Luxembourg aims at becoming the first non-Muslim country to issue sovereign sukuk

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In mid-December 2013, a new draft bill (Projet de loi n° 6631) has been submitted to the Luxembourg parliament reflecting Luxembourg's intention to become the first non-Muslim country issuing a sovereign *sukuk*. This article depicts the fundamental elements of *sukuk*, outlines how Luxembourg's sovereign *sukuk* will be structured and analyses Luxembourg's role as a hub for structuring Islamic finance investments in and through Europe.

I. Introduction

Islamic finance has gone through a period of exceptional growth. Although no conclusive data is available, it is estimated that the global Islamic finance industry has up to USD 1 trillion in managed assets. *Sukuk* represent one of the fastest-growing sectors within that industry and undoubtedly received the most public attention.

As part of its strategy to diversify the financial centre, the Luxembourg government is keen to place Luxembourg as a partner of choice for Islamic finance transactions in Europe. Given the potential of Islamic finance, major steps have been taken by Luxembourg in recent times to elevate its status to that of a global hub for Islamic finance. The contemplated issuance of a sovereign *sukuk*, which has already been discussed since several years, is meant to be another political statement.

Luxembourg is, however, not the only location competing for the attention of Muslim investors. Instead, the UK Prime Minister David Cameron recently announced that Britain (as well) wants to become the first non-Muslim country to issue *sukuk* in 2014. It will be interesting to see whether Luxembourg will be able to implement its sovereign *sukuk* first in order to benefit from the first mover advantage.

II. What is *sukuk*

Sukuk (plural of the Arabic word sakk meaning certificate) is a *Sharia*-compliant certificate based on an acceptable Islamic financial contract. In many ways it is similar to a conventional bond. However, unlike bonds which are debt-based instruments with interest remuneration, *sukuk* returns are derived from the ownership of assets or *Sharia*-compliant (investment) activities. Thus, *sukuk* investors have a right to receive payments from the ownership of assets (notably, financial assets may not be financed by *sukuk*) or *halal* (permissible) business transaction rather than interest payments which are prohibited under Islamic law (i.e. the prohibition on *riba* [i.e. interest!).

The Accounting and Auditing Organization for Islamic financial Institutions (AAOIFI) lays down 14 different types of *sukuk*. The most popular structures are the *sukuk-al-ijara* (sale and lease back) and the *sukuk-al-musharaka* (partnership or joint venture). It is critical that the issuer of the *sukuk* must invest the proceeds in a *Sharia*-compliant manner using one (or more) of the *Sharia* modes of financing.

The creation of *sukuk* can be done in two ways:
(i) direct structuring of securities, or
(ii) through asset securitization.

While the direct structuring of securities involves the initial issuance of securities and the investment of the funds received in assets/projects, asset securitization assumes the identification, pooling and securitization of assets by a special purpose vehicle (SPV).

Returns are paid to the investors in line with their proportional ownership in the underlying assets. While *riba* is prohibited, the *Sharia* accepts the validity of financial assets that derive their return from the performance of a real asset. *Sukuk* may be issued by governments or by private companies.

III. Tax treatment of *sukuk* in Luxembourg

In Luxembourg, the issuance of *sukuk* may ideally be structured through a SOPARFI or a securitization vehicle. Both vehicles provide for significant flexibility and may issue *sukuk* in the frame of private placements or listings on the Luxembourg stock exchange.

The tax treatment of *sukuk* issued by a Luxembourg company has been clarified in a tax circular released on 12 January 2010 (Circular L.G.-A No. 55 of 12 January 2010). The Circular confirms the classification of *sukuk* as debt for Luxembourg tax purposes. Consequently, under domestic tax law, yield payments[1] under the *sukuk* are treated as deductible expenses at the level of the paying entity.

Furthermore, unlike many other jurisdictions, the Circular confirms that no withholding tax is levied on yield payments.[2] It follows that yield paid under *sukuk* are treated like interest payments under conventional bonds, creating a level playing field between Islamic and conventional finance.

At the level of a Luxembourg resident recipient, yield payments under the *sukuk* are classified as interest income within the meaning of art 97 (1) 3 LIR and assimilated to corresponding payments under bonds in conventional finance.

IV. *Sukuk-al-ijara*

While *sukuk* may be based on all *Sharia*-compliant financing, most *sukuk* currently issued are based on underlying ijara transactions (lease) whereby the stream of income generated from the (sale and) leaseback of real estate or infrastructure assets (for example, airports or buildings) funds the coupon payments to the *sukuk* holders.
The sovereign *sukuk* to be issued by the Grand-Duchy of Luxembourg will also rely on this structure.

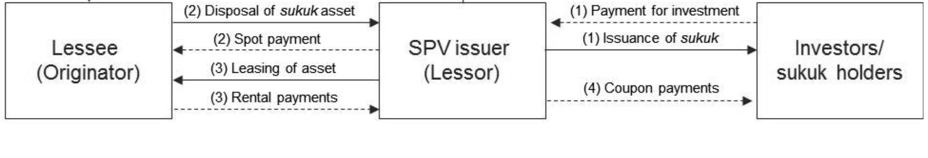
In an ijara transaction, the owner of an asset (the lessor) leases the asset to a lessee who pays periodic rental payments to the lessor for the use of the asset. The duration of the rental and the amount payable are agreed in advance and ownership of the asset remains with the lessor. Following the conclusion of the rental agreement, the lessor cannot increase the rent unilaterally. However, in case of long duration lease, the increase of rental payments may be based on any agreed benchmark during the lease period (e.g. inflation rate or interest-based rate such as EURIBOR). Although under *Sharia* the lessor is responsible for the maintenance and insurance, the related costs can be structured into and recovered through the periodic rental payments.

Steps involved in the structuring of *sukuk-al-ijara*:
1. The obligator sells certain assets to the SPV at an agreed pre-determined purchase price.
2. The SPV raises financing by issuing *sukuk* certificates in an amount equal to the purchase price and this is passed on to the obligator (as seller).
3. A lease agreement is signed between the SPV and the obligator for a fixed period of time where the obligator leases back the assets as lessee.
4. The SPV receives periodic rentals from the originator (Lessee). The cash flow from the lease rentals will be used to service the coupon payments under the *sukuk*.
5. At maturity, or on a dissolution event, the SPV sells the assets back to the seller (obligator) at a predetermined value. That value should be equal to any amounts still owed under the terms of the *sukuk-al-ijara* (i.e. the nominal amount of the certificates).

Sukuk-al-ijara is securities that represent the ownership of well-defined existing and known assets that are tied up to a lease contract. Therefore, such *sukuk* can be traded on the market at a price determined by market forces.

An example of a classic *sukuk-al-ijara* structure would be as follows: An originator sells a pool of physical assets to a SPV for a sales price of EUR 100 million. The SPV finances the acquisition by cash raised via the issuance of *sukuk* certificates. Thereafter, the SPV leases back the assets to the originator for annual rental payments amounting to EUR 8 million. The coupon payments to the *sukuk* holders mirror the rental payments of the lessee.

Chart 1: *Sukuk-al-ijara*

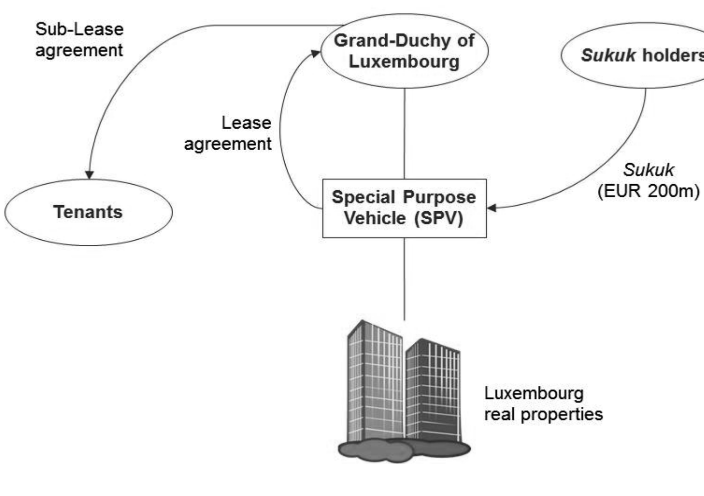


As mentioned above, the sovereign *sukuk* to be issued by Luxembourg will involve the sale-and-leaseback of assets (*sukuk-al-ijara*). More precisely, three buildings including the two towers situated at the Place de l'Europe in Kirchberg[3] and the Gutenberg building in Strassen[4] will be transferred to an SPV (a Luxembourg S.A. owned by the state of Luxembourg) that will issue EUR 200m of *sukuk* (corresponding to the value of the three properties). The *sukuk* may be denominated in EUR or USD.

The *sukuk* will have a term of five years after which the Grand-Duchy of Luxembourg will repurchase the real properties for the initial sales price (the SPV will use the proceeds to redeem the *sukuk*).

Over the lifetime of the structure, the Grand-Duchy of Luxembourg will enter into a lease agreement with the SPV and, in case of third party tenants, sub-lease the properties. The SPV will use the rental income to pay yield to the *sukuk* holders.

Chart 2: Luxembourg's sovereign *Sukuk*



V. Luxembourg: a hub for Islamic finance

Luxembourg has a long track record in the sector of Islamic finance and the Luxembourg government has been actively supporting several initiatives to foster the development of the Islamic finance industry in Luxembourg and to create a pro-Islamic finance environment.

• Luxembourg's track record in Islamic finance

In 1978, Luxembourg hosted the first Islamic finance institution to establish in a western country (i.e. Islamic Banking System International Holding S.A.). In 1983, the first *Sharia*-compliant insurance (*takaful*) company in Europe was established in Luxembourg.

In 2002, Luxembourg was the first European stock exchange to list a *sukuk*. As of December 2013, sixteen *sukuk* with a combined value of circa EUR 5.5 billion are listed and traded on the Luxembourg Stock Exchange (the Luxembourg Stock Exchange ranks number 3 worldwide for *sukuk* issuance). Moreover, with some 40 Islamic funds Luxembourg is already the largest non-Muslim fund domicile with 7% of the global market share (i.e. the only non-Muslim country in the top five).

In the last decade, Islamic investors including sovereign wealth funds from Middle East countries, Islamic investment banks and other *Sharia*-sensitive investors (in particular, high net worth individuals) have been quite active in structuring their investments via Luxembourg (mainly real estate and private equity investments). It is interesting to note that some Sovereign Wealth Funds from Middle East countries[5] (focusing on real estate investments in and through Europe) have opened offices in Luxembourg with own staff to manage and monitor their investments. This development reflects that there is a strong commitment to Luxembourg as a holding location.

The signature on 11 and 12 January 2010 of a memorandum of understanding between Bahrain and Luxembourg, and between the Dubai International Financial Center and Luxembourg for Finance respectively, was meant to foster strong existing business relationship and to further enhance bilateral cooperation and wide-ranging industry development (market access, financial regulation and infrastructure).

In 2010, the Luxembourg Central Bank became a founding member of the International Islamic Liquidity Management Corporation which is an international institution established by central banks, monetary authorities and multilateral organisations to create and issue short-term *Sharia*-compliant financial instruments to facilitate effective cross-border Islamic liquidity management. The Luxembourg Central Bank is further the first European institution to be admitted as an associate member of the council of the Islamic Financial Services Board (IFSB).[6]

In May 2011, Luxembourg hosted the 8th Islamic Financial Services Board (IFSB) Summit, the first time ever in a non-Muslim country. Also in 2011, the CSSF (Commission de Surveillance du Secteur Financier) has issued two press releases with respect to *sukuk* and Islamic funds. In 2012, the ALFI (Luxembourg Investment funds Association) published best practices for setting up and servicing Islamic funds.

• The Luxembourg legal and tax framework

While Islamic finance structuring in non-Islamic jurisdictions must abide by all of the traditional limitations of *Sharia* law, it generally faces the additional challenge of operating in legal and regulatory environments that are unaccustomed to Islamic finance techniques. The compatibility of the Luxembourg legal framework with Islamic finance requirements for the implementation of *Sharia*-compliant products is in this context of major importance.

In contrast to many other Western jurisdictions, when determining the Luxembourg tax treatment of a business transaction, the economic nature of the transaction generally takes precedence over its legal characteristics (i.e. application of the substance-over-form principle and the economic approach). Therefore, many Islamic finance techniques may be implemented tax efficiently in Luxembourg.

In addition, financing instruments may be structured with a direct link to a particular asset or investment portfolio, bearing variable yield depending on the income deriving from the asset and participating in the business risk of the borrower as required by the *Sharia*. Unlike many other jurisdictions, yield paid on pure profit or income participating financing instruments may be deductible for Luxembourg tax purposes and not subject to Luxembourg withholding tax, irrespective of the status or the residence of the recipient. Key to Islamic investors is the possibility to obtain advance certainty from the Luxembourg tax authorities on the Luxembourg tax treatment of their investments.

In 2010, the Luxembourg tax authorities published two circulars relating to the direct and indirect tax treatment of certain Islamic finance techniques. On 12 January 2010, the Luxembourg direct tax authorities issued a Tax Circular (Circular L.G.-A No. 55) defining the tax treatment of various Islamic modes of finance under Luxembourg tax law. This Circular testifies to the willingness of the Luxembourg tax authorities to grant beneficial tax treatments to *Sharia*-compliant structures so as to put conventional and Islamic finance on the same footing. On 17 June 2010, Luxembourg's indirect tax administration, issued a second circular (Circular n° 749) outlining the indirect tax and VAT treatment of *murabaha* and *ijara* structures.

Last but not least, Luxembourg's extensive tax treaty network (enabling tax-efficient structures through the avoidance of double taxation) includes several Islamic countries such as Qatar, the United Arab Emirates, Bahrain, Azerbaijan, Indonesia, Malaysia, Turkey and Tunisia, cementing Luxembourg's favorable status as an Islamic investor-friendly environment. Furthermore, tax treaties with Kuwait, Saudi Arabia, Kazakhstan and Kyrgyzstan are awaiting ratification while tax treaties with Pakistan, Lebanon and Oman are in negotiation.

VI. Conclusion

The current initiative of the Luxembourg government testifies to the willingness of the Grand-Duchy to solidify Luxembourg's status as a hub for Islamic finance in Europe and is part of the strategy to diversify the Luxembourg financial centre. The issuance of the first sovereign *sukuk* in a Western country will be a strong signal to *Sharia*-sensitive investors and definitely not miss its desired marketing effect.

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1) Yield paid under sukuk may be variable and should depend on the income stream derived from the underlying activity/investment. In many countries such yield payments would not be tax deductible and subject to withholding tax.
2) Section 3.2. of the Circular.
3) Tower A and B situated 10 and 11, avenue J-F Kennedy, Luxembourg, Place de l'Europe.
4) Gutenberg building situated 1, rue des Primeurs, Strassen.
5) Many sovereign wealth funds from Middle East countries are not, however, investing in a Sharia-compliant manner but merely replicating structures used in conventional finance.
6) The IFSB is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets, and insurance sectors. The IFSB approved the admission of the Central Bank of Luxembourg on November 23, 2009.