

Islamic Finance: Structuring Compliant Transactions For Owner-Managers

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Islamic finance is a fast-growing force. In 2007, Islamic based financial institutions experienced an average 40% balance sheet growth, with solid leadership from banking communities in the UK and Malaysia. Price Waterhouse Coopers estimates 70-75% of Muslims worldwide would like Sharia compliant products and services at competitive prices. Dow Jones now maintains an Islamic Finance Index. Understanding and being able to structure Sharia compliant transactions is something owner managers and their professional advisors need to consider.

What Is Islamic Finance?

At this time there is no single definition of “Islamic” or “Sharia compliant” transactions. However, the goal is fairly well understood – structuring financial transactions that are in accordance with three key principles in the Qur’an, regarding prohibitions against (1) usury, (2) unfair distributions of risk and reward, and (3) investing in proscribed activities.

Consider these sample quotes from the Qur’an:

Those who charge usury are in the same position as those controlled by the devil's influence. This is because they claim that usury is the same as commerce. However, God permits commerce, and prohibits usury. Thus, whoever heeds this commandment from his Lord, and refrains from usury, he may keep his past earnings, and his judgment rests with God. As for those who persist in usury, they incur Hell, wherein they abide forever ([Qur'an 2:275](#))

O you who believe, you shall observe God and refrain from all kinds of usury, if you are believers. If you do not, then expect a war from God and His messenger. But if you repent, you may keep your capitals, without inflicting injustice, or incurring injustice. If the debtor is unable to pay, wait for a better time. If you give up the loan as a charity, it would be better for you, if you only knew. ([Qur'an 2:276-280](#))

O you who believe, you shall not take usury, compounded over and over. Observe God, that you may succeed. ([Qur'an 3:130](#))

That they took riba (usury), though they were forbidden and that they devoured men's substance wrongfully – We have prepared for those among men who reject faith a grievous punishment ([Qur'an 4:161](#))

The usury that is practiced to increase some people's wealth, does not gain anything at God. But if people give to charity, seeking God's pleasure, these are the ones who receive their reward many fold. ([Qur'an 30:39](#))

And that which you give in gift (loan) (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allâh; but that which you give in Zakât (sadaqa - charity etc.) seeking Allâh's Countenance, then those, they shall have manifold increase ([Qur'an 30:39](#))

The Qur'an widely and continuously reaffirms the true Muslim's commitment to charity, without expecting any earthly reward in return. In terms of application to commerce, passages such as these have been interpreted to mean:

- You cannot make money simply from money.
- You can generate money from legitimate trade and commerce, which means you must share in the risk of any investment, and make money from profits not simply from interest.
- You cannot make money from participating in proscribed activities, such as gambling, alcohol, institutions that make money from charging interest, or activities that violate the fundamental principles of Islam.

Interpreting and applying these principles is not without controversy, even with the Muslim community. Islam includes, after all, a large, growing, varied, worldwide and multi-cultural community.

The traditional "Western" view is that the interest component in any particular transaction represents a fair reflection of the risk to the lender. After all, there is risk in every transaction, and the greater the risk then the greater the interest rate. Many Muslims, especially those living in Western countries, feel even the basic Western-style interest based transactions satisfy the requirements of the Qur'an in terms of the prohibition against usury. However, many, many Muslims seek transactions that serve a more conservative interpretation.

There is also the question of whether any transaction that creates a profit for a lender without real investment in the underlying business transaction can satisfy the Qur'an. Many conservative Muslims regard various efforts to avoid the appearance of usury to be usury nevertheless. They look to the substance of the transaction, not to its form.

What all members of the community seem to acknowledge, however, is that financial transactions cannot be exploitive, and cannot be made to support activities proscribed by the Qur'an or which are themselves exploitive. In this respect, the goals of Islamic finance are in harmony with broad principles in the Western tradition as well.

Structuring Transactions That Are Not Usury

Putting aside the issue of exploitation and proscribed activities, the most common issue in structuring Sharia compliant transactions is avoiding simply charging interest on money lent. The transaction must be structured so that the lender gets return *of* investment, with a return *on* investment that amounts to more than simple interest and includes an element of risk sharing with the borrower. Here are some ideas that could be of assistance in structuring Sharia compliant transactions for owner-mangers:

Royalty Based Repayment. A transaction can be structured so that return *on* investment is based gross margin or net profit. In this respect, if the business is not successful the lender makes no return *on* investment. Such a structure could include a graded scale of returns, and even maximum returns. In other words, the greater the profits of the underlying business, the greater the payments. However, it is hard to imagine how any minimum return *on* investment could be compliant. (This practise is sometimes called Musharaka).

Profit Sharing. These transactions resemble joint ventures, in that the lender contributes capital and the borrower contributes other assets, labour or both. The profits are shared between the lender and the borrower. The return *of* capital must be taken into account, as well as some strategy for the lender to exit the business at a certain point. Generally speaking losses are borne according to capital contributed, and on a different basis than profits are distributed. (This practise is sometimes called Mudaraba.)

Purchase And Flip. The lender could purchase the property to be financed, and then re-sell it to the borrower at a profit that takes into account the lender's return *on* investment in the re-sale price and payment terms. These can be difficult transactions to structure, especially if transaction taxes like land transfer tax or sales taxes come into play. There is also the lender's potential capital gains tax to consider. However, the transaction can be structured to include payments over time, or a single payment at the maturity date. (This practise is sometimes called Murabaha.)

Rent To Own. Under the rent to own approach, the lender purchases the property and rents to the borrower on a rent to own program, reflecting the lender's return *on* investment in the rental payment terms and buyout price. Again, tax issues come into play and must be considered. (This practise is sometimes called Ijarah.)

Goodwill Loan. In this kind of transaction, the borrower is only legally required to repay the original capital amount borrowed, but is expected to pay an extra amount at his or her discretion as a token of appreciation and at no pre-agreed amount. This approach could have application in family situations, or where the borrower regularly needs to borrow money. After all, if not much appreciation is shown, the lender will not want to lend a second time. (This practise is sometimes called Qard Hassan).

Some Local Impediments

There can be local impediments to structuring Islamic finance compliant transactions. In Ontario, for example:

Double Tax. Depending on the nature of the underlying asset or the transaction structure, the parties can be looking at double land transfer tax, GST, RST, capital gains tax, etc.

Double Costs. The parties could also be facing double transaction costs, especially on buy and flip or rent to own type transactions.

Cost Base Issues. Purchase prices that include the lenders return *on* investment can artificially boost assessments for municipal tax purposes, or land transfer tax payments. They can also skew adjusted cost base for income tax purposes, which may or may not be accepted by Canada Revenue Agency. They might even artificially boost depreciation and amortization expense, artificially depressing profits. There may be difficulties properly reflecting these transactions under generally accepted accounting principles.

Environmental and other Owner Risks. Lenders also have to be aware of environmental lender and other risks of ownership, which might tag along with an Islamic compliant transaction.

Opinion from Local Scholar. Depending on the community the parties come from, an opinion from a local Sharia scholar might be recommended or required, so that they can have the assurances they need within their community that the transaction their lawyers and accountants have structured will in fact meet their community standards on Islamic finance.

A Closing Thought

In the end, structuring Islamic compliant financing is a matter of personal choice, for both the borrower and the lender. Making a wise choice involves respects for the principles set out in the Qur'an, including a fair allocation of risk and reward between the borrower and the lender, and scrupulous avoidance of exploitation. While the marketplace in general in most Western countries takes such matters into account, it is the most vulnerable who need the most protection. By imposing the burdens of compliance and charity on those most capable of being exploitive, Islamic compliant financing can be an extra margin of protection for those who need it most.