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Do not hesitate
to contact us:

Olivier Leclipteur

Member of the Executive Board
Head of Private Wealth Management

Tel: +352 26 92 55 48 90

Fax: +352 26 92 55 28 66

olivier.leclipteur@experta.lu

Virginie Deconinck

Head of Corporate Engineering

Tel: +352 26 92 55 51 71

Fax: +352 26 92 55 36 41

virginie.deconinck@experta.lu

Luxembourg is becoming the new Islamic finance platform in Europe

Islamic finance remains a growth sector around the world despite the financial crisis and the global downturn. Those reluctant to invest in conventional financial products are increasingly considering Islamic products, i.e. which comply with *Shari'ah principles*, as an alternative.

The objective of Islamic finance is to share profits and losses between those who provide the capital and those who use it. Some features of Islamic finance are that transactions must be backed by tangible and identifiable assets, while the use of money for the purposes of making money is expressly forbidden. Speculation, interest-bearing products, and investments in certain "*haram*" sectors such as weapons, alcohol, tobacco or casinos are outlawed.

In order to be part of this growing market and facilitate the emergence of an Islamic financial market in Europe, Luxembourg has demonstrated a proactive attitude, over recent years. The stock exchange in Luxembourg was indeed the first European stock market to list *sukuk* (the so-called Islamic bonds) and was recently admitted as the first European member state to the council of the Islamic Financial Services Board (IFSB).

At present, Luxembourg intends to become a global hub for Islamic finance. In that respect, the recent issuance of a circular by the Luxembourg tax authorities confirms the importance Luxembourg attaches to this position.

The circular describes the major Islamic finance principles and instruments and focuses on the treatment of *murabaha* and *sukuk* under Luxembourg tax law.

Murabaha – cost-plus financing

In the conventional financial system, banks lend funds to clients to enable acquisition of a target asset with leverage. The loan is either secured, or not by the asset acquired and repaid to the bank, plus an interest rate constituting the return to the bank on the loan. Interest or "*Riba*" is forbidden in the Islamic financial world, therefore, loans as we know them are not allowed.

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Within a *Murabaha* agreement, the bank (or any other finance provider) acts as the partner and acquires the asset identified by its client with the intention of immediate delivery to the client at a predetermined higher price (i.e. including an agreed profit margin). Therefore, by paying the higher price by installments, the client has effectively the possibility to acquire the asset without paying interest.

Luxembourg takes the view that *Murabaha* corresponds to a sale agreement. Consequently, the profit realised by the finance provider on that sale is deemed to be realised upon signing of the agreement with the client and should in principle be taxed immediately and in its entirety.

However, the circular specifies that the part of the profit realised by the finance provider for the grant of the deferral payment may be spread over the life of the agreement, irrespective of the reimbursement, under the following conditions:

- ▶ the agreement has to clearly indicate that the finance provider acquires the asset with a view to deliver/resell it to its client, at the latest within six months following the purchase;
- ▶ a distinction has to be made in the agreement between the remuneration received by the finance provider for the deferral of the payment, the commission received in return for its intermediation and the purchase price of the asset for both the client, and the finance provider;
- ▶ a clear specification of the remuneration of the finance provider is included, which must be known and accepted by both parties;
- ▶ it is specified in the agreement that the remuneration of the finance provider is a consideration for allowing the client to acquire the asset with payment by installments; and
- ▶ for accounting and tax purposes, the remuneration is spread over the deferred payment term in the finance provider's books, regardless of when the repayments are actually received.

Sukuk – Islamic bond

Sukuk are considered as a Shari'ah-compliant variant of a conventional bond. However, unlike bonds, which are debt-based instruments with interest remuneration, *sukuk* are asset-backed or asset-based instruments. Indeed, *sukuk* represent the beneficial ownership of the *sukuk* holders (i.e. investors) in an underlying tangible asset.

The potential yield on *sukuk* is variable and contingent on the performance of the tangible asset held by the *sukuk issuer*. *Sukuk holders* are entitled to a share in the profits generated by the underlying asset and are in counterpart exposed to the economic risks relating to this asset. Please note that "*Tracking Sukuk*" can enable the tracing of the profits and losses to specific assets.

The Circular confirms the classification of *sukuk* as a conventional debt instrument for Luxembourg tax purposes. Consequently, yield payments made on *sukuk* are treated as tax deductible interest expenses at the level of the *Sukuk issuer* and are not subject to withholding tax.

At the level of the *Sukuk holder*, payments received are classified as interest within the meaning of art 97 (1) 3 LIR and are assimilated to the corresponding payments under bonds in conventional financing.

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The circular issued by the Luxembourg tax authorities confirms the compatibility of the Luxembourg tax environment with the *Shari'ah principles* and enhances the commitment of Luxembourg to Islamic finance.

Luxembourg, March 2011

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