

A COMPARATIVE STUDY BETWEEN SOUTH AFRICA AND THE UNITED KINGDOM IN THE TAX TREATMENT OF ISLAMIC FINANCING PRODUCTS

by

SHABANA ABOO BAKER EBRAHIM
Student number: 26077567

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STUDY LEADER: Mrs. H. du Preez

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ABSTRACT

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by

Shabana Aboo baker Ebrahim

STUDY LEADER: HANNEKE DU PREEZ

DEPARTMENT: TAXATION

DEGREE: MAGISTER COMERCII

Within the South African banking environment, mainstream bank clients earn interest on their investments and receive a tax exemption. However, Islamic banking clients, in keeping with the principles of Shari'a law, do not receive interest. They are paid a profit share on their investments, and hence do not enjoy the tax exemption.

The new section 24JA of the Income Tax Act has introduced tax treatment for the following Islamic financing transactions effectively removing 'interest' from the equation:

- Mudarabah – Investment account
- Murabahah – Cost plus financing
- Diminishing Musharakah – Joint ownership

This study attempts to compare the tax treatment of Islamic financing products between the United Kingdom and South Africa. Moreover, this study also investigates the issues of the new section 24JA of the Income Tax Act as well as the United Kingdom's tax legislation, regarding Islamic financing, as to how far they ensure tax parity between Islamic financing products and conventional financing products. The case of tax regimes in Islamic finance operating in a conventional system was demonstrated in the two countries. The study is supported by a literature review related to Islamic finance tax background and Islamic finance products between the two countries.

The major revelation of the study shows that the degree of parity of the Islamic income tax legislation leaves a lot to be desired in order to ensure a sense of confidence in the conventional financing environment. Its biggest challenge lies in its degree of simplicity

and flexibility in order to address issues in tax that may be complex and fall between its requirements and the conventional and already popular systems.

KEY WORDS:

Islamic finance

Income Tax

South Africa

United Kingdom

Conventional system

OPSOMMING

TEENSTELLENDEN STUDIE TUSSEN DIE BELASTING HANTERING VAN ISLAMITIESE FINANSIERINGS PRODUKTE IN SUID-AFRIKA EN DIE VEREENIGDE KONINGRYK

deur:

Shabana Aboo baker Ebrahim

STUDIELEIER: HANNEKE DU PREEZ

DEPARTMENT: BELASTING

GRAAD: MAGISTER COMMERCII

Binne die Suid-Afrikaanse bankwese, verdien kliënte van die hoofstroom banke rente op hulle beleggings. Hierdie rente-inkomste is belasting vry. In teenstelling hiermee verdien kliënte van Islamitiese banke 'n winsdeling in plek van rente, op hulle beleggings. Hierdie winsdeling beginsel word verplig deur die Shari'a wetgewing. Bogenoemde winsdeling is nie belasting vry nie en word dus ten volle belas.

Artikel 24JA van die Inkomstebelasting wetgewing behandel die hantering van Islamitiese Finansiering transaksies in fyner besonderhede:

- Mudarabah – Beleggings rekening
- Murabaha – Koste plus finansieringskoste
- Diminishing Musharaka – Gesamentlike eienaarskap

Hierdie artikel verwyder effektiewelik die 'rente' komponent.

Hierdie studie be'oog om die belasting hantering van Islamitiese Finansierings produkte in Suid-Afrika en die Verenigde Koninkryk te vergelyk.

In hierdie studie word die moontlike probleme ten opsigte van die nuwe artikel 24JA oorweeg. Spesifieke aandag word ook geskenk aan die belasting hantering tussen Islamitiese Finansierings produkte en die konvensionele finansierings produkte.

Die studie word ondersteun deur literatuur wat handel oor Islamitiese belasting agtergrond en finansierings produkte tussen twee verskillende lande.

Die belangrikste uitkoms van hierdie studie, het bewys dat die Islamitiese Inkomstebelasting spesifiek met betrekking tot finansierings opsies steeds baie ontwikkel moet word.

Bo en behalwe die uitkoms geïdentifiseer, is die grootste uitdaging daarin dat die Islamitiese belasting wet moontlik nie komplekse situasies sal kan aanspreek nie. Dit word toegeskryf aan die feit dat die wetgewing baie simplisties is.

SLEUTERWOORDE:

Islamitiese Finansiering

Inkomstebelasting

Suid-Afrika

Verenigde Koninkryk

Konvensionele stelsel

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

Islam, like all other religions has set out principles and good practice relating to carrying out ethical business. Usmani (2002:18) mentions that these principles and good practice, which form the backbone of the Islamic financial system come from four main sources, namely, the Holy Quran, the Sunnah, the Ijma and the Qiyas.

According to Islamic Shari'a law, Usmani (2002:26) mentions that Muslims are strictly prohibited and condemned from receiving or paying *Riba*, commonly known as 'Usury or Interest,' in their financial dealings due to the fact that it does not promote equal wealth distribution in society and is thus unjust to society. Thus the basic concept relating to Islamic financing is that it is an 'interest free system,' with profits and losses shared amongst all parties of the transaction (Ahmad, 2008:17).

Today, it is well known amongst many economies in the world that Islamic financing and banking is constantly gaining market share among leading financial service providers in the world (Visser, 2012:21). The opportunity of opening up Islamic banking subsidiaries and the promising growth trend of Islamic financing products are being explored by major players in the banking sector such as HSBC, Deutsche Bank and many others (Goud, 2009:88).

In the South African banking environment, it is with great satisfaction that tax legislation dealing with Islamic finance has been introduced. South Africa is following countries such as the United Kingdom (UK), Malaysia, Australia and France that have introduced similar legislation and have attracted substantial investments following from the regularisation of these types of investments from a tax perspective. Should one consider the entering into financial transactions from an Islamic law perspective, one of the key issues is that the derivation of interest is prohibited. In section 24JA of the Income Tax Act (hereafter

referred to as “the Act”), three forms of Islamic finance products will be recognised, namely: Mudarabah; Murabahah and Diminishing Musharakah. Understanding these forms of finance and their parity aspect will go a long way to induce the business world to do business in South Africa (Brincker, 2010).

From a tax perspective, one of the major challenges facing the industry internationally is that tax laws generally cater for conventional banking products, which generally involve the charging of interest on monies lent (Ahmed, 2010:2). While many Islamic products are structured to replicate the economic effects of conventional products, the legal form of these products is very different from conventional products. This may lead to differences in tax treatment that may potentially place Islamic banks and their customers at a disadvantage compared to banks with conventional products (Africa Research Bulletin, 2010:18843A – 18844B).

According to the Holy Qur’an;

‘Those who devour Riba (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity’ (Ali, 2004:111).

From the above verse, it is evident that Shari’a (Islamic law) forbids any transaction which involves the receipt or payment of interest. Equally, Islam forbids transactions dealing with any activities which are forbidden as stated in the Qur’an and mentioned by Usmani (2002:26), such as gambling, and any activity where there is uncertainty of the outcome of the transaction (‘sale of the unseen’). Islamic financing is based on the principle of trade and the sharing of risk between financier and borrower (Freudenberg & Nathie, 2010:5).

In recent years the Islamic financial market has grown substantially globally (Conway & Feese, 2007:20). The footprint of the application of Islamic finance in Africa and South Africa is both promising and enormous as per the opinion of many economists (Cape, 2010a:17).

However, Islamic financing is faced with many challenges, especially in the western world. This is due to the fact that legal as well as financial systems are not designed to deal with such structures (Ahmed, 2010:2). One main problem or challenge is the abovementioned taxation consequences. The different tax systems around the world result in different tax treatments and consequences for the same transaction. Dar and Moghul (2010:14) mention the very important fact that most tax systems do not cater for Islamic financing structures, thus creating a tax disadvantage.

Another challenge mentioned by KPMG (2012:1) is the fact that tax authorities and taxpayers lack knowledge of the specific features of Islamic finance products.

During the 2010 budget speech, Finance Minister, Pravin Gordhan said '[as] an on-going part of the process of simplifying our tax system, government proposes further measures to reduce red tape and enhance our attractiveness as a viable and effective location from which businesses can extend their African and other worldwide operations. We will also review the tax treatment of financial instruments to ensure appropriate accommodation of Islamic-compliant finance' (Department of Finance, 2010:14).

Until the recent insertion of section 24JA into the Act, relating to 'Shari'a compliant financing arrangements', South Africa did not have any legislation in place which treated Islamic financing in a manner compliant with Shari'a law or dealt with Islamic financing at all. An effective date for this legislation is however yet to be announced. It is believed that this new amendment will attract more foreign investment into the country and is likely to become a permanent feature of South Africa's 'economic landscape'. (Grant Thornton, 2010).

1.2 PROBLEM STATEMENT

There is evidence of a close correlation between financial sector development and growth. Countries with larger financial systems tend to grow faster (Ebrahim, 1999:590). Providing access to finance has been proposed as a tool for economic development and poverty reduction. Islamic finance has the potential to expand access to finance to unprecedented levels for millions of Muslims, especially the poor, throughout the world. A large number do

not use formal financial services as they view conventional products as incompatible with Shari'a law. (Harding, 2011). Part of the appeal of Islamic finance lies in its inherent ability to enrich and supplement conventional finance while effectively and efficiently allocating capital and allowing opportunities to optimise the economic value and activity. Moreover, while not immune from the recent financial crisis, Islamic finance, given its unique characteristics, has illustrated a degree of resilience and stability. (Parashar & Venkatesh, 2010).

There is very limited literature on the expansion of Islamic finance. Most literature focuses more on assessing the impact of conventional banking development on growth, and very little on Islamic banks. The importance of Islamic finance has grown in the last two decades and especially recently with the global financial crisis, when it was realised that Islamic financial institutions were more resilient to shocks. Islamic finance is viewed by many as inherently stable as it avoids interest and interest based assets, focuses on equity as opposed to debt, and restricts speculation. The issue of Islamic finance is receiving increasing attention worldwide as a result of the role conventional financial institutions played in the global financial crisis. (Parashar & Venkatesh, 2010)

Many banks, such as First National Bank and Al Baraka, and the South African Institute of Chartered Accountants have introduced a number of initiatives and the institute believes it is through consultations with its members and the general public that it could place a call for legislative and regulatory amendments, similar to the adoption of the tax legislation (South African Institute of Chartered Accountants, 2012).

The introduction of section 24JA of the Act attempts to address the anomalies that exist within the previous tax treatment of Islamic finance and to ensure tax parity between Islamic finance products and conventional financing products. One reason is that, whilst interest is prohibited, an Islamic finance structure can enable a financier to receive a return called a profit that is interest-like. On the other hand, the customer under the arrangement can suffer an interest-like finance cost. A further issue relates to the ownership of assets as an Islamic financing sales product which gives the lender ownership, whereas in substance it is the borrower who is the owner.

1.3 PURPOSE STATEMENT

If a greater understanding for Islamic finance is developed, this financial system could provide the individuals engaged in finance activities with a safer and more ethical alternative compared to conventional banking.

When Islamic finance and banking is misinterpreted or wrongly connected to consumers' prejudices of the religion of Islam, it reflects negatively on the companies that provide this type of banking service. Not only does this affect the financial system as a whole, it also affects the consumers, as they miss out on the positive attributes that the different products of Islamic banking can actually provide. This is a problem that is likely to become even larger as Islamophobia is increasing around the world.

The unfamiliarity surrounding Islamic finance can also be considered as a contributing element to the lack of understanding. Islamic finance and banking has been in existence for no more than 30 years, compared to conventional banking which dates back to the 18th century (Hallberg & Nettelbladt, 2011:8). Hence, the consumer may be reluctant to use any other way of borrowing than the one that they are used to. In Western countries, the conventional banking system has a long history which can contribute to customers being more attached to this type of business model and thus not as willing to switch to a new alternative, which Islamic banking with its relatively short history could be perceived as.

However, the Islamic way of finance with its interest-free principles is not a new phenomenon, as all major religions at some point during their history have encouraged the same principles. Islamic finance can be seen as a more human option that is characterised by sustainability and social responsibility, thus it can appeal to all consumers regardless of their religion. (Hallberg & Nettelbladt, 2011:8).

The aim of this study is to critically analyse the new section 24JA of the Act of South Africa in comparison to the UK's tax legislation regarding Islamic financing, using synthesis analysis. Does the legislation offer enough tax parity between Islamic financing products

being offered by many financial and conventional financing institutions? When investigating whether or not Islamic finance products are within a transferrable system that could function alongside the conventional system, a comparative study of both the UK and South Africa was conducted to gather information about how the two systems can co-exist. As UK is a multicultural country that has been a western pioneer within Islamic finance, it was able to provide a valuable overview of how a dual system can work in a country with similar features. Islamic finance could have been studied in a Middle East country as well, however the UK with its ethnically diverse population can be considered to be a better comparison to Western society, where immigration has led to different religions being represented among the citizens, and above all, the South African tax regime and laws borrow heavily from the UK.

Having regard to the prevalence and complexity of Islamic finance today as mentioned earlier the study will provide valuable insight to both Muslims and Non-Muslims as to whether the new section 24JA of the Act and UK's tax legislation will serve its purpose to provide tax parity between Islamic financing products and conventional financing products. The existence of previous studies in this regard is scanty and hence the need for further studies in order to deal with the abovementioned matters are indeed required.

1.4 RESEARCH QUESTION

The following question therefore arises:

Does the new section 24JA of the Act ensure tax parity between Islamic financing products and conventional financing products?

1.5 RESEARCH OBJECTIVES

The study will be guided by the following research objectives:

- To critically analyse whether the new section 24JA of the Act ensures parity of tax treatment of Islamic finance products with conventional finance products in South Africa.

- To compare tax legislation between the UK and South Africa relating to Islamic finance products.

1.6 DELIMITATIONS AND ASSUMPTIONS

The following delimitations and assumptions applicable to this study should be noted:

1.6.1 Delimitations

This study will only focus on the tax implications relating to Islamic financing or the like, but will exclude any focus on Islamic bonds commonly known as Sukuk.

This study will not focus on the implications of Islamic financing transactions on the following:

- The Value-Added Tax Act 89 of 1991 (VAT Act);
- The Transfer Duty Act 40 of 1949;
- The United Kingdom Value Added Tax Act; and
- The United Kingdom Stamp Duty Land Tax Act.

Since this study is conducted on a subject that is in its nature very broad, many of the chapters could have been further explored. However, the decision was made to focus on tax regimes as linked to Islamic finance principles, and therefore four major issues were developed, namely the background to Islamic finance; the differences between Islamic finance and conventional financing products; income tax consequences of Islamic finance in the UK and income tax consequences of Islamic finance in South Africa. From these issues, the strategies were derived and each one can be seen as general guidelines rather than an in-depth analysis. Thus, this study could encourage further research.

1.6.2 Assumptions

The research is done with the following assumptions:

- The current Income Tax Act 58 of 1962 and VAT Act 89 of 1991 will remain the same for the duration of this study and section 24JA of the Act will come into effect.
- The provisions of the UK Finance Act 2006 and the UK Corporations Tax Act (CTA) 2009, relating to 'Alternative Financing Arrangements' will remain the same for the duration of this study.

1.7 DEFINITION OF KEY TERMS

The main terms that are used in this research are defined in this section.

Diminishing Musharakah is an Islamic financing structure used in place of conventional mortgages, whether residential or commercial (Iqbal & Mirakhor, 2011).

Dividend is an amount attributable or receivable by a person by virtue of that person having a shareholding in a company. This amount must be declared to the shareholder and can be transferred in cash or kind (section 1, Income Tax Act).

Finance Lease is 'a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred' (International Accounting Standards Board, 2009).

Fiqh is Islamic Jurisprudence (Iqbal & Mirakhor, 2011).

Gharar (uncertainty) refers to a situation in which either one party to a contract has information unknown to the other party or the outcome of a contract depends on the occurrence or non-occurrence of an event not within the control of any of the parties to a contract (Buksh, 2006:109). This definition is very similar to what is commonly known as a contingent liability contained in International Accounting Standard (IAS) 37 of International Financial Reporting Standards (IFRS) (International Accounting Standards Board, 2009).

Haraam is that which is forbidden and prohibited by Islam (Iqbal & Mirakhor, 2011).

Ijarah is a medium term mode of financing in an arrangement where a lessor purchases an asset and subsequently transfers the right of use of the asset to a lessee for a specific period of time in exchange for an agreed rental against a fixed charge (Ayub, 2007).

Instalment Credit Agreement (section 1, Value Added Tax Act) 'means any agreement entered into on or after the commencement date whereby any goods consisting of corporeal movable goods or of any machinery or plant, whether movable or immovable-

a) are supplied under a sale under which-

i) the goods are sold by the seller to the purchaser against payment by the purchaser to the seller of a stated or determinable sum of money at a stated or determinable future date or in whole or in part in instalments over a period in the future; and

ii) such sum of money includes 'finance charges' stipulated in the agreement of sale.

Interest 'includes the-

a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;

b) amount (or portion thereof) payable by a borrower to a lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and

c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party,

irrespective of whether such amount is-

i) calculated with reference to a fixed rate of interest or a variable rate of interest; or

ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement; ...' (Section 1, Income Tax Act).

Maysir is gambling or speculation in contracts (Iqbal & Mirakhor, 2011).

Mudarabah is a contract entered into by two parties, where the one party provides capital and the other provides labour, skills and expertise. Profits and losses are shared between the two parties according to a pre-agreed profit sharing ratio. This represents the Islamic principal of profit and risk sharing. (Ayub, 2007).

Murabahah (Cost plus) is 'a concept that involves the sale of goods at a price, which includes a profit margin agreed by both parties. All terms of the contract such as purchase price, profits and other costs must be clearly stated at the time of the sale agreement' (Patel, 2010:16).

Musharakah is literally translated as 'sharing.' Based on the principles of a partnership, this type of arrangement gives each partner the right and power to equally manage and make decisions for the business, even though partnership interests might not be the same. However, conditions stipulated in a written contract will allow for the partners to deviate from this presumption. (Ahmad, 2008:18).

Operating Lease 'is a lease other than a finance lease' (International Accounting Standards Board, 2009).

Riba (Interest) is any return of money earned by lending money (Iqbal & Mirakhor, 2011).

Shari'a is Islamic Law that is derived from Qur'an and Sunnah and governs a Muslim's life (Iqbal & Mirakhor, 2011).

Sunnah are sayings and actions of the Holy Prophet (pbuh) (Iqbal & Mirakhor, 2011).

Wakala is an agreement between two parties under which one party acts as an agent for the other in carrying out investments. Profits are shared. (Usmani, 2002:78).

The abbreviations used in this study are summarised in Table 1.

Table 1: Abbreviations used in this document

Abbreviation	Meaning
BEE	Black Economic Empowerment
CTA	Corporation Tax Act
GDP	Gross Domestic Product
HMRC	Her Majesty Revenue and Customs
IAS	International Accounting Standard
IDB	International Development Banks
IFRS	International Financial Reporting Standards
JIBAR	Johannesburg Interbank Agreed Rate
LIBOR	London Interbank Offered Rate
Pbuh	Peace be upon him
PLS	Profit and loss sharing
SWT	Subhana Wata Allah
The Act	Income Tax Act 58 of 1962
UK	United Kingdom
VAT	Value Added Tax
VAT Act	Value Added Tax Act 89 of 1991

1.8 RESEARCH DESIGN

The research design will be a qualitative review of literature on the taxation consequences of Islamic finance in relation to the legislation amendments of the UK and South Africa. The reason for selecting a non-empirical approach is due to the fact that the nature of the topic requires an analysis of the legislation amendments which can only be achieved through a non-empirical approach. In addition, the research design will primarily consist of a non-empirical extended literature review study based on the fact that the researcher will not create new data.

Section 24JA was enacted into the Income Tax Act in 2011. Literature is therefore very limited. In addition, no case law is available to provide further guidance in applying this section and the interpretation of its complex terms and definitions.

However, due to Islamic financing becoming a popular topic, some literature does exist with regard to the background principles of this method of financing, however very little literature is available on the tax issues.

Therefore, apart from the information provided in the Act and the UK tax legislation, a search was conducted on the internet and any related information, articles, opinions and commentary were identified to form the basis of the review together with the other sources.

Special attention will be given to the representativeness of the sources used, as it is imperative in any literature review that the sources of the analysis are deemed to be representative.

The analysis will focus on the main implications of section 24JA of the Act and the UK legislation dealing with Islamic financing and how it improves current tax legislation as well as its purpose of solving the tax dilemma surrounding Islamic finance. The review of the literature is essential to ensure a proper understanding of section 24JA of the Act in order to critically analyse the section and to identify any potential 'grey' areas that might exist.

1.9 OVERVIEW OF CHAPTERS

Chapter 1 introduced the background to the research to be conducted on the taxation consequences of Islamic finance and the analysis to be performed on the newly enacted South African tax legislation relating to Islamic finance. The problem statement, research question and research objectives were introduced to identify the gap in research regarding Islamic finance. The key terms were defined and the delimitations and assumptions of this research were stated. The layout of the research was broadly described.

Chapter 2 provides an explanation of the concept of Islamic finance. The chapter describes the nature and origin of Islamic finance highlighting issues around Islamic law and the Islamic financial system, the demand for Islamic finance and the basics of Islamic finance structures.

Chapter 3 explains basic conventional financing structures and the differences between Islamic financing and conventional financing. The chapter also includes a review of the tax dilemma involved with Islamic financing.

In Chapter 4, an analysis of the UK income tax legislation regarding Islamic finance is conducted and a review of what measures the UK income tax legislation has in place to ensure tax parity between Islamic finance products and conventional finance products.

In Chapter 5, the income tax consequences of Islamic finance products based on the South African income tax legislation prior to the amendments will be reviewed. An analysis will then be conducted on the amended legislation and the changes will be assessed to determine whether the changes have been effective in ensuring tax parity between Islamic finance transactions and conventional financing products.

Chapter 6 includes a summary of the research conducted and a conclusion that addresses the research question.

CHAPTER 2

ISLAMIC FINANCE

2.1 INTRODUCTION

The previous chapter introduced the background to the Islamic finance market and its challenges. This chapter contains an explanation of the nature and origin of Islamic finance, the demand for this type of financing, Islamic law and the basic Islamic financing products commonly used within the market.

Further in this chapter and chapter 3, the differences in conventional and Islamic finance systems are handled in more detail. Due to the 'riba' element in the finance system, Muslims are often confused about Islamic and conventional finance while it is also believed that Non-Muslims are ignorant and unaware of the role and importance of such (Fahmy, 2011).

2.2 THE NATURE AND ORIGIN OF ISLAMIC FINANCE

2.2.1 Islamic law

'He (Allah) has directed you to the religion (law), which He enjoined upon Nuh and that which we revealed to you and that which we enjoined upon Ibrahim, Musa and Isa (Jesus Christ) saying, set the religion right and cause not dissension therein' (Ali, 2004:1308).

According to this Quranic definition one can say 'Islamic law' is not a new law brought by Prophet Muhammad (pbuh). Prophet Muhammad (pbuh) introduced a purified form of Islamic law according to the Quran laws (words). As one knows the Holy Quran is Allah's (SWT) last book that came through the last messenger Prophet Muhammad (pbuh). The Quran concluded the Islamic law as follows: 'Quranic law comprises of Allah's (SWT) orders and Prophet Muhammad's (pbuh) saying or actions which we call Hades or 'Sunnah'' (Coulson, 2006:9). 'Obey the Messenger of Allah and leave ignorant of the law, and these are the limits of Allah, and for the infidels is a painful torment' (Ali, 2004:183).

Essentially this is the embodiment of all aspects of the Islamic faith including beliefs and practice.

Islamic finance is a financial system that is intended to function in accordance with Shari'a law. For Muslims, Shari'a law serves as the principal source of guidance for all areas of their lives (Bilal, 1999). According to Ayub (2002:21), Shari'a refers to a code of law that regulates the way people conduct their lives. The primary source from which Shari'a Law is derived includes, in order of significance, the Holy Qur'an, Sunnah, Ijma (consensus) and Qiyas (analogy). Sunnah refers to the actions and sayings of the Holy Prophet (pbuh) (Iqbal & Mirakhor, 2011).

Abdur Rahman and Abdassamad (2008: 175) explain that for a Muslim to adhere to Shari'a is of utmost importance, for it does not only involve the performing of duties of a servant to his master but a continuous and united effort by Muslims all over the world to determine and preach to their communities and offspring those actions that will gain them God's pleasure and be good believers.

Islamic finance involves using classical Shari'a compliant investment techniques and structures to create arrangements that work in a similar way to modern conventional or western finance. According to Cook (2006), the Islamic financing system is not completely different from the conventional financing system. It includes the same principles of western practice such as saving deposits and providing financing and loans to those who are in need, but there are a few elementary differences in the objectives and practices of an Islamic financing system. One of the differences being that Islamic banking is interest free. The main objective of an interest free system is to promote and encourage the equality of wealth distribution, thereby decreasing poverty and increasing investment opportunities (Iqbal & Mirakhor, 2011).

2.2.2 The Islamic Financial System

The possibility of a financial system that would conform with the laws of Shari'a was discussed as early as the 1940s (Warde, 2000:26), but the idea was not put into practice

until the establishment of a rural bank in Egypt in 1963, followed by a cooperative bank in Pakistan in 1965. Since the creation of the Islamic Development Bank (IDB) in 1975 (Hassan & Lewis, 2007:361), the Islamic banking system has developed into a rapidly growing segment of the international banking and capital markets. Today there are more than 200 Islamic banks operating in over 70 countries, including most of the Muslim world and several Western countries. In addition, there are 50 Islamic insurance (takaful) companies which are operating in 22 countries as well as Islamic investment houses, mutual funds, leasing companies and commodity trading companies. There are also hundreds of small Islamic financial institutions such as urban cooperative credit societies and financial associations that are operating at a local level and dealing with urban units, small business firms and individual households. (Hassan & Lewis, 2007:366).

So what is Islamic finance? It is defined as those financial institutions that are based in their objectives and operations, on the Islamic law, the Shari`a (Hallberg & Nettelblatt, 2011:19). Shari`a, as explained above, is a legal system based on the code of behavior derived from the Qur`an, the Holy Book of Islam, and the tradition of the Holy Prophet, the Hadith. For banks to be able to conform to Islamic rules and norms, six religious features must be followed in terms of investment behavior (Hassan & Lewis, 2007:130):

- Riba is prohibited in all transactions.
- There should be profit and loss sharing involved in the transaction.
- Business and investment are based on halaal activities.
- Maysir (gambling) is forbidden and transactions should be free from gharar (speculation or uncertainty).
- Zakat (almsgiving) must be paid by the bank to benefit society.
- All activities should be in line with Islamic principles, and there should be a special Shari`a board that supervises and advises the bank on the propriety of transactions.

The above mentioned religious features that Islamic banks need to have in order to conform to Islamic rules and norms are discussed below.

i) Riba

Muslim scholars term interest as Riba. Under Shari'a, the term riba is defined as the premium paid to a lender by a borrower for the use or lending of money. (Chapra, 2000:193). Riba is thus payment for the right of use of money which is usually pre-determined. Consensus has been reached amongst Muslim scholars that the term riba does not only refer to 'excessive' interest but it refers to all forms of interest. (Khan, 1995:52).

The most important characteristic of riba according to Hassan and Lewis (2007:22) is that it is the result of money being used to make money without any goods or services being delivered, or without there being any physical or productive work being done. The basic characteristics **of riba** mentioned by Warde (2000:39) are:

- money must be lent in a form of a loan,
- at the end of the loan period a prefixed amount consisting of a premium and the capital will be paid,
- the time for the repayment is fixed, and
- the above are taken as the terms and conditions of the loan.

Since prohibition on transactions based on interest payments is the most important factor and is at the heart of the Islamic financial system, it will be unjust not to provide some information on it.

Table 2 provides a comparison between riba and profit.

Table 2: Comparison between Riba and Profit

Riba	Profit
1. When money is used as a commodity and traded, the positive and definite result is riba.	1. When money is used as a medium of exchange for a productive activity, its uncertain result is profit.

Riba	Profit
2. Riba is defined as the charge for borrowing money. It is the additional amount payable over and above the capital amount.	2. Profit is defined as the residual amount of revenue less cost of sales.
3. Riba is usually pre-determined and fixed. It is a certainty for both parties to a loan.	3. The profit sharing ratio might be pre-determined and fixed. However, the actual amount of profit is uncertain for both parties.
4. Riba is usually a positive amount.	4. Profit can be positive, zero or even negative.
5. Riba is seen as haraam (forbidden) in Islam.	5. Profit is seen as halaal (acceptable) in Islam.

Source: (Chapra, 1985:66).

Warde (2000:39) emphasises that making money from money is not permissible. Money is not supposed to be traded like other commodities but is to be used as a measure of value for the provision of goods and services between parties and to act as a medium of exchange.

Hassan and Lewis (2007:22) reiterate the above by stating that if money is borrowed, the repayment should equal the capital borrowed to avoid money being traded. Hassan and Lewis (2007:22) also mention that money is only actual capital when it is used to undertake productive activity and not when it is being borrowed to earn more money and that 'Islam does recognize the time value of money, but only when it acts as capital, not when it is 'potential' capital.'

ii) Profit-and-loss sharing (PLS)

The concept of profit-and-loss sharing is built upon the idea that all profits and losses derived from a physical investment should be shared between the lender and the borrower, and should be based on the parties' respective level of participation. This is what the Muslim world believes in. In Islamic banking, return-bearing contracts are used instead of interest-bearing, which means that the bank establishes a partnership with the borrower. Two types of partnerships exist: Mudarabah, which is a partnership or a finance trusteeship, and Musharakah, which is a longer-term equity-like arrangement. In both types of partnerships, the bank acquires a contractual share of the profits developed from business ventures. What differentiates profit-sharing from interest, and thereby makes it

legitimate, is the fact that it is a somewhat limited partnership. (Hallberg & Nettelblatt, 2011: 20).

The principle of PLS means that Islamic banks become directly concerned regarding the profitability of the physical investment, just as conventional banks are concerned about the profitability of the project, due to the risk of potential default on the loan. However, conventional banks emphasise the receiving of interest payments, agreed upon by the borrower, and the profitability of a conventional bank is not directly affected by the investment project's rate of return as long as interest is being paid. The profitability of Islamic banks, on the other hand, is directly connected to the real rate of return and the banks must thus focus on the return of the physical investment. (Hassan & Lewis, 2007:180).

What also differentiates the PLS contracts from the interest-based contracts used in conventional banking is the superior attributes for risk management, as the payment that the borrower makes to the bank is adjusted with regards to the client's economic situation. Islamic banks regularly gather information about the situation of their clients, in order to calculate their share of profits. Due to this, contracts based upon the PLS principle are said to provide greater stability in the financial markets and encourage banks to acknowledge the importance of long-term relationships with their clients. (Hassan & Lewis, 2007:183). This is confirmed in Warde (2000:54), where Islamic banking is stated to be a safer option for the borrower, as a bank cannot demand payments if the client is incapable of paying (e.g., a business gone bankrupt), although this is not the case if negligence, mismanagement or fraud can be proven. The reason behind this is that Islamic banks are considered to be investors, in comparison to lenders, and thereby have a stake in the longer-term success of the client. Thus, the client can focus on a long-term endeavor that in turn could generate social and economic benefits for the society instead of being concerned with debt-servicing (Warde, 2000:55).

The concentration on long-term relationships in the PLS philosophy may, however, result in higher costs within the Islamic banking system, because of the need for supervising the

borrower's performances, and often means that the banks must invest more in managerial skills and expertise in order to analyse investment projects (Hassan & Lewis, 2007:184).

iii) Halaal

Islamic financial activities must follow a strict code of 'ethical investments', meaning that Islamic banks cannot invest in business or goods that are haraam (forbidden) in Islam. Haram is for example, pork, drugs including alcohol, prostitution and gambling (Michael, 2007:82). Instead, Islamic banks or banks offering Islamic financing products must engage in activities that are permitted, halaal, according to the Shari'a law. Furthermore, Islamic banks are encouraged to prioritise the production of essential goods that satisfy the needs of the majority of the community, since the fulfillment of material needs is considered to assure religious freedom. In addition, it is seen as unacceptable for Islamic banks to invest in businesses that participate in the production and marketing of luxury commodities due to the lack of essential goods and services such as food, clothing, shelter, health and education that societies suffer from. (Hassan & Lewis, 2007:35).

iv) Maysir and Gharar

The Qur'an forbids all types of gambling, 'maysir', as it allows the gambler to become wealthy without effort. Gambling, by being a game of pure chance, is thought of as unethical by the Shari'a law as it contributes to the unjustified enrichment of society. Alongside gambling, the Islamic law also prohibits business activities which are engaged in or contains any element of gambling, resulting in that no Islamic banks are allowed to have these types of businesses as their clients. (Hassan & Lewis, 2007:40).

In Islam, financial transactions that involve speculation, 'gharar', are another banned feature. The definition of gharar is 'hazard', but is in business terms expressed as 'speculation without adequate knowledge or as an extremely risky transaction' (Buksh, 2006:109). Speculative business, such as buying commodities or shares at a low price in order to sell them for a higher price in the future, is considered to be gharar and thereby disallowed. Gharar is also applicable to investments that include trading in futures on the

stock market, and is in addition seen to exist in all future sales, due to the uncertainty over time. This condemnation of uncertainty and gharar has led to the rejection of insurance, since it contains an unknown risk, and as a result there has been a development of Islamic insurance, called takaful insurance. (Hassan & Lewis, 2007:46).

v) Zakat

According to the religion of Islam, social justice is of great importance and is accomplished through organising society on Islamic social and legal principles. By doing so, justice and equality can be obtained, meaning that all people will have equal opportunities in life. Islamic banks must be engaged in charity since the belief in Islam is that no brother within the Muslim community should be poor. To guarantee every Muslim a fair standard of living, Islam has an implicit mechanism that enables a redistribution of income and wealth. Almsgiving, or zakat, is the most essential instrument in order to redistribute income from the wealthy to the poor and is a mandatory levy within the Muslim community. Islamic banks and financial institutions, which operate in those countries where zakat is not collected by the state, must on their own create a zakat fund. This religious taxation should be collected from the initial capital of the bank, on the reserves and on the profits, and should be distributed by the banks directly to the poor or indirectly through a religious institution. (Hassan & Lewis, 2007:66).

vi) Shari'a Board

All banks engaged in Islamic banking must establish a Shari'a board, which is a committee of religious advisers that will ensure that the activities and instruments of the banks are in compliance with the ethics of Islam. When needed, the board also controls the collection and distribution of zakat. The Shari'a board constitutes an additional layer of governance, making Islamic banks different from conventional banks. (Warde, 2000:62).

2.3 THE DEMAND FOR ISLAMIC FINANCE

As mentioned by Ibrahim (2008: 662), Muslims living in western countries have been trying to adhere to stricter Islamic codes and be better Muslims by re-defining the way and manner in which they conduct their daily lives.

The Islamic financial market has grown substantially globally. According to Patel (2008), Islamic financing structures can be used to positively impact the South African economy through facilitation of Black Economic Empowerment (BEE) deals, encouragement and development of Small and Medium Enterprises, provision of affordable housing and financing of major projects. However, the intention should always be to ensure moral and fair business practices as well as decreasing unemployment and increasing real assets. The prospects for Islamic financing in the future is promising, especially if the current financial instability around the world continues to prevail (Patel, 2008). In an article published by Pricewaterhouse Coopers (2010), it was reported that during the economic recession that occurred worldwide in 2008 and 2009, Islamic financing products remained relatively stable and were not really affected by the economic meltdown. Research conducted by the Chartered Institute of Management Accountants has provided estimates that the Islamic finance global worth is believed to be between £150bn and £250bn with an annual growth rate of 15%-20% (Temkin, 2010a). The growth in Islamic banking and finance can be seen as an attempt by Muslims to adhere to stricter Islamic codes and reconcile living in a Western country with Islamic principles.

In a press release by Standard and Poor's (2010), the opinion of some is that Islamic finance has some promising growth prospects and has become recognised. The press release indicated that the belief amongst many market players is that Islamic finance is to make a greater mark in Western markets soon.

According to French and Menon (2012), large companies such as Emirates airlines are looking at the Islamic finance market in order to fund aircrafts as Euro funding has come to a halt due to the Eurozone crisis. In addition, French and Menon (2012) have also brought to light to the fact that many Western banks such as HSBC are also turning to Islamic financing products due to the tough economic conditions.

The above factors indicate that the Islamic finance market will continue to boom as long as it continues to make profits for its investors and the regulations in Western countries are adapted to ensure equal treatment between Islamic financing products and conventional financing products.

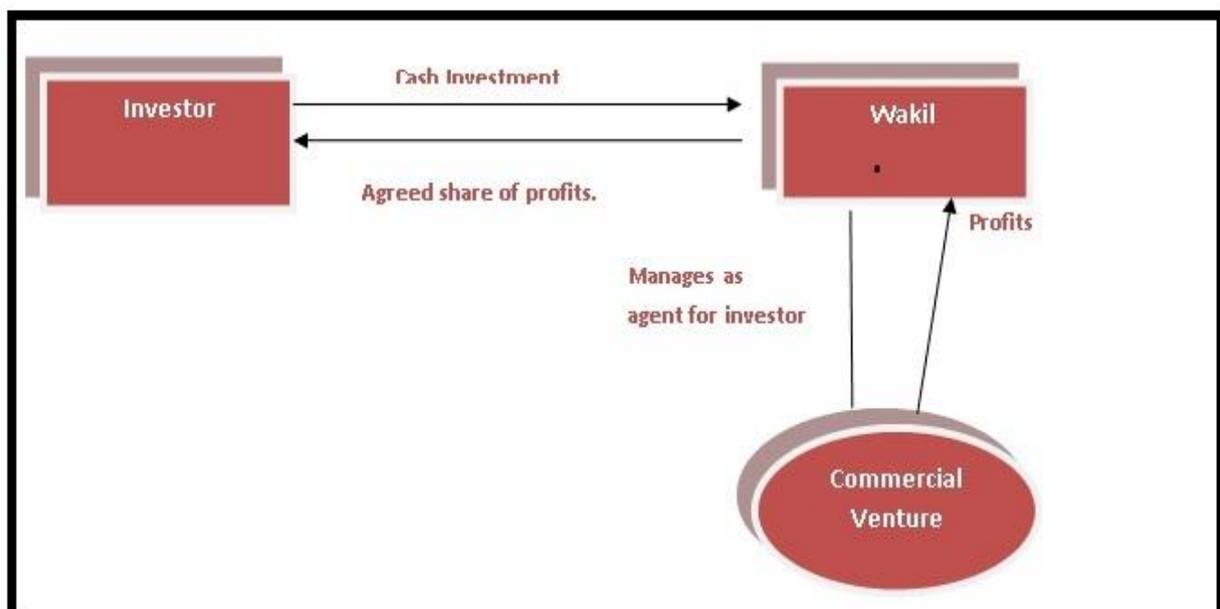
2.4 CURRENT ISLAMIC FINANCING PRODUCTS

A review and explanation of the most common Islamic finance products used in the markets today will be explained in the sections to follow.

2.4.1 Wakala (Agency Deposit)

Financial institutions such as Al Baraka Bank and First National Bank (Wesbank) offer individuals current accounts, investment accounts and saving accounts that function in accordance with Shari'a principles (Harding, 2011). Deposits however can fall into two categories of Islamic financing structures namely, Mudarabah and Wakala. In a Wakala the agreement is that the investor or depositor provides capital to another party for example a bank, known as a Wakil, and the bank will act as an agent for the investor in investing that capital and managing it. The returns on the investment are shared between depositor and the bank based on a pre-agreed ratio. (Amin, 2006:4). Figure 1 illustrates this transaction.

Figure 1: Wakala



Source: (Amin, 2006:4)

2.4.2 Musharakah (Partnership Finance)

This word comes from the Arabic word 'Shirkah', which means 'sharing' or partner. According to Shari'a law Musharakah means a joint partnership established for conducting a business in which all partners share profit according to a predetermined ratio and on the other hand loss is shared according to the ratio of the contribution. (Abdulkader, Cox, Kraty, 2005:35).

A typical Musharakah transaction explained by Amin (2006:5) involves two parties, for example a bank and an entrepreneur. Both parties jointly contribute to the capital and management of a venture or product. Profit and losses are then shared between the two parties based on the terms of the agreement. This type of financing can be used for venture capital, project financing and private equity.

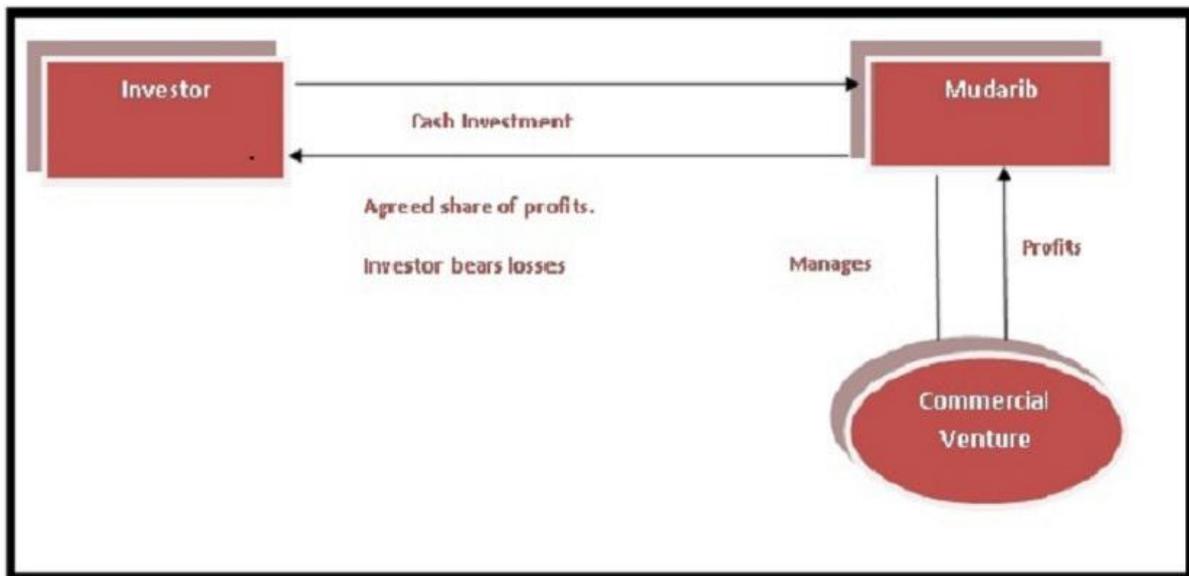
2.4.3 Mudarabah (Trust Financing)

Mudarabah is defined as a contract where an investor provides money to a bank, for example, known as a Mudarib,. The bank invests the money into a profitable investment opportunity and manages the investment using skill and expertise. The profit derived by the bank from the investment is shared between investor and Mudarib based on a predetermined ratio. In the case of a loss, it is the investor who has to bear all the losses. This type of transaction also takes the form of a partnership. This type of financing can be used for venture capital. (Ahmad, 2008:19).

The difference between the Wakala and the Mudarabah is that in a Wakala structure the bank acts as agent in making the investment. In a Mudarabah the bank is the 'investment.' Legally the difference is that in a Mudarabah, the Mudarib is legally indebted to the capital received. The investor is the Mudarib's creditor. In the case of the Mudarib falling into insolvency, the investor is treated like all of the Mudarib's other creditors. In a Wakala, the investor's capital does not belong to the Wakil. The investment made by the Wakil

ultimately belongs to the investor and the investor has claim over that investment in the event of the Wakil going insolvent. (Abdulkader *et al.*, 2005:36). This structure meets the aim of an interest free system as it encourages active participation of an individual in financial activity and society. Figure 2 illustrates how a typical Mudarabah transaction works.

Figure 2: Mudarabah Transaction



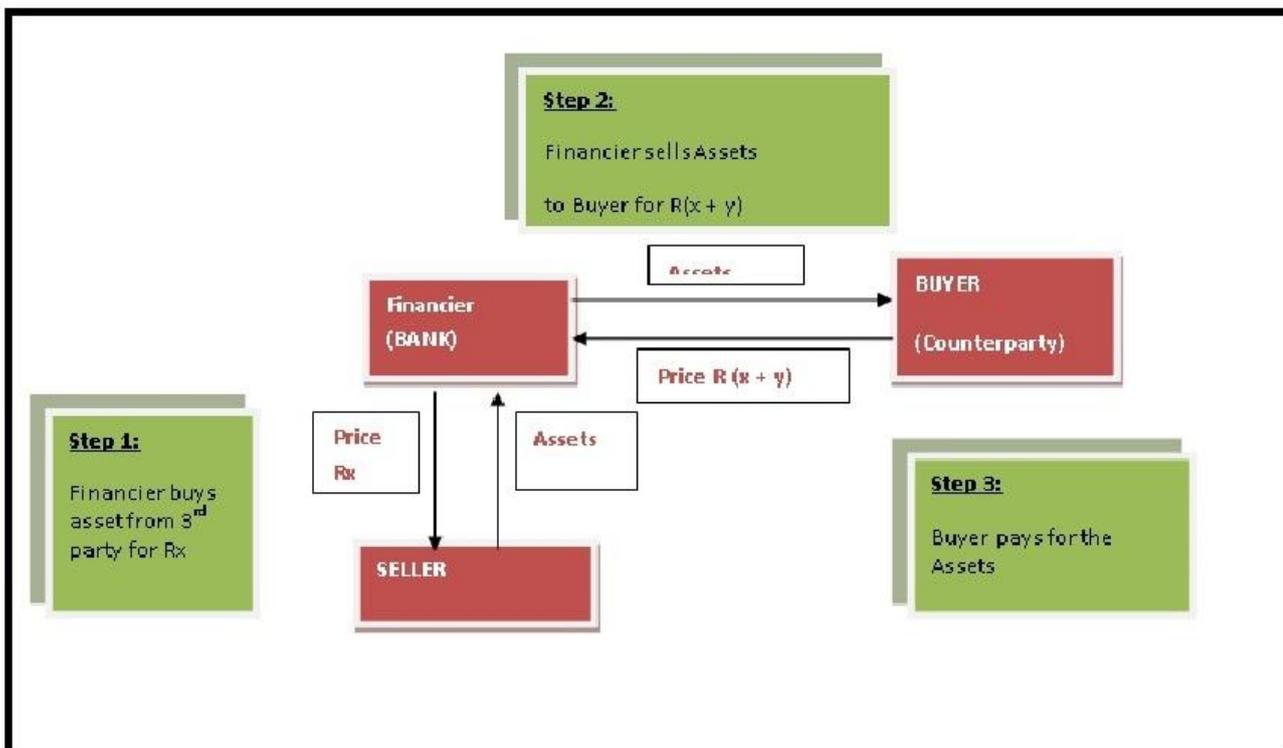
Source: (Amin, 2006:3)

2.4.4 Murabahah (Cost-plus Financing)

This type of transaction can work in two ways. The one involves the bank purchasing an asset which the client needs and negotiates to sell the asset to the client in the future at a profit. The asset remains in the ownership of the bank until the loan is paid in full. It is considered lawful in fiqh (jurisprudence) to charge a higher price for an item if payments are to be made at a later date (Patel, 2010:16). According to fiqh this does not amount to charging interest, since it is not a lending transaction but a trading one (Usmani, 2002:17). The other way that this transaction can take place is when a client needs cash. The bank then buys a commodity that is easily tradable and immediately transfers ownership of the

commodity to the client. The client then sells the commodity and obtains the cash. The bank and client agree that the purchase price together with a profit will be paid by the client at an agreed future date. Murabahah is one of the most popular modes used to participate in interest-free financing. (Patel, 2010:16). Figure 3 illustrates this type of transaction. This type of transaction is commonly used for house financing and fixed asset financing.

Figure 3: Murabahah Transaction



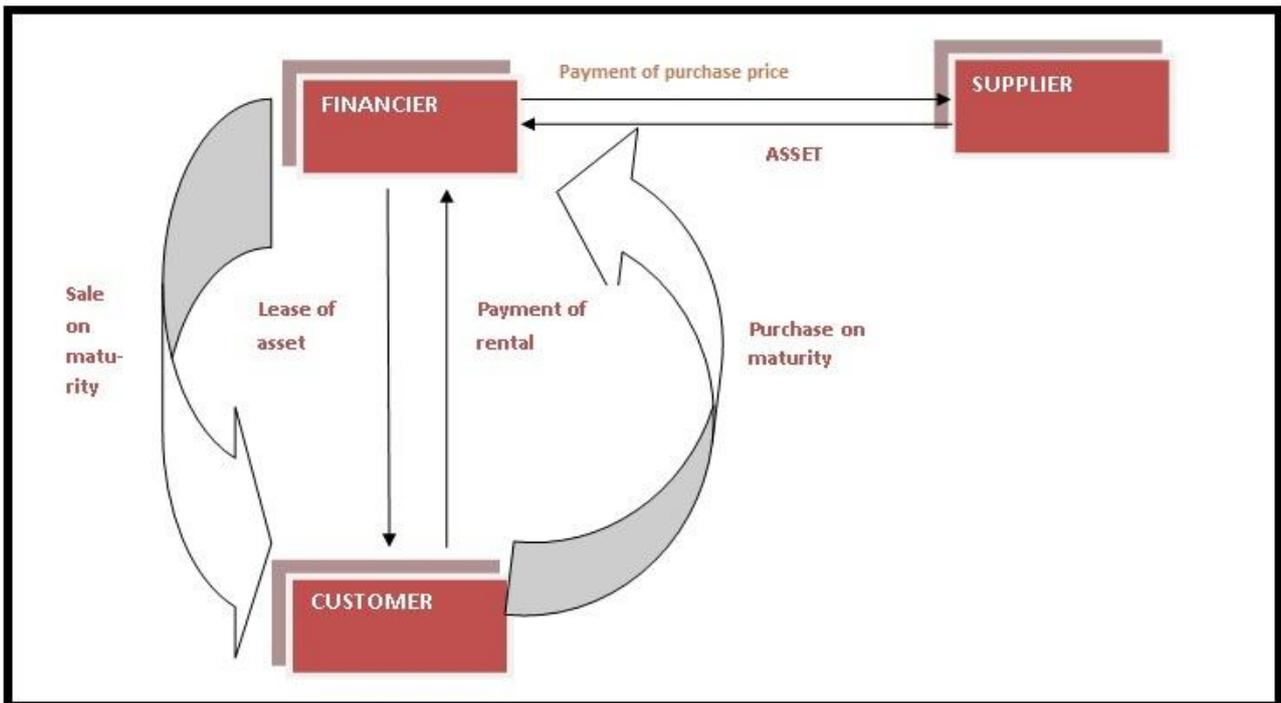
Source: (Patel, 2010:16)

2.4.5 Ijarah (Leasing)

The Ijarah is a form of leasing transaction in which the owner (lessor) of the property or asset rents the property to another party (lessee) having the need for it. Thereafter, the latter can purchase the property. The rental payments and duration of the lease are agreed in advance. The lessor retains certain rights of ownership such as insurance. The lease can be an operating lease or a finance lease. An operating lease being a normal lease where the lessee leases the asset for a period and the lessor remains the owner. A

finance lease being where the lessee eventually becomes the owner or leases an asset for the majority of its economic life. A common example of Ijarah used today is Islamic mortgages which have proven to be quite successful. (Bellalah & Ellouz, 2004:533). Figure 4 illustrates how a typical Ijarah transaction works.

Figure 4: Ijarah



Source: (Patel, 2008)

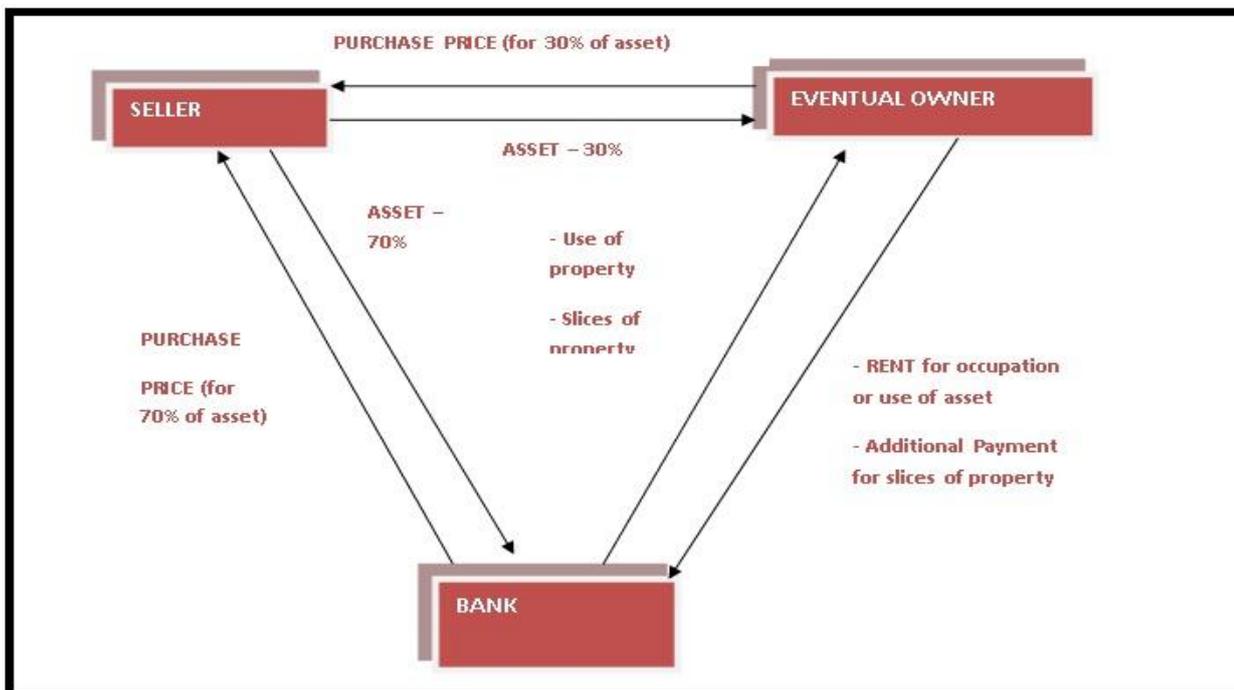
2.4.6 Diminishing Musharakah

According to Shari'a standard 12 (Hijazi, 2009:9), Diminishing Musharakah is based on the principles of a partnership. What essentially happens in such a structure is that an agreement is made stating that one of the partners (referred to as the 'eventual owner' in Figure 5) will gradually buy out the equity share in the partnership of the other partner (the bank) until the former owns 100 % of the partnership. Under a Diminishing Musharakah arrangement capital is contributed by both parties. In Figure 5 the bank buys 70% of the asset on day 1 and the eventual owner buys the remaining 30%. The eventual owner has

immediate occupation or use of the asset per the contract. The bank leases his share of the asset to the other partner for a rental equal to the bank's 70% ownership. In addition to the rent, the other partner makes additional payments to the bank to increase his ownership in the asset, thereby purchasing additional slices of the asset.

Cost of repairs, maintenance and insurance are shared by both parties. In accordance with Islamic finance principles both partners share the risk. To make this sort of structure competitive compared to a conventional 'house mortgage,' some financial institutions sell their 'equity share' at cost to the other party. However, there are some that make a profit. A Diminishing Musharakah transaction can also take the form of a sale and leaseback. The eventual owner could sell his property to the bank and lease it back, gradually buying it back. This is similar to taking out a bond on one's house. (Amin, 2006:10). There is no requirement for the asset or property to be purchased from a third party. This type of transaction is illustrated in the Figure 5.

Figure 5: Diminishing Musharakah



Source: Adapted from Amin (2006:5)

2.5 CONCLUSION

The concept of Islamic financing, the demand and the basic Islamic finance products have been discussed in detail in this chapter. As discussed, the market for Islamic finance is growing rapidly and is soon to become a common type of financing to be used within the markets.

The most common types of Islamic financing products explained, namely, Wakala, Musharakah, Mudarabah, Murabahah, Diminishing Musharakah and Ijarah, all have common characteristics to conventional financing products.

However, Islamic financing structures are relatively complex and the differences between conventional financing and Islamic financing need to be understood and have been explained in this chapter. The next chapter explains in more detail basic conventional financing structures and the differences between Islamic financing and conventional financing. The following chapter also includes a review about the tax dilemma involved with Islamic financing.

CHAPTER 3

A COMPARATIVE ANALYSIS

3.1 INTRODUCTION

Conventional finance encompasses financing that the South African community and most of the world deals with on a day-to-day basis and in most cases the only type of financing known to most.

Conventional financing is characterised in two broad categories namely: debt financing and equity financing (Hallberg & Nettelblatt, 2011:23).

The most basic example of debt financing is a bank loan. The financier receives fixed or variable returns based on market related interest rates for the period the loan is outstanding and does not share in any of the profits or losses incurred by the borrower with regard to that loan. The only risk that the bank carries is non-repayment of that loan. Repayment terms are agreed upon between the two parties. (Hallberg & Nettelblatt, 2011:23).

Buying shares or a stake in a business or company is an example of equity financing. The financier in this case shares in the profits or losses of the company. The return is based on how well the business does and not related to any market rates. (Hallberg & Nettelblatt, 2011:24).

Dar and Moghul (2010:14) mention that taxation laws treat these two types of financing differently. The interest or borrowing costs incurred by the borrower under a debt financing transaction is normally deductible for tax expenses if the loan is used for business purposes as it would be an expense in the course of trade. The borrower, being the company being invested in, in an equity financing transaction will not be allowed any deduction on the returns it pays to its financier (investor) as it would constitute a distribution of profits and would consequently lead to dividends tax implications.

This chapter will go into more detail about the differences regarding Islamic financing and conventional financing products as well as how the tax dilemma is created when using these products.

3.2 ISLAMIC FINANCING versus CONVENTIONAL FINANCING

In understanding the principles of Shari'a it is crucial to take note of the fact that there are numerous factors regarding the manner in which a transaction is carried out and the nature of commodity of the different types of Islamic financing transactions that will affect whether it is valid in terms of Shari'a, and that the Shari'a is very wide and comes from many different sources.

Usmani (2002:18) mentions that the basics of Islamic finance relates to the prohibition of interest, trading in tangible assets, focuses on social responsibility and involves profit sharing. Islamic financing is a form of equity financing and money is never the object of trade. These basic principles are the major differences between the two financing systems.

In addition, the most central practical differences between Shari'a and conventional or western finance as explained by Archer and Karim (2002:33) revolve around the various prohibitions and restrictions on the investments that can be entered into. Interest, speculative investments, and profit and risk sharing form the bulk.

The verse of the Holy Qur'an in Surah Al-Imran says: 'O ye who believe, devour not usury, doubled and multiplied; but fear Allah; that ye may prosper' (Ali, 2004:156).

In Deuteronomy 23:19, God also talks about the prohibition of interest, 'Thou shall not lend upon usury upon thy brother, usury of money, usury of victuals, usury of anything that is lent upon usury' (The English Standard Version Bible, 2009).

The aim of prohibiting interest (riba) is to encourage society to carry out business practices in a manner that involves active participation and discourages debt (Archer & Karim, 2002:67).

Islam teaches that a Muslim entrepreneur needs capital to participate in a free market following the principle of active participation and not just speculation. This principle being opposite to the capitalist economic theory, under which capital and entrepreneurship separately form part of the four factors of production. (Usmani, 2002:98). Islam does allow for profit making, however, profit is defined by Usmani (2002:98) as, the reward an entrepreneur obtains for his work or responsibility taken. Profit is the residual after any losses incurred and expenses paid and should be earned ethically. Thus Islam does not allow profit that is earned unethically or in a manner that is against religious laws (Usmani, 2002:98).

Islamic financing is differentiated from conventional financing in another way, risk is shared between the parties of the transaction and no one person bears the entire burden. Any commercial partnership in which the profits are shared between partners and not the risk is not a valid Islamic commercial transaction. Both profits and risks must be shared. This addresses the Shari'a principal of risk sharing. (Ilias, 2009:2).

Transactions must avoid aspects of uncertainty (Gharar) and speculation (Maysir). Transactions that allow for exploitation or unjust enrichment to any party should also be avoided (Michael, 2007:82). All transactions must be backed up by tangible useable assets. Therefore, if an individual wants to increase his/her wealth, in terms of Islamic financing principles the only way to do this is by increasing his/her provision of goods and services. In the case of speculation, major role players in the market tend to manipulate the financial markets to benefit themselves and thereby disadvantaging others. Therefore trading in derivatives and speculative investments commonly known as 'paper assets' is also forbidden. (Hassan & Lewis, 2007:47). According to Stewart (2011) people that have followed the details of the economic crisis will understand that the economy today is being complicated by financial instruments known as derivatives which are based largely on the Black Scholes model which involves a lot of estimates and no tangible assets. There is

much debate currently regarding whether investing in listed equity instruments is considered to be Shari'a compliant. There are scholars world-wide who consider listed equity instruments lawful, but however this type of investment has not received a definite consensus. (Khatkhatay & Nisar, 2006:4). It is important to note that a discussion on the technicalities of the abovementioned types of investments is beyond the scope of this literature review.

Lewis (2010: 84) also highlighted the following differences:

- Islamic financing will use equity financing through profits to meet these objectives whereas conventional financing will use debt financing.
- Islamic investors deal only with tangible assets, whereas conventional investors deal mainly in paper assets.
- Islamic financiers will share in the profit and risk relating to the funds invested, whereas conventional financiers only take the risk of their investee defaulting and the only benefit he receives is the agreed interest on the loan.

Table 3 shows the key differences explained above between Islamic financing and conventional financing systems.

Table 3: Differences between Islamic and conventional financing systems

Characteristics	Islamic Banking System	Conventional Banking System
Guiding principle	Guided by the Quran, Hadith, Ijma and Qiyas (Islamic laws)	No religious or ethical guidance.
Ethics of financing	Asset backed financing to ensure equality and fair distribution.	Excessive use of loans leads to people being too highly leveraged and thus filing for bankruptcy.
Liquidation Assets	An investment account holder will have similar rights as shareholders.	Depositors are paid before the shareholders.
Involvement of risk & Equity financing	Projects involve equity financing which include profit and loss sharing. Both parties share the risks and the profits.	Venture capital companies are more known to provide equity financing rather than conventional banks. Conventional banks carry very little risk. Most of the risk is transferred to the borrowers.

Characteristics	Islamic Banking System	Conventional Banking System
Return on Capital	The return is uncertain even though the profit sharing ratio might be pre-determined. The return is based on the outcome of the project. Money that is not used for productivity cannot earn a return.	Returns can be pre-determined and certain. Idle money can also earn returns.
Prohibition of Gharar (uncertainty)	Activities that involve uncertainty or speculation such as gambling and trading in futures and derivatives are disallowed.	Trading and dealing in derivatives are widely considered as the main source of liquidity in the conventional financial, commodity and capital markets.
Profit and Loss Sharing	All profits and losses derived from a physical investment should be shared between the lender and the borrower. This ensures both parties manage risks with more care. The performance of the project determines the returns or losses both parties will share.	Conventional banks mostly enjoy risk free investments. There is no correlation between the returns earned by investors and the performance of the project
Zakat	It has become a function of an Islamic bank to administer Zakat.	Taxes are regulated by the government and administered by the Revenue authorities.
Compounding or Interest on interest	The Islamic banks have no provision to charge any extra money from the defaulters.	It can charge additional money (compound rate of interest) in case of defaulters.

Source: Adapted from Chapra (1985:76)

3.3 THE TAX DILEMMA

‘The extent to which a tax system needs to be adapted for Islamic finance depends upon the extent to which it taxes the economic reality or the legal form of transactions’ (Amin, 2006:14). This point made by Amin represents the most important aspect as to why the current tax legislation does not allow for tax parity between Islamic financing products and conventional financing products.

Some tax systems, similar to that of the United States of America, look at the economic substance of a transaction rather than its form (De Souza Ferreira, 2004:312). What this means is that the tax treatment of a transaction is based on its economic realities and

characteristics and not based merely on what it is on paper and therefore, may tax Shari'a and non-Shari'a compliant transactions in a similar way without significant difficulty.

However, systems such as those of South Africa and the UK which generally tax the form rather than the substance of a transaction may not relieve or tax interest-equivalent amounts as interest. The financier may be subject to tax on its finance receipts in a different way to that of the conventional financier who has lent money at interest. The customer may not obtain relief for the finance that it pays to the financier. It is not just the financier and the customer who face uncertainty, but Government as well, given that withholding taxes may not apply to the payment made by the customer to the financier, thus depriving the government of revenue. (Cape, 2010b:40).

The above can be illustrated by way of the following basic example:

Company A requires a machine costing R1 000 000. The company does not have the necessary financing to purchase the machine and approaches the bank to enter into a Murabahah transaction, under which the bank will purchase the machine from the supplier and sell it to Company A for R1500 000. The full R1 500 000 has to be paid at the end of two years. (Adapted Amin, 2006:14).

Under a substance over form system (conventional financing) this transaction will effectively be considered to be a debt transaction since there is an unconditional, legal obligation on Company A to pay the bank the R1 500 000. Therefore Company A will then effectively get the R500 000 'interest like cost' as a deduction.

However, under a legal based system the transaction is not seen as debt transaction and is taken to be a basic sale transaction. Therefore the system will not see the 'interest like cost' component and Company A will not be allowed a deduction.

The effect of the legal based tax system in South Africa has resulted in enormous amounts being unbanked and many Muslims having to keep their money at home because of the restrictions on Islamic banking. Temkin (2010b) mentions that, 'The Banking Association of

South Africa estimates that the ‘unbanked’ in South Africa have put about R12 billion (US\$1.7 billion) under mattresses.’

Many European countries including the UK have accepted Islamic financing and have introduced tax laws to deal with this type of financing (Conway & Feese, 2007:20). The UK for instance has introduced tax rules relating to ‘alternative financing arrangements’ where the different Islamic financing transactions are defined and the ‘profit’ or ‘costs’ relating to the transaction are deemed to be interest to obtain the necessary interest deduction benefits and taxed as such (Finance Act, 2006).

3.4 CONCLUSION

This chapter highlighted the major differences between conventional financing products and Islamic financing products. To sum up the major difference between the two financing systems as mentioned by Patel (2012:12) is that Islamic financing products and conventional financing products have some common objectives, however the manner in which they set out to achieve these objectives differs. Patel (2012:12) highlighted the following objectives that both forms of financing share:

- to facilitate trade;
- to facilitate investments and asset allocation;
- to create investment opportunities; and
- to provide financial services.

These differences were then linked to the reason why there is no tax parity between conventional financing products and Islamic financing products based on the South African tax legislation before the introduction of section 24JA of the Act. One of the main reasons discussed for the tax dilemma was due to the substance over form tax system used in many countries such as South Africa and the UK.

The following chapter contains an analysis of the UK income tax legislation relating to Islamic financing.

CHAPTER 4

UNITED KINGDOM ISLAMIC FINANCING TAX LEGISLATION

4.1 INTRODUCTION

The UK has been identified as the strongest Islamic financial centre outside the Muslim world. The UK fully understands the importance of Islamic finance and has embraced Islamic finance quite strongly as the Islamic finance market is regarded as a more reliable market for the flow of funds during the tough economic period currently being experienced by the UK economy. (Amin, 2012). London has a number of wholesale and retail Islamic banks to facilitate the Islamic finance market (Ainley, Hicks, Mashayehki, Rahman. & Ravalia, 2007:3).

There are several reasons for the UK's massive growth in the Islamic finance market. Bell and Jessop (2009:10) outline some of the reasons as:

- The fact that London has many benefits relating to its traditional financial culture and that the UK shares similar time zones to some Middle-Eastern states.
- Another reason is that the UK has a broader attraction in terms of non-business activities to Islamic investors.
- The fact that New York, being one of the UK's biggest rivals in the conventional markets, is relatively indifferent to Islamic finance which the UK is benefiting from.

Bell and Jessop (2009:12) also make mention of the efforts and intention of the UK's government to 'establish London as a global gateway for Islamic finance.' One of the major regulatory changes conducted by the UK government was the introduction of equal tax treatment for Islamic finance products within the UK and those of a conventional nature by making provisions in the Finance Act 2006 (Bell & Jessop, 2009:12).

This chapter will thus analyse the UK income tax legislation relating to Islamic finance products. An analysis will be done of the tax treatment of Islamic finance products prior to

the amended legislation and subsequent to legislation amendments. This analysis will form the basis on which to compare UK income tax legislation regarding Islamic finance with South African income tax legislation regarding Islamic finance in the final chapter.

4.2 TAX TREATMENT OF ISLAMIC FINANCING STRUCTURES PRIOR TO UK LEGISLATURE AMENDMENTS

The tax treatment of the various Islamic finance transactions in the UK prior to the introduction of legislature to specifically address these types of transactions was the application of basic tax principles and was basically the same as the South African legislation prior to the insertion of section 24JA. There were issues of whether the customer would receive any tax deductible costs such as wear and tear allowances and interest. For example, in a Murabahah transaction, does the customer receive a deduction on the additional amount paid to the bank for the purchase of an asset? (PWC, 2012:102).

4.3 TAX TREATMENT OF ISLAMIC FINANCING STRUCTURES BASED ON NEW UK LEGISLATION

4.3.1 The changes to the Income Tax legislation

The UK legislation was adapted and provisions were introduced to deal with the tax issues relating to Islamic finance. The Finance Act 2005 was the first piece of legislation to include these provisions (Her Majesty Treasury, 2008:10). What is important to note is that the UK legislation does not make provision specifically for 'Islamic financing' or 'Shari'a compliant' transactions nor will one find words such as Murabahah or Ijarah (Her Majesty Treasury, 2008:16). The definitions of the different structures are provided but not named as such. The reason for this was that the government said that they cannot create different legislations for different religions and that such changes to the legislation is for everybody, regardless of their religion (Her Majesty Treasury, 2008:16).

The approach followed by the UK is that certain conditions have to be met in order for the profit element of an Islamic financing transaction to be treated as interest for tax purposes.

Amin (2006:8) mentions that the legislature is very careful not to mention that the profit earned is interest to avoid conflict and bitter feelings between the Islamic community, scholars and the government, as such a characterisation would go against the principles of Shari'a law.

Defining such earned profit as interest would be converting the good and pure (halaal) into what is forbidden (haraam). Therefore, as long as a transaction meets the requirements and definitions prescribed, one can follow the related tax rules, whether or not the transaction was intended for Shari'a purposes or not and whether the transaction is concluded by a Muslim or not (Conway & Feese, 2007:21).

The profit earned in an Islamic finance transaction is either labelled as 'alternative finance return' or 'profit share return.' Alternative finance return is used for Murabahah and Diminishing Musharakah transactions, whereas profit share return is used for Mudarabah and Wakala. (Conway & Feese, 2007:21).

According to Cape (2010b:40), the broad effect of the alternative finance regime is to treat arrangements that meet a prescribed fact pattern as loans, but only for direct tax purposes, namely income tax and corporation tax. The legislation identifies the profit element and, depending on the Islamic finance product, describes this as the 'alternative finance return'. The return is taxed as if it were interest for direct tax purposes, while making it known that it is not interest in actual fact. (Cape, 2010b:40).

Amendments were also made to the VAT and Stamp Duty Land Tax implications of Islamic financing transactions (PWC, 2012:103), but analysis of such amendments is beyond the scope of this study.

4.3.2 Illustrating the change for the different transactions

A key requirement in the alternative finance taxation system is that one of the parties must be a 'financial institution'. The definition of financial institution is broad and includes (Cape, 2010b:40):

- 'A bank as defined by the Income and Corporations Taxes Act 1988 s.840A.
- A building society, as defined by the Building Societies Act 1986.
- A person licensed under Part 3, Consumer Credit Act 1974, to carry on consumer credit business or consumer hire business.
- A person hired outside of the UK to receive deposits from the public. UK taxpayers may find themselves engaging in Islamic finance transactions with foreign Islamic Finance organisations. Unless the foreign organisation falls within this definition, the new tax law will not apply.
- A wholly owned subsidiary of a bank or building society also counts as a financial institution. The legislation is very precise: the subsidiary has to be wholly owned. If there is even one share of that subsidiary owned outside the banking group, say by a private individual, that subsidiary will not count as a financial institution.'

In addition, the amended legislation only applies to commercial returns which in substance equate returns on debt financing (i.e., interest) and thus, does not apply to financing transactions which in substance result in returns which equate returns from equity financing (Cape, 2010b:40).

The tax treatment of the four most known Islamic finance products will be discussed in more detail below.

4.3.2.1 Partnership Structure: *Musharaka and Mudarabah*

Musharaka equivalent to a mortgage will fall within Section 504 (Diminishing shared ownership arrangements) of the CTA 2009 if:

- the finance provider is a financial institution;
- the financial institution (Mr X) acquires a beneficial interest in an asset;
- another person, the eventual owner, (Mr Y) also acquires a beneficial interest in the asset;
- Mr Y is to pay Mr X (in single or multiple instalments) an amount totalling the original price Mr X paid for his interest and in effect acquires Mr X's beneficial interest;

- Mr Y is to make other payments to Mr X (of whatever form such as rent); and
- Mr Y has the exclusive right to use the asset in whichever manner he wishes and is also entitled to any 'fruits' (income or profits) that asset may give rise to.

For the purposes of section 504(1)(a) of the CTA 2009, it is of no importance if Mr Y (purchaser) had a beneficial or legal interest in the asset prior to Mr X (financial institution) purchasing his beneficial interest (Cape, 2010b:41).

Mr Y may have responsibility for any reduction in the asset's value or having a share in a loss arising out of any such reduction (Cape, 2010b:42).

Under the Musharaka transaction falling within section 504 of the CTA 2009, the amount paid by Mr X (financial institution) to purchase his beneficial interest in the asset will be deemed to be a loan extended to Mr Y for tax purposes. The difference between the amount paid and received by Mr X will be deemed to be interest and taxed as such in the hands of Mr X. If Mr Y were to purchase Mr X's interest in stages, Mr X may choose how to allocate the 'deemed' interest element of the transaction over the instalments.

Under the Musharaka transaction falling within section 504 of the CTA 2009, Mr Y (purchaser) will be deemed to have received a loan from Mr X equaling the amount paid by Mr X for his beneficial interest. The difference between the amount payable by Mr Y and the deemed loan amount will be taken as interest for tax purposes in the hands of Mr Y and thus deductible by Mr Y.

Mudarabah is intended to be governed by section 506 of the CTA 2009, which applies where:

- Mr X (investor) appoints Mr Y (financial institution) as an agent;
- Mr Y invests or uses the money given to him by Mr X with an aim of producing a profit;
- Mr X is entitled to a profit share;
- Mr Y is also entitled to a profit share and may also be entitled to a fee for his efforts; and

- payments made because of Mr X's entitlement to profits equate, in substance, to the return on an investment of money at interest.

For tax purposes, a Mudarabah transaction falling within section 506 of the CTA 2009 will be treated as if the amount provided by Mr X to Mr Y under the arrangement is a loan. The profits or the 'alternative finance return' payable to Mr X will be deemed to be interest in the hands of Mr X.

4.3.2.2 *Deferred Credit Sale: Murabahah*

The legislation governing certain Murabahah is in section 503 of the CTA 2009, which applies if arrangements are entered into between two persons under which:

- one person (Mr X) buys an asset and then sells it to another person (Mr Y). The sale must be concluded immediately unless Mr X is a financial institution, in which case the sale may be delayed, provided that the asset was bought by Mr X for the purpose of entering into arrangements falling within the section;
- the sale price payable by Mr Y is greater than the purchase price paid by Mr X. The additional amount payable by Mr Y over Mr X's cost is referred to as the 'alternative finance return';
- the selling price payable by Mr X may be paid in whole or part later than the date of sale to Mr X;
- the difference between the sale price and the purchase price 'equates, in substance, to the return on an investment of money at interest'; and
- at least one of the parties is a financial institution.

Mr X will be taxed as if the original cost of the asset acquired by him were the amount of a loan, and payments made by Mr Y in excess of Mr X's cost will be deemed to be interest in the hands of Mr X. The same principle will apply in the hands of Mr Y. (section 503, Corporations Tax Act).

The legislation provides no guidance on what equates 'the return on an investment of money at interest' (Cape, 2010b:42).

If Mr Y pays the full amount owing to Mr X in a single instalment then the deemed interest in the hands of Mr X is the difference between the selling price and Mr X's original cost, assuming that it equates to 'the return on an investment money at interest'. If Mr Y pays Mr X the amount owing in more than one instalment, each instalment will be split into an 'interest' and 'principal' component using the guidance set out in section 503 of the CTA 2009. (Cape, 2010b:42).

4.3.2.3 *Leasing Structure: Ijarah*

The corporation tax treatment of Ijarah will generally depend on what type of asset is subject to the Ijarah transaction, the length of the lease period and the option price per section 504 of the CTA 2009 (Cape, 2010b:42).

An Ijarah should be taxable as a lease or hire purchase contract. A detailed analysis of the corporation tax treatment of a lease or hire purchase contract is beyond the scope of this study, so a simplified summary is below:

The Ijarah would be a higher purchase lease (long term lease) if, at the start of the lease (Cape, 2010b:42):

- the lease is treated as a finance lease in terms of IAS17 of IFRS;
- the present value of the future minimum lease payment amounts to at least 80% of the market value of the asset; or
- the lease period is for at least 65% of the economic useful life of the asset; and
- the lease term is for a period between five and seven years.
- If the lease term is more than five years the lessee is deemed to be the owner for capital allowance purposes.

In terms of section 504 of the CTA 2009, the lessee is entitled to a tax deduction in respect of the embedded finance charge in the rentals it pays under the Ijarah. The lessor is subject to tax not on the full amount of the rentals, but on the finance charge element.

The Ijarah may be a short term lease if it is not classified as a finance lease on inception of the lease and thus an operating lease or it might not meet one of the abovementioned requirements of a higher purchase lease. In that case, the lessor is deemed to be the owner of the asset and is thus entitled to claim the capital allowances on the asset. The lessee on the other hand is entitled to claim the full rental paid for the use of the asset as a deduction for tax purposes. The lessor will thus be taxed on the full rental income received from the lessee. (Cape, 2010b:42).

4.3.3 Possible problems with the amended legislation

A problem pointed out by Amin (2006:9) is, for example, in a Murabahah transaction, a property development company is a wholly owned subsidiary of a bank. The property development company therefore meets the definition of a financial institution as discussed above. If the property company sells a building developed 2 years ago, which is regarded as its trading stock, to Company A under a Murabahah contract, the provisions of this legislation will not apply. The reason being that the building was not sold immediately after its development and the reason for developing the building was not solely to sell it to Company A in terms of section 503 of the CTA 2009.

Another issue presented by this legislation is that a transaction between the seller and financier under a Murabahah transaction as illustrated in Figure 3 will not obtain relief from this legislation, as the seller, not being a financial institution, in most cases would not have sold the commodity or asset to the financier immediately after purchase (Amin, 2006: 8).

Cape (2010b:42) points out that an Ijarah financing transaction may or may not fall within section 504 of the CTA 2009. Section 504(1)(a) of the CTA 2009 requires a financial institution to acquire a beneficial interest in an asset. Section 504(1)(b) of the CTA 2009 requires a person, other than the financial institution, to also acquire a beneficial interest. 'Beneficial interest' is not defined in the legislation and thus it is unclear as to what a 'beneficial interest' would be and whether the interest relating to the specific Ijarah transaction meets that requirement.

Cape (2010b:43) also highlights that the legislation allows for a sale and leaseback, as well as for the financial institution to share in the losses relating to the asset or property.

However, provisions in section 46 of the Finance Act 2006 state that ‘another person (the eventual owner) —

- i. is to make payments to the financial institution amounting in aggregate to the consideration paid for the acquisition of its beneficial interest,
- ii. is exclusively entitled to any income, profit or gain arising from or attributable to the asset (including, in particular, any increase in the asset’s value).’

The result of the above provisions is that if the financial institution sells its beneficial interest at a gain or profit, section 46 of the Finance Act 2006 will not apply because the ‘eventual owner’ is required to purchase the interest from the financial institution at the financial institution’s original cost (Amin, 2006:9).

In relation to a Diminishing Musharakah transaction, the alternative finance return, which is deemed to be interest includes all payments made by the eventual owner to the bank excluding the additional payments for the purchase of the banks slices of property as illustrated in Figure 5. Also excluded from the alternative finance return is any payments made by the eventual owner in respect of administration and legal costs. Therefore, only the rentals paid to the bank by the eventual owner will be allowed as a deduction as it is deemed interest, which probably is the same treatment the owner got before the legislation was amended (Cape, 2010b:42).

Cape (2010:42), also points out the problem relating to double taxation in the case where Mr Y (eventual owner) in a Musharakah transaction is the original owner of the asset and sells it to Mr X (financial institution) at a profit, for example, in a sale and leaseback arrangement. The legislation is silent on this type of scenario.

4.4 CONCLUSION

The UK regime for taxing Islamic finance products has come a long way since its inception six years ago. Practitioners generally regard it as working well (Cape, 2010b:48). If a criticism were to be made, it would be that the prescriptive drafting and piecemeal introduction of legislation means that the regime is insufficiently flexible to deal with new products, or existing products that do not fall within the statute. This may lead to uncertainty and punitive taxation (Ainley, *et al.*, 2007:10).

Given the UK's form over substance approach to taxation, and the decision to introduce a tax regime that does not even refer to Islam or Islamic concepts, the UK has a very impressive code that provides fair and certain tax treatment for Islamic financial products. The UK has largely been successful in achieving its aim 'to allow providers to offer Shari'a compliant products without facing commercial disadvantage, and to enable customers to take these products without encountering uncertainty or disadvantage over tax treatment'. (Bell & Jessop, 2009:6).

The UK government is also continuing to improve its legislation to cater for Shari'a compliant variable rate financing arrangements and derivatives, according to Allen and Overy (2012: 6).

Having considered the tax implications and changes to the legislation in the UK, a detailed analysis will be done in the next chapter regarding the tax treatment of Islamic financing products based on the South African legislation prior to amendments and the treatment based on the amended legislation.

CHAPTER 5

SOUTH AFRICAN ISLAMIC FINANCING TAX LEGISLATION

5.1 INTRODUCTION

The Act incorporates amendments dealing with the Income tax consequences of various forms of Islamic financing. Islamic financing implies financial services, transactions and agreements which comply with the precepts of Shari'a or Islamic law.

There have been significant developments with Islamic financial services in South Africa since the tax proposals were announced in 2010. These provisions, once adopted, would also encourage foreign investment into South Africa, resulting in enhanced global connectivity, improved job creation and socio-economic development, as South Africa could position itself as a pioneer in creating a sustainable path for Islamic finance (Patel, 2010). The market share of Islamic finance in South Africa is relatively small compared to countries such as the UK, however it is believed that Islamic financing will become a key component in the South African finance sector in the near future (PWC, 2012:88).

South Africa has a Muslim population of approximately 1.52 million, that is 3% of the total population (Iqra Foundation, 2012). There are a small number of Shari'a compliant financial products currently available and the addressed tax compliance regime is indeed relevant to the Muslim community locally and internationally.

5.2 TAX TREATMENT OF ISLAMIC FINANCE TRANSACTIONS PRIOR TO AMENDMENTS OF SOUTH AFRICAN TAX LEGISLATION

5.2.1 Classification of the 'profit' earned in an Islamic finance transaction

Under the income tax legislation in South Africa prior to insertion of section 24JA of the Act, interest-derived income is taxable in South Africa in terms of the definition of 'gross income', and the expense that is paid by the borrower is a deductible expense in terms of section 11 (a), which deals with the deduction of expenses incurred in the course of trade.

5.2.1.1 *Dividend versus Profit*

Profit is indirectly provided for in the Act in the form of dividends. The difference between profit and dividends however, is the fact that a dividend in essence has to be declared first in order to accrue to the shareholder, whereas a profit does not have to be declared. An investor will earn profit automatically based on the financial performance of the business or project he invested in. The profit in an Islamic financing transaction is earned by the financier and not a shareholder which is a requirement of the definition of 'dividend'. Such profit is based on the outcome of the related project or venture for which the financing was used. (Ackerman & Jacobs, 2008:73). Therefore, profit earned in an Islamic financing transaction does not fall under the definition of 'dividend' and will not therefore result in any Dividends tax consequences effective from 1 April 2012.

5.2.1.2 *Profit versus Interest*

In a typical Murabahah transaction the return on this financing technique can be argued to be the same as interest as defined as the difference between the amount paid by the bank for an asset and the amount received could be a 'discount or premium payable or receivable in terms of or in respect of a financial arrangement.' However, one must keep in mind that the mark-up imposed by the financier is pre-fixed and is not determined by how long one takes to repay the loan (Hallberg & Nettelbladt, 2011:21). The mark-up therefore, is not compensation for the time value of money or deferred payment. It is regarded as a profit margin on a sale even though the financier had to bear the entire cost as a result of the client not being able to make the purchase himself. The mark-up is for the service that the financier provides, namely, doing the necessary research and administration in ensuring that the best deal is made. (Ayub, 2007:132). Although the London Inter-Bank Borrowing Rate (LIBOR) or Johannesburg Inter-Bank Borrowing Rate (JIBAR) rate is used

in some cases as a benchmark to determine the profit mark-up, it does not render a transaction to be an interest based transaction. The LIBOR or JIBAR is just used to enable an Islamic finance transaction to be competitive compared to conventional finance. (Bunker, 2010).

Furthermore, Swanson (2007:1) defines the term premium as 'the excess yield that investors require to commit to hold a long-term bond instead of a series of shorter-term bonds. In addition, the key component of the term premium is investor expectations about the future course of short-term interest rates over the lifetime of the long-term bond. Moreover, measuring term premium can only be obtained through estimating financial market's expectations'. As discussed earlier, the profit earned in an Islamic financing transaction is not based on market expectations or future prospects or compensation for the use of money and therefore, would not amount to a 'discount or premium payable in respect of a financial arrangement' as included in the definition of 'interest' in section 24J of the Act.

To argue this further, the difference in purchase prices between the financier and buyer does not fall under the concept of premium from a tax perspective (Brincker, 2010). This situation is similar to that of a discounted promissory note prior to the introduction of s24J of the Act. According to Brincker (2010), the difference between the face value of a promissory note and the amount paid was not regarded as interest in terms of conventional law. That is why the legislation had to make a provision to deem the difference between the face value of a financial instrument and the amount received as interest for tax law purposes.

Finance charges are defined as payments that a financier receives for allowing the use of money to the borrower to acquire an asset. Thus, finance charges are very similar to interest, the only difference being that finance charges are usually calculated in advance and added to the cash cost of an asset and thus included in the instalments payable. (Gunn & Stack, n.d.:27).

Therefore, the profit does not fall within the definition of 'interest' as it is not compensation for the time value of money or the use of money and is not pre-determined.

Only the profit sharing ratio is pre-determined and not the actual rate of return. This makes profit-sharing permissible in Islam (Warde, 2000:39). This further confirms that this profit is not interest as the return is not pre-determined as required by the definition of 'interest.'

From the financiers perspective the profit earned will not be taxed as interest, but will be included in the financier's gross income as it falls into the definition of gross income in section 1 of the Act being 'total amount in cash or otherwise, received by or accrued to a taxpayer, during the year of assessment not of a capital nature'. The profit would not be 'capital in nature' as providing finance in this manner would fall within the normal operations of the financier, if the financier is a bank, and the intention of the financier when purchasing the asset on behalf of the client would be for a profit making scheme.

The above tax treatment of profits earned is supported by the decisions of case law such as *Commissioner for Inland Revenue v Stott*, 1928 (3) SA 252 (3 SATC 253), *Natal Estates Limited v SIR*, 1975 (4) SA (A) (37 SATC 193) and *Commissioner for Inland Revenue v Pick n Pay Employee Share Purchase Trust*, 1992 SA (A) (54 SATC 271) which held that the sale of assets purchased with the intention of resale or to carry out a scheme of profit making is revenue in nature.

5.2.2 Treatment of a Murabahah transaction prior to legislation amendments

A Murabahah transaction typically involves a seller selling an item to a purchaser at a certain profit which is added to the seller's cost. Murabahah can only be used for a sale transaction and not for a provision of loan to fund, for example, working capital. The following example will illustrate the tax treatment of a conventional loan and of a Murabahah transaction.

Conventional loan:

Mr X requires a machine costing R300 000 for his business. He is unable to afford this and thus approaches Mr Y to extend him a loan. Mr Y extends him the loan for two years with an interest rate of 5%.

Tax treatment:

- Mr X obtains a loan which is capital in nature in terms of the 'gross income' definition included in section 1 of the Act.
- The interest incurred by Mr X will be deductible in terms of the 'general deduction formula' per section 11(a) of the Act, as the machine is used in the course of trade.
- Mr X, being the owner of the machine, will be entitled to capital allowances on the cost of the machine.
- Mr Y will be taxed on the interest on a yield to maturity basis in terms on section 24J of the Act.

Murabahah financing

Mr X requires a machine costing R300 000 for his business. He is unable to afford this and thus approaches Mr Y to finance the machine for him. Mr Y thus buys the machine for R300 000 and then concludes a second sale agreement of the machine with Mr X for R330 000.

From a tax perspective the following problems are incurred:

- The sale of the machine by Mr Y at R330 000 to Mr X is gross income in nature as the machine qualifies as trading stock and the full R330 000 accrues upfront based on the accrual principle highlighted by *Lategan v Commissioner for Inland Revenue*, 1926 CPD 203 (2 SATC 16).
- In addition, Mr X will only be allowed capital allowances on the R300 000 and not the full purchase price.
- Mr X will not be allowed any interest deductibility.
- If Mr Y qualifies as a VAT vendor he would thus have to levy output tax on the transaction with Mr X.

5.2.3 Treatment of assets purchased under a Islamic finance transaction prior to legislation amendments

A typical Ijarah transaction will not be an 'Instalment Sale Agreement' as defined, because the transaction lacks finance charges as required by the definition of an Instalment Sale Agreement in section 1 of the VAT Act. Therefore, it is just a normal lease and the rental received by the financier will be included in the financier's gross income. For the lease of property the rental received will be a special inclusion per paragraph (g) of the definition of gross income in section 1 of the Act.

From the borrower's perspective, the profit paid on the asset purchased forms part of the purchase price of the asset and will not be deductible under section 11 (a), namely: 'expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature' as the profit is of a capital nature. Therefore, the borrower thus far gets no relief. The only possible relief available to the financier is any capital allowances on the asset. In a rental transaction, the borrower will get the rentals paid as a deduction if it meets the requirements of the general deduction formula in section 11(a) of the Act.

Another problem that might arise with the tax legislation prior to amendments would be in relation to the additional payments made for slices of the property by the eventual owner to the bank as illustrated in Figure 5 in a Diminishing Musharakah transaction. These payments are in addition to rent and might be seen as a lease premium which is a specific inclusion per paragraph (f) of the definition of gross income. In the case *Commissioner for Inland Revenue v Butcher Bros (Pty) Ltd*, 1945 SA 301 (13 SATC 21), lease premium was defined as 'consideration having an ascertainable money value passing from a lessee to a lessor, whether in cash or otherwise, distinct from and in addition to, or in lieu of, rent, excluding any obligations accepted by a lessee in respect of matters normally incidental to leases such as undertakings to pay rates and maintain buildings'.

A borrower in a Diminishing Musharakah (eventual owner) or Ijarah (customer) transaction might also be subject to section 8(5) of the Act, dealing with recoupment arising on

purchase of property that was previously leased by the purchaser, amounting to the rentals paid over the lease term when he subsequently purchases the asset from the financier.

This brings us to the issue of ownership. The tax legislation per the Act, allows owners or lessees in an Instalment Sale Agreement as defined in par (a) of the definition of Instalment Sale Agreement of section 1 of the VAT Act, to claim as a deduction certain capital, building or wear and tear allowances if certain conditions are met. In an Islamic financing transaction dealing with assets, ownership remains with the financier until the full deferred amount is paid or the rental period is complete. As discussed above an Ijarah transaction does not fall within the definition of an 'Instalment Sale Agreement' so therefore the borrower is not entitled to any capital, building or wear and tear allowances initially. The financier, however, will in most cases also not be entitled to any allowances as a requirement of common provisions in the Act such as section 11 (e), section 12(C) and section 13, is that the owner uses the asset for the purposes of the taxpayer's trade. The financier will not be using the asset and therefore no allowances are granted. The only exception to this would be if the lessee (customer) under an Ijarah contract uses the asset for purposes of manufacturing, the financier will then be entitled to a section 12C allowance.

5.2.4 Treatment of profits earned on Islamic finance transactions prior to legislation amendments

Individuals using the option of savings accounts and deposits offered by Islamic financial institutions will earn profits. These profits will be taxable in terms of the definition of 'gross income'. Interest earned under a conventional savings account would be treated the same. However, section 10(1) (xv) (bb) of the Act allows a deduction to the maximum of R33 000 for persons over the age of 65 years and R22 800 for persons under the age of 65 years on interest earned in the republic. Therefore, since the profit earned is not interest, individuals are not allowed any deductions on those profits earned. Foreign investors might also forego any interest exemption that they are entitled to in terms of section 10 (1) (h) of the Act with regard to profits earned on Islamic deposits and investments.

5.3 CHANGES TO SOUTH AFRICAN LEGISLATION

Section 24JA of the Act has been introduced to level the tax playing field or to ensure tax parity between conventional financing product and Islamic financing products.

The change in the legislation caters for three types of Islamic Financing products, namely:

- Mudarabah
- Murabahah
- Diminishing Musharakah

5.3.1 A Mudarabah transaction under the new legislation

Tax relief for individual savings

The Mudarabah as defined before, according to Ahmad (2008:19) is very similar to a partnership arrangement where the one party provides the investment and the other manages the investment using skills and expertise to result in a return. The other party in most instances is a bank and the return usually mirrors interest. This type of structure can be compared to a deposit an individual or business makes with a bank.

Based on the rules contained in section 24JA of the Act, the profit or return earned by a natural person will be deemed to constitute 'interest' thus allowing the individual to utilise the basic interest exemption provided in section 10(1)(xv)(bb) of the Act. Thus, individuals utilising a Mudarabah form of financing will receive the same threshold and tax treatment that will be given to an individual making use of a conventional or interest yielding form of finance subject to the qualification criteria provided below.

Qualification criteria

Section 24JA of the Act sets out the following criteria that have to be met for a Mudarabah transaction to be treated as explained above:

- The arrangement must be offered by a bank (or collective investment scheme) to the general public.
- Both parties must share the profits and must agree on the profit sharing ratio when the arrangement is entered into and this ratio cannot be changed.
- The terms of the arrangement must be that the individual making the deposit in the form of Mudarabah financing will incur the sole risk of loss.
- The arrangement must be advertised to the general public as an arrangement that is compliant with Shari'a law.

5.3.2 A Murabahah transaction as per the new legislation

Based on the structure of a Murabahah transaction, one can easily argue that the mark-up on this type of financing is actually interest. As highlighted before, Usmani (2002:17) explains that the mark-up is not interest as the transaction is a trading transaction and not a lending transaction. In essence, this form of financing is structured in a way where an individual or business acquires an asset from a third party and the bank or financier acts as an agent to facilitate the transaction in an Islamic manner (Patel, 2010:16). In terms of the rules set out in section 24JA of the Act, the mark-up by the bank will be re-characterised as interest for the purposes of Income Tax as explained below.

For purposes of Income Tax, a Murabahah transaction will be deemed to have the following impact:

- The bank will be deemed not to be part of the purchase transaction and thus the bank is deemed not to have acquired or disposed of the said asset.
- The individual or business is deemed to acquire the said asset directly from the third party:
 - for an amount equal to the consideration payable by the agent (bank) to the third party, and
 - to have acquired the said asset at the time that the third party disposes of the asset to the agent (bank).

- The ‘mark-up’ on the sale of the said asset by the agent (bank) to the individual is deemed to be interest. ‘Technically, to achieve this result, the Act deems the Murabahah arrangement as a whole to qualify as a section 24J “instrument”, the mark-up to constitute a premium payable or receivable (thereby qualifying as section 24J interest), and the bank consideration payable to the seller to constitute the “issue price” (thereby being taken into account as a section 24J “initial amount”)’ (National Treasury, 2010:54).

Example

Facts:

Mr A requires a printing machine for his publishing business but is experiencing cash flow problems. Mr A identifies a second hand machine that is being sold by Mr B for R10 000. Mr A then approaches XYZ bank for Murabahah finance. The bank negotiates with Mr A that it will buy the machine from Mr B for R10 000 in its own name and sell it to Mr A for R15 000. The agreed selling price is payable by Mr A in two instalments at the end of a 24 month period. The bank acquires the machine from Mr B on 1 July 2012 and Mr A acquires the machine from the bank on 15 July 2012. (National Treasury, 2010:55).

Result:

The Murabahah financing arrangement has the following impact for Income Tax purposes:

- Mr A is deemed to have directly acquired the printing machine from Mr B at an acquisition price of R10 000 on 1 July 2012.
- The bank is deemed not to have acquired or disposed of the printing machine.
- The marked-up amount of R5 000 (i.e., R15 000 less R10 000) constitutes a ‘premium payable’ by Mr A to the bank. The R5 000 amount constitutes an accrual amount in favour of the bank for section 24J purposes.

Qualification criteria

In order for the above tax treatment to apply for natural persons using Murabahah finance, the structure of the finance must satisfy the following requirements:

- The product (i.e., ‘the arrangement’) must be offered by a bank to the general public.
- The purchase of the asset by the bank must be subject to terms and conditions agreed upon by the client and the third party.
- The terms of the arrangement between the bank and the client must include a clause allowing the bank to repossess the said asset should the client fail to comply with the agreement or default on any required payments in terms of the arrangement.
- The client must acquire the asset from the bank within 180 days after acquisition by the bank at a pre-agreed purchase price which is higher than the price paid by the bank to the initial seller and the agreed price must not be amendable.
- The client will pay the purchase price of the asset in more than one instalment from the bank.
- The product (i.e., ‘the arrangement’) must be advertised to the general public as an arrangement that is compliant with Shari’a law (section 24JA of the Act).

5.3.3 A Diminishing Musharakah transaction under the new legislation

Borrowed funds equivalence

As explained by Amin (2006:10), Diminishing Musharaka financing is similar to taking out a mortgage bond to assist one in purchasing a house. In essence, this type of financing is structured similar to the Murabahah financing explained above, where a person or business purchases a property from a third party with a bank acting as an agent to facilitate the transaction in an Islamic manner (National Treasury, 2010:56).

For purposes of the Income Tax Act, Diminishing Musharakah financing will be deemed to have the following impact per the rules set out in section 24JA of the Act:

- The agent (bank) will be deemed not to be part of the purchase transaction and thus the bank is deemed not to have acquired or disposed of its proportionate interest in the said property.

- The client is deemed to have acquired the agent's (bank's) proportionate interest in the property directly from the third party:
 - for an amount equal to the consideration payable by the agent (bank) to the third party, and
 - to have acquired the said asset at the time that the third party disposes of the asset to the agent (bank).
- The rent paid by the individual or business to the agent (bank) for use of its proportionate interest in the property is deemed to be a 'premium payable'.

Technically, to achieve this result, 'the Act deems the Diminishing Musharakah arrangement as a whole to qualify as a section 24J "instrument", the rent to constitute a premium payable or receivable (thereby qualifying as section 24J interest), and the bank consideration payable to the seller to constitute the "issue price" (thereby being taken into account as a section 24J "initial amount")' (National Treasury, 2010: 57).

Example

Facts:

Mr A identifies a house in a security estate which he would like to purchase. The purchase price of the house is R1 500 000. Mr A approaches XYZ bank for Diminishing Musharakah finance. Mr A and XYZ bank come to an arrangement whereby the two parties will purchase the house jointly from the seller in the following manner:

- Mr A will purchase 20% (i.e., R450 000) of the property and XYZ bank will purchase the remaining 70% (i.e., R1 050 000).
- Mr A will purchase 10% of XYZ bank's proportionate interest in the property over the next 7 years at R150 000 per year.
- In addition, Mr A will pay XYZ bank an annual rental of R100 000 for the use of its proportionate interest in the property (National Treasury, 2010: 58).

Result:

- For income tax purposes, Mr A is deemed to have acquired the house directly from the third party at a cost of R1 500 000. XYZ bank is deemed not to have acquired or disposed of its proportionate interest in the house.
- Mr A is also deemed to have acquired the house directly from the third party at a cost of R1 500 000. The R1 500 000 constitutes the issue price of the instrument.
- The annual rental of R100 000 constitutes the 'premium payable' by the client and an accrual amount in favour of the Bank for purposes of section 24J.

Qualification Criteria

In order for the above mentioned tax treatment to apply to Diminishing Musharakah finance the arrangement must satisfy the following requirements:

- The product (i.e., 'the arrangement') must be offered by a bank to the general public.
- The arrangement between the client and the bank must be structured as follows:
 - the client and bank must enter into the purchase transaction jointly,
 - it must be agreed that the client will eventually purchase the bank's full proportionate interest in the property at the same price that the bank had paid for the interest from the initial seller, and
 - the client will pay the bank rent for the use of its proportionate interest.
- The product (i.e., 'the arrangement') must be advertised to the general public as an arrangement that is compliant with Shari'a law (Section 24JA of the Act).

5.4 CONCLUSION

The chapter has provided a sound background on the treatment of Islamic financing transactions prior to the amendment of the legislation as well as a detailed analysis of the amended legislation and its implications.

While the treatment of the returns on the above mentioned transaction amounts as 'interest' for tax purposes might be construed as offensive given the deliberate avoidance of interest under Shari'a precepts, it should be appreciated that if the amounts in question

were not to be treated as interest for tax purposes, the client might be deprived of the right to claim a tax deduction, even where a deduction would have been claimable pursuant to a conventional financing transaction.

For example, if you were to borrow money to acquire business assets, interest on your borrowings would be deductible. You should not be deprived of that right because, in observance of Shari'a, you cast the transaction into a compliant form. The amendments are about extending equal rights to those who observe and comply with Shari'a law.

Based on the discussions above, it can be seen that Islamic financing is a very complex and detailed topic, and really needs to be understood well to be able to analyse the different implications.

Many tax issues and inconsistencies were identified and for legislation to adequately solve the tax dilemma, most of these issues need to be solved.

The possible problems relating to the UK legislation could also apply to the South African legislation due to the fact that the amended legislation deals with the basic Islamic financing structures and addresses mainly the interest component of the tax dilemma mentioned earlier and not much relating to ownership.

CHAPTER 6

CONCLUSION

6.1 INTRODUCTION

‘Judging by the success of ethical funds worldwide, the need to bolster GDP in South Africa and with its intense focus on business ethics, Islamic finance is going to become a permanent feature of South Africa and Africa’s economic landscape’ (Patel, 2012).

Having evaluated the research relating to Islamic finance, its laws and principles as well its challenges, it is evident that Islamic finance is a fast growing market and an opportunity for many economies to take advantage of its growth potential.

Tax authorities in more and more countries around the globe are going to great lengths to ensure that they amend or implement legislation to ensure that their country embraces and adequately addresses the equal tax treatment between Islamic financing and conventional financing products (PWC, 2012:1). The UK and South Africa have both amended their legislations to ensure tax parity between Islamic financing and conventional financing products.

The purpose and objectives of this study is to critically analyse the new section 24JA of the Act in comparison to the United Kingdom’s tax legislation regarding Islamic financing and to analyse whether the amendments to the South African tax legislation ensure tax parity between Islamic financing products and conventional financing products. A detailed analysis of the UK and South African tax legislation relating to Islamic financing was conducted in Chapter 4 and 5 by critically analysing the provisions of the related legislations on Islamic finance products.

This chapter concludes the research by comparing the UK’s and South Africa’s Islamic financing tax laws. This is concluded by an answer to the research question of whether the Act ensures tax parity between Islamic financing transactions and conventional financing transactions.

6.2 A COMPARISON OF UK AND SOUTH AFRICAN LEGISLATION

The South African legislation, mentions specifically Shari'a compliant financing and one of the requirements for section 24JA of the Act to apply is that the related transaction must be advertised as Shari'a compliant and thus will not apply to any transaction structured similarly to an Islamic financing product but not advertised as such as contained in the UK legislation. The South African legislation relating to Islamic finance draws on principles very similar to the UK legislation although it is very limited with regard to the types of transactions or products it addresses as opposed to the UK legislation. Both countries' legislations only address the interest component of the tax dilemma and no guidance regarding ownership or the capital gains tax consequences is given. Another similarity between the UK and South African legislation is that they provide for tax consequences on Islamic finance products which equate returns similar to debt financing and not equity financing.

The UK legislation does not specifically mention Shari'a compliant financing and uses the term 'alternate financing arrangement' and thus is applicable to Muslims and Non-Muslims. The requirements under the UK legislation does not include that the transaction must be advertised as Shari'a compliant. As the UK legislation was introduced as far back as 2006, various amendments were made to improve the legislation and cater for new and more complex products such as Islamic bonds commonly known as Sukuk. The UK legislation deals with ensuring tax parity regarding the interest portion of the Islamic financing transaction and does not give guidance on ownership issues that also present a tax dilemma. The UK has been largely successful in achieving its aim 'to allow providers to offer Shari'a compliant products without facing commercial disadvantage, and to enable customers to take these products without encountering uncertainty or disadvantage over tax treatment' (Cape, 2010b:40).

The broad effect of the UK's alternative finance regime is to treat arrangements that meet a prescribed fact pattern as loans, but only for direct tax purposes, namely income tax and corporation tax. The legislation identifies the profit element and, depending on the Islamic

finance product, describes this as the 'alternative finance return'. The return is taxed as if it were interest for direct tax purposes, while acknowledging that it is not interest in actual fact. (Cape, 2010b:40).

There is seemingly no priority rule contained in the alternative finance regime so, for example if an Ijarah could be taxed under general principles applicable to leases or the alternative finance regime, it is unclear which it would be required to apply or whether it could choose which to apply (Cape, 2010b:42).

6.3 CONCLUSION

The economic and finance sense of tax parity is often so hard to achieve. In such a competitive global space, government policies in the country are often intended to address the challenges that impede development and growth of some kind. It is therefore of critical importance that such tax policies in this regard ensure parity, a major objective of this scrutiny into the new amended tax legislation.

Based on the analysis of section 24JA of the Act in Chapter 5, one can conclude that the amended legislation ensures tax parity between Islamic financing products and conventional financing products to a large extent. If a criticism were to be made, it would be that the prescriptive drafting and piecemeal introduction of legislation means that the regime is insufficiently flexible to deal with new products, or existing products that do not fall within the statute. This may lead to uncertainty and punitive taxation. Although it may be possible to rely on guidance from the South African Revenue Services on the taxation of a particular product, relying on the discretion of a tax authority, particularly if it may not be exercised strictly in accordance with the law, is far from perfect.

Overall, the degree of parity of the Islamic income tax legislation has to ensure a sense of confidence in the conventional financing environment. The biggest challenge of ensuring tax parity lies in the fact that despite the undoubted growth in Islamic finance products, the degree of flexibility of the amended legislation is too limited to address issues in tax that may be complex and falling between what has been defined.

One must also note the fact that creating a framework for Islamic finance in South Africa will require more than just an amendment of the tax legislation. Creating such a framework will require changes to other regulatory processes and policies as well.

In addition, while there is need to be aware of the challenges and time involved in introducing an Islamic finance tax regime, the UK statutory regime, although not perfect, provides an invaluable precedent and thus should be followed by South African tax authorities in improving the legislation to address other types of Islamic financing products.

6.4 RECOMMENDATIONS

The conditions for complying with the tax requirements for Islamic financing transactions are not straightforward. A non-Shari'a compliant arrangement may (intentionally or not) satisfy the conditions. A Shari'a compliant arrangement may fail to satisfy the conditions. For example, the difference between the purchase and resale prices may not be equivalent to the return on an investment of money at interest. The UK's approach to taxing Shari'a compliant transactions has its critics, but practitioners have generally been encouraged by its willingness to engage with the issues, and the legislative framework generally works well.

Ignoring potential tax issues is not an option. A change in the tax statutes is absolutely necessary, and the tax authority will need to devise and publish a policy to give certainty to financiers and customers alike. Without such a change, it is unlikely that Islamic finance will be able to flourish in South Africa.

The South African tax authority will need to consider several issues in determining the nature of its tax regime, including:

- Whether the application of the specific legislation should be optional, that is whether the parties must elect to be taxed under the Islamic finance regime even if they satisfy the conditions.

- The extent to which there should be an anti-avoidance rule, preventing an abuse of the Islamic finance regime.
- The ownership issues regarding assets purchased under Islamic financing transactions, that is capital allowances and capital gains tax consequences.

6.5 FURTHER RESEARCH

Studies into some of the major challenges Islamic finance face are very similar to those of conventional finance, while others are uniquely related to Islamic finance. The most significant challenges are in the areas of: regulation, supervision and international harmonisation; risk management; innovation and financial diversification; and human resources. Further studies in these areas are important.

Specifically, the study would like to suggest the following areas for further research:

- A study on the impact and effect the amended Income tax legislation has on the South African Islamic finance market.
- Do the amendments to the Value Added Tax Act 89 of 1991 and Transfer Duty Act 40 of 1949 ensure tax parity between Islamic financing products and conventional financing products?
- The possibility of South African courts referring to the principles of Islamic law in deciding Islamic finance cases.

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