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Islamic Debt-Equivalents Take Center Stage

By Robert W. Wood and Rafi W. Mottahedeh • Wood LLP • San Francisco

Practicing in the modern world of international commerce sometimes requires the ability to understand and navigate surprisingly ancient legal codes. Islamic law is a prime example. *Shari'a*-compliant financial transactions are designed to comply with Islamic legal rules. Islamic finance isn't just entertainment for religious scholars, however. It's big business that is reshaping the global supply of capital.

In fact, Islamic finance is now more than a $1 trillion industry. There is $822 billion in Islamic finance debt alone. Many Islamic countries have excess liquidity and are on the lookout for legally acceptable investments.

Although reliable data is not readily available, the Financial Services Authority of the United Kingdom ("FSA") estimated in 2007 that there was more than £250 billion in ostensibly Islamic investments around the world. [FSA, *Islamic Finance in the UK: Regulation and Challenges*, 2007, at 7.] Considering that Islamic financial assets are close to surpassing the $2 trillion mark soon, the growth has been exponential.

Numerous jurisdictions have benefited from serving as hosts to these investments. In some cases, it means changing tax laws. Whether it is the United Kingdom in 2005, or more recently Luxembourg in 2010, many countries have been modifying their tax laws to accommodate *sukuk* (plural of *sak*) bond-equivalents to give them similar treatment to debt. As of 2008, the Islamic mortgage market in the United Kingdom had already surpassed the £500 million mark.

This vehicle of investment has proven to be so popular that many governments have issued or are considering issuing *sukuk* bond-equivalents to raise money for their national governments' borrowing needs. [Kashif Jahangiri, Abdel Hamid Attalla and Tony Urwin, *The rise and rise of Islamic finance*, 35 TPR 26, x2 (2008).] The United Kingdom has even begun a program of issuing sovereign

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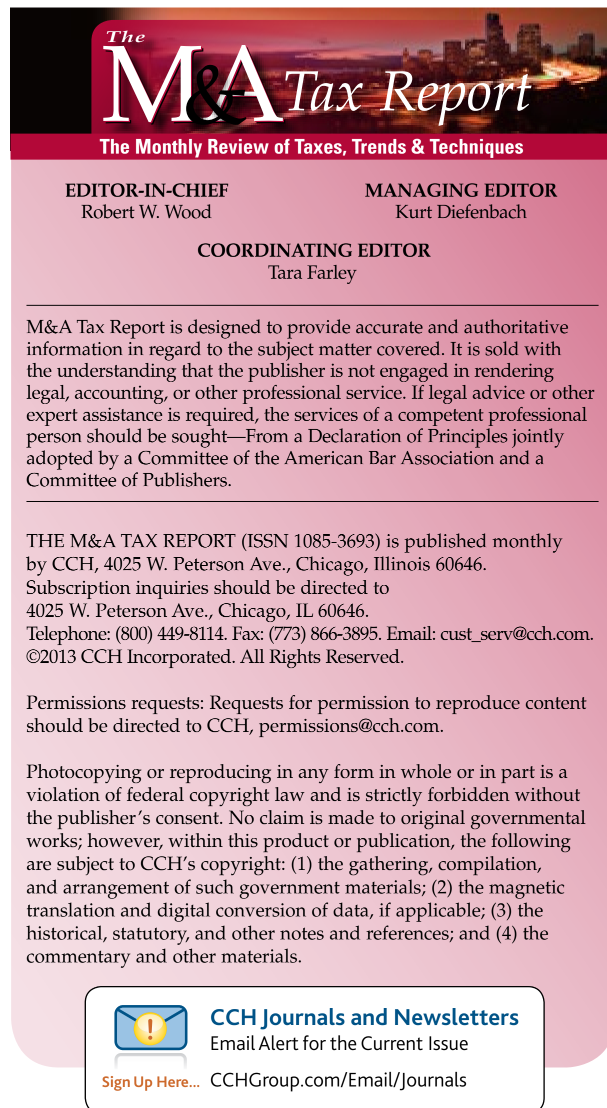
debt in the *sukuk* format. Beyond being an excellent vehicle for raising money, investors in *sukuk* bond-equivalents are often willing to accept lower rates of return. This further encourages borrowers to use these vehicles to access capital.

Now Global

The United Kingdom, Dubai and Malaysia are the primary hubs of Islamic investment products, but the United States is trying to play catch-up. As it does, the United States is hampered by a lack of clear rules for how these instruments should be taxed. The FSA in the United Kingdom began issuing regulations as to how Islamic investment products should be taxed in the early 2000s. [FSA, *Islamic Finance in the UK: Regulation and Challenges*, 2007, at 8.] Detailed regulations for the treatment of *sukuk* bond-equivalents were issued in 2007.



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Secondary sources of the type used by many tax and financing lawyers remain in short supply. A review of literature for practitioners is heavy in scholarly discussion of these financial products, but devoid of information on tax or practical implementation and application. This is especially true for the United States.

Investors from the Islamic world have competing desires and requirements when investing outside their borders. Many customary transactions in the world of "normal" finance are off limits to Islamic investors seeking to comply with Islamic law. Then, too, some work-arounds are terribly inefficient.

Some mechanisms allow the Islamic investor access to wider markets and financing, but many Islamic finance structures have negative tax consequences in the United States. Broadly stated, an investor seeking *shari'a*-compliant financial products does not want debt instruments. This is because interest is generally prohibited. Instead, the investor wants equity investments.

However, equity investments come with a high price. They are often too risky or have disadvantageous tax treatment. This is how debt-equivalents such as *sukuk*, came into being—especially for an investor who wants to take advantage of the portfolio interest exemption (as opposed to many forms of returns on equity). [Internal Revenue Code Section ("Code Sec.") 871(h).]

Hobson's Choice?

As one might expect, trying to have the best of both worlds is often not always possible, or even easy where it is possible. Hybrid entities, credit derivatives and what are essentially collateralized debt obligations represent attempts to have the best of both worlds for tax purposes. Nevertheless, these creative products have yet to be integrated (or in some cases simply cannot be integrated) into the world of Islamic finance.

Indeed, this is a difficult and wide-ranging problem. Islamic financial products may have negative tax consequences in the United States. Many national tax systems in the Islamic world further impede investments in non-Islamic instruments. Moreover, some Islamic investments are attractive to investors with purely financial objectives because of their

low-risk profile and performance during the recent financial crisis.

Three Rules of Islamic Finance

Any discussion of this topic must begin with a few ground rules, a set of rudimentary building blocks. There are three main prohibitions relevant to investments when making them "Islamic." First, and most obviously, the charging of interest (*riba*), or more broadly an unacceptable profit, is strictly prohibited.

The casual observer may focus on that most visible rule and be lulled into thinking that the other two do not matter. The second rule is that excessive risk (*gharar*) is forbidden. Third, gambling (*maysir*) is also disallowed. Gambling and excessive risk often blend together in many transactions. Naturally, there are numerous exhortations in Islamic finance, but these are given little attention compared to the three major prohibitions.

These issues can arise in all sorts of areas. For example, with synthetic derivatives, one has not "invested" money in the underlying reference obligation and therefore these transactions may be considered "gambling." Accordingly, financial institutions have found creative ways to produce equivalents of traditional finance. These are excellent products for some investors, but they are complicated, time-consuming, and often of dubious legality in the jurisdiction where they are created. [*See, e.g., Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd*, [2003] EWHC2118 (Comm), (Eng.).]

Dividends?

The classic method of Islamic debt-equivalents is where an individual or fund invests money in a business enterprise in return for a fixed percentage of profits and a variety of fees. The aggregate of the payments may be pegged to an amount that a more ordinary investor would simply regard as interest. This kind of recharacterization works well in many cases.

Nevertheless, it can be entirely inadequate if the Islamic investor is caught with dividends. After all, dividends may give rise to U.S. taxes on many investments. Many proposed alternatives, including all credit derivatives, are considered un-Islamic by most legal scholars.

Regardless, investors in the Islamic world desire to take part in international financial markets. As hedging and derivatives become near-necessities in the modern world of commerce, views are changing. [Andreas A. Jobst and Juan Solé, *Operative Principles of Islamic Derivatives—Towards a Coherent Theory World Bank* 4 (International Monetary Fund, Working Paper, Paper No WP/12/63, 2012).]

What can be done? One of the most popular alternatives is for an Islamic investor to contribute money in exchange for shares of a special purpose entity (SPE). The SPE then acts as a "hedge fund" of sorts investing in debt instruments. This is essentially the SPE which is well known in the world of debt-based securities.

The shares then pay a "dividend" based on the interest income earned by the SPE. In essence, a glorified collateralized debt obligation (CDO) is created, which references the interest income of the SPE. The CDOs that are created are usually single-tranche, as the groups of investors are often smaller and do not want to take on too much risk.

The SPE must be in a jurisdiction that does not tax such income or dividend payments. However, it must qualify for the portfolio interest exemption in the United States. Unlike most U.S.-source income, interest is generally not taxed by the United States when paid to a foreign person. This makes interest look particularly attractive to foreign investors.

Naturally, though, a focus on the desirability of interest creates a dilemma for Islamic investors. The "Islamic-ness" of this form of transaction is dubious, but it will often satisfy the not-so-pious investor in many situations.

Tax Troubles

Aside from Islamic law concerns, these securities raise the specter of tax issues. Not surprisingly, the tax and Islamic law concerns can work against one another. One obvious federal income tax goal is to take advantage of the portfolio interest exemption.

At the same time, the SPE must be designed carefully to avoid being engaged in the business of making loans to U.S. persons. [Reg. §1.864-4(c)(5)(i)(B).] Such activities can cause an SPE to resemble the activities of a bank. Thus, the SPE could fail to qualify for the safe harbor of the portfolio interest exemption related to lending transactions. Luckily, the SPE is often treated as closer to a foreign hedge fund, which still

gets to take advantage of the portfolio interest exemption. [Code Sec. 881(c).]

The SPE must scrupulously avoid originating loans, but at the same time allay the fears of the owners of the SPE that the loans acquired by the SPE comply with their goals. The line is still unclear as to how close the SPE can come to originating the loans. However, it is likely that some of these concerns will be addressed as the U.S. Treasury continues to issue and propose regulations on the tax treatment of foreign hedge funds. [*See, e.g.,* Dividend Equivalents From Sources Within the United States, 78 FR 73128 (Dec. 5, 2003).]

Other problems arise when organizations plan to create securities which are closer to equity investments. In some cases, the goal will be to allow investors to take advantage of the portfolio interest exemption. Generally speaking, even if debt does qualify as Islamic, it cannot be traded according to Islamic law.

Structuring *Sukuk*

In place of normal bonds are *sukuk* bond-equivalents. In essence, they represent a fancy method of securitizing sale-leaseback transactions. The beauty of *sukuk* bond-equivalents is that the lender or investor actually takes title to the property. As a result, the lender or investor can re-sell it subject to the lease (and hence re-sell the loan).

Such arrangements offer the potential for avoiding the rule against trading debt as one is selling and reselling the actual property. There are two methods commonly used by investors in *sukuk* bond-equivalents. One is for an individual investor to purchase a *sukuk* bond. Another is to invest in an SPE which has a number of *sukuk* bond-equivalents—thereby spreading risk over a larger pool of securities. [Craig R. Nethercott, *Istisna' and Ijara, in* ISLAMIC FINANCE OXFORD 233, 258 (Craig R. Nethercott and David M. Eisenberg, ed., 2012).]

An SPE transaction usually involves several steps. First, the investors put their money in an SPE. The SPE then issues investor shares. The SPE subsequently approaches a promoter that purchases assets from a borrower (which basically creates a security interest for a loan) and then leases them back to the borrower with an exercise price at the end of the lease period.

There are many forms of *sukuk*, but the sale-leaseback variety (*sukuk al-ijara*) is the most popular. The sale-leaseback variety can also accommodate the purchase of new property. Of course, in that case, the promoter will purchase the property from a third party and lease it to the borrower.

Lastly, the promoter sells the property to the SPE—transferring title and therefore not violating the Islamic rules on sale of debts. The function of the promoter in many jurisdictions is to prevent the SPE from being in the business of making loans or for regulatory reasons applicable to financial transactions. The leases are often quite long because the goal is to approximate a mortgage. Thus, while Islamic law strictly prohibits interest and therefore fixed interest rates, it is often considered to be acceptable to tie rental payments to a floating rate—*i.e.,* LIBOR.

A frequent issue to arise in tax planning involves the SPE taking title to the property. Unlike a typical mortgage, where the chattel or real property remains titled to the borrower, a *sukuk* involves the transfer of title to the SPE and then a leaseback to the borrower. Transfer taxes affect both the transfer to the SPE and the return of title from the SPE to the borrower at the end of the leaseback transaction.

This creates problems since the exercise price is often quite low (as that money is simply used to redeem the *sukuk* holder). Taxing authorities may not be used to or comfortable with a transfer occurring for what would appear to be an artificially low price at the end of a lease. This could involve the agreement being re-characterized as a sale disguised as a lease.

A re-characterization of this sort can have wide-ranging implications. For example, who should be entitled to the depreciation deductions? Depreciation is typically a function of title. This problem is two-fold. First, if the SPE is treated as making business profits (as opposed to interest) in the eyes of the IRS, a determination has to be made if it is entitled to take the depreciation deductions on the property to offset its gains.

Naturally, the question of beneficial ownership will arise. The multi-factor test in the seminal *Frank Lyon* case demonstrates exactly how difficult it is to determine which party has the right to depreciation deductions.

[Code Sec. 865(c); *Frank Lyon Co.*, SCt, 78-1 USTC ¶9870, 435 US 561 (1978).]

Second, if the LIBOR-linked rental payments are treated as true loan payments, depreciation deductions will not be useful to the SPE, because (1) it has acted as an overseas hedge fund and taken advantage of the portfolio interest exemption; (2) it is taxed on a gross basis and has useless depreciation deductions; and (3) one cannot depreciate a loan. Careful planning is required.

Where title of the property is treated as ownership rather than simply a security interest, investors will worry about being in an active trade or business or creating a permanent establishment in the United States. Such classification may allow the depreciation deductions but then still subject the rental payments to net taxation, often at a high rate. The question then becomes one of how active the SPE is in dealing with its U.S. properties.

It may have to resort to drastic measures, such as net leases and high-cost management, to avoid these problematic classifications. It may be advantageous for the SPE to elect treatment under net taxation if it involves real property. However, this would undermine the characterization as an interest equivalent.

The degree of connection becomes further complicated as the number of real property investments increase. After all, it can become increasingly difficult to argue that one is not in the trade or business of renting properties.

Conclusions

The issues with taxation of the most basic debt instruments, such as *sukuk* bond-equivalents, are virtually limitless. It is hard to evaluate them and hard to give assurances to clients. Plainly, consistent treatment by the IRS is not possible in the United States under the current tax regime.

Indeed, there is even discord among the different countries that already have created ostensibly consistent tax treatment for these investments. The United Kingdom's treatment of these investments is far different from that of the rest of the European Union. With such a modern complex and international legal environment, it is easy to forget that Islamic investments involve ancient legal rules.

Nevertheless, the ancient nature of the rules should not cause practitioners to shy away from familiarizing themselves with the requirements. In fact, Islamic finance will only grow in importance in the international financial world. One irony is that the Islamic world has sanctioned certain innovations in financial products.

In contrast, the United States, thought to be progressive and a market leader, has yet to update its tax rules to provide clarity for investments in these products. Given that many of the rules remain frustratingly unclear, careful planning is required on both the Islamic law and tax sides of the equation.