

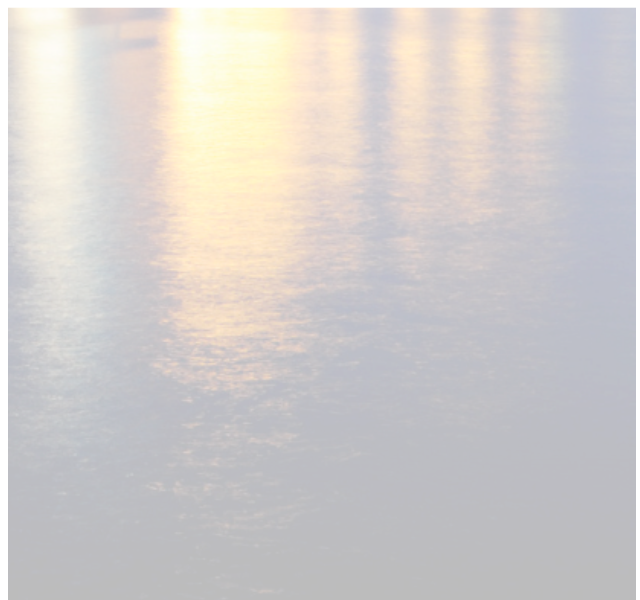
**TORONTO FINANCIAL  
SERVICES ALLIANCE**

# ISLAMIC FINANCE WORKING GROUP



Making Toronto the  
North American Centre  
for Islamic Finance:  
Challenges and Opportunities

May 2010



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## EXECUTIVE SUMMARY

Toronto is the financial services capital of Canada and one of North America's premier financial centres. In 2008, Forbes Magazine listed Toronto as one of the top 10 most economically powerful cities in the world. Toronto is currently ranked #12 in the Global Financial Centres Index and #3 in North America. The City has a sophisticated cluster of financial services companies, offering a range of quality services and expertise that rank among the best in the World. At the same time, Toronto has one of the most multi-cultural populations of any major city and tremendous capability to innovate within the financial sector.

One of the most rapidly growing segments of the international financial services sector is Islamic finance, i.e., the system of financial activity that is consistent with the principles of Islamic law and its practical application through the development of Islamic economics. Recognizing this trend, a number of other financial centres are positioning themselves as global centres for Islamic Finance, including London, England; Dubai, UAE; Bahrain and Kuala Lumpur, Malaysia. At the same time, it has been reported that other Western jurisdictions (Australia, France, Germany, Italy) are exploring the prospects of attracting Islamic financial activity.

As a testament to the importance of the financial sector, in 2001, the City of Toronto and its financial cluster developed a unique public-private partnership called the Toronto Financial Services Alliance (TFSA). The mandate of TFSA is to enhance and promote the competitiveness of Toronto as a premier international financial centre. One of the ways to do this is to build leading hubs of expertise in defined areas. With a prominent and growing Canadian Muslim community and strong and innovative financial sector, there is every reason to believe that Toronto could emerge as a North American centre for Islamic finance. Exploring the opportunities

that exist in this developing segment is consistent with the TFSA's mandate, and the creation of an Islamic Finance Working Group (IFWG) has been endorsed to scope out the possibilities in this growing arena.

Set out below is the initial report of the IFWG on public policy issues that are relevant to promoting the development of an Islamic financial sector in Toronto. The report provides a summary of existing as well as past Islamic finance activity in Toronto, identifies tax, regulatory and legal issues that need to be addressed to ensure the growth of Islamic finance in Toronto and Canada and outlines some recommended next steps as follows:

- help members of the Islamic community to network within the conventional Canadian financial system;
- clarify the regulatory environment relevant to products and services compliant with Islamic commercial law;
- work with the new Centre of Excellence in Financial Services Education to build linkages with other countries where Islamic Finance is well established to facilitate in Toronto educational and awareness building initiatives;
- partner with Canadian governments to increase the level of foreign direct investment from the Gulf region; and
- prepare and issue a series of technical working papers on the following topics: Education, Retail Markets and Sukuks (Corporate and Sovereign).

The IFWG is optimistic that if the proposed next steps are undertaken, it will be possible to position Toronto to become the centre for Islamic Finance in North America.

The members of the IFWG are set out in Appendix A to this report.

## INTRODUCTION

The City of Toronto is home to Canada's five largest domestic banks, all of the major foreign banks with a presence in Canada, the major bank owned investment dealers, as well as more than 100 non-bank owned investment dealers.

Toronto is also headquarters to Manulife and SunLife - two of the top 10 life insurers worldwide, based on market capitalization and a significant number of domestic and international property and casualty insurance companies, as well as the major corporate brokerage houses.

In the world of fund management, the leading Canadian mutual fund companies, institutional fund managers and the pension funds are headquartered in Toronto.

In addition, Toronto is the home-base of the TMX Group, the third largest stock exchange group in North America and the eighth largest in the world based on market capitalization. For example, more mining companies are listed on TSX and TSX Venture Exchange than any other exchange in the world. Combined, TSX and TSX Venture Exchange have over 1,200 mining companies valued at over \$320 billion.

The Toronto region is also the home to a growing and increasingly influential Islamic community, with emerging financial services businesses serving a growing need for retail products and services that are compliant with the requirements of Islamic commercial law.

Over the past several years, a number of Canadian based financial entities have emerged that have focused on a growing demand for Islamic law compliant residential mortgages. In addition, there appears to be growing interest from the international community, both Islamic financial institutions and individuals (including Canadians living abroad), in investing in Canada in entities or structures that are compliant with the principles of Islamic commercial law. In that regard, it is noteworthy that a new North American organization, the Usury Free Association of North America, which includes Canadian entities, held its inaugural event in Toronto at the end of March 2010.

# THE ISLAMIC ECONOMIC MODEL

## Background

The origins of capitalism and free markets, concepts that we consider to be part of Western economic thinking, can in fact be traced back to the Islamic Golden Age which occurred between the 8th and 12th centuries. A vigorous monetary economy was created by Muslims based on expanding levels of circulation of a stable high-value currency (the dinar) and the integration of monetary areas that were previously independent.

Innovative new business techniques and forms of business organisation were introduced by Muslim economists, merchants and traders during this time. It is reported that such innovations included the earliest trading companies, contracts, bills of exchange, partnerships (mufawada), including limited partnerships (mudaraba), and the earliest forms of many concepts that are at the heart of modern business and finance in the Western World including credit, debt, profit, loss, capital (al-mal), capital accumulation (nama al-mal), circulating capital, capital expenditure, revenue, cheques, promissory notes, trusts (waqf), savings accounts, transactional accounts, pawning, loaning, exchange rates, bankers, money changers, ledgers, deposits, assignments, and the double-entry bookkeeping system.

The systems of contract relied upon by merchants was very effective. Merchants would buy and sell on commission, with money loaned to them by wealthy investors, or a joint investment of several merchants, who were often Muslim, Christian and Jewish. Recently, a collection of documents was found in an Egyptian synagogue, shedding a very detailed and human light on the life of medieval Middle Eastern merchants. Business partnerships would be made for many commercial ventures, and bonds of kinship enabled trade networks to form over huge distances. Networks developed during this time enabled a world in which money could be promised by a bank in Baghdad and cashed in Spain, leading to the creation of the cheque system of today. These innovations laid the foundations for the modern economic system.

Enterprises similar to corporations independent from the state also existed in the medieval Islamic world. Many of these early capitalist concepts were adopted and further advanced in medieval Europe from the 13th century onwards.

The Canadian legal and commercial system inherited from its founding European nations, the English common law and the French civil law, each of which built on a number of the capitalist concepts that had found their way to medieval Europe from the medieval Islamic world.

## Principles

The beliefs of Islam encompass all aspects of a Muslim's life. Islamic law or Sharia, as revealed in and derived from the Qur'an (Text of God) and Sunnah (the sayings and practices of the Prophet Muhammad), governs all economic activities and undertakings of Muslims.

The Islamic economic model is based on a series of principles, including the following:

- Everyone involved in a transaction must make informed decisions that are based on the principle of fairness. The Islamic economic model aims at social justice and economic prosperity for the whole community;
- The right of individuals to pursue personal economic well-being is encouraged and promoted, but a clear distinction is drawn between those commercial activities that are allowed (halal) and those that are forbidden (haram). For example, transactions involving alcohol, pork related products, armaments, gambling and other socially detrimental activities are forbidden;
- A strict and explicit prohibition of Riba, most usually described as usury or interest. Islamic law scholars consider exchanging interest payments within the conventional banking system as a type of Riba. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth generating investment activities and operations. These include profits from trading in (real) assets and cash flows from the transfer of usufruct (the right to use an asset), for example, rental income;
- A risk and profit-sharing (and loss bearing) philosophy, although not so risky as to constitute gaming or gambling. Islamic transactions are similar to equity based transactions in rewarding performance. However, Islamic law requirements go further to ensure that in distributing profits, more emphasis is placed on reward for effort rather than reward for merely owning capital; and

- Islamic commercial jurisprudence consists of principles and rules that must be observed for transactions to be acceptable in Islam. One important principle is contractual certainty.

### **Development of Islamic Banking**

The first modern experiment in Islamic banking occurred in 1963 in Mit Ghmar in Egypt. The Mit Ghmar savings project, a form of microfinance, was based on profit-sharing and the modern credit union movement and in 1971 it became the Nassar Social Bank.

In 1975, in consultation with Malaysia and Saudi Arabia, the Islamic Development Bank was created to provide funds for development projects in member countries.

In the 1970s and 1980s investors focused on replicating traditional commercial banking functions in an Islamic law compliant manner.

More recently, over the past 20 years, Islamic banks have become increasingly sophisticated and their products reach into almost every element of retail banking, wealth management and investment banking.

There are three regional developments to note. First, there is the status of Islamic finance in the Co-operation Council for the Arab States of the Gulf Countries (GCC) (i.e., Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates). Bahrain was the first GCC country to develop a comprehensive approach to Islamic banking and finance. The Central Bank of Bahrain (CBB) is playing a key role in the adoption of Islamic banking in Bahrain. In addition, Bahrain is the host to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Bahrain has mandated AAOIFI standards for CBB related entities and has an Islamic bond (Sukuk) issuance program.

Qatar (including Qatar Financial Centre), the United Arab Emirates (including Dubai International Financial Centre) and Kuwait have all formally supported Islamic banking and investment. The Kingdom of Saudi Arabia has formalized a robust regulatory structure for Islamic banking and finance.

Second, in the South East and South Asia, Malaysia has successfully implemented a dual banking system (conventional alongside Islamic), and has shown a significant commitment to the development of an Islamic banking industry globally. Malaysia is the home for the Islamic Financial Services Board (IFSB) that is the second multi-state regulatory body, along side AAOIFI. In addition, in Pakistan, the State Bank of Pakistan (the central bank of Pakistan) has also developed a dual track system of bank regulation.

Third, in Europe and North America, there is growing interest in the development of Islamic banking as a complement to conventional banking systems and institutions. Of particular note, are the steps taken by the U.K. Financial Services Authority and the City of London to help London position itself as a global centre for Islamic finance. There are also U.S. developments of note including the willingness of U.S. federal government sponsored mortgage companies to support the development to traditional mortgages.

### **Key Concepts**

#### **Banking**

In a conventional banking environment, the bank is a financial intermediary collecting deposits and making loans of funds deposited at a higher rate of interest than the rate paid in respect of the deposits.

In an Islamic banking environment, the transformation of deposits into loans does not justify the spread as the latter constitutes a pure return on money, i.e., forbidden Riba. In an Islamic banking environment, a return on capital is justified only when the capital has been taken in the form of a real non-monetary asset.

In an Islamic banking environment, the Islamic bank functions as a fund or asset manager and not simply as the financial intermediary, as it does typically in the context of a conventional banking environment.

In an Islamic banking environment, the “deposit” contract between the customers and the bank is a partnership contract – a Mudaraba contract – where the bank is the Mudarib and its customers are the Arbab al Mal (investors). The customers are not lenders or creditors, rather they are investors. This relationship entitles customers to a share of profits and potentially exposes them to a loss of capital. Customers are known as investment account holders.

The Mudaraba is like a deposit account for customers. In accordance with Sharia principles, the account is based on a profit and loss sharing concept. Customers may lose their initial capital placed with the Islamic finance provider. The account provider pools its customers’ funds with its own funds to invest in Sharia-compliant assets (i.e., certain commodities). Each month, the account provider calculates the actual profit and credits its customers’ accounts based on previously-agreed profit sharing ratios. As noted, in the case of losses, customers may lose some or all of their initial capital.

Typically an Islamic current account is either an “Amanah trust” or Wadia (deposit), the latter in Malaysia. In the case of an Amanah account, the bank is entrusted with

the money for safekeeping and it should be returned in whole. In a Wadia account, the bank promises to return the money to the depositor. In each case, there must be complete segregation of the funds from those of the bank. Further, there is a need for a Sharia Supervisory Board engaged by the bank or provided by a properly constituted third party to review the accounts to ensure compliance with the requirements of Islamic commercial law.

In an Islamic banking environment, there is no traditional lending activity. Rather, there are typically three preferred applications of funds. First, deferred contracts of exchange/ fixed income instruments: Murabaha or instalment credit sale; Ijara or lease; or Salam or forward sales by the bank on behalf of its customers. Second, profit sharing methods of Islamic commerce, namely Musharaka (general partnership) and another form of partnership, Mudaraba. Third, service applications provided by Islamic banks are based on other Islamic concepts: Hawala (transfer of money), Sarf (exchange of money) and Wakala (agency contact).

### **Islamic mortgages**

In various jurisdictions, Islamic mortgages have been structured under three different Sharia-compliant contracts, namely, Murabaha, Musharaka and Ijara. In the UK, it is reported that Islamic mortgages have been structured as both Murabaha and Ijara. In Canada, it has been reported that Islamic mortgages have been structured as Murabaha and Musharaka.

Under the Murabaha method, the provider buys the property and sells it immediately to the consumer for the original purchase price plus an agreed profit margin. The consumer pays this higher price in deferred payments in line with a fixed payment schedule.

Ijara and Diminishing Musharaka are the commonly used methods in other jurisdictions, including the UK. In an Ijara contract, the finance provider buys the property and becomes the legal owner. The customer agrees to buy the property from the provider at a defined price at the end of a set period, and signs a lease agreement to occupy the property. During this period, the customer makes regular payments to the provider, consisting partly of the rental payment and partly of a payment towards buying the property. At the end of the term, the legal ownership of the property is transferred to the customer.

In the case of Diminishing Musharaka, the transfer of the ownership is gradual, as the payments made by the customer gradually buys the provider's equity in the property.

### **Islamic Fund and Asset Management**

As noted above, Islamic commercial law draws a distinction between investments that are "halal" (acceptable) or "haram" (not acceptable). An industry screening process is employed to determine whether a particular sector is compatible with the restrictions of Islamic commercial law.

A second screen, a financial screen, is employed to determine whether a particular company is compliant with certain financial ratios that are established and monitored by the financial institution's Sharia Supervisory Board. For example, the S&P/TSX 60 Shariah Index requires that total debt to market capitalization (12 month average) must be less than 33% (leverage compliance). Accounts receivable to market capitalization (12 month average) must be less than 49%. Cash plus interest bearing securities to market capitalization (12 month average) must be less than 33% (cash compliance).

In certain circumstances, revenue from non-compliant activities is permissible, if they comply with the following threshold: Non-permissible income to total revenues can not be greater than 5%.

In 2008, it has been reported that the marketplace for Islamic funds increased to over \$800 billion from about \$75 billion in 2005. Over the next five years, the total market is expected to increase to \$4 trillion. In Canada, to date, there are a small related number of investment fund products that are compliant with the requirements of Islamic commercial law, although one can expect Canada to follow the global trend of significant growth in the coming years.

A certain amount of the growth is expected to come from non-Muslim sources as the principles of Islamic Finance are a good proxy for "ethical" investors.

### **Islamic finance in wholesale markets**

In the last few years, the number of firms offering Shariah-compliant products and services has increased significantly in the global market place. The greatest growth has been in Sukuk markets. The volume of outstanding issues is estimated to be \$70 billion globally, a considerable portion of which is listed in Bahrain and Dubai. London has, however, started to follow suit and has taken steps to become a global centre for Islamic finance and a centre of choice for listing Sukuk by establishing the world's first secondary market for Sukuk. Most recently in December 2009, in what is the first initiative by a major North American Corporation, GE Capital, through a Bermuda subsidiary, GE Capital Sukuk Ltd., has issued a \$500 million Sukuk.

The financial services industry is also very supportive of the idea of a Canadian government issuing a sovereign Sukuk. Their hope is that a sovereign Sukuk will provide a benchmark for pricing, enhance liquidity in the markets and boost Toronto's ability to attract further Sukuk structuring activity.

In the light of Islamic law's prohibition on interest payments, conventional bonds and debt instruments are forbidden under Islamic commercial law. So Sukuk are structured to generate the same economic effects as conventional bonds, but in an Islamic law-compliant manner. This is achieved through using assets and various contractual techniques acceptable under Islamic law.

Initially, these instruments were viewed by the industry as 'asset-backed' debt instruments. Structuring Sukuk is in many aspects similar to securitizations, one common characteristic being that the payouts are based on the performance of the underlying assets. However, there are two key differences between Sukuk structures and securitizations. First, for Sukuk there is no delinkage of the assets from the originator (in other words, there is no 'true sale' of the assets by the originator to the Special Purpose Vehicle). Second, investors in Sukuk are exposed to issuer's risk rather than the assets' risk. The implication for the issuer is that cash flow segregation is only a book entry.

### **Sukuk-al-Ijara – Illustrative Structure**

Conventional bonds and the Sukuk differ in the way they are structured and marketed. In the Islamic version of a bond, the issue is based on the exchange of a Sharia-compliant asset that allows investors to earn profits. While similar in economic terms to conventional bonds, Sukuk may have significantly different underlying structures. It has been reported that AAOIFI has identified at least 14 possible structures for Sukuk and more are being developed. For the purposes of this initial review and in particular the taxation comments below, consider the following Sharia-compliant structure, a Sukuk al-Ijara:

- An obligor enters into a sale-leaseback arrangement using a Special Purpose Vehicle ("SPV") for commercial real estate.
- Investors buy Sukuk certificates in the SPV, obtaining beneficial ownership in the asset that the SPV buys from the obligor.
- The investors may choose to trade the Sukuk on a secondary market.
- A facilitator of the transaction may be paid fees for arranging the structure.

### **Regulatory treatment of Sukuk**

The structures of Islamic products such as Sukuks have created some challenges over their regulatory definitions in the UK and other centres around the world.

There are really two different levels of regulation. First, there is the relationship of the Sukuk to Islamic commercial law. Recently, AAOIFI has issued guidance to Islamic financial institutions and Sharia Supervisory Boards. First, it has indicated that for a Sukuk to be compliant, the real assets of the SPV whether tangible, usufructs or services must be owned by the Sukuk holders, with all the rights and obligations of ownership. The sukuk certificates must certify the transfer of ownership of such assets in its (SPV) books, and the SPV must not keep them as its own assets.

Second, for a Sukuk, to be compliant, it must not represent receivables or debts, except in the case of a trading or financial entity selling all its assets, or a portfolio with a standing financial obligation, in which some debts, incidental to physical assets or usufruct, are included unintentionally.

Third, it is not permissible for the manager of a Sukuk, whether the manager acts as the mudharib (investment manager), or sharik (partner), or wakil (agent) for investment, to undertake to offer loans to Sukuk holders, when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus. It is not objectionable to distribute expected earnings, on account, or to obtain project financing on account of the Sukuk holders.

Fourth, it is not permissible for the mudharib (investment manager), sharik (partner), or wakil (agent) to undertake to re-purchase the assets from Sukuk holders or from one who holds them, for its nominal value, when the Sukuk is extinguished, upon its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of its actual purchase. It is acceptable that a Sukuk manager can be a guarantor of the capital, at its nominal value, in case of his negligent acts or omissions or his non-compliance with the investor's conditions, whether the manager is a mudharib (investment manager), sharik (partner) or wakil (agent) for investments.

Fifth, it is permissible for a lessee in a Sukuk al-Ijarah to undertake to purchase the leased assets when the Sukuk is extinguished for its nominal value, provided the lessee is not also a sharik (partner), mudharib (investment manager) or wakil (agent).

Sixth, AAOIFI indicates that Sharia Supervisory Boards should not limit their role to the issuance of fatwa (i.e., a legal pronouncement in Islam) on the permissibility of the structure of a Sukuk. All relevant contracts and documents related to the actual transaction must be carefully reviewed and they should oversee the actual means of implementation, and make sure that the operation complies, at every stage, with Sharia guidelines and requirements. Furthermore, AAOIFI advises Islamic financial institutions to decrease their involvements in debt-related operations and to increase true partnerships based on profit and loss sharing, in order to achieve the objectives of the Sharia.

There are issues that need to be addressed with respect to compliance with stock exchange listing requirements and securities laws. These are not novel issues. They have been sorted out in other jurisdictions such as the UK, albeit under other regulatory regimes. In the UK, the debate seems to have been whether to treat Sukuks for the purposes noted above, as asset backed securities or collective investment undertaking, rather than as debt securities of the issuer. These issues will require further consideration in the context of any particular Sukuk offering as they would in any other complex offering of securities, however, the Canadian regulatory regime has the flexibility to satisfactorily deal with these issues.

### **Sukuk and Creditor Rights**

In the context of the consideration of a Sukuk by a Canadian issuer, the rights of Sukuk holders and other conventional creditors must be considered. Recent international developments involving the East Cameron Partners 2006 Sukuk, which are now the subject matter of a Chapter 11 proceeding before a US Federal Court in the Western District of Louisiana, and most recently the difficulties faced by Dubai World, and most immediately its Nahkeel subsidiary, reinforce the importance of a clear understanding of the legal framework of the rights and obligations of holders and creditors.

One issue that has arisen in the above noted transactions is the issue of cross-collateralization or conflicting lender interests. In a conventional reorganization, an intercreditor agreement determines how “silent” a holder of a security interest in second position must remain. The holder of the first ranking security interest wants a free hand to negotiate any amendments, out of court restructurings, or reorganization plans, and relevant clauses generally attempt to reserve voting power to the first ranking security interest.

Sukuk-specific issues layer on more legal complexity. Issues start from the status of the Sukuk certificate holders, where there is a trust structure employed.

The issue is whether the certificate holders are actually secured debt-holders (good for them, bad for other creditors) or equity-holders (the converse).

Further, with Sukuks essentially structured as securitizations of a stream of revenues, the status of the conveyance is critical. As with other securitizations, if deemed a true sale, the Sukuk holders have more leverage than not.

In summary, to the extent that rights can be clarified for all parties, market receptivity, certainly with respect to corporate issuers, will be enhanced.

### **Takaful**

Takaful operations are mutual in nature and similar to conventional mutual insurers. Takaful firms and products are structured in a manner to address the specific concerns of Sharia scholars with conventional insurance products, namely uncertainty (gharar), gambling (maisir), interest (riba) and investment strategy. To deal with these concerns, Takaful products have three distinctive features – greater transparency in providing a clear distinction between the Takaful fund, which consists of contributions from policyholders akin to premiums, and the Takaful operator who manages the fund; an element of profit sharing; and limitations on acceptable investments.

Specific models for Takaful will vary, but Takaful operations often have a two-tier structure consisting of one or more funds belonging to policy holders, above which sits a limited company with share capital which is responsible for overall governance, underwriting of risks, and investment management. Like conventional insurers, Takaful companies can generate a return based on their underwriting activity and their investment activity. The remuneration is either based on fixed fee or performance, but is commonly a combination of both, with underwriting subject to a fixed fee and investment management performance related. At times when the Takaful operator’s activities generate a loss and the funds are in deficit, this can be made up by an interest free loan provided by the limited company, to be repaid once the funds are in surplus again.

As yet, Takaful activity in Canada remains very limited, with only one provider active. From a regulatory perspective, the Canadian regulators would treat a Takaful provider as it would any other insurance provider, assuming there was enough similarity in function and form. Given the parallels drawn between Takaful providers and conventional insurers, particularly mutual insurers, ratings agencies are also likely to assess them using the same method.

## THE DEVELOPMENT OF ISLAMIC FINANCE IN CANADA

The roots of Islamic finance in Canada trace back to Toronto, beginning with the establishment in 1979 of the Islamic Co-operative Housing Corporation Ltd. (the "Co-operative"). The Co-operative was the only available solution for financing hundreds of homes for over 25 years relying on limited community investment funds. These funds were reinvested in homes to structure a home financing partnership based on a rent-to-own model. Over the years, additional co-operatives have been organized that have similar objectives to those of the Co-operative. Subsequently, a number of other Islamic housing co-operatives have been formed in Montreal and Toronto.

Earlier in this decade, there have been some initial attempts to establish other financial products compliant with the requirements of Islamic commercial law. These include an Islamic deposit account at Metro Credit Union, a term deposit product at McMaster Credit Union and the issuance by Royal Bank of Canada of Islamic commercial law compliant equity-linked notes sold through bank branches.

In recent years, there have been a growing number of initiatives as follows:

- At least two mutual fund groups, frontierAlt and Global Prosperata, have launched mutual funds that are designed to hold only investments that are Islamic commercial law compliant.
- The Cooperators Group has launched an auto Takuful product in association with Ansar Co-Operative Housing Corporation.
- UM Financial has a real estate brokerage firm called UM Realty and a real estate investment company called UM Investment. UM Financial offers home financing using funds invested in UM Real Estate Investment Fund Inc. In addition, UM Financial services a \$120 million home finance portfolio that was offered through a Mudaraba financing agreement with Credit Union Central of Ontario (now Central 1 Credit Union). UM Financial also offers RRSP and RESPs through a Real Estate Investment Fund that is organized as a mortgage investment corporation. Most recently, UM Financial has launched a pre-paid Mastercard product.

- Standard & Poor's has launched a Sharia compliant version of the S&P/TSX 60. The S&P/TSX 60 Sharia Index is highly correlated to the S&P/TSX 60 Index, and as such provides a comparable investment portfolio while adopting explicit selection criteria defined by Islamic law.
- AYA Financial is providing Islamic finance advisory services to institutional clients, including commercial and residential real estate and auto financing and leasing. AYA specializes in structuring and developing Sharia compliant products for financial intermediaries.
- State Street, a leading global provider of financial services to institutional investors, is providing advice and services to sovereign wealth funds from its significant Toronto platform, including a Sharia compliant portfolio. State Street has organized a Professional Muslims (employee) Network to help highlight the emergence of Islamic finance and State Street's commitment to this expanding investment market.
- An Islamic Finance Advisory Board (IFAB) has been formed. The Board is an independent, non-profit organization, which provides professional and authoritative Shariah-compliant advisory, awareness, and audit functions to the financial services industry in Canada, including financial institutions in Ontario, Manitoba and Alberta.

These recent announcements and developments reflect the growing interest in the Canadian market for financial products and services that are compliant with Islamic commercial law, as well as growing the relationship between Canada and the Islamic world.

### *Regulatory Developments*

As one would expect given the growing interest in Canada of Islamic finance, it is reported that Canadian financial services regulators have undertaken to study the implications of authorizing financial institutions compliant with Islamic commercial law to carry on business in Canada.

It is reported that a joint task force that included representatives of the Financial Institutions Steering Committee – The Bank of Canada, Office of the Superintendent of Financial Institutions of Canada (OSFI), Canada Deposit Insurance Corporation (CDIC) and the Department of Finance – has considered the extent to which current federal banking and other financial services rules would need to be adapted to accommodate Islamic banks and other institutions that sought to comply with Islamic commercial law, as well as non-Islamic institutions that might seek to offer an Islamic window for a menu of Islamic commercial law compliant products.

In addition, Canada Mortgage and Housing Corporation (CMHC) commissioned a study of the implications of the growth and development of a market for Islamic commercial law compliant mortgages. The report of the CMHC confirmed that Islamic mortgages are permitted under Canadian law.

It has also been reported that a number of applications have been filed with OSFI seeking permission to establish an Islamic bank in Canada.

### **Key Regulatory Challenges**

One can expect that the regulators are considering, among other things, the application of the current rules for federally chartered conventional banks to banks that are either uniquely or in part in business lines that are compliant with Islamic commercial law. This would include the application of the Bank Act and the Canada Deposit Insurance Corporation Act to banking institutions that are compliant with Islamic commercial law, as well as commodity and income tax issues related to the activities of those entities. Reforms in 2001 were put in place to encourage competition in the Canadian domestic market, and since that time a number of new financial institutions have been authorized to carry on business. There is no reason to believe that certain banking institutions that are compliant with Islamic commercial law could not also obtain the necessary authority to carry on business in Canada, subject to satisfying the requirements of Canadian law.

#### **Bank Act**

In determining whether to grant an applicant a charter to become a chartered bank, the Minister of Finance is required to take into account all matters that the Minister considers relevant to the application, including: (a) the nature and sufficiency of the financial resources of the applicant or applicants as a source of continuing financial support for the bank; (b) the soundness and feasibility of the plans of the applicant or applicants for

the future conduct and development of the business of the bank; (c) the business record and experience of the applicant or applicants; (d) the character and integrity of the applicant or applicants or, if the applicant or any of the applicants is a body corporate, its reputation for being operated in a manner that is consistent with the standards of good character and integrity; (e) whether the bank will be operated responsibly by persons with the competence and experience suitable for involvement in the operation of a financial institution; (f) the impact of any integration of the businesses and operations of the applicant or applicants with those of the bank on the conduct of those businesses and operations; (g) the opinion of the Superintendent regarding the extent to which the proposed corporate structure of the applicant or applicants and their affiliates may affect the supervision and regulation of the bank, having regard to (i) the nature and extent of the proposed financial services activities to be carried out by the bank and its affiliates, and (ii) the nature and degree of supervision and regulation applying to the proposed financial services activities to be carried out by the affiliates of the bank; and (h) the best interests of the financial system in Canada. These criteria are relevant, whether or not the business being proposed were a conventional banking business or one that was compliant, in whole or in part, with the requirements of Islamic commercial law.

All applicants, whether they be seeking letters patent to undertake a conventional banking business or one that was compliant, in whole or in part, with the requirements of Islamic commercial law must satisfy three fundamental elements of the application process: a strong business plan, experienced management and adequate capitalization. All applicants are subjected to a very high level of scrutiny.

There is no evidence that Canadian regulators are considering an entirely separate system of regulation for Islamic banking institutions. Rather, the focus is likely to be on considering the extent to which, if at all, current rules may need to be revised to accommodate banking business that is compliant, in whole or in part, with the requirements of Islamic commercial law.

For example, the regulators may have issues with the extent to which a Sharia Supervisory Board might purport to exercise some of the responsibilities that are traditionally vested in a Board or Directors.

The regulators may be concerned with the role of an Islamic bank in acquiring and holding real estate, as part of murabaha-based residential lending activities.

For some applicants who have capital sourced largely or exclusively from abroad, the regulators may be concerned with issues related to ownership or control.

The regulators may also be concerned with whether some of the activities of an Islamic bank can be construed as dealing in goods, wares and merchandise.

The Bank Act includes limitations on the ability of a bank to be a general partner in a limited partnership, or a partner in a general partnership without the approval of the Superintendent. The need for the Superintendent's approval may be an issue for a bank acting in accordance with the requirements of Islamic commercial law.

In addition, the rules with respect to disclosure of borrowing costs may need to be adjusted to reflect the non-interest bearing nature of lending provided by a Canadian bank acting in accordance with the requirements of Islamic commercial law. There is regulation making authority to exempt loans that are in a class prescribed in regulations and this could perhaps be relied upon to address the needs of a Canadian bank chartered to undertake the activities consistent with Islamic commercial law.

Finally, there are portfolio limits imposed on Canadian banks that may be an issue. Specifically, a Canadian bank cannot hold real estate or equities beyond limits that are prescribed by regulations.

### **Canada Deposit Insurance Corporation Act**

Generally, the CDIC is required to insure deposits held by a financial institution, including a bank, in respect of which an order approving the commencement and carrying on of business has been made by the Superintendent unless the order prohibits the institution from accepting deposits in Canada; or the order authorizes the institution to accept deposits in Canada on a limited basis.

An issue that may arise, is the extent to which banking institutions acting in accordance with the requirements of Islamic law will be compliant with CDIC requirements.

### **Other Regulatory Issues**

There are a variety of other issues that have a regulatory dimension on which Canadian regulatory authorities, both federal and provincial, would likely appreciate some input from applicants or other interested parties. These issues have been identified in the UK, and the summary below relies on the UK analysis. These include the following:

- Contract and documentation risk. In contracts for Islamic transactions, the enforceability of terms and conditions depends on the governing law. In the case of a dispute, it is unlikely that a Canadian court will give a verdict based on Sharia law. The most proximate precedent here is the case of Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd et al, where the

U.K. Court of Appeal ruled that it was not possible for the case to be considered based on principles of Sharia law. There were two main reasons. First, there is no provision for the choice or application of a non-national system of law, such as Sharia. Second, the application of Sharia principles was a matter of debate, even in Muslim countries. To mitigate this risk, contracts have to be written very carefully to minimize potential disputes and state the governing law.

- Risk management framework. Sharia scholars of a wholly Islamic firm require all transactions within the firm to be in compliance with Sharia, including risk management. Many of the commonly used tools (for example, certain types of derivatives which are used for hedging against currency, interest rates and other risks), are not acceptable to almost all Sharia scholars.
- Liquidity management has also been a challenge because of the lack, or limited availability, of Sharia-compliant instruments.
- Capital requirements. UK experience in respect of capital adequacy may be instructive in Canada. Under Basel 1, Murabaha-based home finance products were considered to have the same risk as conventional mortgages, risk weighted at 50%. Ijara-based products, however, were risk weighted at 100%, making them more expensive for providers than conventional mortgages. Under the EU Capital Requirements Directive, the risk weights of all three products are the same in the UK, set at 35%, under the standardized approach. The new Basel 2 capital risk framework has now been implemented in Canada. Basel 2 is a revision of the existing Basel accord, which aims to make the framework more risk sensitive and representative of modern banks' risk management practices. If, in practice, certain risks affect Islamic institutions more or less than conventional firms, OSFI would expect these to be identified and quantified under Basel 2.
- The role of Sharia scholars. While some of these principles and rules are based on clear and explicit rulings, others are derived from Sharia scholars' interpretations and understanding of the law, known as Fiqh, as set out in the Qur'an. These interpretations can and do differ between Sharia scholars. Certain contractual terms, deemed to be acceptable under Sharia by the scholars of one school of Fiqh, may not be acceptable to scholars from another school.
- On a global level, the approval of Islamic firms' products and services may also depend on the jurisdiction in which they are to be offered in. This can add another layer of complication for regulators.

- Sharia compliance throughout the product life cycle. For Islamic finance providers, gaining approval on Sharia compliance of a product before its launch is vital. Equally important is recognizing that Sharia compliance is a continuous process that means their products and services are adequately monitored. Unlike conventional finance, this has implications for an Islamic firm's prudential requirements as well as conduct of business: some products, if they breach Sharia compliance rules, can adversely affect a firm's solvency by converting an asset into a liability on the balance sheet.
- Addressing the unique issues facing sovereign issuers of Sukuks in Canada, including analysis and proposing relevant changes to legislation governing borrowing and guarantees by governments, and the sale/lease of public land. In Ontario, this would include consideration of the Financial Administration Act and the Public Lands Act.
- The applications of Canadian consumer and real estate law to private transactions that are compliant with Islamic commercial law principles.

## CANADIAN TAX CHALLENGES

Obtaining clarification on the income and indirect tax treatment of Islamic finance products will be important to the development of Islamic finance in Canada for a number of reasons.

First, Sharia-compliant products generally do not fit within the definitions that currently govern conventional financial products, despite their similar economic features. Second, tax authorities and taxpayers lack knowledge of the specific features of the Islamic finance products. Third, the wide number of Islamic finance products may create the need for significant resources to approach tax authorities. The process of obtaining rulings from tax authorities can be quite lengthy, considering the technical, interpretative and policy issues to be addressed. From a Canadian tax perspective, a taxpayer should follow the legal nature of the transaction provided that tax legislation does not indicate otherwise, or the transaction is a sham.

Set out below are some preliminary comments on what are likely to be the key Canadian taxation related issues, that will arise in the context of some of the most common forms of transactions, subject to Islamic commercial law.

### *Mudaraba*

#### **Income Tax Issues**

The fees, profit and loss from the Mudaraba should be included in the provider's business income. The customer's share of the profit should be treated as income and fully taxed. Issues may arise where the customer is not a resident of Canada. In this case, it will be necessary to examine the character of the payments from a Canadian legal perspective, and in some cases, non-resident withholding tax may arise. As there are penalties for failure to withhold, it may be advisable to seek advance tax rulings from the Canadian tax authorities in order to obtain a higher degree of certainty on the proper tax treatment.

#### **Commodity tax issues**

The Mudarib fee, or manager's fee, relates specifically to the Islamic finance provider's profit and is often explicitly identified along with other profit components. Issues arise as the fee may be viewed as analogous to a fund manager's fee and therefore subject to GST. Therefore, it is important to properly characterize in any terms and conditions the fee as a share of or deduction from the overall profit and not a fee related to fund management.

#### **Income Tax Issues**

Generally, a taxpayer should include in business income the difference between the cost of a good and the amount for which it has been sold to the customer in the year of sale. Where the proceeds have not been fully received in the year of sale, the taxpayer may claim a reserve (except where the property is real property) for unpaid amounts for up to three years. Accordingly, it is possible that a financial institution may report financing income earlier under a Murabaha structure compared to a conventional financing structure such as a loan.

However, where it is reasonable to consider that a payment is partially of an income nature (such as interest) and partially of a capital nature, Canadian tax legislation provides that the part of the payment that can reasonably be regarded as being of an income nature should be included in taxable income in the year in which the amount was received or became due. As the fair market value of the property is less than the amounts to be paid over the term of the Murabaha, each payment under the Murabaha may be considered to be partially of a capital nature and partially of an income nature. Accordingly, the profit margin may be recognized in the provider's taxable income over the term of the Murabaha as each payment is made. If the provider takes this position, then there should not be a significant difference from an income tax perspective between a Murabaha and a conventional loan.

For a customer, the total amount paid for a property typically should be the cost to the customer of the property. However, where only a portion of the amount paid can be considered to reasonably represent interest or another income item to the recipient, the customer may be able to claim a deduction for the income portion of the payment if it was incurred to earn business or property income.

#### **Commodity tax issues**

Under a conventional credit arrangement under which the title to property being sold is transferred on the date of the sale and the borrowed amount is payable by instalments, the sale of the product would be subject to GST and the credit charge would be GST-exempt as a financial service. In the case of the Murabaha, the institution purchases and resells the good. As there is a second transaction on an increased amount (i.e., the price of the good plus the profit), a higher GST and QST amount may be exigible. GST and QST would not arise if the profit amount could be viewed as a financing cost or interest and thus

as a financial service. However, the current definition of “financial service” does not appear to support this interpretation.

The net effect is that the consumer under a Murabaha could face higher costs than a consumer who uses a conventional financial instrument, raising the risk that Murabaha products will be unattractive to the marketplace. Ensuring the profit element (i.e., the amount equivalent to a financing charge) is GST-exempt will be crucial to the product’s competitiveness, and achieving this treatment will require collaboration with the tax authorities.

PST issues will also arise under a Murabaha. Under a conventional structure, PST applies on the sale of the good from the retailer to the customer absent any relieving mechanism such as an exempting certificate or permit. Under a Murabaha structure, a higher amount of PST could apply to the sale by the institution to the customer because the tax is payable on the value that includes the profit element. Steps could be taken to exempt the sale from the vendor to the institution from PST. Issues regarding place of supply could also arise where the institution is registered in multiple PST jurisdictions.

In summary, the Murabaha structure could result in higher GST, QST and PST costs to the purchaser, and additional compliance obligations and costs for the Murabaha provider.

### *Diminishing Musharaka with Ijara*

#### **Income Tax Issues**

Where the transaction is considered to be a lease of the property combined with a series of dispositions by the financial institution, the institution should include the monthly rent in taxable income when the payments are received or on an accrual basis. In addition, where the property is depreciable property, it will be categorized into various tax depreciation classes according to the type of property. The financial institution should be able to claim a deduction for tax depreciation, based on the tax depreciation rate for the particular class. The amount of tax depreciation that can be claimed may be restricted where the leased property is considered to be “specified leasing property.”

The portion of each instalment payment that represents proceeds of disposition of a portion of the property should be credited to the relevant class of property, to the extent that the proceeds do not exceed the original cost of the assets. Under certain circumstances, a recapture

of previously deducted tax depreciation may occur or a terminal loss for the undepreciated portion of leased property may arise in the year.

For the customer, the total amount paid for a good typically should be the cost to the customer of the good. Consequently, the portion of each instalment that represents consideration for acquiring an additional ownership share should be added to the customer’s cost of the property. The portion of each instalment that represents rent may be deductible by the customer for tax purposes, if it was incurred to earn business or property income.

#### **Commodity Tax Issues**

The Diminishing Musharaka with Ijara illustrates how Islamic finance could create GST issues, particularly where the property is a newly constructed residential housing.

A Sharia-compliant mortgage structure involves four steps:

- Step 1 — The Islamic finance provider purchases the property from the vendor.
- Step 2 — The Islamic finance provider enters into a long-term lease for the property with the purchaser.
- Step 3 — The purchaser’s equity interest increases over time.
- Step 4 — The purchaser ultimately purchases the remaining legal interest in the property.

Under a conventional mortgage, the purchaser would pay GST to the builder and likely assign any resulting GST new housing rebate to the builder, where the conditions for that rebate are satisfied. Any interest payable to the lender under the mortgage would be GST-exempt as a financial service.

Under the Diminishing Musharaka with Ijara, Step 1 would constitute a GST-taxable supply. As the institution would be entering into a long-term lease with the customer in Step 2, the institution would be considered a builder and required to self-supply. Consequently, the financial institution would be required to account for GST on the fair market value of the property and claim an input tax credit for the GST paid under Step 1. As the institution would be leasing the property to the purchaser, the institution would be eligible for a new housing rebate as a landlord. The rents would be GST-exempt. The supplies made in Steps 3 and 4 should be exempt.

Considerably more GST issues must be managed under a Diminishing Musharaka with Ijara. The increased compliance obligations and costs risk making this product uncompetitive. In reviewing such proposed transaction, the key objective would be to ensure that no unanticipated GST cost would arise.

Also of note is the potential application of land transfer tax ("LTT"). In Ontario, absent any provincial government relief, the transaction under Step 1 would be subject to LTT. The transactions under Step 3 and Step 4 would also attract LTT, although the legal title transferred in Step 4 probably would have only nominal value. Under Step 3 not only would LTT apply again, but, depending on value of the real property interest transferred, timing and valuation complications could arise due to the tiering of LTT rates. It would be critical that the provincial tax authority view this as a "back-to-back" transaction and apply relief administratively on this basis.

## **Sukuk-al-Ijara**

### **Income Tax Issues**

From an income tax perspective, the taxation of the Sukuk-al-Ijara product described above may be similar to that of a sale-leaseback transaction, from the perspective of the SPV and the obligor. As such, there are no unique tax issues to resolve. If the transactions are determined in law to be a sale followed by a lease, the obligor should realize a gain or loss on the sale of the asset to the SPV and may be able to claim a deduction for the lease payments if they were made in order to earn income from a business or property.

If on the other hand, the transactions are considered to be a loan arrangement in law, then a sale of property is considered not to have occurred and the SPV and obligor are considered to be lender and borrower respectively. In this case, the payments are treated as a combination of principal and interest for tax purposes. The Canadian tax authorities have indicated that the intent of the parties to enter into a loan arrangement is evident where the sale price of the property is substantially different from its fair market value.

The SPV will typically be structured as a flow through vehicle, such that the SPV will not pay any income tax. Where the transactions are considered a sale and leaseback in law, the investors will be considered to receive either trust income or rental income, depending upon whether the SPV is a trust or a partnership. In both cases, the income from the SPV will be fully taxed.

Potential issues may arise where the investors are non-residents. Under a conventional bond instrument, interest should not be subject to Canadian withholding tax when paid to arm's length non-residents, provided that the interest is not "participating debt interest." However, depending upon the legal character of the transactions and of the SPV, an investor holding a beneficial interest in the underlying asset may be considered to be receiving rent on that asset. Payments of rent to non-residents are subject to Canadian withholding tax at a rate of 25% on the gross amount, unless a tax treaty reduces the rate. Where the rent is in respect of real or immovable property in Canada, the non-resident may instead choose to file a Canadian tax return and pay Canadian tax on the net income from the property. Alternatively, the investor may be considered to be receiving trust income. Trust income paid or credited to non-residents is also subject to Canadian withholding tax at 25%, subject to treaty reductions. Accordingly, non-resident investors in a Sukuk-al-Ijara product could be at a disadvantage to investors in a conventional bond.

### **Commodity tax issues**

The GST issues for a conventional bond arrangement are fairly straightforward. Interest paid by the issuer to the investor is exempt from GST. Any services provided by arrangers or facilitators of the transaction would also have to be analyzed to determine if any related fees would be taxable (e.g., as advisory fees) or exempt (as fees for arranging services) for GST purposes.

In the equivalent Sharia-compliant transaction, GST could have a significant impact. GST implications would arise on the sale-leaseback between the obligor and the SPV depending on the nature of the assets. Assume the property is commercial real estate. The SPV would sell a beneficial ownership in the underlying asset, which would not be an exempt financial service. As the property is commercial real estate, GST would apply to the sale of the beneficial interest to the investors. Any rents paid to the investors would be subject to GST. Any subsequent trading would also have GST implications. Finally, any fees paid to arrangers or facilitators of the transactions would be subject to GST, as no exempting provision applies. GST could have a significant impact at each stage of the transaction.

Where the SPV or investors are non-residents, particular care should be taken to determine which party accounts for the GST on the real property transactions (i.e., the initial sale and the sale of the interest to investors). More mundane issues, such as triple net leases and property

improvements, would also have to be managed. Ultimately, the transaction potentially creates GST compliance obligations and costs for the obligor, the SPV and the investors, and potentially cash flow issues.

As this example involves commercial real estate, significant LTT could also arise. As with the Diminishing Musharaka with Ijara, there is a risk of multiple LTT applications, which could cause significant additional costs.

In short, even though a Sukuk would be designed to give the same return as a conventional bond, the impact of GST and LTT could make these structures less attractive.

## EDUCATION AND HUMAN RESOURCES

It is widely acknowledged that there is a global shortage of experienced professionals in the Islamic finance sector. Malaysia appears to be the world leader in having taken steps to address this issue of a skilled workforce, having established in 2006, the International Centre for Education in Islamic Finance, and more recently the Sharia Research Academy. The Centre offers a three-year chartered Islamic professional qualification.

Bahrain, through the Bahrain Institute of Banking and Finance, is a leading world-class provider of training, education and professional development programs to the financial services industry in Bahrain and the Gulf region.

In the UK, the Securities and Investment Institute, working in partnership with the Central Bank of Lebanon, has developed education programs leading to an Islamic Finance Designation.

The absence of a pool of skilled professionals could also be an issue for Toronto if it takes steps to accelerate the development of an Islamic financial community. Accordingly, it will be important for Toronto to develop a pool of professionals with the requisite understanding of the principles of Islamic Finance.

The newly created TFSA Centre of Excellence in Financial Services Education (Centre) is well positioned to play an important role in helping to ensure that the relevant skills are readily available. At the same time, the Centre will be able to assist the community to build linkages to other countries where Islamic finance is well established and there are opportunities to create strategic information and related relationships.

In addition, the Centre could also establish and maintain a portal, a clearinghouse, for interested parties to access recent developments. It should also be able to establish a portal in order to start posting program offerings, conferences and upcoming research symposia related to Islamic Finance.

The TFSA should seek to align itself with one or more leading international organizations that have the capacity to help fill the educational gap. In addition, the Centre should be able to act as a catalyst for local educational initiatives as well.

## OUTLOOK AND FUTURE DIRECTIONS

### Overview

The foundations for the development of Islamic finance in Canada continue to be laid. Although the rate of growth cannot be predicted accurately, there is clearly scope for expansion.

To date, the industry has largely concentrated on providing mortgage and savings products for retail consumers. Clarification of the tax and regulatory developments outlined above could benefit the market and provide incentives for further expansion.

There is also the prospect for one or more Islamic banks, which would be a focus for further growth, either in the retail market or the wholesale market.

As regards structuring financings as Sukuks, the recent GE Capital Sukuk is likely to increase interest in Sukuk financings within the North American community.

At the same time, the prospect of helping to finance the recently elevated debt levels of Governments in Canada, in the form of one or more Sukuks, may be one of the most important short-to-medium term opportunities for the development of Islamic finance in Canada.

Looking further ahead, there is scope to expand the market for Islamic products and services to non-Muslims, as well as Muslims. The market is not confined to a particular group of consumers, and Islamic finance providers can position their products to appeal to the much larger non-Muslim population. Their success in doing so will, in part, depend on the ability to demonstrate how the products are underpinned by generally accepted ethical principles. If Sharia-compliant products are no longer seen as 'exotic' or niche products, the industry could benefit from economies of scale that would help to sustain it over the longer term.

While there have been a number of encouraging developments over the past five years, there is considerable work to be done to translate the potential of Islamic finance into a sustainable reality in Canada, and in particular, in Toronto.

The key question is how the TFSA can work to encourage the growth of Islamic finance in Canada and Toronto, in particular.

To begin with, TFSA can help the current members of the Islamic community who have been working to enhance the existing level of Islamic finance, network within the conventional financial system. It seems clear that an important building block for these entrepreneurs will be the willingness of the conventional financial system to design and offer products and services compliant with Islamic commercial law. The work of the IFWG can contribute to this effort.

The TFSA can work to help clarify the regulatory environment, relevant to products and services compliant with Islamic commercial law. In the past, TFSA played a strong role in lobbying governments to eliminate capital taxes imposed on financial institutions. For Islamic finance to flourish there must be certainty, both with respect to retail and financial activities. TFSA can help to create reasonable positions on the key areas of uncertainty, starting with issues of taxation, both income and commodity, and make the case to governments that changes are desirable.

In addition, the newly authorized Centre of Excellence in Financial Services Education is well positioned to assist the community in building linkages to other countries where Islamic finance is well established, and where there are opportunities to create strategic alliances and related relationships. In addition, the Centre can establish and maintain a portal, a clearinghouse, for interested parties to access recent developments and to start to post program offerings, conferences and upcoming research symposia related to Islamic finance.

Building on these efforts, TFSA can become a valuable partner to Canadian governments seeking to increase the level of foreign direct investment from the Gulf Region. If TFSA can actually contribute to a more favourable environment in Canada for Islamic finance, then this effort can be used to help promote Canada to the Gulf Region and other parts of the world where Islamic finance has flourished.

In 2010, it is recommended that the IFWG undertake a research agenda that will include background papers on key issues relevant to the development of retail Islamic finance, Sukuks, in particular, sovereign Sukuks, the taxation of Islamic finance and professional education and development programs.

On issues of Canadian law, the IFWG has already formed some preliminary views of key issues and the preferred resolutions.

## **Principles of Reform**

Below are a number of suggestions to changes to Canadian tax and commercial legislation that should be considered, in order to ensure a level playing field between traditional financial products and Islamic finance products. The intent is to ensure that the parties to an Islamic financial product are taxed in a way that is neither more nor less advantageous than the parties to the equivalent “traditional” financial product. In addition, Sharia-compliant products generally do not fit within the definitions that currently govern conventional financial products. Accordingly, it is desirable to eliminate uncertainty and unpredictability over their treatment for Canadian tax and commercial purposes. Set out below are the preliminary views of the IFWG with respect to key issues that need to be addressed.

## **Taxation**

### **Income Tax**

Under Sharia principles interest is strictly prohibited. Instead, many Islamic financial products involve the sharing of “profit” (e.g. Mudaraba, Sukuk). It may be unclear whether non-resident withholding tax applies to such sharing of “profit”. It may also be uncertain whether expenses incurred in lieu of interest are deductible. Accordingly, consideration should be given to amending the *Income Tax Act* (Canada) (ITA) such that any references to “interest” apply to gains or profits received, “alternative finance return” and expenses incurred in lieu of interest in transactions conducted in accordance with Sharia principles.

Many Islamic finance transactions require an interest in an underlying asset and thus may involve the transfer of an asset. To the extent a portion of the gain realized by the finance provider upon the transfer of the asset (e.g., in a Murabaha transaction where an asset is purchased by the finance provider for the customer and then sold to the customer, almost immediately, for a profit) can economically be treated as remuneration for the deferral of payment and is comparable to interest on a conventional financial product, changes to the ITA should be considered to spread the taxation of the gain over the payment term.

Consideration should be given to amending the definition of a disposition to exclude disposal of an asset pursuant to a financing transaction required solely for the purpose of complying with Sharia principles (i.e., to exclude a disposition strictly required for the sole purpose of complying with Sharia, but that would not be required in any other financing transaction).

### **GST/HST**

A number of amendments to the Excise Tax Act (ETA) would be required in order to take into account certain Islamic finance transactions. The ETA, which governs the GST/HST legislation, is very prescriptive in its form, and therefore requires clear legislation and/or regulation in order to address specific terms and concepts. Notwithstanding, certain issues regarding the application of GST/HST to a Sharia compliant product could be addressed via interpretive policy by the Canada Revenue Agency. We note the UK experience, where Sharia compliant transactions have been addressed for UK VAT purposes via interpretive policy and not specific legislation.

A number of sections within the ETA would warrant consideration for amendment in order to introduce certain Islamic finance concepts. The definition of “financial instrument” found in Subsection 123(1) of the ETA could be amended to include certain types of Sharia compliant products, such as a Murabaha or an Istisna’. These products have a profit component which is akin to a financing charge, and thus like treatment with conventional products within the ETA, would be warranted. By amending the definition of “financial instrument” the Islamic finance products can be caught by the definition of “financial service” found in that same subsection. This is important as inclusion within this definition gives rise to the GST/HST exemption that applies for financial services found in section 1 of Part VII of Schedule V to the ETA

It would also be important to consider whether a provider of Islamic finance products would be considered a “financial institution” as defined in Section 149 of the ETA. This determination will be important in order to determine how the ETA would apply to the provider as well as the compliance obligations. Section 149 contains a list of the types of persons that would be considered a “financial institution”, including a bank, credit union, a person whose principal business is the lending of money and an insurer. There is also a *de minimus* test that looks at revenue generated financial services, and where certain thresholds are achieved, the person is considered to be a financial institution.

If the Islamic finance provider is not considered to be a financial institution this could have some benefits. Under the ETA financial institutions are subject to certain provisions principally focused on restricting Investment Tax Credits (e.g., Section 185, Section 200). These sections would not apply to the benefit of the Islamic finance provider. Moreover, the proposed rules under Section 217.1 for financial institutions that import services from outside of Canada would not be applicable. In addition, the Section 156 election would be available to assist on cash flow relief. (The Section 156 election under the ITA could apply but no relief under the Section 150 of the ITA election would be available.) Finally, the compliance obligations would be lessened. For example, there would be no requirement to file the Annual Information Return.

It is important to note that certain Islamic finance products could, in absence of any amendments to the ETA, receive like treatment with conventional products. For example the GST/HST rules that would apply to an operating lease could equally apply to an Ijara. Similarly, certain Musharaka structures in the residential real property realm could be as GST/HST efficient as a conventional mortgage by virtue of other exemptions contained within the ETA for residential real property. Finally, Islamic insurance – or Takafal – arguably falls within the current GST/HST legislation and could offer like treatment to other types of mutual insurance.

### **Indirect Taxes**

Other indirect taxes may have to be revised to take into account Islamic finance. Quebec Sales Tax is essentially based on GST/HST legislation/interpretive policy, and thus any changes at the Federal level could be replicated by the Quebec Government.

Similarly, provincial sales taxes in other provinces, including Ontario, can impact Islamic finance transactions, particularly where goods are involved (e.g., a Murabaha), thus requiring relieving provisions in order to ensure like treatment with conventional products.

In addition, provincial land transfer taxes, including warrant consideration where Islamic financing vehicles are deployed for real property transactions since they are typically imposed on each transfer of an interest in real property except as security. Here again, what is needed, is legislative relief to eliminate the potential for double taxation.

## **Commercial Law**

Earlier in this report, there is a discussion of the federal financial institution statutes that will need to be considered as part of any such review. In addition to federal and comparable provincial financial institution legislation, it will be necessary to consider the extent to which legislation and regulations relevant to private transactions as well as such legislation and regulations relevant to public transactions (e.g., a sovereign Sukuk), will need to be updated to ensure a level playing field between traditional financial products and Islamic finance products. Set out are some key areas for further consideration, with preliminary approaches to the issues identified.

### **Real Property Considerations**

Certain Islamic finance structures to finance residential property may be caught by provincial legislation relevant to rental of properties. In Ontario, the relevant statute is the Residential Tenancies Act (Ontario). Other provinces have similar statutes. If applicable, among other things, the special residential tenancy enforcement process would be applicable. Presumably, what will be needed is to clearly exempt from the application of these statutes Islamic finance structures to finance residential property. In addition, there are rights provided to a mortgagor under the Mortgages Act (Ontario) that are not generally available, if the statute in its current form is not applicable. The key issue would be how to create a level playing field for the party providing the financing in an Islamic finance structure compared to a conventional finance structure.

### **Consumer Protection**

Each Canadian province and territory has various statutes and regulations that seek to provide consumers with certain protections in credit transactions as defined. It is not clear that consumers who participate in certain financial transactions, structured so as to be compliant with the principles of Islamic commercial law, will enjoy benefits of consumers of conventional financial products and services. It will be important to revise the application of the disclosure requirements so that they also apply to transactions where no interest is charged to the consumer.

## Government Finance

There is, of course, a special body of law that is relevant to financial transactions involving governments in Canada. Each government has a statutory framework that makes provision for the government to finance its operations. In Ontario, this authority is in the Financial Administration Act. In relevant part, the statute describes how the Government of Ontario would authorize the borrowing of money and its ancillary powers with respect thereto. There is no provision in the statute for the Government to structure its borrowing in a form of a sovereign Sukuk, for example, and such authority would be required to be

added to the statute for that purpose. In addition, since a sovereign Sukuk would also require the disposition of crown property, at least on a temporary basis, the authority of the Government to entertain such a transaction would need to be reviewed in light of the general authority of the Government to dispose of such property on that basis. Further, the rights of third parties in respect of entities created to facilitate the financing transaction would also need to be considered. In this regard, one would need to consider whether the special purpose vehicle that would be created to facilitate a sovereign Sukuk would be a crown agency, and therefore an agent of the Crown, and if so, what its status in law might be.

## APPENDIX “A”

### TFSA Islamic Finance Working Group

#### Members List

LAST NAME	FIRST NAME	ORGANIZATION
Graham	Jeffrey	TFSA – Co-Chair/Capital Markets Lead (Borden Ladner Gervais LLP)
Watts	Steven	TFSA – Co-Chair/Retail Financial Services Lead (KPMG)
Viegas	Susan	TFSA – Special Liaison/Education Lead (TFSA)
Palotto	Carmela	TFSA – Tax Lead (KPMG)
Carruthers	Stuart	TFSA – Insurance Lead (Stikeman, Elliott LLP)
Bain	John	KPMG LLP
Bell	Debbie	CSI Global Education Inc.
Butler	Gary	Seneca College
Darroch	James	York University, Schulich School of Business
Daruwalla	Parvez	Ontario Financing Authority
Ebrahim	Salima	Deloitte Inc.
El-Alfy	Hanaa	Ontario Ministry of Economic Development
Faisal	Sarim	UM Financial
Firth	Michael	PricewaterhouseCoopers LLP
Fleming	Andrew	Ogilvy Renault LLP
Ghaeli	Reza	Ontario Financing Authority
Green	Michael	Hill & Knowlton Canada
Habeeb	Alli	North American Muslim Foundation
Hodgson	Tyler	Borden Ladner Gervais LLP
Huda	Rehan	Amana Canada Holdings Inc.
Iyengar	Srini	BMO
Jeffrey	Linda	Central 1 Credit Union
Kalair	Omar	UM Financial
Kelly	John	Seneca College
Khan	Farhan	Scotiabank
Khan	Asad	UM Financial
Koscak	Brian	Cassels, Brock & Blackweel LLP
Llewellyn	Rania	Scotiabank
McPhee	Kevin	Ogilvy Renault LLP
Moore	Glen	Global Prosperata Funds
Puddy	Marc	Jones Brown Inc.
Qazi	Tahmyna	AYA Financial
Rathee	Kam	Blake, Cassel & Graydon LLP
Saeed	Rehan	AYA Financial
Saeed	Ziad	KPMG LLP
Sayeed	Imtiaz	RBC Financial
Sharma	Sunil	CVCA
Stephens	Gina	Ministry of Finance
Subhani	Azeemuddin	University of Waterloo
Yuce	Ayse	Ryerson University, Ted Rogers School of Management
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