Islamic finance: a corollary to legal pluralism or legal diversity in South Africa and the Netherlands?

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Abstract

In this contribution we discuss the position of Islamic finance in South Africa and the Netherlands in the light of legal pluralism and legal diversity in each legal system. Islamic finance is based on Islamic law, which is a set of moral and religious principles. According to Islamic law, the payment and receipt of *riba* (interest) and *gharar* (contractual uncertainty) are forbidden. Consequently, alternative Islamic finance contracts are structured where the financier makes a profit either through trade in tangible assets or through a profit-and-loss-sharing arrangement, instead of making profit through charging interest.

INTRODUCTION

Globally, the interest in Islamic finance is growing exponentially as the world shifts its attention to alternative ideas of financing.[1] The Netherlands, a member of the European Union (EU), and South Africa, a member of the African Union (AU), are no exceptions. In the Netherlands support appears

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1 Salah *Islamic finance:structuring sukuk in the Netherlands* (2010) 1. Saidi 'Relationship between ethical and Islamic banking systems and its business management implications' (2009) 40 *S Afr J Bus Manage* 43 points out that Islamic banking is the fastest growing sector in contemporary financial markets, with an average growth of 15 per cent a year. Also see Saini, Bick & Abdulla 'Consumer awareness and usage of Islamic banking products in South Africa' (2011)14 *SAJEMS* 298; Cobbett 'The shaping of Islamic finance in South Africa: public Islam and Muslim publics' (2011) 31 *Journal for Islamic Studies* 29–30.

to be growing for Islamic financial service companies because of their impressive performance in a time of global economic crises.[2] This is further fuelled by the international growth of the *sukuk* (Islamic securities) market, with *sukuk* issues by the governments of the United Kingdom, Hong Kong and Luxembourg in 2014.[3]

In South Africa Islamic finance was introduced in the late 1980s on a limited scale by the Albaraka Banking Group,[4] but since 2005 some of the conventional banks have also offered their clients services based on Islamic principles.[5] The government of South Africa issued a *sukuk* in 2014, showing the international world of finance that it aims to become a serious player in the Islamic capital markets.

As the title suggests, this article explores the rise of Islamic finance as a corollary to legal pluralism or legal diversity. The origins and development of legal pluralism have been explored in various contexts.[6] In the context of our examination, the term refers to the co-existence of various normative orders within a single social order. In the words of Griffiths:[7]

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2 See Ubels 'Staten hengelen naar het geld van moslims' *Nederlands Dagblad* (12 August 2014); Kist 'Bankieren moslims verstandiger?' *NRC Next* (8 November 2011); Anon 'Netherlands keen to attract Islamic banking' *Gulf News* (14 July 2007) at http://gulfnews.com/business/banking/netherlands-keen-to-attract-islamic-banking-1.189797 (date of access 19 February 2015).

3 See De Waard 'De sukuk komen naar het Westen' *de Volkskrant* (13 May 2014); Van der Schoot 'Sharia-obligatie is ook lucratief voor Nederland' *De Financiële Telegraaf* (28 April 2014).

4 The South African Reserve Bank issued licences to two Islamic banks, *viz* the Al Baraka Bank (http://www.albaraka.co.za/home.aspx) and the Islamic Bank of South Africa. The former is still in operation in South Africa but the latter collapsed in 1997. Cobbett (2011) 42–43. Also see Anon 'Three more SA banks' (9 September 1988) 35; Ackermann & Jacobs 'Developing banking products for Islamic corporate clientele' (2008) 12 *Southern African Business Review* 67–68.

5 For example, the ABSA group delivers a variety of unique banking, saving and investment solutions that operate in strict compliance with Islamic principles. Islamic banking is offered as an alternative to conventional banking and is available to anyone who seeks a different approach to financial services, not only for members of the Muslim community. For more information, see: http://www.absa.co.za/Absacoza/Individual/Banking/Exclusive-Banking/Islamic-Banking (last accessed 19 February 2015).

6 The general consensus is that the idea of legal pluralism as a social phenomenon grew out of the writings of Ehrlich *Fundamental principles of the sociology of law* (1936); Pospisil *Anthropology of law: a comparative theory* (1971); and Moore *Law as a process: an anthropological approach* (1973). Also see the important work of Griffiths 'What is legal pluralism' (1986) 24 *Journal of Legal Pluralism and Unofficial Law* 1.

7 Griffiths (1986) 38.

> It is when in a social field more than one source of "law", more than one "legal order", is observable, that the legal order of that field can be said to exhibit legal pluralism.

Narrowly interpreted, legal pluralism usually refers to 'state law pluralism' or 'weak pluralism'. This form of legal pluralism is born out of the idea of state centralism[8] and is thus based on the assumption that only the state has the power to make laws. A broader interpretation of the concept of legal pluralism, however, recognises the social realities of a diverse society, where members of certain communities function in accordance with their own legal norms, which are not necessarily recognised by the state. This form of plurality has been referred to as 'deep legal pluralism'.[9]

On the other hand, the concept 'legal diversity' merely describes a situation where different legal rules for different groups or situations are provided for by a single legal order. It is a government's way of providing for differences within its geographical boundaries.[10]

The possibilities of legal pluralism or legal diversity in Islamic banking, regardless of one's understanding of these two concepts, are legion. The South African legal system, which reflects elements of both state and non-state law pluralism,[11] as well as legal diversity as we understand it, seems to adapt more readily to unconventional banking principles, whilst the less flexible, unified Dutch legal system may, at first glance, appear to be less open to this.

Against this background, this contribution focuses on the main principles of Islamic finance, its religious elements, and its contractual structures. The discussion illustrates how financial transactions are structured through religious incentives. The global growth of and developments around Islamic finance are addressed to show how Islamic finance has entered the scene as one of the by-products of globalisation. We also describe the legal practice

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8 Legal centralism is the idea that the law of a state should be uniform, exclude other laws and be administered by one single set of state institutions. In this setting, all other normative orderings (such as the church, the family, voluntary associations and other personal law or religious systems) should take the back stage as only 'state law' can decide which laws should be recognised and which not. See Griffiths (1986) 3.

9 Rautenbach & Bekker *Introduction to legal pluralism in South Africa* (4ed 2014) 7.

10 Griffiths (1986) 11.

11 Rautenbach 'Deep legal pluralism in South Africa: judicial accommodation of non-state law' (2010) 60 *Journal of Legal Pluralism and Unofficial Law* 144–146.

of Islamic financial transactions to illustrate how Islamic financial products are structured.

Finally, we compare the situation in South Africa and the Netherlands to illustrate the two countries' different approaches towards Islamic financing. Both countries are familiar with the phenomenon of legal pluralism and legal diversity, albeit from different perspectives and with different backgrounds.[12] Owing to its history of colonisation, the slave trade, and early immigration dating back to the 1600s, South Africa has a diverse society. This diversity is manifested in its laws. The legal system of the Netherlands remains, in spite of a large influx of immigrants from Muslim countries, significantly homogenous, and so do its laws. By comparing these two legal jurisdictions, one African and the other European, one a former colony and the other a former coloniser, we illustrate that Islamic finance is not only a corollary to legal pluralism or legal diversity, but that it can also exist in a homogenous legal order.

ISLAMIC FINANCE: ITS PRINCIPLES AND RELEVANCE

Islamic finance and the *Shari'ah*

Islamic banking and finance have the same purpose as conventional banking and finance, save that they operate in accordance with Islamic law or, as it is also known, the *Shari'ah*.[13] *Shari'ah* literally means 'the way' and comprises the body of Islamic religious and legal rules. Islamic law in the context of Islamic finance does not refer to the black-letter code of any particular jurisdiction, but rather to a set of moral and religious principles as developed throughout history.

In terms of the discipline of *Usul al-Fiqh* – the 'roots of Islamic law', there are four sources of Islamic law: the Quran, *Sunna*, *Ijma*, and *Qiyas*.[14] The Quran is the Holy Book of Islam. The second source of Islamic law is *Sunna*, which is the normative or model behaviour of the Prophet Muhammad.[15] The collection of authentic *Hadith* is considered to be the proof of *Sunna*. Third, *Ijma* is the consensus of the Islamic religious scholars. *Qiyas* refers to

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12 The collection of papers in Von Benda-Beckmann and Strijbosch *Anthropology of law in the Netherlands* (1986) reveals that the Netherlands deals with legal pluralism at least in an anthropological sense.

13 Qadri, 'Islamic banking: an introduction' (Jul/Aug 2008) 17 *Business Law Today* 59.

14 Schacht *An introduction to Islamic law* (1964) 112–15; Pearl (1979) 5; Coulson (1994) 24.

15 Pearl *A textbook on Muslim law* (1979) 5; Coulson, *A history of Islamic law* (1994) 24–5.

reasoning by analogy, and is the fourth source of Islamic law. Therefore, there are two material sources, a method, and a declaratory authority. Of these, the *Ijma* is decisive and enjoys precedence in cases of conflict between the two sources, as it guarantees the authenticity of the two material sources and determines their correct interpretation.[16] Some scholars also consider *Ijtihad* as a secondary source of Islamic law.[17] *Ijtihad* refers to independent reasoning based on common sense.

There are two main branches of Islam, *Sunni* and *Shi'a*.[18] Each branch has different schools of Islamic law (referred to as the *Madhahib*). The four *Sunni* Islamic schools are *Hanafi*, *Maliki*, *Shafi'i*' and *Hanbali*.[19] The three *Shi'a* schools are *Ithna Ashari*, *Isma'ili*, and *Zaydi*.[20] Since each school of law has its own interpretations, the development of the Islamic financial market is characterised by a lack of uniformity. While some transactions were approved as *Shari´ah*-compliant by the *Shari´ah* Supervisory Board[21] of one Islamic financial institution, identical transactions were prohibited by the *Shari´ah* Supervisory Board of another Islamic financial institution as a result of differences in interpretation of the *Shari´ah* by the different schools of Islamic law. This situation has been one of the main reasons for legal uncertainty in the industry.

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16 Schacht (1964) 112–15.

17 Some scholars believed that from about 900 AD the exercise of *Ijtihad* had exhausted itself and the 'door of independent reasoning' was closed, while others refer to the early tenth century as the date of the closing of the door of *Ijtihad*. See eg Pearl (1979) 14–5. However, recent studies have shown that the door of *Ijtihad* was never closed, *ie* that the exercise of *Ijtihad* continued. See Hallaq 'Was the gate of *Ijtihad* closed?' (1984) 16 *International Journal of Middle East Studies*, 3–41, with further references.

18 Islam consists of a number of religious denominations, with the primary division being between *Sunni*, by far the largest group in Islam, and *Shi'a*, the second-largest group in Islam. An important point on which they differ is the question who the rightful successor of the Prophet Muhammad was.

19 Pearl (1979) 16.

20 *Id* at 17.

21 A board within an Islamic financial institution that (dis)approves transactions from a *Shari´ah* perspective. For example, Absa Islamic Banking in South Africa is advised and guided by the independent *Shar'iah* Supervisory Board and a panel of experts in *Shar'iah* law. For more information, see: "http://www.absa.co.za/Absacoza/Individual/Banking/Exclusive-Banking/Islamic-Banking"http://www.absa.co.za/Absacoza/Individual/Banking/Exclusive-Banking/Islamic-Banking (last accessed 19 February 2015).

Institutions such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)[22] publish *Shari'ah* standards that are followed widely. This has resulted in harmonisation and standardisation in the Islamic finance market. The Islamic Financial Services Board (IFSB),[23] which publishes various technical standards for Islamic banks, has also made several attempts to bring harmony and standardise the Islamic finance market. The *Shari'ah* standards of the AAOIFI, in particular, play an important role. These standards contain Islamic financial rules that are generally accepted throughout the Islamic finance industry to such an extent that they can be regarded as soft law.[24]

Islamic finance: the main principles

Islam endorses the concept of making profit through trade. The relevant verse in the Quran reads:[25]

> Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like [*riba*]." *But Allah has permitted trade* and has forbidden [*riba*]. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in *riba*] – those are the companions of the Fire; they will abide eternally therein.

Islam encourages and promotes the right of individuals to pursue personal economic wellbeing.[26] Provided that higher values remain intact, striving to

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22 The AAOIFI is 'an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and *Shari'a* standards for Islamic financial institutions and the industry'. See http://www.aaoifi.com. Saidi (2009) 44-47 sets out the characteristics of ethical *vis-à-vis* conventional banking and comes to the conclusion that Islamic banking satisfies to a great extent the majority of the characteristics of ethical banking.

23 The IFSB is 'an international standard-setting organisation 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 banking, capital markets and insurance sectors'. See http://www.ifsb.org/.

24 Salah 'Islamic finance: the impact of the AAOIFI resolution on equity-based *sukuk* structures' (2010) 5 *Law and Financial Markets Review* 507–517.

25 Quran 2:275. Emphasis added. International translation accessible at: "http://corpus.quran.com/translation.jsp?chapter=2&verse=275"http://corpus.quran.com/translation.jsp?chapter=2&verse=275 (last accessed 19 February 2015).

26 Ainley *et al Islamic finance in the UK: regulation and challenges* (November 2007), accessible at http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf (last assessed 19 February 2015).

gain profit is ethically justified.[27] Furthermore, Islam stimulates commercial transactions.[28] From a *Shari'ah*-perspective, trade should take place on the basis of a legal structure: there should be a contract,[29] because the Quran encourages written commitment to obligations, such as commercial contracts.[30] The contract is binding and must be executed.[31] In addition, the legal concept of good faith should be an element in the contract,[32] which means that the seller has a pre-contractual obligation to inform the purchaser as to the quality of the goods.

One of the most important principles of Islamic finance is that commercial and financial transactions cannot be *haram*, *ie* forbidden by Islamic law.[33] Transactions that relate to activities and investments in alcohol, drugs, armaments, military technology, pornography, prostitution, and gambling, among other things, are prohibited as they are regarded as immoral. Hence, all transactions should be for permitted purposes only, *ie halal* transactions.

Another important principle of Islamic finance is the giving of *zakat*, *ie* alms. This is one of the five pillars of Islam, the five duties incumbent on every Muslim.[34] The notion is that if an owner sees the value of his property increase, he should share some of his growing prosperity in this world to gain favour in the next.[35] It is a mandatory charity that, over and above a threshold of one year's accumulated wealth, every Muslim must contribute to the poor and needy.[36]

Prohibitions within Islamic finance

Under Islamic law all transactions are permissible, subject to the principles described in the previous section, and unless there is a clear prohibition in the sources of Islamic law. This raises the question of whether there are any

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27 Küng *De Islam: de toekomst van een wereldreligie* (2006) 742.
28 Quran 4:29; Quran 2:275.
29 Tjittes 'Islamitisch financieren in Nederland' (2008) 4 *Rechtsgeleerdheid Magazijn THEMIS* 139.
30 Quran 2:282.
31 Quran 5:1; Quran 17:34.
32 Quran 17:35.
33 Kamali *Islamic commercial law: an analysis of futures and options* (2000) 45.
34 The other four pillars of Islam are: *Shahada* (profession of faith); *Salat* (prayers); *Sawm* (fasting during the holy month of Ramadan); and *Hajj* (pilgrimage to Mecca).
35 Wilson 'The development of Islamic economics: theory and practice' in Taji-Farouki & Nafi (eds) *Islamic thought in the twentieth century* (2004) 214.
36 Durrani & Boocock *Venture capital, Islamic finance and SMEs* (2006) 152.

explicit prohibitions in respect of Islamic finance in the sources of Islamic law.

There are two prohibitions: the prohibition on (i) *riba,* and (ii) *gharar*. The best known feature of Islamic finance is the prohibition of *riba*, a term which is often translated as interest.[37] However, that translation is not entirely accurate because *riba* refers to more than interest alone. Due to its broader scope, it has also been translated as 'unjust enrichment'.[38] The Quran contains several references to the prohibition on *riba*.[39] According to Ibn Rushd – who is also known as Averroes in Europe[40] – *Shari'ah* scholars draw a distinction between *riba* in sales and other forms of *riba*, such as the *riba* of the time of *jahilliyya*.[41] Within Islamic finance, the *riba* in sales is divided into *riba al-fadl* and *riba al-nasi'a*.[42] *Riba al-fadl* refers to any goods-for-goods exchange transaction in which the goods are of the same type but unequal measure – for example, a kilo of wheat is being exchanged for 2 kilos of wheat. *Riba al-nasi'a* refers to the increase or growth of the goods due to postponement, for example, interest on a loan.[43]

Today we think of *riba al-nasi'a* as interest paid on loans. From an Islamic perspective this is not permitted because within Islam a loan is regarded as a charitable act.[44] Nevertheless, making a profit is permitted provided that it is generated by trade.[45] Thus, money must be used to create real economic value, and it is permissible to earn a return from investing money in a permissible commercial activity only if the financier or investor takes some

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37 El-Gamal. *Islamic finance: law, economic and practice* (2006) 11–2.

38 Vogel & Hayes, *Islamic law and finance, religion, risk, and return* (1998) 84.

39 Quran 2:275; Quran 2:276; Quran 2:277; Quran 2:278; Quran 2:279; Quran 2:280; Quran 2:281; Quran 3:130; Quran 4:161; Quran 30:39.

40 Ibn Rushd (1126–1198) was an Islamic jurist, doctor and philosopher. He was a master of Islamic theology, Islamic philosophy, and Islamic jurisprudence. In Europe he was known as Averroes and he is even referred to as the founding father of secular thought in Western Europe. See http://www.fordham.edu/halsall/source/1190averroes.asp (last accessed 19 February 2015) and also Ibn Rushd *The distinguished jurist's primer: Bidayat al-Mujtahid wa Nihayat al-Muqtasid* (translated by Imran Nyazee & reviewed by Rauf) (1994).

41 The period of *jahiliyya* refers to the pre-Islamic period. This form of *riba*, too, is prohibited. Ibn Rushd (1994) 158.

42 Ibn Rushd (1994) 158.

43 Vogel & Hayes (1998) 74.

44 Moghul & Ahmed, 'Contractual forms in Islamic finance law and *Islamic Inv Co of the Gulf (Bahamas) Ltd v Symphony Gems NV & Ors*: a first impression of Islamic finance' (2003) 27 *Fordham International Law Journal* 168.

45 Quran 2:275.

commercial risk.[46] Since Islamic banks cannot charge fixed interest in advance, they operate by participating in the profit resulting from the use of the bank's funds.[47] The concept of interest is replaced by the concept of profit-and-loss-sharing.[48]

Due to the prohibition on *riba*, charging and receiving interest are prohibited. Interest is the payment of money for the use of money. Hence, within Islamic financial transactions there must always be a tangible asset on (at least) one side of the transaction. Consequently, the trade in debts – the so called *bai al-dayn* – is also forbidden within Islamic finance. Since, from a financial perspective, a debt represents the payment of an amount of money, the trade in debts must occur at par value otherwise it resembles the forbidden *riba*.

The second prohibition of *gharar,*[49] results in the prohibition of contractual uncertainty as to the essential elements of a contract. A financial contract should not lack specificity in its terms,[50] *ie*, among other things, in its sales price, deliverability, quantity, quality and existence.[51] Therefore, open-ended terms and those that are deliberately structured to convey more than one meaning, are prohibited.[52] In relation to conventional finance, *gharar* exists in insurance, futures, and options contracts, among others.[53] Business risks that are generated by financial and commercial factors are permitted as long as the parties to the transaction have advanced knowledge of the elements making up the transaction.[54] The rationales for prohibiting *gharar* include mitigating disputes over the interpretation of contracts, and mitigating problems arising from asymmetric information, so that injustice and inequity do not fall on the ill-advised contracting party from the outset.[55] However,

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46 Hanif (2008) 10.

47 Olson & Zoubi 'Using accounting ratios to distinguish between Islamic and conventional banks in the GCC region' (2003) 43 *The International Journal of Accounting* 47.

48 Olsen & Zoubi (2003) 47.

49 Quran 2:90; Qur'an 2:91

50 DeLorenzo 'The religious foundations of Islamic finance' in Simon Archer & Karim (eds) *Islamic finance: innovation and growth* (2002) 22.

51 Archer & Karim 'Introduction to Islamic finance' in Archer & Karim (eds) *Islamic finance: innovation and growth* (2002) 3.

52 Ahmed (2002) 109.

53 Abd Jabbar 'Islamic finance: fundamental principles and key financial institutions' (2009) 30 *Company Lawyer* 24.

54 Saleh & Ajaj *Unlawful gain and legitimate profit in Islamic law: riba, gharar and Islamic banking* (1992) 81.

55 Saleh & Ajaj (1992) 80–1; Archer & Karim (2002) 42–43.

a transaction with minimal *gharar* could be valid, because the *Shari'ah* acknowledges the impossibility of totally eradicating *gharar*.[56] Hence, certainty is required on the essential elements of a contract only.

As a result of the prohibition of *gharar*, *mayseer* and *qimar* are also prohibited under the *Shari'ah*.[57] *Mayseer* refers to a transaction where something is gained by pure speculation and not by productive effort.[58] *Qimar* includes every form of monetary gain the acquisition of which depends purely on luck and chance.[59] Speculation and gambling are prohibited as both involve an attempt to make a profit and amass wealth without putting in any productive effort.[60] Conventional future contracts and equity derivatives can contain elements of *mayseer* and *qimar*.[61]

Islamic financial contracts and structures

As a result of the Islamic prohibitions on the types of financial transaction described in the previous section, conventional loans are not permitted within Islamic finance. Therefore, Islamic finance contains different financing techniques to fulfil the need for funding. Islamic financial rules such as the prohibition on *riba* and *gharar,* are intended to achieve fairness through the equitable distribution of wealth in society.[62] Islamic finance, consequently, first and foremost, prefers the concept of profit-and-loss-sharing as a means of funding.[63] Profit-and-loss-sharing arrangements are forms of equity-based financing and are in line with the Islamic view on financial transactions in that one cannot be entitled to a reward before having taken a risk. Thus, within Islamic law the ideal instruments of financing are profit-and-loss-sharing agreements such as *musharaka* and *mudarabah* agreements.[64] In addition, several debt-financing arrangements, such as *murabaha*, *ijarah*, *salam*, and *istisna'* have been accepted by way of

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56 Fadeel 'Legal aspects of Islamic finance' in Archer & Karim (eds) *Islamic finance: innovation and growth* (2002) 91.

57 Qur'an 2:219; Qur'an 5:90.

58 Hanif (2008) 10.

59 Ayub *Understanding Islamic finance* (2008) 112.

60 International Organization of Securities Commission (IOSCO) *Islamic capital market: Fact finding report* (2004) 8.

61 Hanif (2008) 10; Jabbar *(*2009) 25.

62 Usmani *Sukuk and their contemporary applications* (2007) 13.

63 Farooq 'Partnerships, equity-financing and Islamic finance: whither profit-loss sharing?' (2007)11 *Review of Islamic Economics* 67–88.

64 Usmani *An introduction to Islamic finance* (2002) x.

exception to meet the need for debt-finance. All these contracts will be discussed in greater detail below.[65]

Murabaha *(mark-up contracts)*

Murabaha contracts are contracts with a mark-up, *ie* a profit margin – which is disclosed by the seller to the buyer – is added to the purchase price of the object. In Islamic financial transactions these contracts are used as an alternative to loans. A party sells a property to a financier, and this sale is followed by a resale of that property by the financier to the ultimate buyer, who pays the cost price plus a profit to the financier in instalments. The *murabaha* can be used for asset finance purposes only. In the *murabaha* contract, the buyer knows the purchase price and agrees to the profit margin, which is paid to the bank.[66] The bank is not compensated for the time value of money outside of the contracted profit margin.[67]

This concept is, for example, used in Islamic mortgage transactions: instead of lending the money to the buyer to purchase property, the bank purchases the property from the seller and then re-sells it to the buyer at a profit, while allowing the buyer to repay the bank in instalments.[68] In general, there are no additional penalties for late payment (except when such penalties are intended to compensate for costs incurred or the amounts are donated to charity) and the bank requires strict collateral.[69] Note that in this contract, the bank must own the item when the customer (buyer) buys it at a specified profit from the bank.[70] Afterwards, the property is registered in the name of the buyer and, accordingly, the buyer is in fact able to benefit and receive tax credits.[71] The concept of cost-plus sales in *murabaha* is not regarded as interest and is therefore justified from an Islamic perspective because:

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65 Also see Porzio 'Islamic banking versus conventional banking' in M Khan & Porzio (eds) *Islamic banking and finance in the European Union: a challenge* (2010) 92–99 for a discussion of the various types of Islamic products on the market.

66 El-Gamal (2006) 10–11.

67 Qadri (2008) 60.

68 Qadri (2008) 60.

69 Qadri (2008) 60.

70 El-Gamal (2006) 10–11.

71 The concept of tax credit refers to (a) a recognition of partial payment already made towards taxes due; or (b) to a state benefit paid to workers through the tax system. Both concepts are not known in the Netherlands, so the concept is not relevant to the Dutch legal context. However, the fact that the asset is registered in the name of the buyer is also important in the Netherlands, because this is relevant to the deductibility of the profit mark-up as a cost of home financing – the so called *eigenwoningschuld* – due to the Income Tax Act 2001 (*Wet Inkomstenbelasting 2001*).

- the financier shares in the risk, such as theft or damage to the property, since it owns the property for a short time;
- he financier acts as an agent in the trade sale and is compensated for its activities as agent; and
- the object of the trade sale is not money, but a tangible asset, *ie* the property.

Mudarabah *and* musharaka *(partnership contracts)*

Mudarabah and *musharaka* are forms of partnership. Financing through *mudarabah*, which can be viewed as 'venture capital', and *musharaka*, which is commonly referred to as a 'joint venture', means participation in the business by the financier.[72] Profits, determined as a percentage of the realised revenue, will be distributed among the partners on the basis of the proportion to which they have agreed in advance.[73] The profit-sharing continues until the entrepreneur becomes the complete owner of the business, which transition often takes the form of a buy-out of the interest of the financing entity.[74]

In a *mudarabah* contract the financing entity, which is known as *rab-al-maal*, provides the funding for the business venture, while the entrepreneur, the *mudarib*, provides expertise, labour and management.[75] Under a *mushaira* contract, each partner retains an equal right to management of and participation in the business.[76] Another important difference between the *mudarabah* contract and the *musharaka* contract relates to losses: in a *mudarabah* contract the *rab-al-maal* bears the main loss, because the *mudarib* has not invested anything. One should not overlook the fact that the *mudarib* bears the loss of time and the effort he has put into the venture. Furthermore, the *mudarib* is liable for any losses caused by his negligence, misconduct, or dishonesty.[77] In a *musharaka* contract each financier must share the losses incurred by the business, in proportion to his contribution to the financing.[78] This concept reflects the Islamic view that there should

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72 Usmani (2002) 17.
73 Qadri (2008) 59–60.
74 *Ibid*.
75 *Ibid*.
76 *Ibid*.
77 Usmani (2002) 13.
78 *Id* at 17.

be a balance between the parties: the borrower must not bear all the risks of a failure, and the lender must not receive all the profits.[79]

Salam *and* istisna' *(future goods contracts)*

The contracts of *salam* and *istisna'* are Islamic forward contracts. The sale of non-existent objects is forbidden because of the prohibition of *gharar*. However, there are two contracts which are an exception: *salam* and *istisna*. In a *salam* contract a buyer immediately pays for a commodity or other fungible item, which will be delivered by the seller on a specified date.[80] An *istisna'* contract involves the future purchase of goods to be manufactured to certain specifications.[81] The price can be paid in instalments as the work progresses during the manufacturing stage of the otherwise non-existent object.[82]

Ijarah *and* ijarah-wa-iqtina *(leasing contracts)*

Ijarah and *ijarah-wa-iqtina* contracts are comparable to leasing contracts. From a legal perspective, a lease contract is not for the sale of an object, but rather the sale of the right to use it, or of a usufruct over it,[83] for a specified period.[84] The sale of the right to use or of the usufruct (*manfaa*) is permitted in Islam.[85] Hence, under an *ijarah* contract, the bank (lessor) makes available to the customer (lessee) the use of an asset for a fixed period against an agreed rental.[86] The lessor must own the leased object for the duration of the lease in an *ijarah* contract.[87] The *corpus* of the leased property remains the property of the lessor and only its usufruct is transferred to the lessee.[88] Thus, all the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities referable to the use of the property are borne by the lessee.[89] The main difference between the *ijarah* and the *ijarah-wa-iqtina* is that the *ijarah-wa-iqtina* is a combination of the *ijarah* with a unilateral

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79 Qadri (2008) 59–60.
80 Vogel & Hayes (1998) 220.
81 *Ibid*.
82 El-Gamal (2006) 17.
83 A usufruct can be defined as a personal servitude giving the usufructuary a limited real right to use and enjoy another person's property. See Van der Linde 'Content of wills: substitution, usufruct and accrual' in Jamneck & Rautenbach (eds) *The Law of Succession in South Africa* (2012) 167.
84 El-Gamal (2006) 13–14.
85 Qur'an 28:26; Qur'an 28:27; Qur'an 65:6.
86 Ayub (2008) 280.
87 El-Gamal (2006) 13–14.
88 Usmani (2002) 70–71.
89 *Ibid*.

undertaking by the lessor or the lessee to transfer the ownership of the leased asset to the lessee at the end of the lease period. In the *ijarah-wa-iqtina* a bank provides assets to the client under an agreed rental, together with a unilateral undertaking by the bank or the client pursuant to which, and at the end of the lease period ownership in the asset will be transferred to the client.[90] The *ijarah* is often used to structure *sukuk* transactions, in which case the transaction is referred to as a *sukuk al-ijarah* transaction.[91] The *sukuk* issued by the South African government in 2014 was also a *sukuk al-ijarah*.

South Africa's recent legislative amendments include at least three of these types of Islamic financial transaction and are discussed below.

ISLAMIC FINANCE IN SOUTH AFRICA: IN RECOGNITION OF DIFFERENCE?

Islamic finance: legal pluralism or legal diversity?

As already mentioned, South Africa's official legal system is a mixed pluralistic one consisting of transplanted European law (the core being Roman-Dutch law, subsequently influenced by English common law and developed by means of legislation and judicial decisions), commonly known as the common law,[92] and African customary law, which is an umbrella term for the various laws observed by indigenous communities.[93]

The co-existence of the common (mixture of western laws) and customary (mixture of indigenous laws) law embodies official (or weak) legal pluralism in South Africa. Although the South African legislature has not yet incorporated cultural or religious forms of non-state law into the mainstream legal systems, the judiciary has increasingly acknowledged that there are

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90 Qadri (2008) 59–60.

91 *Sukuk* are Islamic securities. Due to the prohibition of *riba*, underlying Islamic financial contracts are used, the profits of which are paid through to the holders of the *sukuk* in capital markets, instead of the payment of interest as is the case with conventional bonds. See Salah (2014) 60–71.

92 This law can be found in legislation, precedent, Roman-Dutch law, custom, and legal textbooks. See Rautenbach 'Deep legal pluralism in South Africa: judicial accommodation of non-state law' (2010) 60 *Journal of Legal Pluralism and Unofficial Law* 144 n 3.

93 Rautenbach & Du Plessis 'African customary marriages in South Africa and the intricacies of a mixed legal system: judicial (in)Novatio or confusio?' (2012) 57 *McGill Law Journal* 751 n 2. Also see Salah & Rautenbach 'Lief en leed van juridisch pluralisme in Zuid-Afrika: a case study' (2008) 2 *SecJure* 51–56.

other normative orders (Muslim, Hindu and Jewish law) which warrant some form of recognition or protection.[94] In other words, one could say that the courts have been instrumental in accepting the fact that unofficial (or deep) legal pluralism is indeed a reality in South Africa.[95]

As already indicated, legal pluralism must not be confused with legal diversity. Whilst legal pluralism is more than one legal system in a single legal order – such as common and customary law in South African law – legal diversity occurs where different legal rules for different groups or situations are provided for by one legal order.[96] For example, South Africa has its own military courts dealing with crimes by members of the Defence Force, which operate independently from the national courts.[97] The co-existence of these two kinds of court is an example of legal diversity. On the other hand, the co-existence of traditional courts operating in terms of African customary law and conventional courts operating under national legislation, is an example of legal pluralism.[98]

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94 See for example Rautenbach 'The contribution of the courts in the integration of Muslim law into the mixed fabric of South African law' in Mattar, Palmer & Koppel (eds) *Mixed legal systems, East and West* (2014) 225–244

95 Rautenbach 'Celebration of difference: judicial accommodation of cultural and religious diversity in South Africa' (2010) 10 *The International Journal of Diversity in Organisations, Communities and Nations* 117–132 discusses examples where the judiciary in South Africa has given recognition to certain aspects of religious personal laws in South Africa. It is argued that this is recognition of the fact of deep legal pluralism in South Africa.

96 Griffiths (1986) 11–14.

97 Military Discipline Supplementary Measures Act 16 of 1999 and the Military Discipline Code (First Schedule to the Defence Act 44 of 1957). Anyone who has been convicted or acquitted of an offence by any military court is not liable to be tried again in respect of that offence by any other court. The constitutionality of having two separate court systems for soldiers and civilians came to the fore in *Minister of Defence v Potsane* 2002 (1) SA 1 (CC). The Constitutional Court found that the differentiation between soldiers and civilians was not an infringement of the soldiers' rights to equality. The differentiation was rationally connected to the legitimate governmental purpose of establishing and maintaining a viable military system and thus not unfair, as envisaged in the equality provision (section 9(1) of the Constitution of the Republic of South Africa, 1996). Also see the discussion of Carnelly 'The South African military court system – Independent, impartial and constitutional?' (2005) 33 *Scientia Militaria: South African Journal of Military Studies* 71–72.

98 The traditional court system is partly regulated by section 20 (criminal jurisdiction) and section 12 (civil jurisdiction) of the Black Administrations Act 38 of 1927. Conflict rules indicate when the traditional courts are in operation in a given situation. Legal reform is in the pipeline but currently these courts generally function in terms of 'living customary law', a situation which can be classified as deep legal pluralism. For a general discussion of customary courts in South Africa, see Rautenbach & Bekker (2014) 231–253.

The South African legal system's long-standing accommodation of cultural and religious diversity is probably one of the reasons why Islamic financial principles have been able to seep into the conventional banking sector fairly seamlessly and largely unnoticed.[99] Nevertheless, it is debatable whether this type of accommodation is, strictly speaking, legal pluralism (where there is more than one law, and therefore a situation which necessitates the introduction of rules of conflict), or merely legal diversity (where there are different rules for different situations). Considering that future tax legislation in South Africa may incorporate Islamic principles to allow for the inclusion of *Shari'ah*-compliant banking products, Islamic finance in South Africa is, at least theoretically, most likely a corollary to legal diversity rather than legal pluralism.

The rationale for Islamic finance in South Africa

Recent statistics reveal that the Muslim population of South Africa constitutes less than one and a half percent of the total population;[100] numbering an estimated 654 063 persons,[101] a relatively small minority that is commercially active, creating a demand for products that are *Shari'ah*-compliant.[102] As early as 2007, it was pointed out by the former Minister of Finance, Trevor Manuel, that South Africa had between 350 000 and 400 000 Muslim households with the potential to create a savings and investment market of R1,8 billion a year.[103]

Although Islamic financing started in the 1980s,[104] the few mainstream banks that have established Islamic subsidiaries and departments, did so only after

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99 See also the arguments raised by Cobbett (2011) 30–31.

100 The total population of South Africa is around 50 million people. See Statistics South Africa *Stats in Brief* (2011) 7.

101 Information provided by Norah Maake from Statistics South Africa on 9 April 2013. Also see Saini, Bick & Abdulla (2011) 298; Central Intelligence Agency (2013) *The World Factbook: South Africa* at https://www.cia.gov/library/publications/the-world-factbook/geos/sf.html (last accessed 19 February 2015).

102 Suliman 'Unlevel banking fields' (2010) 24 *Tax Planning* 43.

103 Trevor Manuel speech at the official opening of the International Waqf Conference in Cape Town (17 August 2007) http://www.docstoc.com/docs/19593596/Finance-Minister-Trevor-Manuel-Speech-Waqf-Conference-17082007 (last accessed 10 February 2015).

104 Today there are two Islamic banks in operation, viz. the Al-Baraka Bank and the Habib Bank AG Zurich (HBZ) Bank (https://hbzbank.co.za/). The Al-Baraka Bank was the subject of public debate on Islamic finance compliance issues in 2009. See Cobbett (2011) 43–44.

2000.[105] Examples are WesBank, [106]ABSA,[107] and First National Bank (FNB)[108] which have opened departments operating within the framework of Islamic principles.[109] These banks offer fully-fledged Islamic banking products such as property finance, motor vehicle finance, trade, savings, investment accounts, equity participation accounts, equity share portfolios, and estate planning mechanisms.[110] In addition to banking institutions, Oasis Crescent Capital[111] was created in 2002 to offer *Shari'ah*-compliant equity funds and unit trusts.[112]

Although the products offered by the above institutions are *Shari'ah*-compliant, a client does not have to be a Muslim to use them. As pointed out by Muhammad:[113]

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105 The regulatory context of South African banking is made up of various statutes, common law principles, jurisprudence and other regulatory measures. None of these statutes excludes Islamic principles from banking procedures and institutions. Some of the statutes are the Banks Act 94 of 1990; the South African Reserve Bank Act 90 of 1989; the Mutual Banks Act 124 of 1993; the Postal Services Act 124 of 1998; the Co-operatives Act 14 of 2005; the Inspection of Financial Institutions Act 80 of 1998; the Financial Institutions (Investment of Funds) Act 39 of 1984; the Currency and Exchanges Act 9 of 1933; the National Payment System Act 78 of 1998; the Securities Services Act 36 of 2004; the Financial Advisory and Intermediary Services Act 37 of 2002; the Financial Intelligence Centre Act 38 of 2001; the Bills of Exchange Act 34 of 1964; and the National Credit Act 34 of 2005. For a general discussion of banking law in South Africa, see Jones & Schoeman *An introduction to South African banking and credit law* (2006) and Moorcroft *Banking law and practice* (2009).

106 See http://www.wesbank.co.za.

107 A full range of Islamic products provided for by ABSA is available at http://www.absa.co.za/Absacoza/Individual/Banking/Exclusive-Banking/Islamic-Banking. ABSA bank is one of the largest banking institutions in South Africa and was established in 1991 as a conglomeration of a number of former banks, *viz*: Volkskas Bank, United Bank, Allied Bank and Trust Bank. ABSA Bank's Islamic banking sector was formed in 2006 and since then it has been ranked as the World's Best Islamic Financial Institution for the Non-Gulf Cooperative Council (GCC), Middle East/Africa region by Global Finance magazine for three consecutive years. See Anon 'Absa wins Islamic banking award' *Banking and Finance* (15 May 2011) at http://www.bizcommunity.com/Article.aspx?l=196&c=163&i=59528 (last accessed 19 February 2015).

108 The range of Islamic-compliant products available at FNB can be viewed at http://www.fnb.co.za. FNB was the first conventional bank to open its doors to Islamic banking products, which it did in 2004.

109 Saidi (2009) 43.

110 Saini, Bick & Abdulla (2011) 299.

111 See http://www.oasis.co.za/default/default.aspx.

112 Saini, Bick & Abdulla (2011) 299.

113 Muhammad 'Ramadaan, the Hajj and Islamic banking' (23 November 2010) at http://www.muslimmums.co.za/tag/absa/ (last assessed 19 February 2015).

> You do not have to be a Muslim to achieve your banking goals through Islamic banking; you need only follow the discipline through which Islamic Banks are governed.

Many of the *Shari'ah*-compliant products mirror the economic effects of conventional banking products,[114] but the tax consequences are often different, thus placing Islamic customers at a disadvantage compared to those using conventional products.[115] The government's commitment to eradicate some of the differences was reflected in National Treasury's *2010 Budget Review* as follows:[116]

> The tax system may act as a barrier to certain forms of Islamic-compliant finance, which prohibits payment or receipt of various types of interest. The tax treatment of financial instruments such as forward purchases, financial leasing and purchases of profit shares will be reviewed over the next two years, and tax treaties with relevant countries will be reexamined.

However, apart from pleasing a small minority of South Africans, there is another compelling reason for the South African government's move to advance Islamic finance. This involves gaining access to the estimated 400 million Muslims on the rest of the African continent through global economic operations.[117] In this regard, the government has declared that the lack of access to the growing Islamic financial markets also 'works against South Africa's financial role in non-Western markets, thereby undermining

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[114] Saini, Bick & Abdulla (2011) 301 give a convenient summary in table form of the differences between Islamic banking and conventional banking.

[115] Suliman (2010) 43. Saini, Bick & Abdulla (2011) 304–311 conducted an empirical study to establish the consumer awareness and use of Islamic banks in South Africa. They came to the conclusion that the majority of Muslims in South Africa are aware of Islamic banks but that they do not use them for a number of reasons, such as convenience, availability and accessibility. Also see the problems with *Murabaha* as discussed by Patel 'Islamic finance: problems with handling *Murabahah*' (August 2010) *Without Prejudice* 16–17.

[116] National Treasury (17 February 2010) *Budget Review 2010* 78–79 (http://www.treasury.gov.za/documents/national%20budget/2010/review/default.aspx - last accessed 19 February 2015). Also see SARS *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010* 49 (http://www.sars.gov.za/Legal/Preparation-of-Legislation/Pages/Explanatory-Memoranda.aspx – last accessed 19 February 2015).

[117] Abdullah 'Islamic canon law encounters South African financing and banking institutions: prospects and possibilities for Islamic economic empowerment and black economic empowerment in a democratic South Africa' (2008) 12 *Law Democracy and Development* 137–142 argues that Islamic economic empowerment could also be used to promote and accelerate the government's black economic empowerment programme.

South Africa as a regional financial centre'.[118] With the stage set for South Africa to enter non-Western markets in addition to its having its own local Muslim population, the government introduced several tax-related statutory measures to provide for certain Islamic financial products.

Current and future tax implications of *Shari'ah*-compliant financial products

Since its announcement regarding provision for the tax treatment of Islamic financial products, the South African government has put words into action in the form of the 2010 Taxation Laws Amendment Act (TLAA).[119] The Act introduces several provisions dealing with tax arrangements for Islamic products, with the purpose of levelling the playing field for conventional and Islamic banking.[120] When the relevant sections amended by the TLAA come into operation,[121] the South African tax system will accommodate certain forms of *Shari'ah*-compliant banking products. For example, the definitions of *mudaraba,*[122] *murabaha,*[123] and diminishing *musharaka*[124] are included in

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118 SARS (2010) 49. The development of Islamic finance in South Africa is an important component of the government's strategy to position South Africa as a gateway into Africa. Also see National Treasury (2010) 78.

119 7 of 2010 (hereafter the TLAA). The Act commenced on 2 November 2010. Also see SARS (2010) 48–57; SARS *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011* (7 January 2012) 68–70.

120 The TLAA deals with the tax implications of certain Islamic financial products on a national level only, but there may also be international taxation implications, and these will not be dealt with in this contribution. See, for example, Knickerbocker 'Shari'a finance: rapid expansion with the Islamic Golden Age – Some international taxation implications' (Jan/Feb 2011) *TaxTalk* 22–23.

121 The date of commencement of the relevant sections has not been published yet.

122 The general spelling of the word in Islamic literature is *mudarabah* but in the Act it is spelled *mudaraba*. In terms of section 24JA(1) of the Income Tax Act 58 of 1962 it means 'a sharia arrangement between a bank and a client of that bank whereby— (a) funds are deposited with the bank by the client; (b) the anticipated return in respect of the sharia arrangement is dependent on the amount deposited by the client in combination with the duration of the period for which the funds are deposited; (c) the bank invests the funds deposited by the client in other sharia arrangements; (d) the client bears the risk of the loss in respect of the sharia arrangements contemplated in paragraph (c); and (e) the return in respect of the sharia arrangements contemplated in paragraph (c) is divided between the client and the bank as agreed at the time that the client deposits the funds with the bank.'

123 In terms of section 24JA(1) of the Income Tax Act 58 of 1962 (inserted by section 48 of the TLAA and amended by section 54(1)(a) of the Taxation Laws Amendment Act 24 of 2011) it means 'a sharia arrangement between a financier and a client of that financier, one of which is a bank, whereby—(a) the financier will acquire an asset from a third party (the seller) for the benefit of the client on such terms and conditions as are agreed upon between the client and the seller; (b) the client— (i) will acquire the asset from the financier within 180 days after the acquisition of the asset by the financier contemplated

the Income Tax Act.[125] In addition, a 'sharia arrangement' is defined as an arrangement that: (a) allows for participation by members of the general public; and (b) is presented as *Shari'ah*-compliant to the members of the general public upon issuing an invitation to them to participate therein.[126] In order for natural persons to access the *mudaraba,* the *murabaha* and the diminishing *musharaka* products, these products must be advertised and offered to the general public as *Shari'ah*-compliant.[127]

The first Islamic product with future tax implications is the *mudaraba* agreement. This product's conventional equivalent is a savings account. The Income Tax Act[128] allows for a basic interest exemption – currently R16 000 if you are 65 years and older, and R11 000 in all other cases. In order to qualify for this basic interest exemption in terms of the Income Tax Act,[129] an amount received by or accrued to a client in terms of a *mudaraba* agreement, must be regarded as interest.[130] The rationale behind this arrangement is explained by the SARS as follows:[131] 'The mudaraba acts like a partnership in form and substance while the profit is comparable to

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in paragraph (a); and (ii) agrees to pay to the financier a total amount that—(aa) exceeds the amount payable by the financier to the seller as consideration to acquire the asset; (bb) is calculated with reference to the consideration payable by the financier to the seller in combination with the duration of the sharia arrangement; and (cc) may not exceed the amount agreed upon between the financier and the client when the sharia arrangement is entered into; and (c) no amount is received by or accrues to the financier in respect of that asset other than an amount contemplated in paragraph (b)(ii).'

124 In terms of section 24JA(1) of the Income Tax Act 58 of 1962 it means 'a sharia arrangement between a bank and a client of that bank whereby—(a) (i) the bank and the client jointly acquire an asset from a third party (the seller); or (ii) the bank acquires an interest in an asset from the client; (b) the client will acquire the bank's interest in the asset after the acquisition of the asset by the bank as contemplated in paragraph (a); and (c) the amount of consideration payable by the client to the bank for the acquisition of the interest of the bank in the asset will be paid over a period of time as agreed between the client and the bank.'

125 Section 48(1) of the TLAA inserts section 24JA in the Income Tax Act 58 of 1962. Patel (2010) 16–17 has certain reservations regarding the *Murabahah* financing method as proposed by the amendments because it applies to certain banks only, and not to Islamic transactions in general. Also see Qasaymeh 'Islamic banking in South Africa: between the accumulation of wealth and the promotion of social prosperity' (2011) 44 *CILSA* 281–284 for a discussion of the definitions in the Act.

126 Section 24JA(1) of the Income Tax Act 58 of 1962 under the lemma 'sharia arrangement'.

127 SARS (2010) 50, 51 & 54.

128 58 of 1962: section 10(1)(i)(xv)(bb)(A) and (B).

129 58 of 1962.

130 Income Tax Act 58 of 1962: section 24JA(2).

131 SARS (2010) 50–51.

interest.' Like a conventional savings product, the aim of the *mudaraba* is to offer investors an agreed return on their investment. The bank pools the money with that of other investors and it is subsequently invested in *Shari'ah*-compliant equities. The income is then divided between client and the bank in accordance with the agreement and after deduction of bank charges.[132] The unequal sharing of profits between the partners (the bank and the client) is not uncommon. Any profit earned by a natural person in terms of a *mudaraba* agreement is regarded as interest and qualifies for the same interest exemptions as its western counterpart.[133]

The second Islamic product with future tax implications is the *murabaha* agreement.[134] In this case, the bank purchases the property from a third party for the benefit of its client, and the purchase is based on the terms and conditions agreed upon by its client and the third party. The bank then resells the property to the client with a mark-up agreed upon by the bank and the client. According to the SARS the mark-up can be characterised as interest generated for the bank and interest incurred by the client with certain tax implications. For the purposes of the Income Tax Act,[135] the bank is deemed not be involved in the purchase or sale of the property. The client is deemed to have acquired the property directly from the seller, and the mark-up difference qualifies as interest and thus for the exemption described above. For the purpose of the payment of duty in terms of the Transfer Duty Act,[136] the bank is also deemed not be involved in the purchase or sale of the property, and the client is deemed to be acquiring the property directly from the seller at an amount equal to the amount paid by the bank. Therefore, the client, rather than the bank, will pay the transfer duty. Furthermore, regarding the Value-Added Tax Act,[137] the bank shall be deemed not to be involved in the acquisition of the property representing the object of the *murabaha* agreement. The client is deemed to be acquiring the property directly from the seller for an amount equal to the consideration paid by the

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132 Abrahams 'A guide to the VAT treatment of Islamic financial services in contemporary South Africa' (2007) 27/469 *De Rebus* 52.

133 Suliman 'Islamic banking' (2011) 25 *Tax Planning* 13.

134 According to Swarts '*Contractus trinus* and *murabaha* offshoots for usury: a theoretical and practical approach with regard to Islamic case law on home loans' (2011) 23 *SA Merc LJ* 427 the *murabaha* is actually devised to escape from interest and is thus not an ideal instrument to carry out the real objectives of Islam.

135 58 of 1962: section 24JA(3).

136 40 of 1949: section 3A(1) inserted by section 2(1) of the TLAA.

137 89 of 1991: section 8A inserted by section 121(1) of the TLAA.

bank.[138] The Securities Transfer Tax Act[139] acknowledges the fact that a *murabaha* agreement can also be used by a Collective Investment Scheme in Securities (CIS)[140] as a lender for the acquisition of securities for the benefit of a bank. In such a case the CIS is deemed not to have acquired beneficial ownership of the security under the *murabaha* agreement.

Thirdly, the diminishing *musharaka* product is a form of property financing where the bank and the client have agreed to joint acquisition of the property. The bank and the client thus agree to proportionate shares of the capital to be invested, and to sharing of the income generated by the property. The client may then either share in the profit or losses as agreed upon when the partnership was formed, or purchase the bank's share in the property over an agreed period of time.[141] For the purpose of determining income tax there is a difference between the position of the client and that of the bank. The amount paid by the client to the bank for shares purchased will be treated as ordinary revenue subject to the Income Tax Act,[142] but the client's situation depends on whether the bank offers financing for a new asset or an existing one.[143] With regard to the Value-Added Tax Act,[144] the bank is also deemed not to be involved in the acquisition of the property even if it acquires the property jointly with the client, or acquires an interest in the property from the client.[145] For the purpose of the payment of transfer duty in terms of the Transfer Duty Act,[146] the bank shall be deemed not to be involved in the acquisition of the property and the client must pay the transfer duty at the price obtained by the bank from the seller.[147]

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138 SARS (2010) 52–53.

139 25 of 2007: section 8A inserted by section 128 of the TLA reads as follows: 'In the case of a murabaha between a collective investment scheme in securities and a bank as contemplated in paragraph (b) of the definition of 'murabaha' in section 24JA(1) of the Income Tax Act, 1962 (Act No. 58 of 1962), the collective investment scheme in securities is deemed not to have acquired beneficial ownership of the security under the sharia arrangement.'

140 Future amendments to the Islamic CIS finance matters are also on the cards but fall outside the scope of this discussion. See SARS (Jan 2012) 47–49.

141 SARS (2010) 54; Abrahams (2007) 51.

142 58 of 1962.

143 58 of 1962. See section 24JA(5) & (6) for the calculation of the taxable amount, and also SARS (2010) 54–55.

144 89 of 1991: section 8A(2) inserted by section 121(1) of the TLAA.

145 SARS (2010) 55.

146 40 of 1949: section 3A(2) inserted by section 2(1) of the TLAA.

147 See also SARS (2010) 55–56.

The net effect of all these changes on tax legislation, is that some Islamic financing products will be regarded as comparable to conventional products when it comes to income tax,[148] value-added tax (VAT),[149] transfer duty,[150] and securities transfer tax.[151]

In addition to the products already mentioned, the South African government plans to regulate the tax consequences of Islamic bonds (known as *sukuk*) in the near future, making them competitive with conventional government-issued bonds.[152] Furthermore, *Sharia'h*-compliant *ijarah* contracts and sale contracts (comparable to conventional instalment credit agreements) are to be included in the latter's definition to eliminate or reduce tax consequences.[153]

According to some authors,[154] the new legislative measures pertaining to Islamic finance products were not introduced to ensure compliance with *Sharia'h* principles or to promote Islamic banking, but rather to regulate issues of taxation. However, the double standards when it comes to the taxation of conventional and *Sharia'h*-compliant banking products are part of the reason why clients have not favoured Islamic banking in the past. The knowledge that these products may now be available without disadvantage, could see Islamic banking starting to flourish. As another author puts it:[155]

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148 Income Tax Act 58 of 1962.

149 Value-Added Tax Act 89 of 1991.

150 Transfer Duty Act 40 of 1949.

151 Securities Transfer Tax Act 25 of 2007.

152 Section 54(1) of the Taxation Laws Amendment Act 24 of 2011 amends section 24JA of the Income Tax Act (inserted by section 48 of the TLAA) by adding the following definition: 'sukuk' means a sharia arrangement whereby—(a) the government of the Republic disposes of an interest in an asset to a trust; and (b) the disposal of the interest in the asset to the trust by the government is subject to an agreement in terms of which the government undertakes to reacquire on a future date from that trust the interest in the asset disposed of at a cost equal to the cost paid by the trust to the government to obtain the asset.' A discussion of the *sukuk* falls outside the scope of this contribution. For more information see SARS (Jan 2012) 71–73; Salah (2014) 51–71; Salah 'Legal infrastructure of *sukuk* structures: part I' (2011) 4 *Company and Securities Law Journal* 522–528; Salah 'Legal infrastructure of *sukuk* structures: part II' (2012) 1 *Company and Securities Law Journal* 61–69.

153 SARS *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012* (10 December 2012) 131–132. A discussion of these proposed changes falls outside the scope of this discussion.

154 Qasaymeh (2011) 291–292.

155 Cobbett (2011) 58.

> South African Muslims, [aware of] the potential of these [Islamic] banking and financial services, see the action taken by the state to recognise Islamic finance as an appropriate response towards meeting the needs of minority groups whose rights are secured in the constitution. The development of Islamic finance and banking is considered an obvious and positive outcome of post-Apartheid democracy and cultural pluralism.

ISLAMIC FINANCE IN THE NETHERLANDS: IN DENIAL OF THE REALITIES?

Islamic finance in the Netherlands

Historically, there has been a connection between Islamic finance and the Netherlands.[156] Dutch banks contributed to the development of Islamic finance in early years, eg the Netherlands Trading Society (*Nederlandsche Handel-Maatschappij*), which was one of the predecessors of ABN AMRO, was allowed to establish itself in Jeddah, Saudi Arabia, to provide interest-free money-exchange services to pilgrims from Dutch Indonesia at the beginning of the 20th century.[157] In recent years Dutch banks have offered Islamic finance products in Southeast Asia, eg in Malaysia and the Middle East, but their activities in the Netherlands have been limited. Nonetheless, according to a study by the Central Bank (*De Nederlandsche Bank*), there is a demand for Islamic finance in the Netherlands.[158] In 2007 Wouter Bos, former Minister of Finance, recommended a study of the possibility of Islamic finance in the Netherlands.[159] In response, the extreme right-wing politician, Geert Wilders, and his political party PVV (*Partij Voor de Vrijheid*) posed questions in the Lower House (*Tweede Kamer*), stressing the undesirability of Islamic finance in the Netherlands. The former minister's response was that there appeared to be a demand and that the Dutch financial sector would benefit from the development of an Islamic finance market which would allow the Netherlands to keep pace internationally with Dubai

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156 Salah (2014) 5–6.

157 Wilson *Islamic finance in Europe: RSCAS Policy Papers 2007/02* (2007) 2 at http://cadmus.eui.eu/bitstream/handle/1814/7739/?sequence=1 (last assessed 19 February 2015).

158 Verhoef, Azahaf & Bijkerk *Islamic finance and supervision: an exploratory analysis: DNB Occasional Studies* (2008) 6/3 at 21–24.

159 Editorial 'Bos onderzoekt mogelijkheden voor islamitisch bankieren' *Trouw* (17 July 2007).

and London which have become Islamic financial hubs.[160] So far, however, the Netherlands is lagging behind as Islamic finance has failed to take off.

Islamic finance under Dutch private law

As already indicated, a limited number of Islamic finance transactions have taken place in the Netherlands but, in contrast to South Africa, no legislative progress has been made in facilitating such transactions. However, from a private law perspective, no legislative amendments are required. Dutch corporate, contract and property law allow for the structuring of Islamic finance transactions. It may, therefore, be argued that Dutch private law is compatible with the structuring of the Islamic financial transactions described above. Partnership contracts such as the *musharaka* and *mudarahab* could be structured either through a limited partnership contract (*commanditaire vennootschap*) or a general partnership contract (*vennootschap onder firma*).[161] The *musharaka* and *mudarabah* could also be structured through the incorporation of a stock company (*kapitaalvennootschap*) such as a private limited liability company (*besloten vennootschap*) or a public limited liability company (*naamloze vennootschap*).[162] Further, other Islamic financial contracts such as sale contracts, could be accommodated under Dutch private law. The contract of *murabaha* qualifies as a purchase and sale of property in instalments (*koop en verkoop op afbetaling*).[163] Book 7A of the Dutch Civil Code (DCC) contains mandatory rules for such instalment sales. The contract of *murabaha* does not conflict with these mandatory rules.[164] Finally, leasing contracts such as the *ijarah* qualify as rental agreements under article 7:201 of the DCC and could also be incorporated into Dutch private law.[165]

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160 Bos 'Answers to questions in the Lower House on Islamic banking (*Antwoorden op kamervragen islamitisch bankieren*)' (13 July 2007) at: http://www.rijksoverheid.nl/documenten-en-publicaties/kamerstukken/2008/07/24/antwoorden-op-kamervragen-islamitisch-bankieren.html (last accessed 14 January 2015).

161 For a discussion of the *musharaka* as a limited partnership (*commanditaire vennootschap*) under Dutch law, see Van Rossum 'Islamitisch financieren onder Nederlands civiel recht' (2009) 8 *Ondernemingsrecht* 360–366.

162 For a discussion of the *musharaka* as a private limited liability company (*besloten vennootschap*), see Salah (2014) 73–82.

163 In accordance with article 7A:1576 of the DCC.

164 See Salah (2014) 93–96.

165 The *ijarah-wa-iqtina* may – depending on how it is structured– qualify as a hire purchase under article 7A:1576h of the DCC, in which case complications may arise with mandatory rules under Dutch law. See Salah (2014) 105–111.

Tax implications of Islamic finance in the Netherlands

In Dutch tax law, no legislative amendments have yet been made. Dutch tax law follows an economic approach to financial transactions (whereby the economic substance of a transaction prevails over its formal legal structure). Since most Islamic financial products mirror the economic effects of conventional financial products, Dutch tax law appears to be reconcilable with Islamic financial transactions.[166] This is especially true of wholesale and investment banking. In the case of retail banking, however, tax law has been flagged as an obstacle to the introduction of Islamic retail banking products in the Netherlands. Despite protracted debate on the matter,[167] the Dutch tax authorities are of the opinion that profits generated in Islamic mortgage transactions, eg the profit margin in the *murabaha*, do not qualify as interest and are, therefore, not eligible for mortgage interest relief (*hypotheekrenteaftrek*). This puts Islamic retail banking products at a disadvantage compared to their conventional counterparts. Nonetheless, the Dutch legislature has not introduced any legislative amendments in relation to Dutch tax law, in contrast to other European countries such as the United Kingdom, Ireland, France, and Luxembourg.

Islamic finance in the Netherlands: neither legal pluralism nor legal diversity

Islamic finance in the Netherlands is neither a form of legal pluralism nor one of legal diversity as we understand it. The Dutch legal system is a uniform legal system which does not allow for a multiplicity of diverse financial rules. Moreover, Islamic financial contracts are often governed by English or Dutch law, not by Islamic law. Islamic law is relevant only to the structure of the transactions. Islamic finance in the Netherlands is also not a form of legal diversity, because the Dutch legislature has not introduced different legal rules for conventional and Islamic financial transactions. The

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166 See Muller 'Islamic finance and taxation: a level playing field in sight?' (2010)10/5 *Derivatives & Financial Instruments* 240–258; Rozendal & Westhoff 'Een alternatief voor de financiering van Nederlands beleggingsvastgoed?' in Salah (ed) *Islamitisch bankieren: van religieuze principes naar financiële transactiestructuren* (2011) 89–98.

167 Kranenborg & Talal 'Islamitisch bankieren en de zogenoemde eigenwoningregeling van art. 3.111 Wet IB 2001: 'Dualiteit of perspectief?' (2007) 6742 *Weekblad fiscaal recht* 1259–1267; Kranenborg & Sinke 'The diminishing musharaka: groeiend eigendom als islamitisch perspectief?' (2009) 6816 *Weekblad fiscaal recht* 770–779; Kranenborg & Sinke, 'Islamitisch financieren –de halal hypotheek in Nederland? – Wet BRV / Wet IB 2001 / Wft / Tijdelijke Wet Regeling Huurkoop Onroerend Goed' (2009) *Vastgoed fiscaal & civiel* 5–13; Hooft & Muller 'Shari'a-conforme woningfinanciering ontsluierd' (2008) 6765 *Weekblad voor Privaatrecht, Notariaat en Registratie* 624–632.

current Dutch legal framework already facilitates Islamic financial transactions, especially wholesale and investment banking products, but within the existing framework of its private law. This illustrates that Islamic finance may well co-exist in a jurisdiction where there is no legal pluralism or legal diversity in respect of Islamic financial products.

At the same time, however, the lack of a level playing field from a tax perspective, has precluded the introduction of fully-fledged Islamic retail banking products in the Netherlands. Sensitivity to legal diversity could be the gateway to success here. For example, legislative amendments to Dutch tax law – like those in South Africa or in various European countries – would enable the Islamic retail banking market to evolve in the Netherlands. Although discussions on this subject were initiated almost a decade ago, the Dutch government has not yet been willing to facilitate such legislative amendments. Given the growth of Islamic finance worldwide, the Netherlands may at this point be in denial as regards the realities or, as the British prime minister puts it, the Netherlands may be refusing to recognise that the way the world is changing effects its future success:[168]

> Today our ambition is to go further still. Because I don't just want London to be a great capital of Islamic finance in the western world; I want London to stand alongside Dubai as one of the great capitals of Islamic finance anywhere in the world. There are some countries which naturally look inwards, pull up the drawbridge and refuse to recognise that the way the world is changing affects their future success. But Britain will not make that mistake.

CONCLUSION

In this contribution the position of Islamic finance in South Africa and in the Netherlands in the light of legal pluralism and legal diversity in each legal system has been examined. Islamic finance is based on Islamic law, which comprises a set of moral and religious principles. In terms of Islamic law, the payment and receipt of *riba* (in short: interest) and *gharar* (contractual uncertainty) are forbidden. Consequently, alternative Islamic financial contracts are structured where the financier makes a profit either through trade in tangible assets, or through a profit-and-loss-sharing arrangement instead of making a profit through charging interest.

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[168] Watt 'David Cameron to unveil plans for £200m Islamic bond' *The Guardian* (29 October 2013).

The South African legal system, which reflects elements of both state and non-state legal pluralism, as well as legal diversity, seems to be more adaptable to the nature of Islamic finance. South Africa has introduced tax laws to facilitate Islamic financial transactions, although these laws are not yet in operation. South Africa's accommodating attitude to Islamic finance through its legal diversity explains, at least to some extent, the promise of success of Islamic finance in South Africa.

The unified Dutch legal system may, at first glance, appear to be less inclined to allow or facilitate legal pluralism or legal diversity. Nonetheless, the Dutch legal framework is compatible with the structuring of Islamic financial transactions, especially in respect of Islamic wholesale and investment banking. Dutch private law is sufficiently flexible to facilitate Islamic financial transactions, and Dutch tax law benefits from an economic-substance-over-legal-form approach in this respect. However, the introduction of Islamic retail banking products in the Netherlands is still being obstructed as a result of the disadvantageous treatment of Islamic financial products under Dutch tax law, compared to conventional financial products. The introduction of legal diversity in the Netherlands could be a solution. For example, the amendment of Dutch tax law (similar to that undertaken in South Africa) to give Islamic retail banking products a tax-neutral treatment, could enable the development of an Islamic retail banking market in the Netherlands. So far, however, the Dutch government has not introduced such legislative amendments.

Comparing the South African legal system with the Dutch, shows that Islamic finance can be a corollary to legal pluralism or legal diversity, but that it can also exist in a homogenous legal order. At the same time, it shows that the manifestation of the diversity of South African society within its pluralistic legal system enables the introduction of new economic and financial developments in a globalising world. Although Islamic finance can exist in the a homogenous Dutch legal order, failure to recognise its specific features through legal diversity in Dutch tax law has, so far, prevented the realisation of its full potential in the Netherlands.