The taxation treatment of Islamic finance in Canada
Discussion paper
In May 2010, the Islamic Finance Working Group of the Toronto Financial Services Alliance issued a report "Making Toronto the North American Centre for Islamic Finance: Challenges and Opportunities". The report discussed at a high level the development of Islamic Finance in Canada and also highlighted some of the Canadian tax challenges.

This discussion paper provides a more comprehensive analysis of the direct and indirect tax implications from a Canadian perspective. The report also highlights some of the measures taken by other western jurisdictions to deal with the tax implications of Islamic Finance products.

From a Canadian perspective, we hope that this paper will help in the ongoing discussion of Islamic Finance in Canada and enable policy makers, regulators and practitioners to take steps to further the development of Islamic Finance in Canada. Certainty in the taxation realm is a critical part of ensuring that Toronto and Canada can emerge as a North American centre for Islamic Finance.

We would like to express our sincere thanks to members of the Islamic Finance Working Group, and in particular, Jeffrey Graham of Borden Ladner Gervais LLP, for their insight in the preparation of this report.

Steven C. Watts
Partner, Audit

Carmela Pallotto
Partner, Tax

John Bain
Partner, Tax
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I. Introduction

Islamic financial products and services are based on Shariah or Islamic law, which sets out guiding principles. Under these principles, Shariah-compliant financial products can differ significantly from conventional financial products. For this reason, financial institutions and other parties that seek to offer these products must address certain challenges to achieve success in the Canadian marketplace. From a tax perspective, Islamic financial products pose a challenge because:

- Tax authorities and taxpayers lack knowledge of the specific features of Islamic financial products
- The wide array of Islamic financial products may require significant resources to approach tax authorities
- Obtaining rulings from tax authorities can be a lengthy process because of the technical, interpretive, and policy issues that must be addressed.

Because these products must adhere to Shariah principles, understanding the exact nature of the product and its corresponding income and commodity tax treatment are essential. This knowledge can help address any potential issues that would give an Islamic finance product an advantage or disadvantage compared to a conventional product.

At year-end 2009, assets of the top 500 Islamic banks expanded 28.6% to $822 billion and it is estimated that Shariah-compliant assets currently total about $1 trillion worldwide. Accordingly, Shariah-compliant financial products offer tremendous opportunities and growth potential. Many jurisdictions have implemented, or are in the process of implementing, taxation, financial regulation and supervision systems to deal with Islamic finance products and transactions. To take advantage of the available opportunities and remain competitive in the finance sector, it is imperative that Canada address the taxation of Islamic products and services. While there are currently some products being offered in Canada, if the tax issues can be remedied, more financial institutions will offer Shariah-compliant products and more of them such that consumers will have more choice.

1 Standard & Poor’s, Islamic Finance Outlook 2009, 12 May 2009, p.5.
Institutions that offer Islamic financial services must follow Shariah principles or Islamic law. Essentially, Islamic finance must function in accordance with the rules of the Islamic faith, which is generally premised on the following principles:

- **Prohibition of interest**: It is unacceptable, in and of itself, for money to increase in value merely by being lent to another person.
- **Prohibition of uncertainty or speculation**: Contract terms should not be ambiguous or lack clarity as this can often give rise to speculation. Transactions should not be undertaken for purely speculative purposes.
- **Prohibition of investing in sectors that are prohibited**: Investment should not be made in sectors that are incompatible with the Muslim faith, such as pork products, arms and ammunitions, alcohol, gaming or pornography.
- **Sharing of risk and return and asset backing**: Risk and return must be shared and transactions must be tied to an underlying or tangible asset.
The United Kingdom, Australia, Ireland, South Korea, France, Singapore, Malaysia and Indonesia have modified or are modifying their taxation regimes to ensure Islamic finance products and treated the same as conventional products. These jurisdictions have implemented the following changes:

- **United Kingdom**: The United Kingdom introduced tax legislation to ensure that Islamic finance products are treated in a tax-neutral manner compared to conventional products. Certain definitions were introduced, but no mention of Shariah or other Islamic finance terms are made. Generally, the tax treatment is similar to the treatment of interest. Likewise, existing legislation that applies to debt instruments also applies to alternative financing arrangements or Sukuk (see below). For the purposes of UK value-added tax (VAT), interpretive guidance was published on several Shariah-compliant financial products. This guidance draws heavily on existing legislation, interpretive policy, and jurisprudence. The UK tax authorities also provided rulings and interpretations that taxpayers can rely on to facilitate the timely commencement of trade. To achieve tax neutrality, changes were required to the stamp duty and land reserve tax.
• Ireland: Generally, Ireland treats the tax treatment of an Islamic finance product the same as their conventional economic equivalents. Ireland introduced legislation to facilitate Islamic financing arrangements such as credit transactions, deposit transactions and investment transactions. For example, the tax legislation clarifies that the return on a Sukuk, or Islamic bond, certificate is interest on a security and that a Sukuk issuer can deduct the interest paid on a coupon. Legislation has also been proposed to exempt certain Islamic financial transactions from VAT.

• France: Essentially, France found that changes to tax legislation were not necessary, and instead provided guidelines to explain the tax treatment of Islamic financing. For example, the same tax rules were applied to Islamic financing arrangements that resembled debt instruments.

• Singapore: Singapore has taken steps to align the treatment of Islamic finance products to equivalent conventional products.

• Malaysia: A key global player in Islamic finance, Malaysia has enacted tax legislation to ensure that Islamic financial arrangements are taxed in the same manner as conventional arrangements. For tax purposes, the profits of Islamic financial arrangements and the payment of profits is generally treated as interest. Furthermore, Malaysia has introduced tax incentives to promote the growth of Islamic finance in the country.

• Indonesia: Indonesia has introduced specific laws to recognize trust structures which now allow for the use of Sukuk to raise finance. In addition, legislation was introduced to ensure Islamic finance products are not subject to double taxation.

• South Korea: As with Indonesia, South Korea is looking to remove tax barriers which prevent the use of Sukuk. It is thought that the tax treatment will be similar to conventional bonds.

• Australia: Australia’s Board of Taxation is reviewing the tax treatment of Islamic finance products to make recommendations to ensure that the tax treatment of Islamic products is at parity with conventional products, where possible. Should the Board determine that amendments to tax legislation are required, it will consider whether existing tax legislation can be adjusted rather than developing specific provisions that apply solely to Islamic financial products.

As this overview demonstrates, many countries have been proactive in their consideration of Islamic finance. These global experiences could serve as a useful roadmap for Canada to address the income and commodity taxation of Islamic finance products.
When considering applying income and commodity tax to Islamic finance products and services, it is important to analyze all aspects of these products and their current tax treatment. While this analysis should be straightforward for products that are structured similar to conventional products, there are challenges in structuring more complex Islamic financial products and services to be both Shariah-compliant and income and commodity tax neutral. Experience has shown that the income and commodity tax treatment of Shariah-compliant products can be at odds with the tax treatment of conventional financial services.

The following Islamic finance products all have specific income and commodity tax challenges, as discussed below:

- Mudaraba (an Islamic deposit account)
- Murabaha (an Islamic credit arrangement)
- Diminishing Musharaka with Ijara (an Islamic mortgage product)
- Sukuk-al-Ijara (an Islamic “bond”)
- Takaful (Islamic insurance).

**MUDARABA**

The Mudaraba is a deposit account for customers who wish to maintain a regular (or irregular) saving pattern. In accordance with Shariah principles, this type of account is based on a profit or loss-sharing concept, with a risk that customers may lose some or all of their initial capital saved with the Islamic finance provider. The financial institution (or Mudarib) pools its customers’ funds with its own funds to invest in Shariah-compliant assets (i.e., certain commodities) and charges a fee (Mudarib fee), which is often explicitly identified along with other profit components. Each month, the Mudarib calculates the actual profit and credits its customers’ accounts based on previously agreed profit-sharing ratios. As noted, in the case of losses, customers may lose some or all of their initial capital.

A Mudaraba may be compared to an index-linked note or another type of note where the return is tied to the future value of a commodity, such as certain metals. In a way, a Mudaraba is a partnership, as risk is shared, although in practice the risk is minimal.
**Income Tax Issues**

The Mudarib fees, profit and loss from the Mudaraba should be included in the financial institution’s business income.

There may be uncertainty about whether the customer can treat the profit on account of capital. It will be necessary to examine the legal nature of the relationship between the financial institution and the customer. The Canadian tax authorities’ view is that, generally, transactions in commodity related instruments should be treated as ordinary income for tax purposes. However, in certain circumstances, a taxpayer can elect to treat all their gains and losses on transactions in commodities as capital gains and losses. Accordingly, if the customer is viewed from a legal perspective as engaging in the underlying commodities transactions and the customer is able to treat the profit on account of capital, only one half of the gain is subject to tax. This would be a preferential tax treatment compared to an equivalent traditional financial product, where the full amount of the interest is generally subject to tax.

Where a customer has elected to treat commodity transactions on capital account and realizes a loss, the loss should be on account of capital under both the Mudaraba and the traditional financial product. Capital losses can only be deducted to the extent the taxpayer has a capital gain in the year, the three preceding years, or future years. In contrast, if the customer has not elected to treat the gains and losses on the Mudaraba and other commodity transactions on capital account, losses on a Mudaraba will be fully deductible. Again there is the possibility for the Islamic finance product to receive a preferential tax treatment.

There may be additional issues where a customer is not a resident of Canada. In this case, it is necessary to examine the legal nature of the relationship between the customer and the provider and the character of the payments from a Canadian legal perspective. Where the relationship is viewed as a partnership, the non-resident may potentially be considered to be carrying on business in Canada and therefore required to file Canadian income tax returns, unless the non-resident can elect to treat all gains and losses on commodity transactions on capital account. In contrast, a non-resident investing in a note linked to the return on a basket of commodities would generally not be considered to be carrying on business in Canada solely by virtue of making such an investment.

**Income Tax Changes Required**

To ensure a level playing field between a Mudaraba and a traditional deposit or linked note product, changes to the Income Tax Act (Canada) are required. These changes should deem that, in transactions conducted in accordance with Shariah’s principles, gains or profits received in lieu of interest are considered interest. In addition, changes are required to ensure that associations established to enable Shariah-compliant investment are not considered partnerships or agency relationships for Canadian income tax purposes.

**Commodity Tax Issues**

The application of GST/HST to fees or charges related to the operation of a Mudaraba should be GST/HST exempt, in accordance with existing legislation and interpretive policy that applies to bank accounts. However, issues could arise as the Mudarib fee may be viewed as comparable to a fund manager’s fee and, therefore, subject to GST/HST;
That is, the fee would be excluded from the definition of “financial service” in subsection 123(1) of the Excise Tax Act and, therefore, not exempt.

Even though the Mudarib fee may be specifically identified, in practice it is simply one of the figures deducted in determining the profit element to be shared by the financial institution and the customers. Thus, the fee is not consideration for a supply for GST/HST purposes and GST/HST does not apply. No PST issues should arise either. Therefore, it is important to properly characterize the Mudarib fee in any terms and conditions as a share of or deduction from the overall profit and not a fee related to fund management.

Commodity Tax Changes Required

It is unlikely that changes to the GST/HST legislation are required. However, CRA guidance would need to be updated and amended to ensure a clear understanding of the proper GST/HST treatment (e.g., the GST/HST Memoranda Series).

MURABAHA

The “white-goods” Murabaha (as opposed to the Commodity Murabaha or Tuwarruq) is an Islamic financing facility to help customers buy consumer goods (e.g., cars, home furnishings). This product works as follows:

- The purchaser selects a good for purchase
- The purchaser and the Islamic finance institution agree on a profit margin and the institution purchases the good from the vendor
- The purchaser takes possession of the good as an agent of the institution
- The institution sells the good to the customer based on cost plus the agreed profit margin, which is payable over an agreed period of time
- The title to the good passes to the customer at the time the sale occurs.

The Murabaha is a Shariah-compliant substitute for conventional credit arrangements under which the title to property being sold is transferred on the date of the sale and the borrowed amount is payable by instalments.

A Murabaha may be compared to a traditional mortgage product or other loan product used to finance acquisition of an asset such as a car.

Income Tax Issues

From the financial institution’s perspective, the Murabaha’s tax issues relate to the timing of recognizing the profit where the term is more than a year or straddles a financial institution’s taxation year-end. For example, if the Murabaha is used as an equivalent to a five-year loan to finance acquisition of business assets, there is uncertainty whether characterized as profit or interest, the effect could be the same if properly structured.
regarding when a financial institution would be required to include in taxable income the gain on sale of the asset—at the time of sale of the business assets, over three years, or over the payment period. In a conventional loan scenario, the economically equivalent “interest” would be recognized over the term of the loan (i.e., five years).

Generally, a taxpayer should include in business income the difference between the cost of a good and the amount it was sold to the customer for in the year of sale. Where the proceeds were not fully received in the year of sale, the taxpayer may claim a reserve (except where the property is real property) for unpaid amounts for up to three years. Accordingly, from the perspective of the financial institution, the profit from selling the assets to the customer at a mark up should be included in income over three years at most.

However, if it is reasonable to consider that a payment is partially of an income nature (such as interest) and partially of a capital nature, Canadian tax legislation provides that the part of the payment that can reasonably be regarded as being of an income nature should be included in taxable income in the year in which the amount was received or became due. As the fair market value of the goods in the example above is less than the amounts that are paid over the term of the Murabaha, each payment under the Murabaha may arguably be considered to be partially of a capital nature and partially of an income nature. Accordingly, it may be possible to recognize the profit margin in the financial institution's taxable income over the term of the Murabaha as each payment is made. If the financial institution takes this position, there should not be a significant difference between a Murabaha and a conventional loan, from an income tax perspective.

Where the financial institution is not resident in Canada, it may be deemed to be carrying on business in Canada by virtue of offering something for sale in Canada. Consequently, the non-resident financial institution may be subject to Canadian income tax on the gain unless a tax treaty between Canada and the foreign financial institution's country of residence provides relief. In contrast, a foreign financial institution that solely provides a conventional loan to a Canadian resident and does not have any other Canadian activities or presence would not likely have to pay Canadian non-resident withholding tax on the gross amount of interest received nor Canadian income tax on the net income earned from the loan to the Canadian resident.

Typically, for the customer, the total amount paid for a good should be the cost to the customer of the good. There is uncertainty regarding whether a customer that has used a Murabaha to finance an asset used to earn business or property income can deduct the “profit” component paid to the financial institution. Where only a portion of the amount paid can reasonably be considered to represent interest or another income item to the recipient, the customer may be able to claim a deduction for the income portion of the payment based on the same provision in the tax legislation described above. If this position is taken, the profit component should not form part of the cost of the asset. However, if the customer is not able to take this position, the customer will be at a disadvantage by using a Murabaha rather than a conventional loan.
**Income Tax Changes Required**

To eliminate uncertainty over the timing of recognizing income, profits received in lieu of interest in transactions conducted in accordance with Shariah principles should be deemed to be interest. This would also permit customers that have used a Murabaha to finance an asset used for business purposes to claim a deduction, provided that all the regular tests for interest deductibility are met.

**Commodity Tax Issues**

Under the conventional arrangement, the sale of a good is subject to GST/HST and, as a financial service, the credit charge is GST/HST-exempt under subsection 123(1) of the ETA.

In the case of the Murabaha, the institution purchases and resells the good through an arrangement that is typically structured to generate a return in line with conventional financing rates. As there is a second transaction on an increased amount (i.e., the price of the good plus the profit), a higher GST/HST is exigible. GST/HST would not arise if the profit amount could be viewed as a financing cost or interest and, thus, as a financial service. However, the current definition of “financial service” in the ETA does not appear to support this interpretation.

As a result, consumers face higher costs under a Murabaha than under a conventional financial instrument, increasing the risk that Murabaha products would be unattractive in the marketplace. Ensuring the profit element (i.e., the amount equivalent to a financing charge) is GST/HST-exempt is crucial to the product’s competitiveness. PST issues will also arise under a Murabaha. Under a conventional structure, PST applies on the sale of the good from the retailer to the customer absent any relieving mechanism, such as an exempting certificate or permit. Under a Murabaha structure, a higher amount of PST would apply to the institution’s sale to the customer because the tax is payable on the value that includes the profit element. Steps could be taken to exempt the sale from the vendor to the institution from PST, for example, by using exemption certificates or permits (depending on the jurisdiction).

As the table below shows (the example assumes that only GST at a rate of 5% applies), the Murabaha structure would result in higher GST/HST and PST costs to the purchaser and additional compliance obligations and costs for the Murabaha provider.

<table>
<thead>
<tr>
<th>Table 1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conventional Loan</strong></td>
</tr>
<tr>
<td>Price of good: $100</td>
</tr>
<tr>
<td>Finance cost: $10</td>
</tr>
<tr>
<td>GST: $5.00 ($100 × 5%)</td>
</tr>
<tr>
<td>PST: $7.00 ($100 × 7%)</td>
</tr>
</tbody>
</table>

**Commodity Tax Changes Required**

To ensure that the profit amount is treated like a finance cost or interest for GST/HST purposes, and therefore exempt, it is necessary to review the definitions of “financial instrument” and “financial service” in subsection 123(1) of the ETA.

**DIMINISHING MUSHARAKA WITH IJARA**

The Diminishing Musharaka with Ijara is a form of Islamic mortgage product. This mortgage could be structured as a joint

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4 See additional comments under “GST compliance” below.

5 Issues regarding consumer protection (e.g., warranties) under the provincial statutes governing sales of goods would also need to be managed.
purchase by the lending institution and the customer as follows:

- The ownership is split in the ratio of funding contributed by the respective parties (i.e., the ratio of deposit paid by the customer compared to the balance paid by the Islamic financial institution)
- The institution rents its part of the property to the customer for a monthly consideration that covers the cost of the financing and the repayment of an installment of the capital sum “lent”
- When all of the installments are paid, the lending institution transfers its legal ownership share to the customer at a nominal price.

**Income Tax Issues**

Where the transaction is considered to be a lease of the property combined with a series of dispositions by the financial institution and the payments are received on an accrual basis, the institution should include the monthly rent in taxable income. In addition, depreciable property will be categorized into a tax depreciation class according to the type of property. The financial institution should be able to claim a deduction for tax depreciation based on the tax depreciation rate for the particular class. The amount of tax depreciation that can be claimed may be restricted where the leased property is considered to be “specified leasing property.”

The portion of each installment payment that represents proceeds of disposition of a portion of the property should be credited to the relevant class of property to the extent that the proceeds do not exceed the original cost of the assets. Under certain circumstances a recapture of previously deducted tax depreciation may occur.

There may be a difference in the timing of the recognition of income compared to a conventional term financing arrangement. In particular the recognition of income will be delayed until the cash received exceeds the undepreciated cost of the asset, assuming there are no other assets in that particular class. This deferral would be advantageous to a financial institution.

Where a financial institution is not resident in Canada and the Musharaka is viewed as a partnership, the financial institution could be viewed as carrying on business in Canada and, hence, required to file a Canadian tax return.

The non-resident may also be subject to withholding tax. Rent payments to non-residents are subject to 25% Canadian withholding tax on the gross amount, unless a tax treaty reduces the rate. Where the rent is for real or immovable property in Canada, the non-resident may instead choose to file a Canadian tax return.
return and pay Canadian tax on the net income from the property. In either case, the non-resident financial institution likely requires the customer to cover the Canadian tax costs.

Under a conventional term loan, interest should not be subject to Canadian withholding tax when paid to arm’s-length non-residents, provided that the interest is not “participating debt interest.” Here, the customer would only pay the stated interest rate. Accordingly, a customer obtaining financing via a Musharaka product would be at a disadvantage to a customer obtaining financing from a traditional loan product.

**Income Tax Changes Required**

Again, changes to the tax legislation that deems a portion of the payments to be interest would resolve the inequity between a conventional finance product and a Shariah-compliant one.

**Commodity Tax Issues**

The Diminishing Musharaka with Ijara illustrates how Islamic finance creates GST/HST issues. Conventional residential mortgages essentially involve two steps:

- **Step 1**—The purchaser receives funding from the finance provider.
- **Step 2**—The purchaser buys the property from the vendor.

The purchase is either GST/HST-exempt (e.g., used residential housing) or GST/HST-taxable (e.g., a newly constructed residential complex). Any interest paid to the financial institution is GST-exempt.

As noted above, a Shariah-compliant mortgage structure involves four steps:

- **Step 1**—The Islamic finance provider purchases the property from the vendor.
- **Step 2**—The Islamic finance provider enters into a long-term lease for the property with the purchaser.
- **Step 3**—The purchaser’s equity interest increases over time.
- **Step 4**—The purchaser ultimately purchases the remaining legal interest in the property.

GST/HST-exemptions could apply to an Islamic residential mortgage, provided the residential complex was considered “used.” For example, the supplies by way of sale under Steps 1, 3 and 4 would be GST/HST-exempt, under section 2 of Part 1 of Schedule V to the ETA. The long-term lease between the financial institution and the purchaser could also be GST/HST-exempt, under section 6 of Part 1 of Schedule V.

However, where the property is newly constructed, many issues must be considered. Under a conventional mortgage, the purchaser pays GST/HST to the builder and likely assigns any resulting GST/HST new housing rebate to the builder. Any interest payable to the lender under the mortgage is GST/HST-exempt as a financial service.

Under the Diminishing Musharaka with Ijara, Step 1 would constitute a GST/HST-taxable supply. As the institution would enter into a long-term lease with the customer in Step 2, the institution could be considered a “builder” and required to self-supply under subsection 191(1) of the ETA.

Consequently, the lender would be required to account for GST/HST on the fair market value of the property and claim an input tax credit for the GST/HST paid under Step 1. As the institution would be leasing the property to the purchaser, the institution would be eligible for a new housing rebate as a landlord under subsection 256.2(3) of the ETA. The rents would be GST/HST-exempt under section 6 of Part 1 of Schedule V. The supplies made in Steps 3 and 4 should be exempt under section 4 of Part I of Schedule V.

As outlined above, many more GST/HST issues must be considered under a Diminishing Musharaka.
with Ijara. The increased compliance obligations and costs risk making this product uncompetitive compared to a conventional mortgage product.

**Commodity Tax Changes Required**

From a GST/HST perspective, several rule changes are needed. In particular, the rules in the aforementioned sections must be reviewed, including the definition of “builder” found in subsection 123(1) of the ETA, the self-supply rules found in section 191 and the GST/HST new housing rebate rules.

**Additional Concern**

The land transfer tax (LTT) may also apply to the Diminishing Musharaka with Ijara. In Ontario, absent any provincial government relief, the transaction in Step 1 would be subject to LTT. The transactions under Step 3 and Step 4 would also attract LTT, although the legal title transferred in Step 4 probably would have only nominal value. Under Step 3, LTT would apply again and timing and valuation complications could arise due to the tiering of LTT rates, depending on value of the real property interest transferred. It is critical that the provincial tax authority view Step 3 as a “back-to-back” transaction and either amend the legislation accordingly or apply relief administratively on this basis. It is our understanding that this issue has been raised with the Ontario Ministry of Finance and is currently under review.

**SUKUK-AL-IJARA**

Conventional bonds are fixed income securities that promise the holder a specified set of payments. In effect, a bond investor lends money to the bond issuer in return for the issuer’s promise to pay interest and repay the principal on maturity. An Islamic “bond”, or Sukuk, is asset backed and the certificates represent an undivided share in the underlying asset. In contrast, a conventional bond is a debt security providing a right to income from the issuing entity. Conventional bonds and the Sukuk differ in the way they are structured and marketed. In the Islamic version of a bond, the issue is based on the exchange of a Shariah-compliant asset that allows investors to earn profits. Consider the following Shariah-compliant structure, a Sukuk al-Ijara:

- An obligor enters into a sale-leaseback arrangement using a Special Purpose Vehicle (SPV) for commercial real estate
- Certificates in the SPV are issued to investors who acquire a beneficial interest in the underlying asset sold by the obligor to the SPV
- Investors buy Sukuk certificates in the SPV, obtaining beneficial ownership in the asset that the SPV buys from the obligor.

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6 There is a Murabaha model for a residential mortgage that involves the ownership of the property being transferred twice in succession. It is understood that the Ontario government has previously granted Land Transfer Tax relief.
• The investors may choose to trade the Sukuk on a secondary market.
• A facilitator of the transaction may be paid fees for arranging the structure.

Income Tax Issues
From an income tax perspective, the taxation of this Sukuk-al-Ijara may be similar to a sale-leaseback transaction, from the perspective of the SPV and the obligor. As such, there are no unique income tax issues to resolve. If the transactions are determined in law to be a sale followed by a lease, the obligor should realize a gain or loss on the sale of the asset to the SPV and may be able to claim a deduction for the lease payments if they were made to earn income from a business or property.

If, on the other hand, the transactions are considered to be a loan arrangement in law, then a sale of property is considered not to have occurred, and the SPV and obligor are considered to be lender and borrower, respectively. In this case, the payments are treated as a combination of principal and interest for tax purposes. The Canadian tax authorities have indicated that the parties’ intent to enter into a loan arrangement is evident where the sales price of the property is substantially different from its fair market value.

Typically, an SPV is structured as a flow through vehicle so that the SPV does not pay any income tax. Where the transactions are considered a sale and leaseback in law, the investors are considered to receive either trust income or rental income, depending upon whether the SPV is a trust or a partnership. In both cases, the income from the SPV is fully taxed in the hands of the investors.

Issues may arise where the investors are non-residents. Under a conventional bond instrument, interest should not be subject to Canadian withholding tax when paid to arm’s-length non-residents, provided that the interest is not “participating debt interest.” However, depending upon the legal character of the transactions and of the SPV, an investor holding a beneficial interest in the underlying asset may be considered to be receiving rent on that asset. Payments of rent to non-residents are subject to 25% Canadian withholding tax on the gross amount, unless a tax treaty reduces the rate. Where the rent is in respect of real or immovable property in Canada, the non-resident may instead choose to file a Canadian tax return and pay Canadian tax on the net income from the property.

Alternatively, the investor may be considered to be receiving trust income. Trust income paid or credited to non-residents is also subject to 25% Canadian withholding tax, subject to treaty reductions. Accordingly, non-resident investors in a Sukuk-al-Ijara product could be at a disadvantage compared to investors in a conventional bond.

Income Tax Changes Required
A level playing field should be restored by changing the tax legislation to treat interest equivalents paid by the SPV to non-resident investors as interest.

Commodity Tax Issues
Under a conventional bond arrangement, GST/HST issues are relatively straightforward. Interest paid by an issuer to an investor is an exempt financial service for GST/HST purposes. Any services provided by arrangers or facilitators of the transaction must also be analyzed to determine if any related fees are taxable (e.g., advisory fees) or exempt (i.e., fees for arranging services).7

In the equivalent Shariah-compliant transaction, GST/HST could have a significant impact. GST/HST implications

7 CRA Policy Statement P-239, “Meaning of the term ‘arranging for’ as provided in the definition of ‘financial service’.”
could arise on the sale-leaseback between the obligor and the SPV, depending on the nature of the assets.

In this example, as the property is commercial real estate, GST/HST would apply. However, rather than selling shares, the SPV sells a beneficial ownership in the underlying asset, which would not be an exempt financial service. As the property is commercial real estate, GST/HST would apply to the sale of the beneficial interest to the investors.

Any rents paid to the investors would be subject to GST/HST. Any subsequent trading would also have GST/HST implications. Finally, any fees paid to arrangers or facilitators of the transactions would be subject to GST/HST as no exempting provision applies.

GST/HST would have a significant impact at each stage of the transaction. Where the SPV or investors are non-residents, particular care should be taken when determining which party accounts for the GST/HST on the real property transactions, under subsection 221(2) of the ETA (i.e., the initial sale and the sale of the interest to investors). Routine issues, such as triple-net leases and property improvements, would also have to be managed. Ultimately, the transaction creates considerably more GST/HST compliance obligations and costs for the obligor, the SPV and the investors, and potentially cash flow issues.

As this example involves commercial real estate, significant LTT could also arise. As with the Diminishing Musharaka with Ijara, there is a risk of multiple LTT applications, which could cause significant additional costs.

In short, even though a Sukuk is designed to give the same return as a conventional bond, the impact of GST/HST and LTT could make these structures unviable.

Commodity Tax Changes Required

Revisions to a number of GST/HST provisions in the ETA are required for a Sukuk to achieve a similar tax treatment to a conventional bond. One approach would be to have the provision of a Sukuk be considered a financial service, and thus GST/HST exempt, under the supporting definitions in subsection 123(1) of the ETA. This may require a new, stand alone definition or an amendment to an existing one (e.g., “financial instrument”).

TAKAFUL

Takaful, or Islamic insurance, is based on concepts of social solidarity, cooperation and mutual indemnification of the losses of policyholders. Takaful products must respect the guiding principles of Shariah law. Essentially Takaful involves the payments of contributions that are wholly or partly donations to form an insurance portfolio. These contributions may be split into two components: one to cover risk and one for investment purposes. The objective of the investments is not to make profits, but rather to mitigate losses. The pooled donations are then used to pay any claims when the insured risk occurs. A surplus that remains after the payment of indemnities and expenses is distributed among the participants. Conversely, the participants may be required to make additional contributions if there are losses in excess of the contributions made to date and investment return.

Broadly speaking, a Takaful arrangement is similar to a mutual insurance arrangement. The difference is that Takaful members are typically not shareholders/unit-holders in the Takaful company, which operates the arrangement for the Takaful members.

8 If the property is situated in Canada and the SPV or investors are non-residents, significant withholding tax issues could arise for income tax purposes.
The operator company is paid a fee for the services rendered (i.e., Wakala) and/or is entitled to a share in the return received on the fund’s investments (i.e., Mudaraba). Takaful includes general (e.g., property), family (e.g., life) and re-takaful.

**Income Tax Issues**

There do not appear to be any income tax issues applicable to such mutual risk sharing arrangements. The existing tax regime that applies to mutual insurance companies should apply to Takaful. However, consideration should be given to the potential different tax treatment of compensation paid to the Takaful operator company (i.e., Wakala vs. profit share). In addition, it is necessary to consider the possible tax issues relating to the Islamic financing alternatives in which the contributions are invested.

**Commodity Tax Issues**

Generally, the ETAs exempting provisions related to insurance premiums should apply to Takaful. However, specific definitions must be satisfied for the GST/HST exemptions for insurance to apply; in particular, the definitions of “insurer” and “insurance policy” in subsection 123(1) of the ETA. Therefore, the GST/HST treatment of Takaful will largely be driven by other regulatory provisions (e.g., does a Takaful provider meet the definition of “insurer”).

There are other issues related to a Takaful structure. For instance, there may be different commodity tax issues such as determining the GST/HST status of a fee charged by an operating company using a Wakala model with respect to the operating companies’ compensation, or a Mudaraba model whereby the operating company shares profits from investment activities (please see the previous comments on Mudaraba for this matter).

**MISCELLANEOUS GST/HST COMPLIANCE ISSUES**

A key question for any Islamic finance product supplier is whether it qualifies as a “financial institution,” as defined in section 149 of the ETA. This determination will govern the application of the ETA to the institution and its compliance obligations. Subsection 149(1) of the ETA lists the types of persons that would be considered a “financial institution,” including a bank, credit union, a person whose principal business is the lending of money and an insurer. The provision also sets out a de minimis test, which provides that persons generating revenues from financial services over certain thresholds are considered to be a financial institution.

It would be critical for an Islamic financial services provider to determine its treatment under other regulatory statutes. For example, if the provider was authorized under section 2 of the Bank Act, it would be considered to be a bank for ETA purposes and thus qualify as a financial institution under subsection 149(1) of the ETA. Likewise, if person is licensed or authorized to carry on an insurance business, the insurer requirement would be satisfied. Alternatively, unless the ETA is interpreted liberally, Islamic finance providers’ activities may not indicate that their principal business is lending money, since their transactions typically generate profits or rents in lieu of interest. Finally, the de minimis tests would not likely be satisfied as the tests are based on revenue generated from the provision of financial services, such as interest from loans or credit cards.

Again, a liberal interpretation of what constitutes a financial service would be required. Potential benefits could arise for Islamic finance providers that are not considered to be financial institutions. Under the ETA, financial institutions are subject to certain provisions principally focused on restricting input tax credits (ITC) (e.g., sections 185 and 200 of the ETA). These sections would not apply to the benefit of the Islamic finance provider. The proposed rules under section 217.1 of the ETA for financial institutions that import services from outside of Canada would not apply. The election under section 156 of the ETA would be available to help relieve cash flow. Finally, the provider’s compliance obligations would be lessened as it would not be required to file the Annual Information Return (GST 111). However, if the provider is captured within the definition of “financial institution,” it would ensure that the Islamic finance products and services provider does not benefit from a competitive advantage!

Other compliance issues may arise. For example, a financial institution having both GSTexempt and taxable activities must use a GST/HST allocation methodology to determine the extent to which GST/HST paid on inputs can be recovered. How would the additional transactions necessary to achieve a Shariah-compliant facility be treated for ITC allocation methodology purposes? Regarding loan facilities, how would the buying and selling of taxable goods affect a method? The asset transactions that underpin Islamic finance could potentially distort the results of the GST/HST allocation methodology, and would need to be carefully considered. Finally, fees are often charged for “arranging for” loans, and the GST/HST status of the financing element as exempt interest or taxable profit is critical for determining the status of these charges.

**Commodity Tax Changes Required**

Section 141.02 of the ETA should be reviewed to ensure the appropriate application to Shariah-compliant products.
**Income tax**

Many Islamic financial products involve the sharing of “profit” (e.g., a Mudaraba, a Sukuk). It may be unclear whether non-resident withholding tax applies to such sharing of “profit.” It may also be uncertain whether expenses incurred in lieu of interest are deductible. Accordingly, consideration should be given to amending the ITA so that any references to “interest” apply to gains or profits received, “alternative finance return” and expenses incurred in lieu of interest in transactions conducted in accordance with Shariah principles.

Islamic finance transactions often require an interest in an underlying asset and, thus, may involve the transfer of an asset. To the extent a portion of the gain realized by the finance provider upon the transfer of the asset (e.g., in a Murabaha transaction, where a finance provider purchases an asset for the customer and then sells it to the customer, almost immediately, for a profit) can be treated as remuneration for the deferral of payment and is comparable to interest on a conventional financial product, changes to the ITA to spread the taxation of the gain over the payment term should be considered.

Consideration should also be given to amending the definition of a “disposition” to exclude disposal of an asset pursuant to a financing transaction required solely for the purpose of complying with Shariah principles (i.e., to exclude a disposition strictly required for the sole purpose of complying with Shariah but that would not be required in any other financing transaction).

Islamic finance transactions that are viewed as partnerships often pose tax issues. Changes are required to ensure that associations established to enable Shariah-compliant investment are not considered partnerships for Canadian income tax purposes.

**Commodity tax**

The above analysis demonstrates the need for a thorough review of the federal GST/HST legislation and interpretive policy related to financial services, PST legislation of provinces that operate a retail sales tax, and other legislation, such as land transfer tax.

Definitions in several sections of the ETA must be reviewed to accommodate Islamic financial products. In particular, the definitions of “financial instrument,” “financial service” and “insurer” in subsection 123(1) of the ETA must be reviewed and amended where necessary, as well as the definition of “financial institution” in section 149 of the ETA. Arguably, if these definitions can be appropriately amended to include Shariah-compliant products, this would address many of the commodity tax issues for GST/HST purposes.

**General remarks**

Islamic financial products and services is a fascinating area with a real potential for growth, but a number of critical issues must be addressed, including the tax treatment of Shariah-compliant financial products and services. As this paper has demonstrated, an understanding of Islamic finance products and the resulting tax treatment can ensure that any potential issues that would place an Islamic finance at a competitive disadvantage or advantage compared to a conventional finance product can be addressed on a timely basis.

Experience shows that a collaborative approach between industry and the tax authorities is necessary to ensure an equitable tax treatment and the competitiveness of Islamic finance services and products. Other jurisdictions where the tax authorities have taken, or are in the process of taking, steps to ensure equitable treatment of these services and products offer useful precedents for Canada.
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