Taxation of Islamic Finance: Part I, *Ijara* and *Sukuk al-Ijara*

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Wood and Mottahedeh consider U.S. tax issues affecting Islamic finance. In particular, they examine the taxation of *sukuk*, one of the most popular sharia-compliant investment products. They suggest that treating *sukuk* as bond equivalents may be inappropriate in many circumstances.

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Islamic finance is a popular subject beyond traditionally Islamic countries. In the United Kingdom, sovereign debt can be issued in a *sukuk* format, a type of securitization that often resembles a bond. Large amounts of liquidity in the Arabian Gulf and Southeast Asia have entities and individuals around the world rushing to attract investors from these regions. This interest in Islamic finance is often accompanied by confusion and misinformation.

Even basic differences can be missed. For example, *marhaba, musharaka,* and *maslaha* all sound similar but have quite different meanings (hello, partnership, and public benefit, respectively). Eager practitioners may confuse *mudaraba* transactions with *murabaha* transactions. A *murabaha* transaction provides for a fixed return, while a *mudaraba* transaction is typically an equity-based investment similar to a partnership. However, one of the greatest misunderstandings involves *sukuk*.

Three Financial Taboos

Many in the finance and banking worlds regard *sukuk* (plural of *sak*) as a specialized category of bonds. This may cause tax practitioners to wonder how to handle the interest equivalent. Simplistic thinking produces simplistic answers — which are becoming increasingly dangerous given the many types of *sukuk*.[1]

Islamic finance has three main prohibitions that bar many traditional investments. An investor cannot make an unacceptable profit (*riba*), take or bear excessive risk (*gharar*), or gamble (*maysir*). The most well-known of these is the rule against making an unacceptable profit. This is often interpreted as a ban on interest, which it is. Yet *riba* also encompasses much more than interest and can include unduly high profit margins as well.

There are standard methods of determining whether an investment complies with Islamic law (sharia). Nonetheless, like much else in the religious and quasi-religious world, interpretations can vary. Moreover, if rules are to be bent, most scholars justify these deviations by arguing that the result is a public benefit (*maslaha*). If an investment is similar to a transaction commonly accepted in Islamic law, a scholar can reason by analogy as to its acceptability (*qiyas*). This complicated weighing of factors is accomplished by exerting independent legal reasoning (*ijtihad*).

Risk Shifting

Islamic finance requires risk sharing and bars excessive risk and gambling, which have been interpreted together as a ban on many forms of risk shifting. Several financial instruments, such as synthetic derivatives, are therefore disallowed. Thus, *sukuk* must always have identifiable, underlying assets. A corporate bond can be premised on the capacity of a corporation to repay it. In contrast,

[1]Notably, many types of *sukuk* can be pure equity investments. This article deals with *sukuk al-ijara*, the most popular form of *sukuk*.

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sukuk would have to be linked to some specific corporate asset, such as an office building.

The bar on risk shifting in Islamic finance also prevents the creation of different levels of risk from the same investment pool. Therefore, all *sukuk* are single-tranche. Recently, exceptions have been made to this rule for reinsurance and retrocession (re-reinsurance), but single-tranche remains the norm for financial instruments.[2]

With all of the exhortations and prohibitions, most investments must be examined by a sharia scholar (*mujtahid*). A *mujtahid* is generally a scholar of Islamic law who has received a classical Islamic education. Many financial institutions will even have a sharia board composed of several *mujtahidun* (plural of *mujtahid*). As one can imagine, there is a large degree of ''shopping'' for a *mujtahid* willing to give a favorable opinion. This is further complicated by the fact that there are different ''schools'' of Islamic law, so what may be acceptable in Malaysia might be prohibited in Saudi Arabia.

Ijara

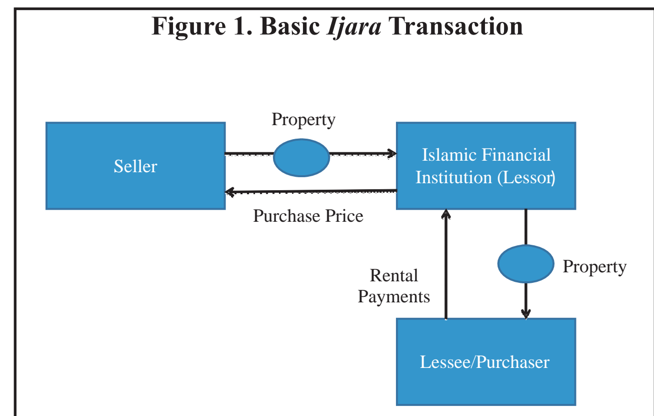
The most common form of *sukuk* is *sukuk al-ijara* (often referred to as *ijara sukuk*). These are often designed to produce debt equivalents, as the *sukuk* will be a securitization of a series of *ijara* transactions. But treating them as debt equivalents across the board is a mistake. Before delving into *sukuk*, the underlying transactions must be understood.

An *ijara* transaction in its most basic form uses leases. The legal fiction is that rental payments are profits, not a return of capital and interest. The Islamic financial institution will purchase from one person something requested by another and lease it to them. In some cases, it can also take the structure of a sale-leaseback.

The rental payments will often be tied to a rate such as LIBOR. One inquiry at the outset may be whether the rental payments represent principal and interest or simply rental income. True leases generally produce rental income,[3] which is subject to tax by the United States even when paid to a foreign investor.[4]

In contrast, leases that are in fact financing a sale are typically treated as loans. The criteria for determining whether a lease should be treated as a loan are complex. They generally include the economic reality of a transaction and what benefits and burdens have been transferred.[5]

Figure 1. Basic *Ijara* Transaction



In a true lease, the lessor can depreciate the property.[6] The lessor bears the risk and reaps the reward if the property increases or decreases in value when it is retaken at the end of the lease.[7] Sometimes, however, an *ijara* transaction includes an option to purchase at the end of the lease, termed an *ijara muntahia bi-tamleek*.

Form matters in Islamic finance. Islamic law usually does not allow a sale to be in a lease contract itself. Therefore, the lease will be separate from the agreement to sell the property in the future at a fixed price. An *ijara muntahia bi-tamleek* more closely resembles a mortgage, as the lessor merely holds title as security.[8]

Nevertheless, an option to purchase at the end of a lease does not necessarily mean the lease will be treated as a loan for federal income tax purposes. The challenge of Islamic finance transactions is obtaining appropriate and advantageous tax treatment while satisfying religious constraints at the same time. U.S. tax advisers are well versed in the sale-lease dichotomy.

Thus, when there is an option to purchase at the end of the term, the IRS and courts ask whether it is economically certain that the option will be exercised.[9] If the purchase price at the end of the lease is nominal, the leasing transaction will typically be

[2]For a discussion of Islamic rules for reinsurance, see Mohammed Burhan Arbouna, ''The Operation of Retakaful (Islamic Reinsurance) Protection,'' 15 *Arab Law Quarterly* 335 (2000).
[3]Section 61(a)(5).
[4]Section 861(a)(4).

[5]Rev. Proc. 2001-28, 2001-1 C.B. 1156; *Levy v. Commissioner*, 91 T.C. 838 (1988).
[6]Reg. section 1.167(a)-4.
[7]Rev. Rul. 55-540, 1955-2 C.B. 39.
[8]*See, e.g., First American Nat'l Bank v. United States*, 467 F.2d 1098, 1101 (6th Cir. 1972) (holding that a bank was not the tax owner of bonds when title was held as security).
[9]*See, e.g., Northwest Acceptance Corp. v. Commissioner*, 58 T.C. 836 (1972).

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treated as a sale.[10] Until recently, the IRS was hostile to the idea of fixed purchase prices at the end of equipment leases.[11]

Moreover, a lease without an option to purchase can still be considered a sale if the duration of the lease covers the entire useful life of the property.[12] With a loan in the form of a lease, the incidents of ownership are transferred to the lessee.[13] The lessee can depreciate the property and enjoy the benefits of any increase or decrease in value at the end of the lease. The lessor may treat a portion of the payments as a return of capital and interest, which should shelter payments from tax under the portfolio interest exemption.[14]

How the interest accrues for tax purposes remains unanswered in many cases. Should the ''lease'' be amortized like a mortgage when the first payments are primarily interest? This may not be a major concern if the interest qualifies for the portfolio interest exemption because a foreign investor is unlikely to be liable for U.S. taxes on either interest or a return of capital.

Even if the *ijara* transaction is properly treated as a lease for U.S. tax purposes, the tax treatment of lease payments is not simple. For example, section 467 applies complicated and often punitive rules to leases when total payments under the lease exceed $250,000,[15] including rent-leveling.[16] An *ijara* transaction that is in the form of a sale-leaseback could be ensnared in the section 467 rules.[17]

An Islamic finance transaction such as an *ijara muntahia bi-tamleek* may still avoid characterization as debt if there is no investment by the lessee. For U.S. tax purposes, the taxpayer must have an amount at risk to be considered the owner of real estate[18] or personal property.[19] This typically entails an upfront investment. The Islamic financial institution, as the putative lessor, should have a sufficient investment in the property, having paid cash for it.

The larger question involves the lessee, who in many cases wants to be treated as the owner/mortgagor. If the lessee does not make a down payment or assume personal liability for nonpayment of the lease, it may not qualify as the owner. The vast majority of case law is focused on whether the lessor's investment is sufficient for it to qualify as an owner.[20]

Important questions, such as what the applicable standard is for the lessee to be treated as the owner/mortgagor for tax purposes, may be left unanswered. It is common to receive 100 percent financing, which rekindles the old debt vs. equity debate.[21] If the lessee in an *ijara muntahia bi-tamleek* transaction is not considered the owner for tax purposes, the Islamic financial institution or special purpose vehicle (SPV) holding the properties could end up receiving rental payments. A party expecting not to pay any U.S. tax (because the return of capital and interest qualifies for the portfolio interest exemption) may be quite unhappy with rent (which is fully taxable).

Depreciation can also be a surprisingly difficult issue. Substance, not form, controls for U.S. tax purposes. However, when form and substance diverge, consistent classifications are difficult. Moreover, some circuits believe that a taxpayer may not disavow the form of its transaction,[22] which may pose a problem for leases designed to approximate loans.

Names given to legal instruments are not necessarily determinative for federal income tax purposes. Nonetheless, instruments that do not take the form of debt are rarely recharacterized as debt.[23] The IRS has ruled that in some cases, equity can

[10]Rev. Rul. 55-540; *United Circuits v. Commissioner*, 70 T.C.M. 1619 (1967) ($1 purchase option).

[11]*Compare* Rev. Proc. 75-21 (now obsolete) *with* Rev. Proc. 2001-28.

[12]*See, e.g.*, *Helvering v. Lazarus & Co.*, 308 U.S. 252 (1939) (taxpayer-lessee with 99-year lease had the right to depreciation deductions on the property).

[13]Notably, substance — not form — controls in determining whether there is a lease. *See, e.g.*, *Estate of Thomas v. Commissioner*, 84 T.C. 412 (1985); *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975); *Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221 (1981).

[14]Sections 871(h) and 881(c).

[15]Section 467(d)(2).

[16]Section 467(b).

[17]Section 467(b)(3)(A).

[18]*Franklin Est. v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

[19]*Bolger v. Commissioner*, 59 T.C. 760 (1973).

[20]*See, e.g.*, Rev. Proc. 2001-28 (lessor should make a minimum investment of 20 percent of the purchase price in the property); *Larsen v. Commissioner*, 89 T.C. 1229 (1987) (lessor's 15 percent investment was sufficient to qualify as owner); *Sanderson v. Commissioner*, 50 T.C.M. 1033 (1985) (lessor's 1.69 percent initial equity in real property was sufficient).

[21]*See PepsiCo P.R. Inc. v. Commissioner*, T.C. Memo. 2012-269. *Compare NA General Partnership et al. v. Commissioner*, T.C. Memo. 2012-172 (citing *Hardman v. United States*, 827 F.2d 1409, 1412 (9th Cir. 1987), for a similar 11-factor test in the Ninth Circuit).

[22]*Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).

[23]*PepsiCo P.R. Inc. v. Commissioner*, T.C. Memo. 2012-269 (holding for the taxpayer that instruments treated as debt in the Netherlands were equity for U.S. federal income tax purposes). *But see Hewlett-Packard Co. v. Commissioner*, 103 T.C.M. 1736 (2012) (an instrument that took the form of equity was recharacterized as debt in a case involving foreign tax credit planning).

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exist even when the instrument promises to pay a sum certain in a fixed duration.[24] Instruments that take the form of equity (or as something other than debt) are generally respected as equity (or as non-debt) unless they have very strong debt-like features or are issued in connection with tax-structured transactions.[25]

Of course, if a lease is a true lease, the lessor can depreciate the property. The lessee can deduct rental payments as an ordinary and necessary expense.[26] Similarly, if the lease is actually a loan, the lessee can depreciate the property and deduct the interest as an ordinary and necessary expense.[27] Yet simply treating all *ijara* transactions as mortgages is far too simplistic.

A Lack of Congruence

Matters become more complicated when trying to bridge the accounting/tax divide in connection with leases. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has developed flexible and intelligent accounting rules that make substance paramount and allow tax and accounting treatment to be closely aligned.[28] Most of the world uses the well-known international financial reporting standards (IFRS) issued by the International Accounting Standards Board.

The IFRS rules have also adapted well to *ijara* transactions, although differences remain between the AAOIFI and IASB rules. The United States, by contrast, uses generally accepted accounting principles, which in fact are not generally accepted at all in the realm of Islamic finance. Fortunately, the SEC and others have set a goal of transitioning the United States to the IFRS and have been working on convergence with the IASB.[29]

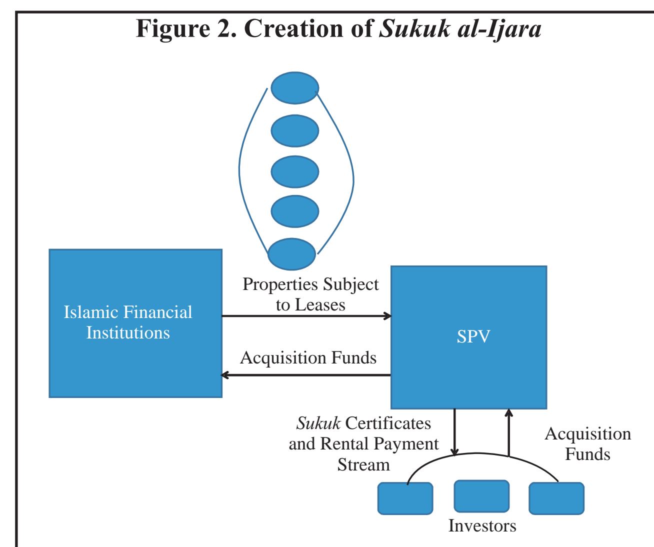
Until that actually occurs, however, the differences between systems of accounting make it harder to obtain consistent treatment in the United States and Europe, even though tax should not necessarily follow accounting.

Sukuk

Although *sukuk* transactions are the principal topic in most recent discussions regarding Islamic finance, the creation of *sukuk* is the final stage in a complicated process. In fact, the taxation of *sukuk* is more a question of the taxation of the underlying investments. The recent financial crisis showed just how mistaken the assumption that securitizations produce debt instruments is.

In a typical *sukuk al-ijara*, a group of investors fund an SPV. Properties leased in *ijara* transactions are gathered and then sold or transferred to an SPV by the financial institution originating these leasing transactions. The SPV issues the *sukuk* certificates, which are ownership shares of the underlying properties. The *sukuk* holders receive a steady stream of income, which is considered a profit for Islamic purposes.

Figure 2. Creation of *Sukuk al-Ijara*



Because of this hypothecation, *sukuk al-ijara* may actually hold interests in properties subject to true leases and properties subject to leases treated as loans. Moreover, many leases fall somewhere between these two poles. If the holders of the *sukuk* certificates are receiving interest payments, the *sukuk* certificates will likely have to be in registered form to take advantage of favorable tax treatment for interest.[30] However, it is unclear how ''mixed'' *sukuk* should be taxed.

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[24]*See, e.g.*, LTR 201128008 (holding that preferred stock that was mandatorily redeemable on a specific maturity date and that was supported by a liquidity facility qualified as equity for federal income tax purposes).

[25]*See TIFD III-E Inc. v. United States*, 666 F.3d 836 (2d Cir. 2012) (partnership interests of foreign tax-exempt banks recharacterized as debt rather than equity in a highly tax-structured financial transaction).

[26]Section 162(a)(3). Note that section 162(a)(3) only allows the deduction of rental payments for property ''which the taxpayer has not taken or is not taking title or in which he has no equity.''

[27]Section 163(a).

[28]*See* AAOIFI Financial Accounting Standard 8.

[29]*See, e.g.*, Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards, June 24, 2010, *available at* http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176156953931.

[30]A passthrough or participation certificate for an interest in a pool of mortgage loans must be in registered form, which can be assumed to apply by analogy to *sukuk*. Reg. section 1.163-5T(d)(1).

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Regardless of whether the lease is a true lease or a lease treated as a loan, there are tax differences based on whether the underlying property is real property, tangible personal property, or intangible property (such as patents). In the rush to conclude that *sukuk* are simply approximations of bonds producing interest, a tax adviser may go astray.

If the SPV is comprised of real property subject to ''leases,'' other international tax issues may present themselves. Owning loans presumably does not mean that an investor has a Permanent Establishment or active trade or business in the United States. However, rental property can bring about both classifications.[31] Rental income is taxed regardless of whether it is paid to a foreign or domestic person,[32] whereas interest income is typically not taxed when paid to a foreign person.[33] If an investor has an active U.S. trade or business (for non-treaty partners) or a PE (for treaty partners), it will be subject to net taxation.

Another major concern for investors is whether taxes are creditable. The United States gives tax credits for foreign income taxes only. VAT, wealth taxes (such as those in Saudi Arabia), and transfer taxes (often termed stamp duty taxes) are not creditable for U.S. income tax purposes.[34] With the numerous transfers incident to these leases, especially the *ijara muntahia bi-tamleek*, transfer taxes can be a major expense. How they are deducted from the ''profits'' of the SPV and their effect on *sukuk* holders can vary depending on numerous factors.

Conclusion

To remain competitive, the United States should take action on *sukuk*, or at a minimum, *sukuk al-ijara.* Finding a way to accommodate these instruments is in the best interest of investors and capital markets. The United States remains the only major developed economy that fails to provide any useful information on how these instruments should be taxed.[35]

In many cases, a conventional financial vehicle such as a real estate investment trust could be used instead of *sukuk*. Although Islamic finance is gaining traction with investors, overuse of *sukuk al-ijara* may result from forcing comparisons with products designed for other markets. That may lead to uncertainty and at least some parties ending up disappointed.

The tax treatment of payments made to the holder of a *sukuk* certificate depends largely on the underlying transaction. Frequently, it is an *ijara* transaction. This is a key point. By rushing to reach conclusions on the taxation of *sukuk*, some investors fail to recognize that *sukuk* are merely securitization or pooling transactions. *Sukuk al-ijara* are often very similar to bonds and are arguably comparable to REITs and real estate mortgage investment conduits as well. However, just because an instrument resembles a bond, REIT, or REMIC does not mean it is a bond, REIT, or REMIC.

Like other jurisdictions, the United States should find a way to harmonize its tax rules with the unique needs of the Islamic segment of investment and financing markets. Hopefully, it will help to resolve confusion rather than add to it. Given the growing importance of Islamic finance, U.S. interests would benefit from clear guidance.

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[31]Notably, however, the SPV must behave like a foreign hedge fund and avoid being involved in the actual *ijara* transactions. Failing to do so could bar the SPV from receiving the portfolio interest exemption. Reg. section 1.864-4(c)(5)(i)(b).

[32]Section 61(a)(5).

[33]Sections 871(h) and 881(c).

[34]Sections 901(b) and 901(m)(5).

[35]*See*, *e.g.*, Guidance Notes on the Tax Treatment of Islamic Financial Transactions, Oct. 2010, Office of the Revenue Commissioners (Ireland), *available at* http://www.revenue.ie/en/practitioner/tech-guide/guidance-notes-islamic-finance.pdf; deemed loan relationships: alternative finance: investment bond arrangements: tax treatment of 'bond assets,' CFM44240, HM Revenue and Customs (U.K.), *available at* http://www.hmrc.gov.uk/manuals/cfmmanual/cfm44240.htm.

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