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FISCAL HINDRANCES AND THE ITALIAN WAY OUT



Summary

- The state of the art
- The fiscal hindrances
- European solutions
- *Sukuk's* structures
- The Italian way out



1. THE STATE OF THE ART

Despite the fact that in Europe the interest for Islamic finance is growing for several years now - due to its financial safety and ethical reasons - **in Italy the growth and development of the Islamic branch is still in its early days.**



- *Sharia* compliant assets represent approximately 2% of the global international financial assets;
- as set forth in *Standard & Poor's* reports, in 2018 the value of those assets will be around 3 trillion dollars;
- 350 Islamic banks or banks with a specialised branch, over 250 investment funds following the Koran's principles, over 100 issuers (corporate or public) of Islamic bonds;
- according to the ECB, in Italy Muslim's savings are around 6 billion dollars.



The continued growth and development of Islamic financial instruments also requires **support from parallel developments in domestic legal and regulatory framework.**

The current Italian legislation does not provide for these new ways of investment, making the **attraction of the Arab capitals difficult.**

Financial instruments and agreements considered *Sharia* compliant aim to pursue the same economic results of the equivalent conventional instruments, but they require more complex structures which, currently, **are not fiscally competitive.**



2. THE FISCAL HINDRANCES

Islamic finance main principles and restrictions:

- **interest payment** is forbidden (*riba*);
- any agreement that has a significant part of **uncertainty** (*gharar*) or **speculation** (*maysir*) will be considered as invalid;
- preventable **ambiguities and faults** in the terms of the contract are forbidden;
- any **income from unlawful** (*haram*) **activities** (e.g. gambling, alcohol) should not form a part of an Islamic investor's portfolio;
- any financial transaction should be **asset-based**;
- **equal wealth distribution**.



The problem:

The variety of prohibitions entails a double taxation on Islamic transactions - if compared to the equivalent conventional ones - due to their structure which is necessary to ensure the compliance with the Koran's principles .

The Italian legislation does not totally prevent *Sharia* compliant transactions, but it entails an ongoing reference to our fiscal principles, with the effect of increasing the uncertainty, discouraging the investments and foreclosing the tax revenue.



3. EUROPEAN SOLUTIONS

Several European jurisdictions have already developed their fiscal and a regulatory systems in order to permit and attract *Sharia* compliant transactions:

- ✓ United Kingdom;
- ✓ France;
- ✓ Ireland;
- ✓ Luxemburg.



United Kingdom

- First jurisdiction to adapt its tax laws and regulations;
- tax regulation is based on the transaction's substance - > *“no obstacles, no special favors”* principle;
- the **regulatory action** (including Finance Acts from 2003 to 2007 and the Corporate Tax Bill issued in 2009) created a positive operational environment for Islamic finance transactions, by treating them as *alternative finance arrangements*.



France

- The *Bourse de Paris* has reserved a specific market segmentation to *sukuk*.
- There have been issued **four tax laws** - concerning *Murabaha*, *Ijàra* and *Istisna'* agreements as well as *sukuk* - pursuant to which Islamic finance transactions shall be fiscally treated as conventional ones.
- «*substance over form*» principle.



What is necessary?

- National level:

- ✓ identify interpretative guide lines to harmonise our domestic legislation;
- ✓ provide *ad hoc* tax regulation;

- International level:

- ✓ harmonisation of domestic law in order to prevent international double taxation.



4. *SUKUK'S* STRUCTURE

There are two types of Islamic banking and finance contracts:

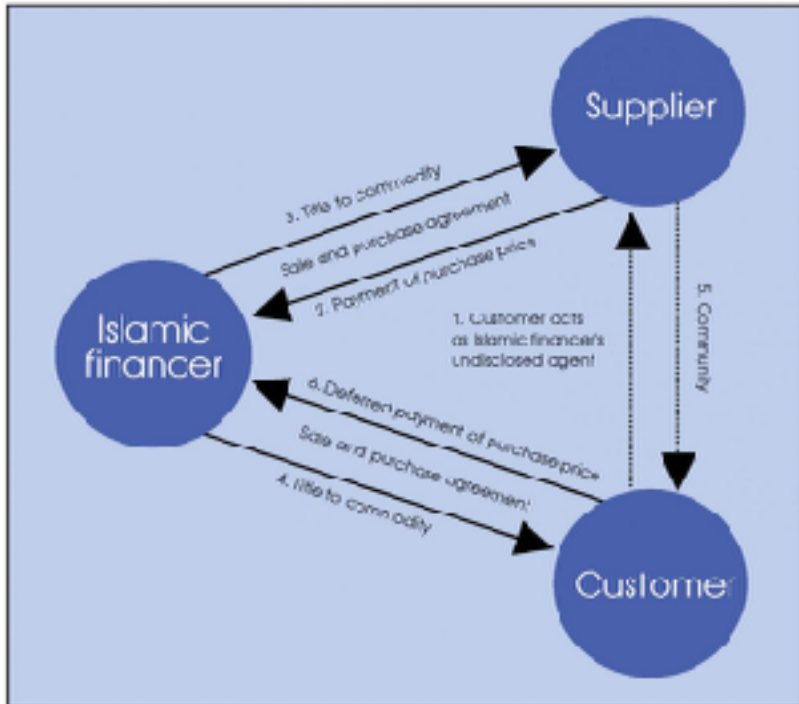
- **profit-loss sharing** contracts;
- **non-PLS** contracts: goods and services exchange applying a mark-up on selling price.



The most commonly used contracts are:

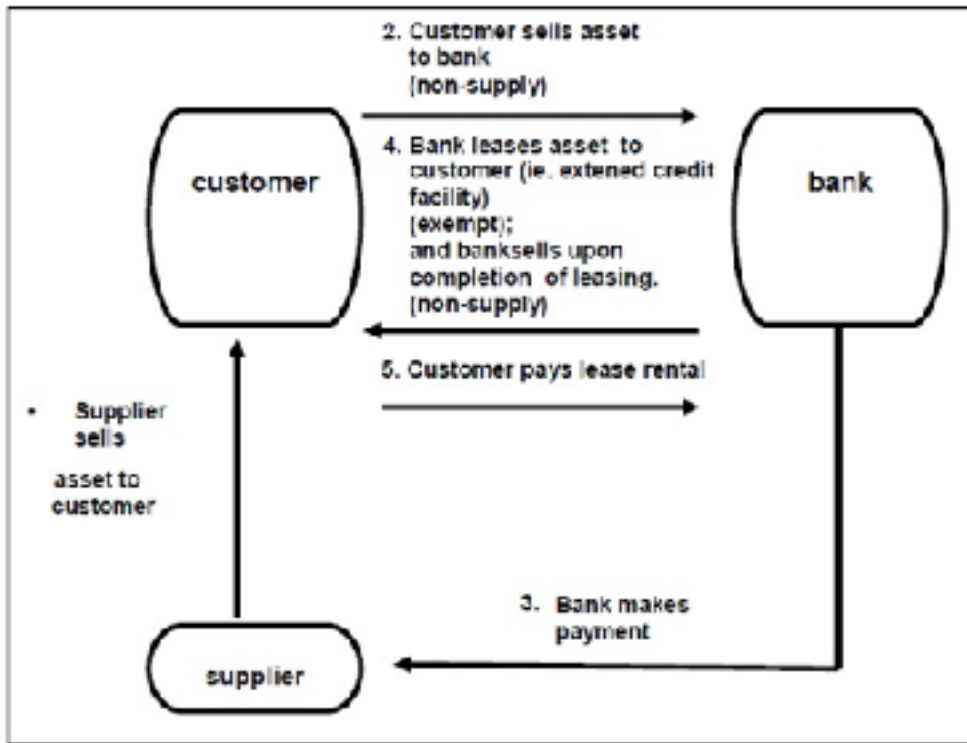
- ***Murabaha***: cost-plus financing contract which substitutes **Italian unsecured and mortgage loans**. It is a contract of sale between the bank and its client for the sale of goods at a price plus an agreed profit margin for the bank. The contract involves the purchase of goods by the bank which then sells them to the client at an agreed mark-up. Repayment is usually in installments.
- ***Ijarah***: is an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred. It is essentially of the same design as an **installment leasing agreement**.





- **Italian civil law:** two purchase agreements or a contracting agreement and a purchase agreement.
- **Italian tax law:** two different transactions which are to be individually taxed (especially for indirect taxation).





- **Italian civil law:** a purchase/contracting agreement and a lease agreement;
- **Italian tax law:** two different transactions which are to be individually taxed (especially for indirect taxation).



Main features:

- ✓ **purchased/leased goods:** tangible or intangible assets (other than money and any currency) or any lawful activity under Koran's principles;
- ✓ selling price, repayment plan, profit margin, commission, etc. must be **clearly stated** at the time of the sale agreement.

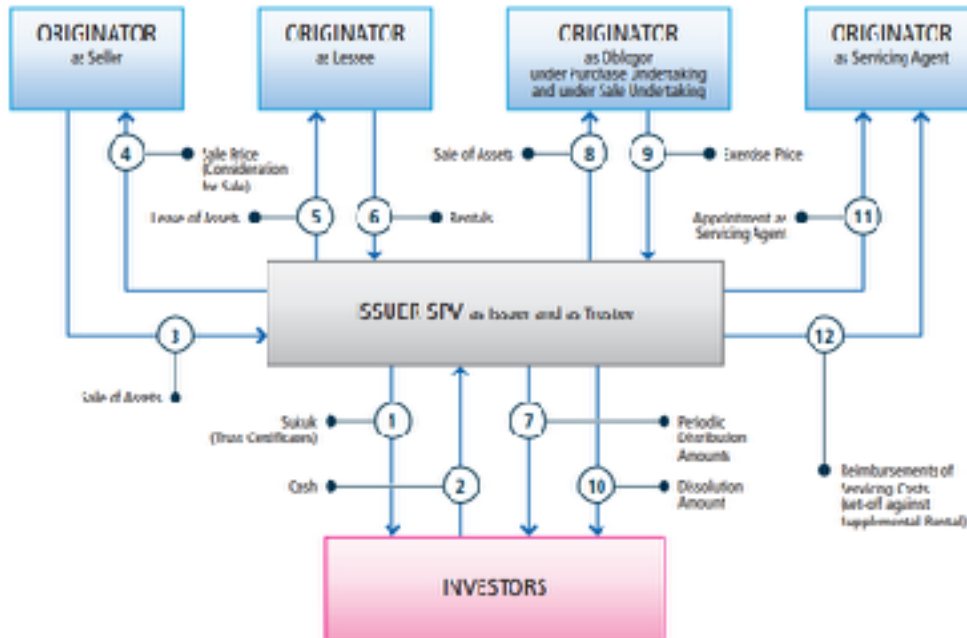


Issuance of *sukuk*

- AAOIFI definition: «*certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity*».
- Islamic securitisation structures are made possible with the issuance of *sukuk* on the basis of a *Sharia* compliant contracts (e.g. *Ijarah*, *Istisna* or *Murabaha*).
- *Sukuk*'s issuance follows the scheme of loan securitisations as provided by Law no. 130/1999.



Sukuk al-Ijarah



The Originator sells certain assets to the Spv which leases them back to the Originator as lessee. The Spv securitizes those assets, issuing *sukuk*.

For tax purposes the transaction is viewed as a whole.

The fiscal guide lines which should be followed are those regarding the conventional loan securitisation transactions.



A regulatory intervention seems to be necessary also for *sukuk* in order to harmonise their financial structure to the one of the Italian securities («**valori mobiliari**») as defined in art. 1, co. 1-*bis* TUF and to equal - for tax purposes - these financial instruments to conventional **bonds**, depending on the investor's **risk sharing**.



In case of **asset-backed *sukuk*** the investors co-own the underlying assets, which generate incomes. In case of **default** those assets will embody the investor's lien (financial instrument that can be assimilated to **conventional bonds**).

In case of **asset-based *sukuk*** there is no transfer of the underlying assets' ownership, but only **beneficial interest transfer** (cash-flows deriving from the assets utilization). In case of **default** investors are ranked *pari passu* with any other transferor's creditor (similar to **conventional shares**).



5. THE ITALIAN WAY OUT - the transaction

- «*substance over form*» principle -> notwithstanding art. 20 d.p.r. n. 131/86 -> preceding interpretation (Circ. 48/E del 6 agosto 2007, Cass. 24552/2007, Cass. 21770/2014) -> **the transaction is viewed as a whole**, taxation depends on the economic substance of the transaction;
- **contract's purpose** clearly specified: bank's purchase occurs with the **sole aim of re-selling/leasing-back** to the client - the asset should be transferred immediately (within 6 months);
- the **profit margin** should be defined as the **compensation for the deferred payment granted by the bank**.



THE ITALIAN WAY OUT (*continued*) - direct taxation problems

Interpretative solutions:

- **Bonds? No**, the Italian Revenue Agency ruled that bonds shall be identified on the base of the right to obtain a full principal repayment;
- **Participating bonds** (art. 44, co. 2, lett. c) TUIR)? **No**, eventhough pursuant to art. 2411 c.c. exist bonds that besides being entitled to interest at a fixed rate are further entitled to share in additional distributions on a specified basis with the common stock of the issuing company (risk similar to *sukuk*), they are still bonds which need a full principal repayment.



- Shares (art. 44, co. 2, lett. a) TUIR)? No, payment is not fully linked to the economic results;
- Atypic financial instruments («titoli atipici»)? Yes! (residually) subjected to fiscal treatment under art. 5 d.l. 30 September 1983, no. 512, which would be harmful.

The income related to the company's economic development would not be deductible for the issuer.

There is no possibility to follow any interpretative way to solve the direct taxation problems .



THE ITALIAN WAY OUT (*continued*) - regulatory intervention

- For fiscal purposes the double transaction structure is to be considered as a **whole financing operation**;
- consider those financing operations as conventional transactions (i.g. **considering profit margin as investment income ex art. 44, co. 1, lett. h) TUIR** and as **deductible interest ex art. 96 TUIR**);
- indirect taxation only on the first purchase agreement.

