The new UK tax law on sukuk

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Diagram 1 illustrates an ijara sukuk. The owner has a building and decides to raise money using that building. It sets up a special purpose vehicle (SPV) and sells the building to that SPV, and then rents it back. The SPV pays for that building by issuing sukuk. Those sukuk are not a debt owed by the SPV; instead they are a direct legal claim on a proportionate share of the building and of the rent it generates.

Diagram 2 illustrates a mudarabah sukuk, based upon an actual example. XYZ trading company has a collection of business assets and wants to raise $500 million to use in its business. It sets up an SPV, here XYZ Sukuk Ltd, which raises $500 million to buy the assets. That $500 million comes from the investors as payment for sukuk certificates. Next the assets, which are now owned by XYZ Sukuk Ltd on trust for the investors, are contributed to a mudarabah whereby 99 per cent of the profits of the mudarabah will go to the trust for payments to investors subject to a maximum limit, in this case of six per cent, i.e. six per cent of $500 million = $30 million p.a. Again, the investors are not receiving interest but a share of the business profits.

Before this year's tax law, what happened if a sukuk was issued? The basic problem was that tax costs arose in the issuing SPV company. The SPV is receiving something that is clearly taxable income. However the payments that the SPV makes to the investors do not give rise to any tax relief. Those payments to the investors are not interest; they are simply paying on to the investor the fractional entitlement to the rent or the fractional entitlement to the income of the mudarabah. There is no reason why the SPV should get tax relief for those payments under basic UK tax law. So tax arises in the SPV.

Even if the sukuk-issuing SPV tried to argue that this payment to the investors should really be treated like interest, it still wouldn't get tax relief. There is a very specific provision in our tax code, in the Income and Corporation Taxes Act (ICTA) 1988 section 209(2) (e) (iii). If you issue securities, in other words debt instruments, under which the interest payable on those securities is dependent upon the results of the company's business, then that interest doesn't get tax relief. Instead it is treated as a distribution, like a dividend. It is not a tax-deductible expense.

We now have some new legislation in the Finance Act (FA) 2007. However, if you search FA 2007 for the word 'sukuk', you will not find it. The rules for sukuk introduced in 2007 follow the same overall approach as the 2005 rules for murabaha transactions or mudarabah transactions. HM Treasury simply created a definition, a new concept in UK tax law; something called an 'alternative finance investment bond' (AFIB). If the definition is met, certain tax consequences follow.

The definition of an AFIB

The legislation requires one or more persons to pay money to a bond issuer. The bond issuer is going to acquire some assets which will generate income or gains.

There has to be a fixed period of time when the arrangements will end. A sukuk that is perpetual won't qualify. As part of the legal agreements, the issuer has to undertake that at the end of the sukuk it will dispose of any bond assets that are left.

The issuer will also make other payments to the investors, which are called additional payments. In *diagram 1*, the additional payments come from the rent and in diagram 2 from the business profits.

The additional payment must not exceed a reasonable commercial return on a loan equal to the amount of the capital. One of the things that the UK Government was most concerned about was ensuring that it did not give a tax deduction for payments on sukuk instruments which had equity characteristics, i.e. which were equivalent to ordinary shares. The law does not stipulate what is a reasonable commercial return; that would depend upon the facts and circumstances.

The bond issuer is going to manage the

bond assets. In other words, the bond assets are not managed by the investors. Of course, the bond issuer can delegate management. In *diagram 2*, once the bond assets have been contributed to the mudarabah, XYZ Trading Company as the mudarib is going to manage that mudarabah.

The sukuk, the bond, has to be transferable. This doesn't mean it has to be physically transferred. The sukuk could be issued and the same people may hold it for its entire five- or ten-year life, which is actually very common with sukuk. There is relatively little secondary trading in practice, but the critical thing is that they have to be transferable.

The AFIB has to be listed on a recognised stock exchange. There is a provision in the Income Tax Act 2007 section 1005 which details what a recognised stock exchange is and there is a provision in the legislation to recognise a stock exchange purely for the purpose of the AFIB rules. As well as a long list of fully recognised stock exchanges, HM Revenue & Customs (HMRC) lists seven exchanges which are recognised only for the purposes of the AFIB rules. (See www.hmrc.gov.uk/fid/rse.htm)

If issuing a sukuk from the UK, it is important to make sure that it is listed on a fully recognised stock exchange within the Income Tax Act 2007 definition to avoid paying withholding tax. If a sukuk is listed on a fully recognised stock exchange, then the consequence of the 2007 rules is that it is treated for tax purposes as if it were a debt instrument and the exemption for listed eurobonds should apply. Interest on listed eurobonds can be paid without withholding tax.

If a UK-based sukuk is created and listed on a stock exchange which is only recognised for the purpose of the AFIB rules and not recognised for any other purposes, then the eurobond exemption would not apply. The eurobond exemption looks specifically at stock exchange designations under Income Tax 2007, not at the extension for sukuk. Finally, there is an accounting test. If the issuer were to prepare accounts under

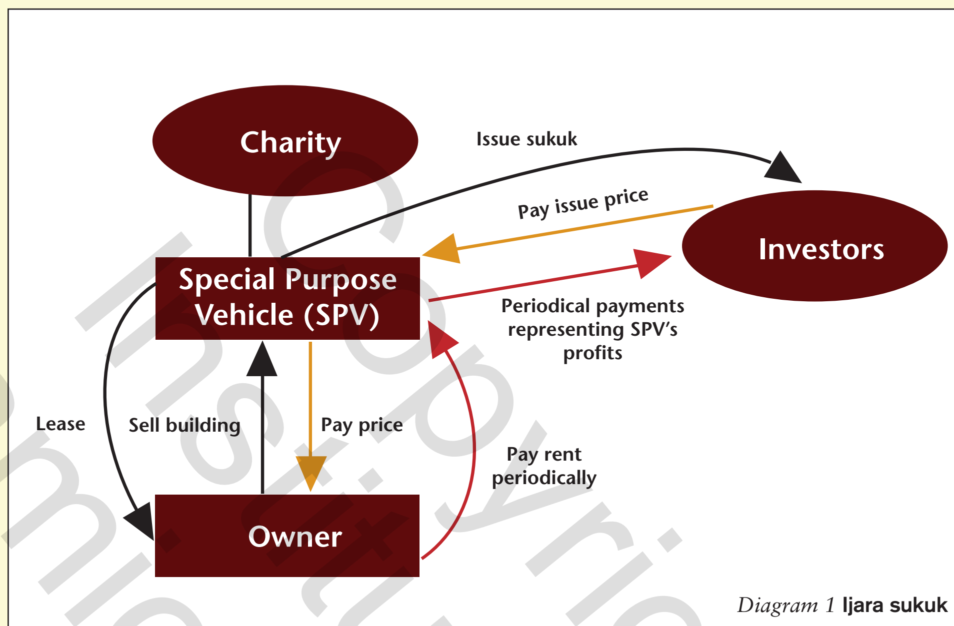

Diagram 1 **Ijara sukuk**

International Financial Reporting Standards (IFRS), the sukuk would be treated as a financial liability.

After all the strict definitions there are a few relaxations:

❑ The issuing entity can acquire the bond assets either before or after the sukuk itself is issued.

❑ Bond assets can be any kind of property and can be secondary rights in property. For example, it could be that instead of owning a building the asset could be a lease over a building.

❑ A declaration of trust is permitted but not mandatory.

❑ Bond holders may be given the right to terminate early.

❑ The additional payment, the economic return to the bond holder, can be either fixed or variable. However, if the payments are not fixed then the test of whether they represent only an amount equivalent to a normal commercial return on the capital is made by looking at the maximum amount of the additional payments. To ensure that the additional payments cannot exceed a reasonable commercial return, it may be worth including a numerical cap in the documentation, as in *diagram 2*.

❑ Finally, the redemption payment can be satisfied by the issue or transfer of shares. This caters for convertible or exchangeable sukuk, corresponding to convertible or exchangeable bonds.

Tax consequences of qualifying as an AFIB

From the issuing company's perspective, the AFIB is treated as a loan relationship. In other words, it is treated as if it were debt and all the tax rules for corporate debt apply to the AFIB. The Government is not saying that this is a debt instrument or that the issuer is paying interest, it is merely saying that it is going to apply the same tax law that would have applied if there had been a debt instrument.

The additional payments are treated as if they were interest for tax purposes. This potentially makes them tax-deductible, and there is an express override of section

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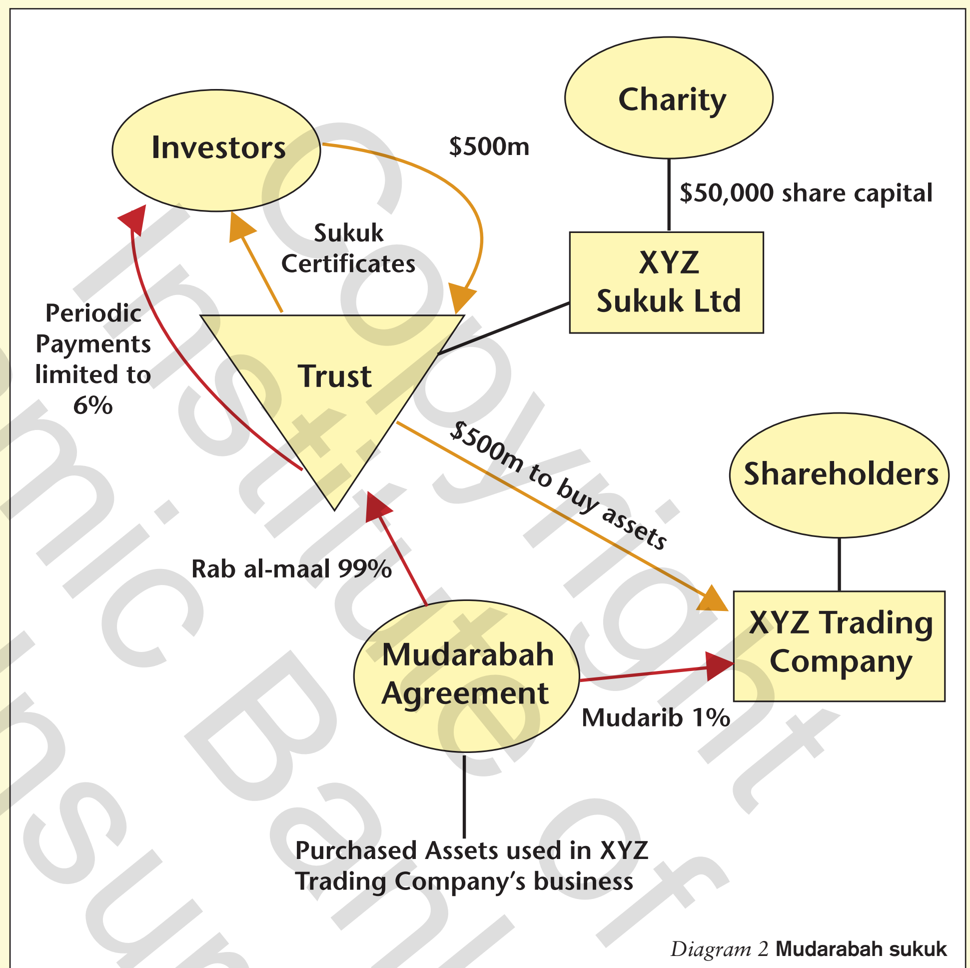

Diagram 2 **Mudarabah sukuk**

209 (2) (e) (iii). The issuer is taxed as if it beneficially owned the assets, which means that it is entitled to any capital allowances (tax depreciation) the assets qualify for.

To a limited extent the issuer is treated as a financial institution. The existing tax law for Islamic finance in FA 2005 and FA 2006 applies only if one party to the transaction is a financial institution, broadly speaking a bank, a building society, a wholly owned subsidiary of a bank or building society, or an overseas recognised deposit taker. The issuer of an alternative finance investment bond is treated as a financial institution but only for two specific categories of asset. These are purchase and resale assets, in other words assets which are used in a murabaha transaction, and diminishing shared ownership assets.

The reason for these two choices is that when drafting this legislation HM Treasury primarily saw sukuk as an equivalent to conventional securitisation. Conventional banks lend conventional mortgages and often securitise them. Islamic banks typically provide mortgages by purchase and resale of property or proportional ownership of property. Accordingly, the AFIB rules enable Islamic banks to securitise their Islamic mortgages.

Taxation of buyers and sellers of AFIBs

Buyers and sellers of sukuk are legally buying and selling a fractional ownership interest in assets. Before FA 2007, this gave rise to many technical questions. Was the purchase and sale of the assets subject to stamp duty; was it subject to capital gains tax or income tax; and was it subject to VAT or stamp duty land tax? If a sukuk paid rental income, was that rental income taxed in the UK if you were non-resident? Most of these questions are actually unresolved because sukuk were quite unfamiliar in a UK tax context.

The situation now is that for both corporate and individual investors, sukuk are treated exactly as equivalent conventional debt would be treated for tax purposes, both for the taxation of income payments and for the taxation of gains or losses from buying and selling sukuk.

Areas where further change is needed

In *diagram 1*, the first thing the owner does is to sell the buildings to the SPV. That sale is a taxable sale. If the building has gone up in value, the company will pay tax on the gain. If the company had issued a conventional eurobond it would not have sold the building or transferred the building anywhere and therefore it would not have paid tax.

There needs to be some mechanism designed to stop tax arising on the gain when the building is sold, perhaps by deferring it as long as the building eventually reverts to the entity which sold it to the SPV.

Similarly, that sale of the building will give rise to stamp duty land tax. Again, that is an extra cost which does not arise if a conventional debt instrument is issued. The sale may also give rise to value added tax consequences. These are areas where the law needs to go further to put sukuk issuers into an equivalent position to conventional bond issuers.

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