Islamic Finance in Australia: Require Level Playing Field

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Abstract This research paper assesses current taxation treatment of Islamic Finance products in Australia. The key difference between conventional and Islamic finance products is that it is demanded that the latter are free of riba or interest. In addition, there are numerous other credentials that should be fulfilled before an Islamic finance product is regarded as Sharia compliant. But Australia needs to introduce regulatory simplicity and to guarantee a level playing field to convert it into a lucrative Islamic financial investment hub in this part of world. Although the local investment banks have been assertive in the feasibility of an Islamic wholesale market, additional progress depends on the wider political atmosphere, more professional opinions from relevant scholars, including Islamic finance researchers and not just the willingness of Australian regulatory officials. More knowledgeable responses on the efforts of Australian government, like ‘Johnson Report’ as well as the discussion paper of the Board of Taxation, should be scrutinized to construct a feasible level playing field for Islamic financial sector in near future.

Keywords: Islamic finance; Regulatory framework; Australian tax

1 Introduction

In recent years Islamic finance has been experiencing exponential growth and it is considered as one of the fastest growing segments of the global financial services industry. This industry has been growing at over 10 per cent per annum over the last 10 years and this trend is expected to continue in the coming days. The current size of the Islamic finance market ranges from $1.66 Trillion to $2.1 Trillion with expectations of market size to be $3.4 Trillion by end of 2018. O’Brien (2012) cites a 2011 Ernst & Young (EY) statement which remarks, that Islamic finance offers capital prospects, claims that the basis for the growth of Islamic finance is comparatively direct. It says: “Islamic instruments have been more resilient than many conventional instruments during the global financial crisis, and they are likely to see growing demand from an increasingly wealthy group of Muslim investors”.

Currently, the Middle East and South East Asia are the primary locations for Islamic capital. In particular, the United Arab Emirates, Bahrain and Malaysia are seen as the main centres of Islamic finance, with significant activity also taking place in the United Kingdom and more recently in Europe, Africa and Indonesia. Importantly, the demand for Islamic finance is not evident only in Muslim countries. Countries with minority Muslims also exhibit demand for Islamic finance products, especially for home loan and savings deposits.

Islamic finance has been available for last 1400 years. However, it was not practiced explicitly even in the Muslim world because of lack of demand and awareness. In the modern world, Islamic finance has been emerged in 1970s and since then experienced phenomenal results and was established itself as an alternative to the conventional finance. Currently, Islamic finance is not only available in Muslim world; it has significant presence in non-Muslim countries. As Islamic finance has fundamental differences compared to traditional finance, it faces obstacles in the non-Muslim countries. For example, mortgage products under Islamic finance face double taxation problem. As many Islamic banking and financial contracts are treated as buying and selling properties and hence are taxed twice. It obviously creates disadvantage to Islamic finance products and therefore, it remains uncompetitive. Ahmad (2007) asserts that required Shariah law for the establishment of Islamic finance offers its own structure for the successful implementation of financial transactions and contracts. It is obvious that non-Muslim countries cannot directly arrange this Shariah-compliant framework to facilitate the implementation of Islamic finance.
However, these non-Muslim countries can organise required changes in their existing regulatory framework since Islamic finance receives equal treatment and as a result can be competitive. As Sam, Rahman and Khanam (2013) suggest that legal and regulatory framework is the basic elements for the establishment and successful operation of any financial system. Therefore, it has paramount importance for Australia to arrange appropriate regulatory framework if it needs to implement and sustain Islamic finance.

Australian Financial Centre Forum (2009) released its first report, called ‘Johnson report’, in November, 2009, commissioned by the Australian Government. The report identifies that Australia needs to remove some regulatory barriers to remain efficient and competitive financial sector in the Asia-Pacific region. The report recognises the importance of the Islamic Finance in Australian context and acknowledges that Australia need to create level playing for Islamic Finance. The first Johnson Report makes two proposals on Islamic finance; the removal of regulatory barriers to the development of Islamic finance products, and a call for an inquiry by the Board of Taxation into whether Australian tax law needs to be amended to ensure that Islamic financial products have parity of treatment with conventional products. In 2010, the assistant Treasurer advised the Board of Taxation to identify the impediments in current Australian tax laws, to examine the tax policy response to the development of Islamic financial products in other countries and to make recommendations to Commonwealth and State tax laws. In this regard, the Board develops some basic principles to create level playing field for Islamic finance: a) the treatment of Islamic financial products should be based on their economic substance rather than their form b) where an Islamic financial product is economically equivalent to a conventional product, the tax treatment of the two products should be the same and c) the Board should consider whether adjustments can be made to existing tax frameworks rather than the development of specific provisions directed solely at Islamic financial products. To complete the study, the Board of Taxation invited discussion papers from individuals and organizations. The Board has received 14 discussion papers and made 14 submissions available to the public. In this research, we will evaluate these 14 submissions to understand the impediments in the current framework for the success of the Islamic finance in Australia and to identify the recommendations. This research article will also address the available approaches to legal framework and will recommend the suitable one in Australian context.

The organization of the article is as follows: Section 2 addresses the situation of Islamic finance in Australia; Section 3 identifies available approaches to legal framework; Section 4 discusses common impediments and recommendations to create level playing field for Islamic finance and Section 5 concludes the study.

2 Islamic Finance in Australia

Ahmed and Hassan (2009) mentions that Australia is making small inroads into this fast-growing segment in comprehensive finance, and with a rising Muslim population which makes up less than 2 percent of the population, it has the probability to become a major centre for Islamic banking and finance. The demand has been growing rapidly as Muslim population increases at a relatively higher rate. Moreover, Australia is in close proximity to a region where more than 60 percent of the world’s Muslim population resides. The potential for the Islamic finance industry is immense. Islamic banks are expected to manage about 40% to 50% of total savings of the Muslim population in eight to ten years. In spite of this opportunity and growing need for Islamic finance, there is little market response from the supply side. One of the main reasons would be high borrowing costs. It is reported that one key aspect of Australia’s economy is its reliance on foreign capital. In this case, various financial organizations can channel the off-shore funds to Australia by borrowing from overseas and lending to business and individuals. As Gulf region has access funds, there is immense opportunity for the Shariah compliant financial institutions to these funds to Australia. This would ultimately lower the
cost of capital. To ensure this funding, it has significant importance to create appropriate system and environment.

Australia's experience with Islamic financing has been relatively recent. The first attempt to introduce Islamic financing products in Australia was made by the Muslim Community Co-operative Australia (MCCA) (Ahmed, Osmani, & Karm, 2010). Currently, there are some organizations offer Shariah compliant products in Australia. However, their operations are at small scale and they offer very limited number of products. It is apparent that there is unmatched demand of Islamic finance, as few small scale organizations engage in supply side. As a result, the market is not competitive and many borrowers find the borrowing cost is significantly higher compared to the conventional financing. Lack of source of fund due to regulatory impediments is one of main factors for high borrowing cost.

3 Approaches to legal framework

An appropriate legal and regulatory framework is a basic requirement for establishing and operating a sound financial institutions and markets. Similar to the Common law and Civil law systems, the Shariah offers its own framework for the implementation of commercial and financial contracts and transactions (Ahmed, 2007). However, Australia like many other countries do not have the appropriate financial, commercial and company laws to facilitate the implementation of Islamic finance and financial contracts. Without having appropriate legal framework, the Islamic finance industry would not be able to flourish. As Ghouse (2010) mentions, there are numerous significant aspects that are backing to a rising interest in Islamic finance, both within the business community and the government sector. Some of these contain the possible sourcing of capital from the Gulf Cooperation Council (GCC) and the welfare arising from the speedy progression in Islamic finance which is the fastest growing area in the global financial structure.

3.1. Total absorption approach

In a total absorption approach, a country can completely伊斯兰 its banking system. Under this approach, conventional banking will be replaced by Islamic banking system and therefore, shariah commercial law will replace conventional finance law. The main intention of this system is to abolish interest based system completely. Sudan and Iran have adopted this approach to Islamize their banking system. It is obvious Australia cannot adopt this system because of its secular nature and also for economic and political reasons.

3.2. A Dual model approach

A dual model approach allows the operation of conventional banking and Islamic banking side by side. This approach recognizes the integrative duality of financial system in which finance exists parallel with conventional finance. The dual model approach represents a special case whereby a government regulated framework allows both conventional and Islamic banking systems to co-exist on an equal basis while competing and complementing each other at the same time. As total absorption approach requires complete departure from conventional banking system, it might not seem plausible for some countries to adopt this model. Malaysia sets an excellent example of embracing dual model approach allowing the existence of both systems simultaneously. Malaysia enacted Islamic Banking Act in 1983 for the establishment of its first Islamic bank (Bank Islam Malaysia Berhad). In regard to the success of adopting dual approach, Yaakop (2003) states that Malaysia has taken the lead in championing dual banking to promote Islamic banking. This approach also might not feasible in Australia as only 2.5% of its population is Muslim and therefore, the market for Islamic banking would not be big enough for the success of the dual approach.

3.3. An integrative approach

An integrative approach is the minimal approach for the success of the operation of the Islamic banking alongside with conventional banking. As Islamic banking requires level playing field for making this system as productive and competitive as conventional banking, tax laws and financial regulations
should not be impediment for the Islamic banking system. The integrative approach allows the Islamic banking system to have seamless integration within a conventional banking structure by changing tax and financial regulations. The United Kingdom (UK) takes approach to accommodate Islamic banking. In 2001, the UK took initiative to examine and understand the barriers to adopting Islamic banking. Amin, Mashayekhi, Hicks, Rahman and Ravalia (2007) prepared a report for Financial Services Authority (FSA) in the UK to identify the regulatory obstacles for the development Islamic finance. The FSA decided that its approach would be ‘no obstacles, but no special favours’. This approach is equivalent to integrative approach as to remove regulatory obstacles and change tax laws to make Islamic finance competitive and sustainable. As financial demographics and regulatory systems in Australia are comparable to the system in the UK, the integrative system is considered as the suitable model for adopting Islamic finance in Australia.

4 Discussion on impediments and recommendations

To understand the potential barriers for the development of Islamic finance and to recommend appropriate way forward suggested by the first Johnson report in September 2008, the Australian government advised the Board of Taxation to carry out a study. In regard to Islamic finance, the Johnson report notes that accessing this market “could increase the diversity of sources of capital available to Australian business and consumers” (cited in Smith, 2010).

The focus of the report of the Board of Taxation was not to give any special treatment to Islamic finance, but to make sure there is a level playing field for the development of Islamic Finance in Australia. This work was undertaken by the Board of Taxation in 2010 and to do this the Board invited interested stakeholders and parties to provide comment on the review of the tax treatment of Islamic finance (BoT, 2010). According to Moore (2013), the report was mainly based on recommendations in the 2010 Johnson Report which offered policy options to better position Australia as a financial centre. It was about ensuring a ‘fair and level playing field’ according to Parliamentary Secretary Bernie Ripoll, and to ensure that Islamic financial products had parity of tax treatment with conventional products.

The Board of Taxation received 14 responses including professional organisations like Chartered Public Accountants (CPA), Ernst and Young, and Australian Financial Market Associations (AFMA) and expert individuals. Some of the responses are comprehensive and there is significant similarity in some responses.
Table 1: List of the submissions to the Board of Taxation

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<tr>
<th>Name</th>
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<tr>
<td>Blake Dawson</td>
<td>Individual</td>
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<tr>
<td>Clark, David</td>
<td>Individual</td>
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<tr>
<td>Condon, Paul</td>
<td>Individual</td>
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<td>CPA Australia</td>
<td>Organization</td>
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<td>Crescent Investment Australasia</td>
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<td>Department of NSW Treasury</td>
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<td>Ernst and Young</td>
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<td>Financial Services Council</td>
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<td>Freudenberg and Nathie</td>
<td>Individual</td>
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<td>Janson, Vickie</td>
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<td>Norton Rose</td>
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<td>MCCA Ltd</td>
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<td>Taxation Institute of Australia</td>
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After analyzing the submitted responses, we identify that all except two is positive about the inclusion of Islamic finance into conventional finance and most of them recommend some regulatory changes in area of tax as Islamic finance can be competitive. The first proposal is by David Clark, a member of the NSW Legislative Council on behalf of the Liberal Party of Australia, and a resilient activist of ‘Christian Values’ and the other is by Vickie Janson, the vice-president of Q Society, a group that opposes what it describes to be the ‘Islamization’ of Australia (Bhatti, 2015). In that research Bhatti (2015) cites the notes of Clark as follows:

...the Board should not be relying on the 'Islamic economic system' as a basis of the review. This is not the system that the Islamic finance operates in and in particular why Islamic financial products must replicate conventional products. As Islamic finance operates in a conventional system and Islamic finance principles adapt to accommodate this system, in substance Islamic finance principles are conventional principles. Thus, the assumption that Islamic finance products are based on Islamic finance principles, operating in an Islamic economic system has no worth in a practical exercise to determine the appropriate tax treatment of Islamic finance products.

Bhatti (2015) mentions the comment of Clark as inconsistent as the Board does not depend on the Islamic economic structure as the foundation of its assessment. The proposal of Janson is identified as similar as Clark, but more confronting approach by Bhatti (2015):

...I would strongly recommend that the government reassess this commitment to sharia finance with its connections to Islamic groups, it’s [sic] theological foundations and it’s [sic] undermining of both western values and economy... It appears support for sharia finance is support for Islamic ideologies rather than the moderates who utilise conventional banking.

Janson also claims that the leaders in the Islamic finance industry, such as Usmani, have jihadist views. She is more concerned about the impact that Sharia products will have on ‘Australian values’ than with the provision of space for Islamic finance products in Australia (Bhatti, 2015).
According to Bhatti (2015), the Board of Taxation’s discussion paper was published in late 2010 and no supplementary tax reforms have taken place since the issue of the Discussion Paper, while judicial modifications were made to accommodate for Islamic finance products in the United Kingdom as early as 2003.

In the following discussion, we explore the most common recommendations put forward by the professional bodies and individuals to create level playing field for the Islamic finance.

4.1 Economic vs legal interpretation in tax law

In developing tax law, there are two choices: economic substance approach and legal substance approach. To achieve neutrality in taxation law for Islamic finance, all the submissions to the Board of Taxation recommend using economic substance approach instead of legal substance approach. Although legal substance approach is simpler to use, it leads to anomalies and unexpected complexities. Importantly, legal substance approach would be disadvantages to develop appropriate tax laws for Islamic financial products. On the other hand, the economic substance approach is relatively complex to use, however, it can lead to greater tax neutrality. Under this approach, similar financial transactions are considered the same. For example, in Islamic finance, home loan is organised in different manner compared to traditional system. Current tax law considers arrangement of Islamic home loan not as a one transaction but as multiple transactions. As a result, taxes incurred multiple times for one event. This makes home loan under Islamic finance unattractive. To achieve greater neutrality in this type of situation, economic substance approach is considered suitable.

4.2 Double stamp taxation

As stated in the previous section, home products in Islamic finance face double stamp duty problem because of the nature of the transaction. The majority of submissions express the view that the States and Territories should address stamp duty through a targeted exemption approach. Targeted consultations further revealed that Islamic finance products involving movable assets would be unlikely to be provided without appropriate stamp duty relief. Importantly the Board of Taxation considers that addressing this issue is a priority in terms of achieving neutrality in tax treatment. Among all the states, Victorian stamp duty laws in 2004 have eliminated distinctions in treatment between Islamic and conventional finance products.

4.3 Debt-equity rules

Broadly, the debt/equity rules are important as they govern if the return on the finance instrument may be deductible to the issuer. The return is deductible in the case of debt interest and non-deductible in the case of equity interest. The outcome can have further implications under the thin capitalisation and withholding tax rules. Broadly, an instrument will be a debt interest where the issuer has an effectively non-contingent obligation to return at least the issue price of the instrument to the holder. Equity interests include ordinary shares and other instruments that provide an element of contingency on the issuer’s obligation to return funds to the holder. For example, an instrument may be an equity interest if it carries a right to a return, which is in substance or effect contingent on the economic performance of the company.

4.4 Uncertainty of income tax issues

The uncertainty issue to the treatment of income tax of financial products in Islamic finance is disadvantageous. However, this issue is not identified by the most of the responses given to the Board of Taxation. However, we think in line with Australian Financial Market Association that there is clearly uncertainty as to the precise income tax treatment under current law of the various Shariah compliant financing techniques. Where uncertainty exists, it can reasonably be assumed to be a disincentive to Shariah compliant investments being made. It may be possible to resolve those uncertainties by seeking rulings from the Australian Taxation Office (ATO). Accordingly, the Professional Bodies consider that some legislative change is required to both remove uncertainty and to achieve parity of income tax treatment. The Professional Bodies consider it reasonable to expect that the Australian demand for capital provided via Shariah compliant financing techniques would be driven by financial sector and other large
business entities. These entities would be expected to already be subject to Division 230 of the ITAA 1997.

5 Conclusion

Islamic finance systems can ensure an ethical financial arrangement available through the process as former Australian senator Nick Sherry says that these service companies are not allowed to charge interest rates and do not invest in gambling or alcohol because of shari’ah law. But he aptly doubts that the unusual way of conducting business can sometimes put the Islamic finance centre at a disadvantage under Western tax code (BBC, 2010). This reality is explicable after observing the existing regulatory set-up of banking and finance in Australia. But as Farrar (2011) states that this has not stopped the emergence of local operators who, by and large, have successfully navigated the existing system notwithstanding the penalising impact and effect of some of those regulations, especially in the area of taxation. Even in the non-existence of any governmental or organizational modifications, local Islamic financial developers will remain to construct their financial products in such a way as to maximise their yields as well as to secure a halal return.

Progresses over a decade, however, show that thrust is emerging to accommodate Islamic Financial institutions through Australia. As Farrar (2011) states the legal proposal from various organisations and individual experts is particularly European in origin, similar to ‘level playing field’ approach of United Kingdom. This may demonstrate to be an error in the long term as Australia is likely to become more dependent on the Asian economies. It should be obvious that Australia should do more than promote its natural assets and level the playing field if considerable infusions of Islamic foreign investment are to materialise.

But Australia needs to go a long way to make this happen and needs to do more to alter the understanding of some of the critics like Muehlenberg (2010) who mentions that all over the Western world, governments are bending over backwards to accommodate sharia finance. Therefore, regulatory simplicity, guaranteeing a level playing field and sketching an outline of incentives are required for attracting foreign Islamic investment funds. Although the local investment banks have been assertive in the feasibility of an Islamic wholesale market, additional progress depends on the wider political atmosphere, more professional opinions from relevant scholars, including Islamic finance researchers and not just the willingness of Australian regulatory officials. More knowledgeable responses on the efforts of Australian government, like ‘Johnson Report’, should be scrutinized to construct a feasible level playing field for Islamic financial sector in near future.

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