</sup> Rammal and Zurbruegg, surveying 300 Australian Muslims, established that only 55.7 per cent of respondents were aware of halal banking practices and only 19.3 per cent had ever held a halal-stylised bank account.<sup>60</sup> It should be recognised that Islamic finance may include underserved segments of the community; where Islamic banking is not available those members of the community who are Muslims may refrain from using conventional banking facilities.<sup>61</sup>

While Australian banks have done little in the way of providing Islamic finance products domestically, there has been some penetration of the overseas market. Australia and New Zealand Banking Group (ANZ) have led the way in terms of Australian banks entering the offshore Muslim banking market, with involvement since the early 1980s.<sup>62</sup> The ANZ reports that it played a leading role in the transition of banking in Pakistan to a non-interest-based Islamic system, and

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<sup>52</sup> There is also potential for the Islamic finance market to increase education opportunities. For example, La Trobe University recently became the first Australian university to launch a Masters Degree in Islamic Banking and Finance.

<sup>53</sup> Dabner, above n 32, 245.

<sup>54</sup> For a history of the MCCA see, Abdullah Saeed and Shahram Akbarzadeh (eds), *Muslim Communities in Australia* (UNSW Press, 2001).

<sup>55</sup> Ahmad, Osmani and Karim, above n 8, 221.

<sup>56</sup> Ahmad and Ahmad above n 12, 225.

<sup>57</sup> For a detailed history of these organisations see, Ahmad and Ahmad above n 12, 227–8.

<sup>58</sup> Ahmad, Osmani and Karim, above n 8, 221.

<sup>59</sup> Rammal and Zurbruegg, above n 10, 65.

<sup>60</sup> *Ibid* 69.

<sup>61</sup> Zaid Ibrahim & Co, above n 18.

<sup>62</sup> ANZ, *Investment Banking ANZ* <[http://anz.com/gsf/Products/Islamic\\_Finance.asp](http://anz.com/gsf/Products/Islamic_Finance.asp)>.



was heavily involved in the development of the Islamic finance documentation utilised by all the banks.<sup>63</sup> It also launched 'First Grindlays Modaraba' in 1987 — an Islamic leasing company in Pakistan. Further, ANZ's Global Islamic Finance unit was established in London in 1989 to undertake cross-border Islamic financing.<sup>64</sup> More recently, in February 2010, Westpac began offering short-term wholesale investment products developed for Islamic financial institutions, and Macquarie Group has announced plans for an Islamic finance joint venture with a Bahrain-based financial entity.<sup>65</sup> However, this small involvement can be contrasted with the fact that globally there are currently more than 300 Islamic financial institutions and 250 sharia-compliant mutual funds across 51 countries.<sup>66</sup> More specially, other Asian jurisdictions have seen the benefits of offering Islamic finance products and Australia, as a late entrant into this market, would be competing with those jurisdictions. Yet, it is still viable for Australia embrace Islamic finance, taking into account any issues which are idiosyncratic to the jurisdiction. Three jurisdictions in particular can be viewed as direct competitors within the region: Malaysia, Singapore and Hong Kong.

Malaysia has been particularly proactive in encouraging Islamic finance, offering Islamic products for over 30 years.<sup>67</sup> In August 2006, it established the Malaysia International Islamic Financial Centre ('MIFC'), an initiative designed to promote Malaysia as a major hub for international Islamic finance. Malaysia currently invites foreign and domestic financial institutions to conduct the full range of international Islamic banking and *takaful*<sup>68</sup> businesses in foreign currency as an International Islamic Bank branch or subsidiary (IIB); as an International Takaful Operator branch or subsidiary (ITO) or as an International Currency Business Unit (ICBU).<sup>69</sup> Malaysia has also been proactive in offering tax incentives and exemptions to Islamic finance investors; for example by providing withholding tax and stamp duty exemptions.<sup>70</sup>

Singapore is another Asia-Pacific jurisdiction that attracts Islamic investments. It has done so not only because it is an established regional financial hub, but also, over the last decade, via amendments to its regulatory framework which allow the offering of certain sharia-compliant products, by providing protections to depositors and by amending tax laws to ensure parity of treatment between Islamic finance products and conventional finance products. Most recently, Singapore has gone further by providing incentives to investors in Islamic finance products through tax concessions and exemptions.<sup>71</sup>

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<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

<sup>65</sup> Sherry, above n 43.

<sup>66</sup> Shahzad Q Qadri 'Islamic Banking: An Introduction' (2008) 17(6) *Business Law Today* 59, 61.

<sup>67</sup> Malaysia International Islamic Finance Centre, *Overview — International Islamic Bank* (17 January 2011) Shaping Islamic Finance Together <[http://www.mifc.com/index.php?ch=seg\\_pla\\_iib&pg=seg\\_pla\\_iib\\_obt](http://www.mifc.com/index.php?ch=seg_pla_iib&pg=seg_pla_iib_obt)>.

<sup>68</sup> '*Takaful*' is an Islamic insurance scheme based on the principle of mutual assistance. Members contribute financially to a fund in order to assist each should loss or damage occur.

<sup>69</sup> Malaysia International Islamic Finance Centre, above n 67.

<sup>70</sup> See Salim Farrar 'Accommodating Islamic Banking and Finance in Australia' (2011) 34 *University of New South Wales Law Journal* 413, 438.

<sup>71</sup> Ibid 439.

Finally, Hong Kong has also made inroads into attracting investment in Islamic finance products. Hong Kong entered the market later than both Malaysia and Singapore but has made significant progress through the establishment of Islamic retail funds, granting permission to foreign banks to operate Islamic banking ‘windows’, working with overseas regulators and reviewing its tax regime for unfair treatment.<sup>72</sup>

Given the potential benefits of Islamic finance to Australia — despite Australia being a late-comer in this area in the Asia-Pacific region — it would seem that it should be embraced and encouraged. Having highlighted why Australia should embrace Islamic finance, the key regulatory impediments to its adoption are considered.

#### IV Key Impediments to Islamic Finance in Australia

It has been suggested that ‘[t]he legal and regulatory problems are the key impediments in the growth and development of Islamic finance industry in the Australian financial market.’<sup>73</sup> Other foreign jurisdictions have recognised these key impediments and addressed the need for amending legislation. For example, regulatory and tax amendments have already been introduced in jurisdictions such as the UK, Malaysia and Singapore in order to accommodate Islamic finance products.

While there are key substantive differences between conventional finance and Islamic finance, ‘like conventional financing, the Islamic finance industry needs to be supported by a strong regulatory and supervisory framework.’<sup>74</sup> Many of the key regulatory impediments have been highlighted in previous scholarly articles; most recently, in the work of Dr Salim Farrar who comprehensively outlines the role and function of the regulators as well as the regulatory legislation affecting Islamic service providers.<sup>75</sup> The broad issues are merely highlighted in this article. There are potentially three broad regulatory problems facing the facilitation of Islamic banking and finance products in Australia: obtaining a banking licence; the need for regulatory amendments such as changes to the tax regime; and the global banking standards — currently the Basel and Basel II<sup>76</sup> standards,<sup>77</sup> as well as the newly released (December 2010) Basel III standards due

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<sup>72</sup> Ibid 439–40.

<sup>73</sup> Ahmad, Osmani and Karim, above n 8, 225.

<sup>74</sup> Ahmad and Hassan, above n 12, 307.

<sup>75</sup> For a discussion on the role and function of the regulators and the regulatory legislation see, Farrar, above n 68, 425–31.

<sup>76</sup> It should be noted that the Islamic Financial Services Board (‘IFSB’) serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with sharia principles, and recommending them for adoption. To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

<sup>77</sup> Ahmad and Hassan, above n 12, 308. Ahmad, Osmani and Karim, above n 12, 226.

to come into effect in 2015. In addition, some legislation, including laws relating to mortgages, which are designed around a system which assumes interest as the cost of lending, compounds the broader problems. From a consumer perspective, there are issues in relation to credit under the *National Consumer Credit Protection Act 2009* (Cth) because of the structure of Islamic finance products not containing interest.<sup>78</sup> Australia's pension regime and insurance regime also fail to offer any formal sharia-compliant products. While this may be more a lack of any market driving the need or want of such products, there are currently no publicly available superannuation schemes to invest in which allow for an interest-free pension fund.<sup>79</sup>

Two specific examples of impediments are highlighted by the Johnson Report.<sup>80</sup> First, there are possible legal consequences through ASIC under the *Corporations Act 2001*<sup>81</sup> because the nature of certain types of Islamic finance products. As some have multiple investors, this brings them within the definition of a 'managed investment scheme.'<sup>82</sup> Second, Sharia Supervisory Boards and their influence over directors on the Boards of Islamic banks may be an issue in terms of meeting the prudential requirements relating to directors.<sup>83</sup>

There are three possible ways to address the legal and regulatory problems. First, a separate legal framework can be adopted; a method that has some limited support.<sup>84</sup> Second, legislative reform may be avoided altogether, with parity potentially achieved by regulatory bodies such as the Australian Taxation Office issuing administrative guidance. Third, a less radical approach to a separate legal regime but still requiring legislative intervention is possible. An integrated approach may be adopted, taking into account any unique properties of Islamic finance and amending the existing legislation to accommodate sharia-compliant service providers and products.

The first approach — that of adopting a separate legislative regime — finds its support in the view that the principles of Islamic finance differ from conventional financing, and, as a consequence, a separate regime is required. The underlying philosophy of Islamic finance, with sharia not as a set of laws but a principles-based legal system governing the economic, social, political and cultural aspects of Islamic societies, means that it is so different from the foundations of conventional finance that any current regulatory regime could not meet its needs.<sup>85</sup>

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<sup>78</sup> Ahmad, Osmani and Karim, above n 8, 227.

<sup>79</sup> Ibid 227.

<sup>80</sup> Australian Financial Centre Forum, above n 3.

<sup>81</sup> For a discussion on the role of ASIC and the implications arising from the *Corporations Act 2001* (Cth), see Farrar, above n 70.

<sup>82</sup> Australian Financial Centre Forum, above n 3, 97.

<sup>83</sup> Ibid 98.

<sup>84</sup> In 2010, Ahmad, Osmani and Karim went so far as to argue that a separate legal framework should be established to facilitate the growth and development of Islamic finance within the Australian financial market: Ahmad, Osmani and Karim, above n 8, 220. They stated, 'The Islamic finance industry needs to be supported by a strong regulatory and supervisory framework': at 222. They also suggested that Islamic financial institutions should 'take an intensified program to familiarise the public and policy makers with an overview of the Islamic finance and of the financial services and products they use in Australia', 221.

<sup>85</sup> Ahmad, Osmani and Karim, above n 8, 223.

However, there are potentially two significant barriers facing the embracing of such an approach: political and social difficulties, and the constitutionality of a separate regime.

The Australian public generally, and federal government specifically, adopts a mixed approach to Islamic law, with Islamic finance law seen as an aspect of Islam that should be embraced, while other aspects of Islamic law, such as family law, are seen as ‘bad’ and warranting denouncement.<sup>86</sup> This stance is one adopted not only by the Australian general public and fuelled by the media,<sup>87</sup> but also promulgated by politicians with their ‘one law for all mantra’.<sup>88</sup> Consequently, given the current Australian political climate, it is unlikely that a separate legislative regime would be successful. Further, compounding the question of whether a separate legislative regime is possible, is the question as to whether the Australian Constitution would allow these laws to be introduced. Freudenberg and Nathie<sup>89</sup> argue that laws introduced to facilitate Islamic finance would not breach s 116<sup>90</sup> (religion) of the Constitution. However, they limit their analysis to the amendment of existing laws rather than the introduction of a separate regime. Constitutional issues arising from the more radical approach of a separate legislative regime for Islamic finance products may need to be overcome.

The second approach is potentially the least controversial but also the least certain. It involves administrative guidance from the relevant bodies. In the context of taxation, this would be the Australian Taxation Office (‘ATO’). The ATO issues what are known as Taxation Rulings — public documents explaining the Commissioner’s interpretation of the laws administered by the ATO. While public rulings deal with priority issues requiring clarification, and as such, could clarify some of the taxation issues surrounding Islamic finance products, these rulings are not law. Further, public rulings cannot deal with situations where there is no

<sup>86</sup> For an analysis of Australia’s mixed response to Islamic law see, Ann Black and Kerrie Sadiq ‘Good and Bad Sharia: Australia’s Mixed Response to Islamic Law’ (2011) 34 *University of New South Wales Law Journal* 383.

<sup>87</sup> Recent examples: Harry Callaghan, ‘Australian Muslim Women Choose to Live by Own Code’, *The Daily Telegraph* (Sydney), 23 July 2011; Chris Merritt, ‘British Experiment a Warning on Sharia’ Law’, *The Australian*, (Sydney), 26 August 2011; Gary Romain, ‘How Sharia is Really Working in Australia as a Shadow Legal System — Academic Report’, *Courier Mail*, (Brisbane), 19 July 2011, Joseph Wakim, *Let’s Give Sharia Another Flogging* (25 July 2011) *The Drum Opinion*, ABC <<http://www.abc.net.au/unleashed/2808192.html>>; ‘One Set of Laws for All Citizens’, *The Australian* (Sydney) Editorial, 20 Jul 2011; Chris Merritt, ‘Sharia Law Already at Work in Australia’, *The Australian* (Sydney), 20 July 2011; National Nine News *Sharia Not Shadow Legal System: PM* (19 July 2011) *Ninensn* <<http://news.ninensn.com.au/national/8275071/sharia-not-shadow-legal-system-pm>>; Leesha McKenny, ‘There is No Place Here for Sharia, Says Scipione’, *The Canberra Times* (Canberra), 20 Jul 2011.

<sup>88</sup> Peter Costello, ‘Worth Promoting, Worth Defending — Australian Citizenship, What It Means and How to Defend It’ (Speech delivered at the Sydney Institute, Sydney, 23 February 2006) <<http://www.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=speeches/2006/004.htm&min=phc>>.

<sup>89</sup> Brett Freudenberg and Mahmood Nathie, Griffith Business School, ‘Submission to the Review of the Taxation of Islamic Finance’ <[http://www.taxboard.gov.au/content/reviews\\_and\\_consultations/islamic\\_finance\\_products/submissions/Freudenberg\\_&\\_Nathie.pdf](http://www.taxboard.gov.au/content/reviews_and_consultations/islamic_finance_products/submissions/Freudenberg_&_Nathie.pdf)>.

<sup>90</sup> Section 116 of the *Commonwealth of Australia Constitution Act (1901)* states: ‘The Commonwealth shall not make any law for establishing any religion, or for imposing any religious observance, or for prohibiting the free exercise of any religion, and no religious test shall be required as a qualification for any office or public trust under the Commonwealth.’

ambiguity in the law. For example, where there is State stamp duty on transfers of property, the legislation is clear and unambiguous. Further, any interpretation of stamp duty legislation would need to be provided by the relevant State authorities. Despite the difficulties associated with this approach, it is not without precedent or support. In 2010, France determined that no legislative changes were needed but rather the French tax authorities issued guidelines explaining how Islamic finance products would be taxed.<sup>91</sup> This approach also avoids many of the political pitfalls associated with the first method of adoption of Islamic finance principles.

Despite limited support for the first two approaches, the third approach — that of legislative amendment — is considered the favoured method to ensure parity of treatment with conventional finance products. This approach is adopted by the Board of Taxation in their recent discussion paper.<sup>92</sup> And, while political and social disagreement may ensue, it is the generally favoured approach by academics and professionals alike.<sup>93</sup> In a 2009 paper, Ahmad and Hassan state that ‘[a]part from a common legal and regulatory framework to a large extent, the IFIs [Islamic financial institutions] in most jurisdictions should be governed by the same regulatory framework that is applied to operations of conventional finance, reinforced by the Islamic legal framework and the Islamic accounting standards.’<sup>94</sup> This view is widely supported.

To demonstrate that the third approach of amendment is the most favourable, the income tax regime is used in this article as a case study to demonstrate the types of legislative issues that arise, along with possible resolution. Some have gone as far as to suggest that ‘perhaps of greatest importance for overseas IFSPs is Australia’s tax regulatory framework.’<sup>95</sup> The merits of this claim are not debated in this article. Rather, the income tax regime is utilised because significant work has already commenced in this area. It does, however, need to be recognised that other areas of legal and regulatory reform, briefly outlined above, as well as broader issues, may be important. To this extent ‘[i]n addition [to the tax measures], the Government has established a cross agency interdepartmental process to examine whether there are any non-tax regulatory barriers to the development of Islamic finance in Australia.’<sup>96</sup>

## V Reform to the Income Tax Regime: a Case Study

In January 2010, the Johnson Report recommended that there be ‘removal of any regulatory barriers to the development of Islamic financial products in Australia, guided by the principle that there should be a “level playing field” for

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<sup>91</sup> Australian Government, above n 9, 65.

<sup>92</sup> Ibid 2, vii.

<sup>93</sup> See, eg, Ashutosh Chotai ‘Islamic Finance Meets Australian Taxation’ (2008) 11 *The Tax Specialist* 310; Rhys Penning, ‘Paper 11: GST and Islamic Banking’ (Speech delivered at 22<sup>nd</sup> Annual GST and Indirect Tax Workshop, Sheraton Noosa, 15-16 April 2010) Norton Rose, Submission to the Board of Taxation (17 December 2010) <[http://www.taxboard.gov.au/content/reviews\\_and\\_consultations/islamic\\_finance\\_products/submissions/Norton\\_Rose.pdf](http://www.taxboard.gov.au/content/reviews_and_consultations/islamic_finance_products/submissions/Norton_Rose.pdf)>.

<sup>94</sup> Ahmad and Hassan above n 12, 307.

<sup>95</sup> Farrar, above n 70, 431.

<sup>96</sup> Sherry, above n 43.

such products.<sup>97</sup> In addition to this general recommendation referring to a broad range of potential regulatory barriers, the Report made the following recommendation in relation to the income tax regime.

**Recommendation 3.6: Islamic Finance Products**

The Forum recommends that the Treasurer refer to the Board of Taxation the question of whether any amendments to existing Commonwealth taxation provisions are necessary in order to ensure that Islamic finance products have parity of treatment with conventional products, having regard to their economic substance.<sup>98</sup>

The federal government responded to the recommendation of the Johnson Report with a joint media release on 26 April 2010 by the then Assistant Treasurer, Senator Nick Sherry, and the Minister for Financial Services, the Hon Chris Bowen.<sup>99</sup> At that date, it was announced that the Board of Taxation would ‘undertake a comprehensive review of Australia’s tax laws to ensure that, wherever possible, they do not inhibit the expansion of Islamic finance, banking and insurance products’.<sup>100</sup> The media release highlighted the size of the Islamic finance, banking and insurance market, currently estimated to be worth nearly AU\$1 trillion. It also drew attention to the main tax issue facing Islamic compliant products. It stated:

[T]he main tax issue faced in relation to accommodating Sharia-compliant financial products in most Western tax systems is the form-based nature of such instruments. That is, whereas Western tax codes normally focus on the details of the transaction in question and levy tax accordingly, this approach may give rise to anomalous tax treatments for Islamic instruments. In a strict ‘form’ approach, a transaction may, on its face, indicate one tax outcome, while the economic substance of the transaction may indicate another.<sup>101</sup>

Subsequent to the announcement that the Board of Taxation would review the taxation treatment of Islamic products, a discussion paper entitled ‘Review of the Taxation Treatment of Islamic Finance’ was released in October 2010. Along with consultation meetings, the Board called for submissions regarding the review, of which 13 have been made publicly available by the Treasury. The Board was asked to report to the Assistant Treasurer by June 2011 and has done so, although the federal government is yet to make that report publicly available. Despite this, it is possible to utilise the Board’s comprehensive discussion paper, which is consistent with previous government reports on Islamic finance, suggesting that tax reforms are needed. Specifically, in January 2010, Austrade stated that the need for regulatory reform, including tax reform, was ‘particularly important for countries that currently only have tax regulations for a conventional finance and banking

<sup>97</sup> Australian Financial Centre Forum, above n 3, 98.

<sup>98</sup> *Ibid* 71.

<sup>99</sup> Australian Government, The Treasury, ‘Board of Taxation to Review Australia’s Tax Laws to Ensure Islamic Finance Market Can Expand’ (Media Release, No 076, 26 April 2010) <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/076.htm&pageID=003&min=njsa&Year=&DocType=0>>.

<sup>100</sup> *Ibid*.

<sup>101</sup> *Ibid*.

system. Successful introduction of Islamic finance to a market will require tax neutrality as compared to the tax treatment of conventional products.<sup>102</sup> This is also supported by the generally consistent and supportive approach of major submissions received by the Board of Taxation on their consideration of the issues in the discussion paper. In particular, submissions made by legal and accounting firms such as Blake Dawson<sup>103</sup> and Ernst & Young,<sup>104</sup> as well as professional bodies such as CPA Australia,<sup>105</sup> and the joint submission made by the Taxation Institute of Australia and Australian Financial Markets Association<sup>106</sup> all support the facilitation of a 'level playing field' for the provision of Islamic finance alongside conventional financing, via legislative amendment.

At the outset, it should be noted that it is not the objective of the Board of Taxation Review to suggest a *different* tax regime for Islamic finance products, but rather 'to ensure, wherever possible, that Islamic finance products have parity of tax treatment with conventional finance products.'<sup>107</sup> That is, the objective is to consider what changes, via legislative amendment, are needed to the current regime, rather than any proposals for new, specifically-targeted provisions.<sup>108</sup> As Farrar points out, this is consistent with the UK model.<sup>109</sup> To achieve this, the current review requires a consideration of the impediments contained in the current taxation regime, policy responses by other jurisdictions and recommendations to ensure parity of treatment.<sup>110</sup> With these terms of reference in mind, the Board is also directed to consider the economic substance (rather than form) of Islamic products, and where there is economic equivalence with a conventional product the tax treatment should be the same, if recommending amendments to the existing tax framework.<sup>111</sup> To illustrate, often because of the prohibition on interest, the form of the arrangement is a return of profits or rent whereas the substance of the arrangement is equivalent to a conventional loan.<sup>112</sup> This approach is consistent with recent taxation of financial arrangements reforms which focused on ensuring the substance of financial products is reflected in the income tax result. This is a departure from the traditional judicial approach which focused on legal form and applied the provisions accordingly.<sup>113</sup>

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<sup>102</sup> Austrade above n 30, 20.

<sup>103</sup> Blake Dawson, Submission to the Australian Board of Taxation, (17 December 2010) <[http://www.taxboard.gov.au/content/reviews\\_and\\_consultations/islamic\\_finance\\_products/submissions/Blake\\_Dawson.pdf](http://www.taxboard.gov.au/content/reviews_and_consultations/islamic_finance_products/submissions/Blake_Dawson.pdf)>.

<sup>104</sup> Ernst & Young, Submission to the Australian Board of Taxation (17 December 2010) <[http://www.taxboard.gov.au/content/reviews\\_and\\_consultations/islamic\\_finance\\_products/submissions/Ernst\\_&\\_Young.pdf](http://www.taxboard.gov.au/content/reviews_and_consultations/islamic_finance_products/submissions/Ernst_&_Young.pdf)>.

<sup>105</sup> CPA Australia, Submission to the Australian Board of Taxation (undated) <[http://www.taxboard.gov.au/content/reviews\\_and\\_consultations/islamic\\_finance\\_products/submissions/CPA\\_Australia.pdf](http://www.taxboard.gov.au/content/reviews_and_consultations/islamic_finance_products/submissions/CPA_Australia.pdf)>.

<sup>106</sup> Taxation Institute of Australia and Australian Financial Markets Association, Submission to the Australian Board of Taxation (18 January 2011) <[http://www.taxboard.gov.au/content/reviews\\_and\\_consultations/islamic\\_finance\\_products/submissions/TIA\\_&\\_AFMA.pdf](http://www.taxboard.gov.au/content/reviews_and_consultations/islamic_finance_products/submissions/TIA_&_AFMA.pdf)>.

<sup>107</sup> Australian Government, above n 9, vii.

<sup>108</sup> *Ibid.*

<sup>109</sup> Farrar, above n 70, 437.

<sup>110</sup> Australian Government, above n 9, 1.

<sup>111</sup> *Ibid.* 8.

<sup>112</sup> Dabner, above n 32, 241.

<sup>113</sup> Australian Government, above n 9, 11.

Taxes may be imposed at a federal or State level. Within the general federal income tax regime, income is recognised when derived, and related expenses are deductible when incurred, with that recognition generally being when the income and expenses are realised. Capital gains, which are assessed under the income tax regime, are based on a combination of form- and substance-based rules with a capital gain generally recognised on a realisation basis. This is distinct from the goods and services tax (GST) framework and State stamp duties, with those regimes providing transaction-based rules. In addition to these taxes are the rules which apply to cross-border transactions, particularly interest-withholding tax. Non-residents are usually taxed on income sourced in Australia. However, dividends and interest paid to a non-resident are generally subject to a final withholding tax. The dividend withholding tax rate is 30 per cent, generally reduced to 15 per cent where there is a treaty partner. Where dividends are fully franked they will be exempt from withholding tax. The interest withholding tax rate is 10 per cent. An exemption from interest withholding tax will apply where the interest is paid on certain publicly offered debentures or debt interests,<sup>114</sup> or it is interest paid by an offshore banking unit in respect of its offshore borrowings.<sup>115</sup>

At State level, while there may be variations between the States, stamp duties are generally imposed. For example, in NSW, stamp duty is payable on a purchase or declaration of trust of land and goods as well as goodwill, intellectual property, shares in an unlisted company and units in an unlisted unit trust scheme, landholder duty for shares and units, and motor vehicles.<sup>116</sup> To date, Victoria is the only State to recognise the potential for for some Islamic finance contracts to incur double stamp duty, due to their structure. In 2004, Victoria introduced legislative amendments to accommodate Islamic finance products. Stamp duty amendments mean that a ‘Cost Plus’ arrangement discussed below is treated as one transaction, rather than two, thereby avoiding double duty.<sup>117</sup> Victoria also recognises the principle of profit sharing and allows Islamic contracts to avoid the use of such terms as ‘interest’ which are not permitted under sharia law.<sup>118</sup>

It becomes obvious, given the information outlined above, that for each Islamic finance contract it is necessary to consider the income tax, capital gains tax, goods and services tax, and stamp duty implications, as well as any international aspects of the transaction. As to specific Islamic finance products, the main contracts as listed by the Board of Taxation and being considered are the *murabahah*<sup>119</sup> (cost plus profit sale), *tawarruq*<sup>120</sup> (cash finance sale), *istisna*<sup>121</sup>

<sup>114</sup> *Income Tax Assessment Act 1997* (Cth), ss 128F(2) and 128FA.

<sup>115</sup> *Income Tax Assessment Act 1997* (Cth), s 128GB.

<sup>116</sup> For a summary of each State, see Australian Government, above n 9, 23–5.

<sup>117</sup> *Duties Act 2000* (Vic) ss 57A–57F. For a discussion of the Victorian law as it applies to Islamic finance products, see, John Barry, ‘Islamic Property Financing’ (2007) 15 *Australian Property Law Journal* 66, 67.

<sup>118</sup> Government of Victoria, ‘Islamic Finance’, Fact Sheet (April 2010).

<sup>119</sup> ‘*Murabahah*’ refers to the sale and purchase of an asset whereby the cost and profit margin are made known and agreed to by all parties involved. The settlement for the purchase can be on either a cash basis, a deferred lump sum basis or on an instalment basis, which will be specified in the agreement. Australian Government, above n 9, 8.

<sup>120</sup> Under a ‘*tawarruq*’ contract, a person buys a commodity or some goods on credit with an understanding of paying back the price either in instalments or in full in the future. The commodity



(purchase order), *salam*<sup>122</sup> (forward sale), *musharakah*<sup>123</sup> (profit and loss sharing partnership), *musharakah mutanaqisah*<sup>124</sup> (diminishing partnership), *mudarabah*<sup>125</sup> (profit sharing partnership), *ijarah*<sup>126</sup> (operating lease), *ijarah muntahiah bi tamlik*<sup>127</sup> (finance lease), *sukuk*<sup>128</sup> (Islamic bond), *takaful*<sup>129</sup> (insurance) and *wakalah*<sup>130</sup> (agency).

To demonstrate the tax issues that arise in relation to Islamic finance products this article now focuses on two of the most frequent Islamic finance arrangements. The first is the *murabahah*, which is often used by Australia's domestic Muslim population, while the second is the *sukuk*, which is likely to attract offshore investment. This allows a discussion of the taxation consequences as raised by the Board of Taxation in its discussion paper, along with potential legislative amendment to overcome any lack of parity between Islamic finance products and conventional finance products.

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is immediately sold by the person to a third party to obtain cash. Australian Government, above n 9, 8.

<sup>121</sup> Under an '*istisna*' contract, a buyer will require a seller or a contractor to deliver or construct an asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties to the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of work completed. Australian Government, above n 9, 8.

<sup>122</sup> '*Salam*' refers to a contract for the purchase of assets by one party from another party on immediate payment and deferred delivery. Australian Government, above n 9, 8.

<sup>123</sup> Under a '*musharakah*' contract, a partnership is established by means of an agreement or arrangement whereby two or more parties agree that each of them contributes to the capital of the partnership either in the form of cash or in kind and shares in its profit and loss. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but a loss will be shared on the basis of equity participation. Australian Government, above n 9, 8.

<sup>124</sup> This is a '*musharakah*' contract in which one of the parties promises to purchase the equity share of the other party gradually until the title of the equity is completely transferred to them. Australian Government, above n 9, 8.

<sup>125</sup> Under a '*mudarabah*' contract, one party provides capital and the other party acts as an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed profit sharing ratio. In the event of a loss, the loss shall be borne solely by the provider of the capital unless it is due to the misconduct or negligence of the entrepreneur. Australian Government, above n 9, 8.

<sup>126</sup> Under an '*ijarah*' contract, a lessor (owner) leases out an asset to its client at an agreed rental fee and pre-determined lease period. The lessor retains ownership of the leased asset. Australian Government, above n 9, 9.

<sup>127</sup> This is similar to the '*ijarah*' contract except that the lessor also makes a promise to transfer the ownership of the asset at the end of the lease period via a separate sale agreement or gift. Australian Government, above n 9, 9.

<sup>128</sup> '*Sukuk*' is the Islamic finance equivalent of conventional tradable notes or bonds, which represents the ownership (actual or beneficial) by the *sukuk* holders in an underlying sharia compliant asset or financing arrangement. Returns are paid to the investors in line with their proportional ownership in that asset and investment, and vary according to asset performance rather than the time elapsed. Australian Government, above n 9, 9.

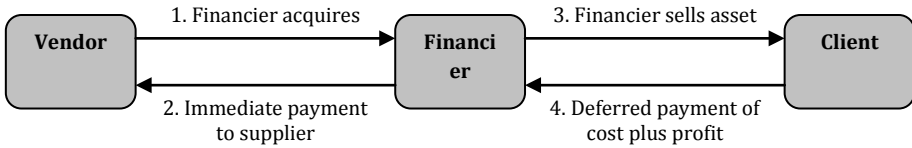
<sup>129</sup> Under the '*takaful*' contract parties invest in a pooled investment vehicle where they joint-guarantee each other against specified events and profits are paid out to investors upon the occurrence of a specified event. The fund does not seek to make profits but to mitigate its losses. However, the fund may invest surplus funds in sharia compliant assets or financing arrangements. Australian Government, above n 9, 9.

<sup>130</sup> *Wakalah* is a contract of agency which gives the power to a person to nominate another person to act on their behalf based on agreed terms and conditions. Australian Government, above n 9, 9.

## A *The Murabahah*

The first case study analyses the *murabahah* or the ‘cost plus profit’ sale. A *murabahah* arrangement is generally entered into where an individual wishes to purchase a property, whether as a main residence or investment, and obtain finance to do so. The conventional way for a person to finance the purchase of a property is by a mortgage arrangement where a mortgage is taken over the real property by the lender. The property is purchased by the borrower with money borrowed from the lender and title is transferred to that borrower. The borrower then repays the lender the principle and interest as per the contract. If the borrower defaults on the repayments the lender may enforce a sale of the property as they hold the property as security for the loan agreement.

The conventional mortgage arrangement outlined does not comply with the principles of Islamic finance as the contract contains an interest component. That is, the prohibition against *riba* is breached. As an alternative way to finance the purchase of a home, Muslims will enter into a *murabahah* arrangement. Within the Islamic finance market, the equivalent product to the conventional mortgage is a cost plus profit sale. The economic substance is the same as a conventional mortgage but the form of the arrangement is different. Under the Islamic equivalent, it is the financier that purchases the property outright. The financier then sells the property to the client at cost plus a profit to be repaid over a specified period of time. The Board of Taxation provides the following example of the cost plus profit arrangement:

**Cost plus profit sale (of a rental property)**

Step 1: A Client agrees to purchase a house from a vendor. The Client approaches a resident Financier to finance the purchase. A purchase instruction with promise to purchase is completed by the Client which is a request that the Financier purchase the asset specified and an undertaking to purchase that asset from the Financier.

Step 2: If the Financier approves the financing, an Asset Purchase Agreement will be executed where the Financier purchases the asset (house) from the vendor on a cash basis for a purchase price of \$360,000. The Financier appoints the Client as its agent to purchase the asset. The asset is transferred to the Financier at this time.

Step 3: Asset Sale Offer and Acceptance notices will be executed, in which the Financier will offer to sell the asset to the Client on deferred terms at the purchase price (\$360,000) plus a profit component (\$384,341). The Financier will typically consider the prevailing mortgage interest rates for a similar credit risk. The Client will complete the Acceptance notice. The sale is executed and title is transferred to the Client with security granted to the Financier.

**Example of Asset Offer Notice**

Description of asset: residential property

Cost price: \$360,000

Settlement date: 1 September 2010

Profit: \$384,341 (8.4 per cent per annum)

Deferred payment price: \$744,341

Deferred payment date: 30 August 2030 (20 Years)

Step 4: The Client will pay the sale price of \$744,341 on an amortising monthly instalment basis over 20 years at \$3,101.42 per month. The schedule for payments will typically look the same as a conventional loan agreement, with the cost and profit components clearly set out.

Source: Australian Government, The Board of Taxation, 'Review of the taxation treatment of Islamic Finance Discussion Paper' (October 2010) 28.

The Board of Taxation in its Discussion Paper has indicated that it views the economic substance of this arrangement as the 'equivalent of a conventional fixed interest loan backed by a mortgage'.<sup>131</sup> However, several issues in relation to taxation arise. The most obvious issue to the reader will be the double transfer of the property and the likely triggering of two dutiable transfers. In all States apart

<sup>131</sup> Australian Government, above n 9, 28.

from Victoria, there will be a dutiable transaction when the property is transferred from vendor to financier and then a second dutiable transaction when the financier transfers the property to the client. However, as evidenced by the Victorian amendments to legislation, the problem of double duty is easily overcome. Amendment, adopting a substance over form approach, to each State's stamp duties legislation would be required to ensure that the transaction is only taxed once.

The second issue to arise relates to the question of income versus capital. Where the property is an investment which is producing income, any associated outgoings are immediately deductible against that income. Therefore, under a conventional mortgage, interest payments are deductible. Under a cost plus profit arrangement it is the profit component which is the economic equivalent to interest. However, its form may be construed as one of a capital payment for the purchase of the property, thereby forming part of the cost base of the asset for capital gains tax purposes. It is suggested that legislative amendment either broadening the definition of interest or specifically deeming the profit component of these arrangements to be interest would negate any issues. Such amendments would also overcome a third and similar issue relating to interest withholding tax where payments are made to a non-resident. Again, it would be necessary to determine whether the profit component payments were income or capital payments. Under a conventional mortgage the payments would be interest and subject to withholding tax. The suggested amendments above would achieve this same result for the Islamic cost plus profit arrangement.

The final issue which may arise relates to GST. Under a conventional arrangement, the mortgagor may be entitled to a reduced input tax credit on certain financial supplies, resulting in the mortgagor incurring less expense associated with providing the mortgage. The same principles will not apply where the supply is in the form of residential premises. Hence, the Islamic transaction may be more costly due to the effects of GST. The cost of this would most likely be embedded in the arrangement with the client.<sup>132</sup> Achieving tax neutrality in relation to GST may be more difficult to overcome due to the very nature of GST and the fact that it attaches to the supply of goods and services with special provisions applying to certain supplies. It is proposed that, in this situation, a *de facto* formula which acts as a proxy for the approximated reduction for conventional products would be the easiest way to achieve parity for Islamic products.

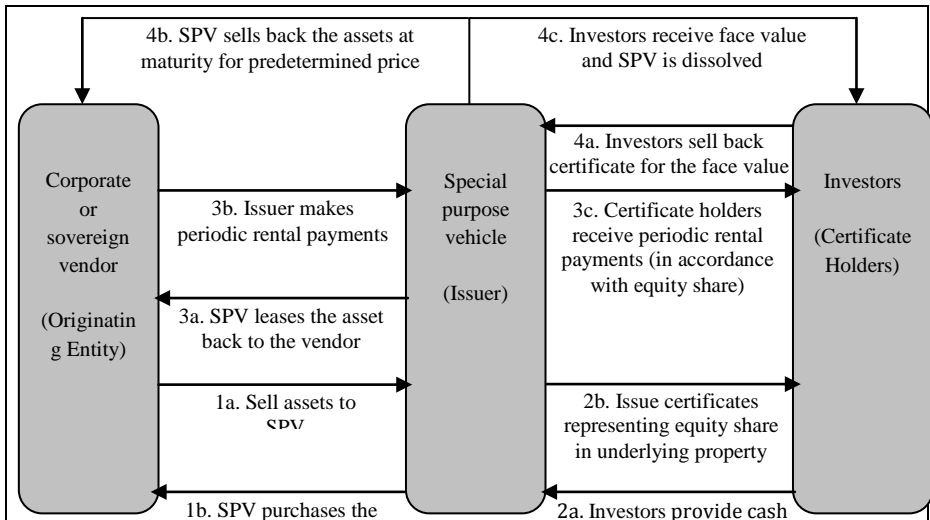
## **B**      *The Sukuk*

The second part of the case study analyses the *sukuk* or the lease-backed Islamic bond. A *sukuk* arrangement is utilised in a similar manner to a conventional bond. Bonds are long term debt instruments sold to investors either by government or companies. Essentially, the investor agrees to loan the government or company money at a predetermined rate of interest. The conventional bond fails to comply with sharia law as there is both an interest

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<sup>132</sup> Ibid 30–1.

component and there is no underlying asset. As such, the *sukuk* is asset backed with the owner of the certificate holding an undivided share in a sharia-compliant underlying asset. The returns on the *sukuk* arrangement are paid in line with the proportional ownership of the underlying asset and in accordance with the performance of that asset. The Board of Taxation provides the following example: Islamic bond backed by a finance lease



An Australian electricity company (Vendor) needs to raise \$500 million to finance an upgrade of its infrastructure over the next five years. The entity identifies an asset or a pool of assets with an approximate value of \$500 million.

Step 1: Once the assets to be securitised are identified the assets are sold to an Australian resident special purpose vehicle (SPV) using a purchase agreement. A purchase undertaking is entered into by Vendor.

Step 2: The SPV, as trustee, raises the cash to purchase the assets by issuing certificates to investors. The certificate holder has a proportionate beneficial interest in the underlying assets held by the SPV and entitlement to income generated through the asset.

Step 3: The SPV then leases the assets back to the original owner and distributes the rent to the certificate holders. The periodic distribution to certificate holders is equivalent to the interest coupon on a conventional bond and can be set by reference to a fixed or floating rate of return (6 million + 50bp). A service agreement is entered into between the SPV and the Vendor.

Step 4: At the end of the defined term (five years), the Vendor (original entity) agrees to purchase the assets back at a predetermined price. The certificate is then sold back to the SPV by the investors for the face value and the SPV is dissolved.

Source: Australian Government, The Board of Taxation, 'Review of the taxation treatment of Islamic Finance Discussion Paper' (October 2010) 53.

The *sukuk* involves a series of transactions which, to a non-tax expert, are difficult to understand. However, even then it is obvious that there are more

transactions involved in the *sukuk* than a conventional bond. Therefore, in order to achieve tax parity, any tax consequences arising out of the establishment of the special purpose vehicle would need to be ignored.<sup>133</sup> However, this is not the case.

The first issue to arise is whether the issuing of the certificates by the SVT gives rise to debt or equity under Division 974 of the *Income Tax Assessment Act 1997* (Cth). The difference between a classification as debt and a classification as equity is that returns made as debt will be deductible (consistent with the conventional bond) whereas returns made as equity will not. Rather, equity returns will be treated like dividends. It is suggested that legislative amendment to either include in the definition of equity interest or specifically deeming the profit component of these arrangements to be interest would negate any issues.

The second issue that will arise relates to the transfer or sale of the assets to the special purpose vehicle. Prior to the lease agreement being entered into, the sale will be subject to the capital gains tax regime.<sup>134</sup> There will also be capital gains tax consequences in relation to the transfer of the use and enjoyment of the assets when the lease is entered into. These issues could be overcome by amending the legislation to provide that what is effectively an internal transaction, be ignored.

The *sukuk* will also involve a series of GST transactions which do not arise under the conventional bond. For example, the initial transfer of the assets will be a supply for GST purposes, as will the lease of the property. Further complicating the GST issues is the issue of the *sukuk* itself and the question of what type of supply is being made; a security, an assignment of a right to a payment stream (both of which are input taxed, that is, not subject to GST on the transfer) or the sale of the partial interest in an asset (which will be subject to GST with credits allowed to be offset).<sup>135</sup> As with the *murabahah*, achieving tax neutrality in relation to GST may be more difficult to overcome due to the very nature of GST and the fact that it attaches to the supply of goods and services with special provisions applying to certain supplies.

Finally, stamp duty issues will again arise on each of the transactions. But again, as evidenced by the Victorian amendments to legislation, the problem of double duty is easily overcome.

## VI Conclusion

Islamic finance is an area which is likely to continue to grow,<sup>136</sup> but one which Australia has been late to embrace. However, current legal and regulatory impediments can be relatively easily overcome through the approach of amendment, achieving parity of treatment between Islamic finance products and conventional finance products. This has been demonstrated using the taxation regime as a case study. As Ghouse suggests, '[g]iven the growing momentum of

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<sup>133</sup> Ibid 53.

<sup>134</sup> Ibid 56.

<sup>135</sup> Ibid 58.

<sup>136</sup> Qadri, above n 66, 61.

the Islamic finance market, evidenced by Government support, along with bank awareness, tax should not be seen as a stumbling block to Sharia compliant financing.<sup>137</sup> It is suggested that this can be expanded to all legal and regulatory impediments. Further, none of these impediments should be seen as 'insurmountable obstacles'.<sup>138</sup> Islamic finance should be viewed as complimenting conventional finance as:

there is potential for Islamic finance to co-exist, complement and contribute to conventional practice since Islamic models begin with the premise that the role of a financial institution is to promote the overall wellbeing of society.<sup>139</sup>

The economic, social and political benefits potentially warrant Australia embracing Islamic finance, and with the right regulatory measures it is argued that Australia could lay the foundation to become a leader in the Asia-Pacific Islamic finance market. Removing barriers to entry to achieve parity of treatment between Islamic finance products and conventional finance products will not ensure a flood of investment. However, if the Australian Government wishes to ensure that Australia is well positioned to meet the financial needs of the international Muslim community, removing legal and regulatory impediments is the first step towards achieving this goal.

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<sup>137</sup> Ghouse, above n 2, 24.

<sup>138</sup> Maryanne Loughnan and Douglas Drummond 'Islamic Banking: Borrowing and Investing out of Haraam's Way' (2010) 48 *Law Society Journal* 62, 66.

<sup>139</sup> Ahmad, Osmani and Karim, above n 8, 232.