

Ireland as a Gateway for Sukuk in Europe

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Sukuk is becoming increasingly popular, particularly in light of the current market conditions as investors look for ways to limit their exposure to tightening interest rates. Sukuk also provide the type of Shariah security that can be understood and is welcomed by the conventional investor market, making Sukuk a possible alternative source of finance in the current market.

With its favorable tax regime, comprehensive double tax treaty network, an established regulatory system and crucially, the willingness on the part of the Irish government, tax authorities and regulator, to adapt and develop to keep pace with the needs and development of the marketplace, it would seem that Ireland is the ideal location for Sukuk issuance.

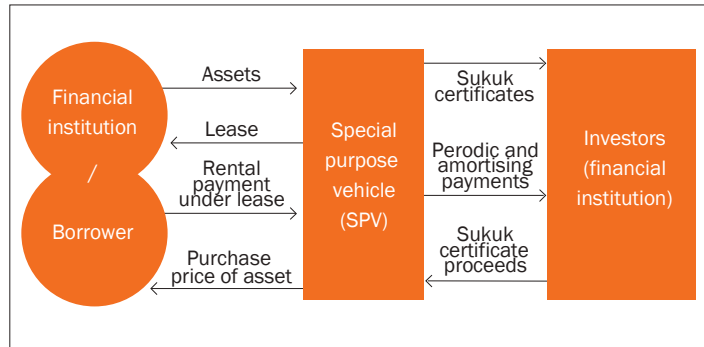
Types of Sukuk

There are many types of Sukuk but two of the most common types which are dominating the market currently are (1) Sukuk Ijarah and (2) Sukuk Murabahah.

1. Sukuk Ijarah

Sukuk Ijarah is mainly used in project finance and can provide an efficient medium to long term mode of financing. Also known as Ijarah Sukuk, they represent a leasing agreement which can facilitate the user of the asset purchasing the asset at the end of the Ijarah period (finance lease).

Diagram 1



A typical Ijarah Sukuk structure is illustrated in diagram 1. The company seeking to raise finance (borrower) sells certain assets to a Sukuk issuer which is likely to be a special purpose vehicle (SPV) in most instances. The SPV makes an upfront payment for the acquisition of assets by using the proceeds from the issue of Sukuk certificates to investors.

The SPV leases the assets back to the borrower in return for a promise to pay rentals on a regular basis over a fixed period of time. The rental rates of return on those Sukuk can be fixed or floating depending on the agreement. The cash flows from the lease are passed to the investors in the form of coupon and principal repayments on their original investment.

2. Sukuk Murabahah

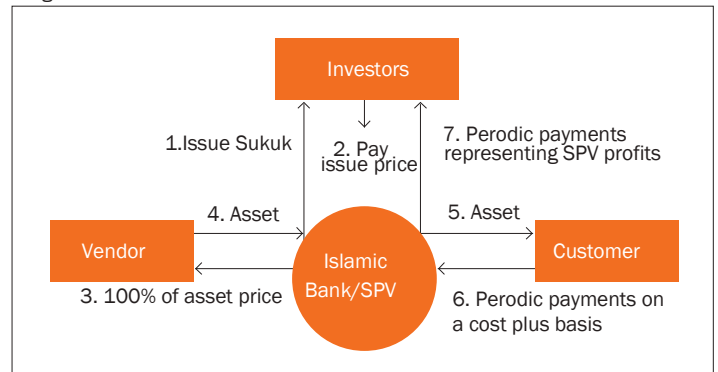
Sukuk Murabahah (cost-plus financing) is mainly issued to finance the purchase of goods. It is one of the most widely used instruments for

Islamic short term financing. This financing structure has capabilities across a number of asset classes.

However, given that the current Muslim population in Ireland is still relatively small, it is more likely that this structure would be used to finance the purchase of significant assets including real estate, aircraft, ships, and such.

In a regular Murabahah transaction, an Islamic bank might purchase equipment or goods from a vendor, and would resell the equipment or goods to a customer at cost plus a reasonable profit, with deferred payment. An SPV might be used to raise funds to purchase the assets through the issuance of Sukuk certificates. The future periodic installments paid by the customer to the SPV would account for the repayment of the cost and the related profit to the investors.

Diagram 2



Asset-backed versus asset-based

Sukuk can be either asset-backed or asset-based. In an asset-backed transaction, the SPV would hold the legal title to the physical property. In this case, the credit risk of the Sukuk is driven primarily by the risk associated with the underlying assets held in the SPV.

Asset-based Sukuk are not legally “backed” by an asset and the Sukuk holders have no lien on the asset in the event of insolvency (other than their rights as an unsecured investor). For example, in an asset-based Ijarah Sukuk, the SPV would hold the receivable but would not legally own the underlying assets.

In an investor service special report, Moody’s noted that by the end of 2009, only 4% of Sukuk issued represented secured “asset-backed” Sukuk. We understand however that investors in MENA are keen to invest in asset-backed Sukuk, particularly in the wake of the recent financial crisis when investors are demanding a measure of certainty which the asset-backed Sukuk provides.

The Irish tax treatment of Sukuk will differ, depending on whether the Sukuk is asset-backed or asset-based. Any profits remaining in the SPV will be taxable in Ireland, however regardless of whether the Sukuk is asset-backed or asset-based, it should be possible to structure the transaction in order to pay minimal taxes in Ireland (subject to certain restrictions).

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Ireland as a Gateway for Sukuk in Europe (continued)

Why Ireland?

Attractive tax regime

- Ireland is a corporate low tax location with a corporate tax rate of 12.5% for trading activities.
- In January 2010, significant amendments to Irish tax legislation were introduced to facilitate Islamic finance transactions in Ireland.
- Irish tax legislation facilitates the origination and issuance of Sukuk transactions by extending to this form of financing the relieving (tax neutrality) provisions which currently apply to equivalent conventional financing by treating the Sukuk return as interest for Irish tax purposes.
- No Irish stamp duty arises on the issue, transfer or redemption of a Sukuk certificate.
- Islamic finance transactions, where those transactions correspond to VAT exempt financial services transactions, are exempt from Irish VAT.

Tax efficient inbound investment

- It should be possible to transfer assets into Ireland without giving rise to any Irish tax liabilities.

Favorable outbound factors

- Generally, no withholding tax on interest payments to person resident in an EU / treaty country or on interest payments on "quoted Eurobonds" made to non-residents. This positive in the context of Sukuk return now being treated as interest.

Onshore versus offshore

- Ireland provides an onshore platform in an environment of increased international focus by the EU and Organization for Economic Co-operation and Development (OECD), the US and such on tax havens and it applies the principles of the OECD, particularly transparency.

Wide double tax treaty network

- Ireland already has a significant double tax treaty network and the Irish government has undertaken to increase the number of double tax treaties in force, particularly with countries in the Middle East and North Africa (MENA).

To date, Ireland has signed double tax treaties with 61 countries, including Bahrain, Morocco and the UAE. Treaties have also been signed with Malaysia, Pakistan and Turkey and treaties with Kuwait and Saudi Arabia are imminent.

Listing

- The rules which are in place in the Irish Stock Exchange (ISE) regarding the listing of specialist debt securities which also cover Sukuk have provided a relatively inexpensive and timely listing process and have proved very popular not just for Irish domiciled SPVs but also non-Irish domiciled SPVs.

The ISE has a turnaround time of maximum of three working days on the initial draft followed by a two day turnaround on subsequent drafts and has practical experience in this space, having listed its first Sukuk in 2005.

Centre of excellence in financial services

- Ireland also offers an excellent legal and accounting/tax

infrastructure, it is English speaking and has a stable political environment, good general infrastructure and international flight access. Ireland offers significant workforce advantages in that it has an experienced workforce, now significantly more cost competitive and an extensive and experienced professional services sector providing support to the financial services industry. In addition, there are a number of multinational financial institutions established in Ireland which provide corporate services such as administration and bookkeeping services to SPVs and can look after the day to day running of the SPV.

Conclusion

All these factors, together with Ireland's international status as a centre of excellence for financial services make Ireland a genuine player in the choice of SPV domicile.

The listing of Sukuk on the ISE in 2005 has not only enhanced Ireland's profile in the global Islamic finance industry, but is an illustration of the receptive attitude of the Irish financial services industry to new entrants to the Irish market.

Given that Islamic finance is a subset of the global financial market, Ireland is well placed to become the European leader of Sukuk issuance and provide a welcome alternative to both companies seeking to raise finance and investors alike. ⁽²⁾

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Yvonne is a member of PwC's global Islamic finance network and has worked with the Irish government and tax authorities on the recent changes to Irish tax legislation to facilitate Islamic finance transactions including Sukuk in Ireland.

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Caitriona worked closely with Yvonne in relation to the Irish tax legislative changes to facilitate Islamic finance transactions and is actively marketing the area of Islamic finance in Ireland.

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Faisal is a manager with the investment management group in Dublin and has been involved in the audits on a number of Islamic funds, Islamic banks and Takaful.