Operating in a dual regulatory and financial system, coupled with the distinctive nature of its contracts and law, the Islamic financial industry needs innovative tax neutrality for the purpose of a level playing field in lieu of tax incentives. While the former is something that is a necessity for sustainability and competitiveness, the latter is something that is nice to have.

Countries such as France, Kenya, Nigeria, Indonesia and Hong Kong are amending their laws to introduce tax neutrality to facilitate Islamic financial products in their jurisdictions. In April 2009, France overhauled its tax laws to facilitate Islamic financial transactions such as Murabahah and Sukuk. In the UK, tax laws have been changed to eliminate multiple stamp duty land tax (SDLT) charges in the acquisition of real estate under diminishing Musharakah and Murabahah arrangements. Double SDLT relief was also extended to partnerships and companies.

This paper seeks to present a micro view of taxation matters in Musharakah Mutanaqisah (MM) transactions in a global Islamic financial hub like Malaysia. Since this hybrid product is naturally a better alternative to Bai Bithaman Ajil (BBA) in home financing, there is a need to explore the taxation intricacies. The processes of MM are depicted in the diagram below.

Essentially, MM involves an unincorporated partnership between a bank and a customer for acquiring property. However, in practice, MM is deemed to be a financing venture in substance. This may be due to the fact that a partnership needs to submit annual partnership returns for income tax purposes, which will increase the transaction costs.

The bank’s ownership shall be recognized if ownership of the financed property is both in substance and form. Thus, any memorandum of transfer will be separately adjudicated as it will not be deemed as a transfer by way of charge. In this regard, central bank guidelines require the applicants to state the economic effect that the scheme intends to achieve (such as structured to have the economic effect of a term loan, project financing or home mortgage), for a clearer distinction or whether it overlaps with conventional products.

MM can be financially engineered to have an amalgam of economic effects. It can be either financing, partnership equity participation or both. In the books of most banks, MM is treated as financing, classified as “Musharakah financing” and not truly recognized as “investment”. Hence, banks take the function of a pure financier without any underlying economic interest as an equity holder (partner).

According to the International Accounting Standards Framework, “if information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form”.

From a Fiqh viewpoint, emphasis should be given to the essence and objective (Maqasid) of the transaction, not the words or the form. Based on Sami Al-Suwailem’s “principle of consistency” for financial engineering, the form and substance of Islamic products must be consistent with each other; that is, form should serve substance, and means should conform to ends. Nevertheless, the form of partnership here does not serve the substance of financing.

As an unequal level playing field will be created, effect is given to the form over substance for public interest (Maslahah) purpose by taking into account extenuating circumstances (rukhshah). Here, an economic benefit shapes the legal landscape, and not vice versa. The financier may still take the role of equity partner in addition to financier depending on the variety of economic purpose and types of financing products.

MM structure for home financing

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**Notes:**
- The initial deposit/down payment made by Customer will be his contribution towards the Musharakah venture while Bank’s contribution will equal the financing amount.
- Lease rental paid by Customer will become “Distributable income” of the Musharakah partners.
- Rental paid by Customer will be distributed in accordance to the prevailing shareholding at the point the rental is received.
- Bank’s portion of the rental income is similar to a financing profit earned by the Bank.

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Page 18 7th August 2009
Musharakah Mutanaqisah in Malaysia: A Taxation Perspective (continued)

In terms of income treatment, income received by the bank whether in the form of lease or sale should be treated as normal and one single business source. The MM rental income from home financing structure and the profit sharing amount from corporate/business financing structure will be treated as "interest" for tax purposes under Malaysia’s Income Tax Act. The same approach is also taken by the UK. However, the law provides that any disposal of an asset or lease under Shariah compliant financing is excluded for tax purposes.

In characterizing an arrangement or a profit element for Malaysian tax purposes, there are interesting attributes that need to be scrutinized, such as:

- The intention of the parties entering into the arrangement.
- The level of risk taken by the investor.
- The rate of return to the investor, and whether the effective return is “contained”.
- Pre-agreed disposition of the relevant assets by the special purpose vehicle (SPV) back to the user of the Islamic product at the maturity of investment.
- Pre-agreed time line for the Islamic venture as opposed to an open-ended investment.

There are exemptions from stamp duty when a financing structure like MM entails additional instruments or documents which are strictly required for the purpose of Shariah compliance but which will not be required for any other schemes of financing. This is to provide a level playing field between Islamic and conventional transactions in tandem with the “no worse off” principle.

Comparisons with the conventional transactions are in two categories — property with title and property without title — in three stages:

- Sale and purchase.
- Loan/financing.
- Expiry of loan/financing.

At the sale and purchase stage, for transactions which entail property with title in the customer’s name, the customer needs to transfer ownership to the bank as trustee in MM. This memorandum of transfer is an additional document/instrument vis-à-vis a conventional loan transaction. During the second stage, there will be ad valorem charges (0.5% of total financing) on the Ijarah lease agreement in MM. By contrast, only a nominal sum of RM10 (US$2.85) will be levied on the memorandum of charge in the case of conventional loan arrangement. At the end of the financing, a substantial sum of ad valorem charge on the memorandum of transfer back to the customer in MM will give the conventional arrangement the edge as there is no stamp duty in the latter scenario.

In the case of property without title at the expiry of financing, ad valorem duty will be charged on the deed of assignment and memorandum of transfer in MM. However, the aforesaid issues have been resolved in light of tax neutrality. The embedded purchase undertaking (Waad) is also deemed to be the secondary or collateral instrument, attracting only nominal stamp duty.

In the case of MM refinancing, the memorandum of transfer — executed in the name of the bank as a registered owner if refinancing is to the bank, or in the name of the customer if refinancing is to another bank from the originating bank — is treated as a secondary instrument in the form of charge and hence subject to a nominal stamp duty.

This again is a form over substance effect for the purpose of tax neutrality whereby the MM refinancing is treated as a financing product and the bank’s ownership is merely to accommodate the provision of such financing. While the UK is still grappling with the issue of capital gains tax on property refinancing which causes unequal treatment for Islamic finance, Malaysia scrapped its capital gains tax on property in 2007.

Since the Malaysian High Court’s prohibitive judgment on BBA in July 2008, there has been some shift away from BBA. Towards the end of 2008, RHB Islamic Malaysia, for example, completely phased out BBA in favor of the MM concept for its home financing products. However, there remains a resolvable issue of converting from ongoing Shariah compliant financing like BBA to another product like MM as there is neither tax neutrality nor stamp duty exemption as of right. That said, stamp duty exemption may be sought.

As perplexing as it may be, perusal of a sample MM co-ownership agreement in Malaysia indicates that “the customer shall pay 100% of the amount of all taxes due in relation to or associated with the property, notwithstanding the customer being the partial owner of the property until the end of the co-ownership”. This unequal position is further aggravated by clauses relating to “expenses” in the form of stamp duty whereby “the customer shall pay all stamp, documentary and other similar duties and taxes to which the agreement or any related documents may be subject and shall fully indemnify the bank...” These provisions have been inserted in view of “the customer having the exclusive right to occupy, possess, use and enjoy the property”. While this complies with the letter of partnership, it is doubtful whether it serves the spirit.

While the call for broadening the diminishing shared ownership rules to allow a bank to participate in property growth is welcome, a property should be valued only when there is a sale of the property resulting in full transfer of ownership. Otherwise, the appreciation or depreciation of value would only be on paper. After all, at the end of MM, any price appreciation would belong to the customer who has acquired the full ownership over time. To allow banks to enjoy the upside growth in value is to allow for a reciprocal assumption of the downside risk, which many Islamic banks have abstained from in light of risk management issues.

According to the Islamic Financial Services Board’s Capital Adequacy Standard, institutions offering Islamic financial services (IIFS) are also subject to the risk that the value for which the client buys the share of the IIFS may be less than the amount invested because the value of the Musharakah assets has decreased. This is a form of equity exposure not held for trading purposes, and as such will be treated using the Basel II approach for “equity exposures in the banking book”.

Moving forward, with increased internationalization of cross border flows, participation in international Islamic financial markets, and expansion in new jurisdictions, tax mismatches in foreign jurisdictions with different tax laws would warrant the inclusion of special clauses into double taxation agreements for investment protection and business accommodation.

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