

# Financial Services Tax News

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## PwC Japan Tax Newsletter

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## Islamic Finance

This special edition newsletter considers in general terms the potential Japanese tax issues related to the development of Islamic Finance in Japan.

The business of Islamic Finance, which should be substantially identified with credit/loan, was added to the scope of business of a subsidiary and a fellow subsidiary of banks and insurance companies as of December 12, 2008 according to the enforcement of the Cabinet Order and the Cabinet Office Regulations related to partial reform of the Financial Instruments and Exchange Law. Although the recent turmoil in financial markets and the decline in crude oil prices may have an adverse affect on the impetus, Islamic Finance is expected to attract great attention due to its ability to increase the investor options open to the recycling of petrodollars into Japanese financial markets.

## What is Islamic Finance?

In general, Islamic Finance is regarded as a system of financial services activity consistent with Shariah as Islamic Law. The four major principles of Islamic Finance based on Shariah are as follows:

- Prohibitions of Riba (interest)
- Prohibitions of Gharar (uncertainty)
- Prohibitions of Maisir (gambling)
- Prohibitions of Haram transactions (related to impure assets, such as alcoholic beverages and gambling)

Investments made based on Shariah principles may be seen to be a form of ethical investing.

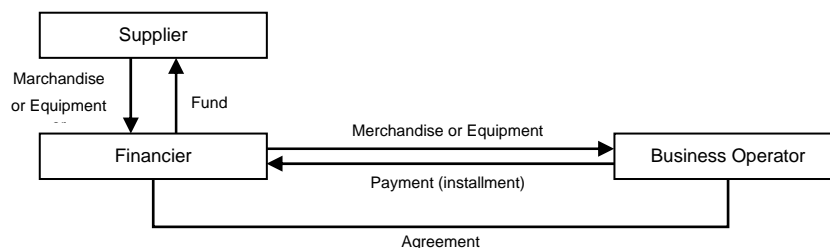
## Major transaction types of Islamic Finance

This section provides a broad conceptual outline (together with associated diagrams) of the major transaction types of Islamic Finance: Murabahah (Cost-plus profit margin); Ijarah (Leasing); Mudharabah (Profit-sharing); and Musharakah (Joint-venture).

### 1) Murabahah (Cost-plus profit margin)

Murabahah is a transaction that involves in general a sale at a cost plus a profit margin (corresponding to an amount of interest). The concept (as depicted in Figure 1) involves a Financier acquiring specified assets from a Supplier, such as merchandise or equipment required by a Business Operator, who then sells it on a deferred payment basis to the Business Operator at the acquisition cost plus an agreed profit margin. Economically, the transaction has comparisons to a loan with the margin corresponding from an economic point of view to an amount of return.

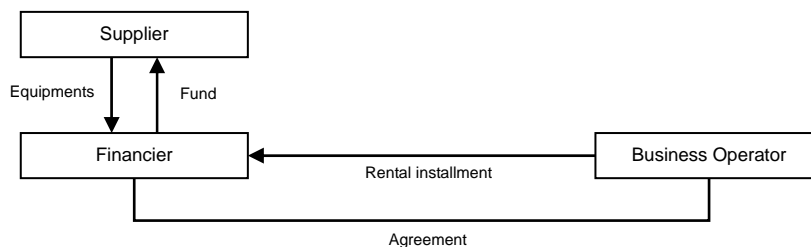
Figure 1: Murabahah



### 2) Ijarah (Leasing)

In general, Ijarah is a transaction (as depicted in Figure 2) whereby a Financier acquires specified assets from a Supplier, such as equipment required by a Business Operator, and collects rental installments, including repayment of the acquisition cost and a return equivalent, that is, in substance, considered to be a lease transaction.

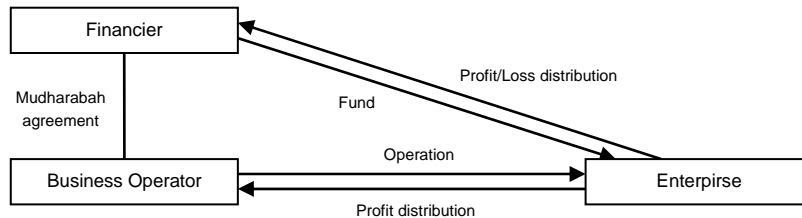
Figure 2: Ijarah



3) Mudharabah (Profit-sharing)

Mudharabah is a transaction (as depicted in Figure 3) whereby there is a capital contribution by a Financier in an Enterprise managed by a Business Operator. Profits generated from the Enterprise are shared in accordance with the terms of the Mudharabah agreement whereas losses are to be borne solely by the Financier unless the losses are due to the Business Operator's misconduct, negligence or breach of contracted terms.

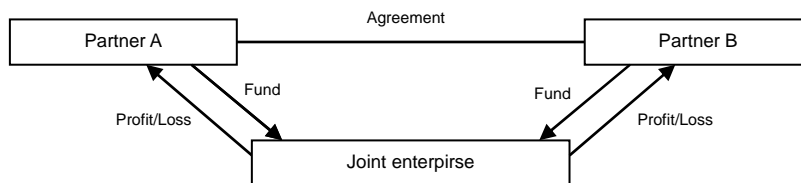
Figure 3: Mudharabah



4) Musharakah (Joint-venture)

Musharakah is generally regarded as a partnership financing agreement between two or more parties to contribute capital to a specific enterprise. As depicted in Figure 4, profits generated from the Joint Enterprise are shared by Partners A and B in accordance with the terms of Musharakah agreement whereas losses are shared in proportion to the respective partner's share of capital.

Figure 4: Musharakah

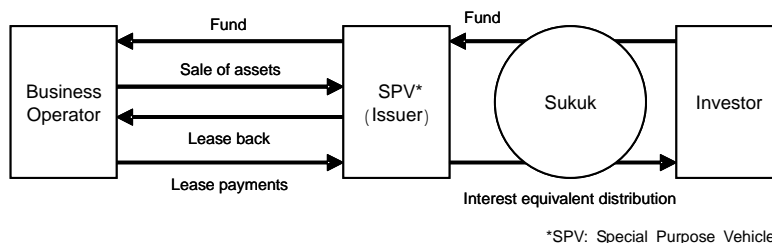


**Sukuk**

Sukuks are, in general, Islamic bonds which have similar characteristics with conventional bonds with the difference being that they are asset-backed/asset-based and free from usury (interest). The returns on Sukuks are linked to the returns and cash flows from the assets purchased.

A typical structure of Sukuk based on Ijarah principle is depicted in Figure 5 as follows.

Figure 5: Sukuk

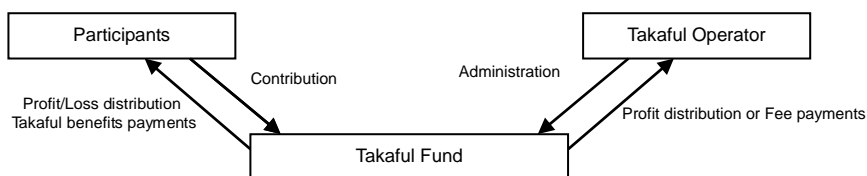


**Takaful**

Takaful is generally regarded as Islamic insurance. As a conventional insurance contract includes Gharar (uncertainty); Takaful is based on "guaranteeing each other" in a form representing a joint indemnification of losses of its members. In general business flow (Mudharabah) Takaful, as depicted in Figure 6, participants make a contribution to the Takaful Fund and receive i) the Takaful benefits payments and ii) the profit/loss

distribution. Although the Takaful Operator acts as the administrator of the Takaful Fund, in principle, the Takaful Operator should not bear losses generated from the Takaful Fund.

Figure 6: Takaful



### Japanese tax issues on Islamic Finance

As stated above, due to the prohibitions of interest under Islamic Finance, transactions such as leases or sale and purchase of assets have, in substance, economic effects similar to a loan. Accordingly, the transaction form or economic substance affects the Japanese tax treatment of Islamic Finance.

Since there is no specific treatment for Islamic Finance stipulated in existing Japanese tax rules, the Japanese tax treatment of Islamic Finance must be considered according to general Japanese tax rules and practice. Some of the relevant Japanese tax issues that arise in the future development of Islamic Finance in Japan include:

- The treatment of consumption tax and real estate transfer taxes on Murabahah, including the sale and purchase.
- Whether the payment of consideration which is in economic substance similar to interest should be treated the same as interest.
- The categorization and treatment of the transaction form with the nature of the profit/loss distribution for Japanese tax purposes.
- The categorization and treatment of Sukuk for Japanese tax purposes, including withholding for purposes and deductibility of funding costs.

Due to the nature of Islamic Finance and the lack of comparability with Japanese law and custom to date, the categorization and treatment under Japanese tax law and procedure remains uncertain in many areas. The further utilization of Islamic Finance requires in effect, the introduction of special tax measures or the clarification of the Japanese tax treatment.

**For more detailed information, please do not hesitate to contact your financial tax services representative or any of the following members:**

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