

1st Ethical Charitable Trust
Research Paper on:
Shariah Compliant Investments



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www.1stethical.com

All praise is for Allah, Creator of the Heavens and the Earth, and owner of the Day of Judgement. I bear witness there is none worthy of worship except Allah (SWT), and I bear witness Muhammed (SAW) is his messenger.

This paper covers:

- Introduction
- Fundamental Rules of Islamic Investment
- Creating a Portfolio – Low, Medium & High Risk
- Tax Efficiency Through Trusts
- Summary & Conclusions

A. INTRODUCTION

The concept of investment lies at the very core of Islamic Finance. Whether it is direct investment into a business venture, or an indirect investment via pooled unit trusts, a Muslim is always encouraged to invest instead of hoard wherever possible. Moreover, Investment is widely accepted as the principal driver stimulating economic growth and prosperity.

Excessiveness has never been the Muslim way and therefore the hoarding of wealth and conversely wasting wealth and being ostentatious are both actions which incur the wrath of Allah. The latter point is emphasised in the Qur'an where Allah says in verse 29 of Surah Isra '*Let not your hands be tied like a miser to your neck, nor stretch it forth to its utmost reach like a spendthrift*'

All too often mankind perceives money as an asset. Indeed accountancy teaches us to treat it on the asset side of the balance sheet. The reality though is that a Muslim will be held accountable on the Day of Judgement with respect to how he acquired and spent his wealth. The truth then if Muslims were to contemplate deeply enough is that the very money we perceive as an asset in our hands today could shockingly turn against us as a liability on the Day of Judgment. *May Allah protect us all – Ameen.* Naturally then the importance of

investing any excess wealth (after basic necessities and charitable donations), in a manner which is pleasing to Allah (SWT) is of paramount importance. It is imperative for a Muslim to learn the rules behind what is permissible in Shariah as an investment, and what is prohibited. A permitted investment will no doubt confer benefit to others and will attain Allah's pleasure, whilst a prohibited investment will incur his displeasure and spell doom for those involved.

Islam's ideal investment lies in the concept of Musharaka, which is similar to a joint venture. In conventional finance, money is usually generated through receiving interest on cash held on deposit. By contrast, with Musharkaka, typically an investor provides the capital required to fund a project and in return receives a percentage of the equity in the venture from the entrepreneur. Each year profits are split in a pre-agreed ratio between the 2 parties. Losses are also shared in proportion to capital investment. It is a sensible approach which binds both parties directly to the success and failure of the venture. This approach avoids the need for an Interest-based lender to intervene and unfairly pocket profits.

FUNDAMENTAL RULES OF ISLAMIC INVESTMENT

Islam is both Din-ul Haq (Religion of reality) and a religion of ease. Therefore the Shariah's guidelines never impose a burden on a soul beyond its capability and have certain flexibilities in light of prevailing circumstances in society.

At the heart of these flexibilities is a central principle of Islamic finance (and much of Islamic jurisprudence in General), which is all concepts and solutions are assumed to be permitted in Islam, unless expressly prohibited by Shariah.

There are three fundamental sets of rules which dictate what a believer can or cannot engage in with respect to business. The first rule is to avoid the giving or taking of interest at all costs, whilst the second is to avoid investment in ventures which are involved in unethical concerns eg Breweries, Pornographic outlets, Tobacconists etc. The third concerns the nature of the contract between the parties. We will take a look at all three.

1. Ban on Interest – Allah (SWT) has placed a bilateral ban on Interest. Neither can the borrower pay it, nor can the lender receive it. Interest is deemed so repugnant in Islam that Allah (SWT) has mentioned that the person dealing in Interest will not stand on the day of Judgement excepts stands he who has been driven crazy by the touch of Shai'taan (Surah Baqarah v 278-279). In addition, in Surah Baqarah v 275-281, Allah (SWT) declares war on a Muslim who engages

in Interest. A declaration of war from the creator to Muslims is a very grave matter. Such strong condemnation of interest has prompted many Ulema and Islamic thinkers to research deeply into why Interest may have been banned.

The reality is that Allah (SWT) has not specified any one reason in particular which can be attributed to the prohibition of Interest. However, as Muslims we accept the prohibition because the creator has ordained it. A valid reason for it which is comprehensible by mankind is simply not a pre-requisite. Indeed, one of the salient features of Islam is *'to submit'*, unconditionally to the will of Allah (SWT). This submission does not relinquish mankind of their right or responsibility in appreciating the possible wisdom behind the ban. It does however reject completely the principle that acceptance is based on understanding the wisdom.

Countless explanations have been offered from various people, Muslims and non-Muslims alike as to why Interest represents an extraordinary evil. 1st Ethical has written a research paper and booklet on this very subject, which are both available at www.1stethical.com/publications. Nonetheless, the following is a small list of some of the reasons exhibiting the problems with Interest. Readers are advised to read the relevant guides for further information.

- A. Rich just get Richer** – A 1998 development report by the United Nations concluded that the richest 225 in the world own more wealth than the poorest 2.5 Billion. Analysts have accused Interest as being the primary driver behind this shocking disparity.
- B. Banks are too powerful** – The interest economy is distinguished by one institution which has almost unbridled control over the production and control capital. This institution of course is the Bank. Banks these days not only create most of society's money supply (the Government creates only 7%), but also utilise a concept known as 'fractional reserve' which allows the Banks to artificially create and lend to the public up to 49 times what is in the vaults. Former US President Thomas Jefferson stated that 'Banking Institutions were more dangerous than standing armies', whilst Lord Josiah Stamp (former director of the Bank of England) warned the British public that *'If you want to be slaves of the Bankers, and pay the costs of your own slavery, then let the Banks create money'*.
- C. Indebting the 3rd World** – Jesse Jackson, the American preacher and activist once famously said 'they no longer use bullets and ropes, they use the IMF and the World Bank'. The wealth of the developing world has been plundered resulting in future generations being plagued with debt owed to Western banks and the World Bank/IMF. Susan George, the

highly respected economist estimated that the debtor nations started the 1990's 61% deeper in debt than the 1980's.

2. Restrictions on Investment in Unethical Areas – Alongside the bilateral ban on interest, the other key parameter around which an investment strategy must be structured is the ethical nature of the investment. Islam totally accepts profitability as the prime business motive, but even this cannot be at society's expense. Recent statistics compiled by police forces in the UK show that between 60-70% of weekend crime is fuelled by Alcohol. Naturally then, fuelling the growth of the Alcohol Industry by Investing in Pubs or Alcohol Distillers is not in society's best interests. In addition, with a clear proven link between tobacco and cancer, cigarette manufacturers are also impermissible to invest in. The following is a concise list of the prohibitions. For a full list of all the prohibitions, please consult the chapter on Islamic Investment in Mufti Taqi Usmani's book, *The principles of Islamic Finance*'.

- *Alcohol* - Alcohol brewers and Distillers, and any other firm involved exclusively in the production or sale Alcohol.
- *Banks* – Banks and other Banking Institutions involved in Interest. (Insurance firms are usually also included in this)
- *Gambling* – Casinos and all other Gambling outlets.
- *Pornography* – Manufacturers and sellers of pornographic material including any firms involved in pornographic activity.
- *Tobacco* – Manufacturers and sellers of tobacco and tobacco related products.
- *Ancillary Activity* – Any business which although may not engage in the above as principal activity, but derives more than 5% income from above unethical concerns.
- *Shariah Reservations* – Any business whose activities the Shariah Board feels are prejudicial to the Interests of Islam or Muslims.
- *Gearing* – Any business which has a debt to equity ratio in excess of 33%.

3. Uncertainty (Gharar) & Gambling (Maysir) - Just like any transaction requires a legally valid contract in order for it be to acceptable under English Law, the Shariah also requires all transactions to concur with Islamic Contract Law. There are certain aspects within Islamic contract Law which are not to be found in Western Law. Chief amongst these is Gharar, which has the ability to effectively render a contract null and void. Gharar represents 'significant uncertainty' in the existence, ownership and availability of the subject

matter as well as ambiguity pertaining to price and delivery. It's quite a wide-ranging definition and hits at the heart of the Shariah's desire to avoid disputes between contractors. Any current uncertainty which may lead to a dispute in the future automatically falls in the domain of Gharar. In addition to Gharar per se, there also other contractual rules such safaqat-fi-safaqat (rolling 2 contracts into one) which need to be avoided. Elements such as Gambling (Maysir), Betting (Rihan) & Qimar (Games of chance) cannot figure in a legitimate contract in the eyes of the Shariah.

Now that we understand the three main guiding principles, we are in a position to construct a Shariah-compliant portfolio.

CREATING A PORTFOLIO – LOW, MEDIUM & HIGH-RISK.

The above discussion has emphasised the importance of any investment being undertaken in a Shariah-compliant manner. Shariah compliance must be considered alongside other parameters which would govern any investment. Prime amongst these other factors (such as charging structure, amount to be invested, access requirements, timeframe for investment, financial strength of companies being invested in and so on) is the risk profile of the client. Without a careful consideration of a client's profile, even the most shariah-compliant portfolio will not effectively address a client's concerns. Risk is inextricably linked to return. The beauty of varying risk-based investment is that they assist in adding valuable diversification to the portfolio. Assets held in low-risk investments will rarely breach the 5% return level. However, they are very unlikely to generate a loss. Conversely assets held in high-risk investments are likely to easily exceed the 10% return mark in any given year, however they could just as easily fall by that amount. Hence, a diversified approach of various assets classes is comparable to *putting one's eggs in different baskets*. Most clients will usually obey the above logic and require a portfolio incorporating all elements of the risk spectrum.

Low-Risk

Low Risk Shariah-compliant investments can be categorised as follows;

- Islamic Bank Accounts
- Direct property Investment
- Property Shares
- Property Investment Bonds

Islamic Bank Accounts

These can be operated either by a home-grown Islamic Bank or by a non-Muslim Bank with an Islamic window. In the UK, the Islamic Bank of Britain and HSBC Amanah both offer the Islamic Bank Account service. Naturally, no interest is paid on these Bank accounts and instead they accrue returns via profit. Profit is made via the concept of *commodity Murabaha*, which is explained below. IBB currently pay up to 4% per annum whereas HSBC Amanah only pays a return on large corporate deals. At a retail level no return is paid to clients. It is however fair to point out that HSBC will ensure that funds in their Islamic Bank accounts are segregated from the main operations and will not be used in any interest-based activity.

CASE STUDY – The Islamic Bank of Britain PLC.

Modaraba & Commodity Murabaha in action

The newly-formed Islamic Bank of Britain (IBB) offers 3 types of Bank accounts; a current account, savings account and deposit account. The current account holds funds in a Shariah-compliant environment avoiding any involvement with interest, however offers no return on the money. It is designed as an Instant Access Account offering a cash card. The savings account holds client funds and pays returns in the region of 2.5% - 3%. The client's funds are subjected to a commodity Murabaha arrangement (see below) via which the Bank makes a return and then shares it with the depositor. The Deposit account, also referred to as a treasury account locks funds in over specified periods from as short as 1 week to 1 year. This system also operates via Commodity Murabaha and pays upto 4% as a return.

Commodity Murabaha is a system whereby the Bank, acting as an agent on behalf of its depositors, purchases frequently traded commodities such as Rhodium, copper, steel etc on the open market at a spot (immediate payable) price. At the point of purchasing these commodities the bank has a separate promise from another party, who agrees to purchase these commodities from the depositors at a higher price, which is payable after an agreed period, typically ninety days. The volume levels engaged in by the Bank allow for a profit margin to be generated overall. The net profit accruing from the trade is split into two parts. One part is kept by the Bank to offset against costs and to retain the balance as profit. The second part is the client's return on his deposit. This way the client generates a halaal return whilst simultaneously keeping his assets in cash.

As mentioned above, the procedure of investing client funds into raw materials such as copper is known as Murabaha. The relationship though between the Bank and its client is that of Modaraba. This is because the client has provided the capital to the Bank which in turn invests that capital on the client's behalf in a capacity as an agent resulting in a Modaraba relationship between them.

Direct Property Investment

This idea we are all too familiar with. Although historically healthy gains have been made in the UK property market, the truth is that many parts of it are close to saturation, if not already saturated. Commercial property still bears some mileage but due to less interest than the residential markets capital appreciation is relatively restricted. These days, the typical rental yield on residential property is around 5% after taxation and Islamic financing costs..

Property Shares

These are shares in a company which in turn invests the money in providing Islamic Mortgages to the general Muslim community. The repayment paid by the occupier of the mortgaged property serves as a return to the investor on his property shares. The latter after deducting the administration expenses of the firm running the scheme. This concept is a great way of providing true Islamic Finance for homebuyers, yet simultaneously generating return on capital.

CASE STUDY – Ansar Finance & Property Shares.

The only organisation in the UK currently engaged in this form of investment-based financing is Ansar Finance in Manchester. Ansar is a community based co-operative aiming at providing Interest-free loans and Islamic Mortgages to members. Ansar runs the property share scheme through their sister-firm Ansar Housing Ltd. The scheme sells shares in Units of £100 with a minimum investment level of £5000. Currently Ansar hold over £400,000 in such client investments. The money is then utilised to provide halaal mortgages for members of Ansar Finance. The Ijara based Halaal Mortgages typically provide a return of around 6.5%. Ansar's expenses on this return are 2.5% which leaves a net 4% to be repaid to the investors. Ansar aims to streamline admin expenses further in an attempt to push up the net dividend received by the investor.

Property Investment Bonds

This investment type is usually a large collective investment run by a reputable investment house such as Norwich Union or Legal & General. Clients purchase

units in a central fund which owns blue-chip property all over the UK. Tenants in the properties tend to be firms such as Homebase, B&Q, Next etc. The investment is low risk and is encashable at any time, though penalties on encashment may apply. An annual management charge of around 1% is also levied by the Fund Manager. These funds have been operating for over 20 years have impressively delivered average annual returns of 9% over this time frame. On a recent estimate, Standard Life alone had over £8 Billion in such funds.

Most clients tend to retain at least 50 - 70% of their investment funds in the above low-risk assets.

CASE STUDY – 1st Ethical & Property Investment Bonds

1st Ethical is regulated by the FSA as a firm of Independent Financial Advisers authorized to give investment advice. In anticipation of falling equity markets, in 2001 the firm took an active decision to redirect client investments into pooled property funds. The advantage of this type of arrangement is that anyone could take part from initial investment as little as £5,000. In addition, there were none of the issues pertaining to legal fees stamp duty or indeed tenants to contend with. The logistics of a pooled property funds are such that investors pool their funds together collectively within a unit trust managed by a respectable firm eg Legal & General (L&G). L&G then issue units to the investors in exchange for their funds. These units represents pro-rata ownership of the underlying assets of the property fund. The fund then invests in blue-chip commercial property lets or builds industrial retail parks for rent by major companies. The monthly rental yields in addition to capital appreciation on the portfolio increase the value of the overlying units thereby increasing the client's investment value. Standard Life has approximately £8 Billion in such arrangements. Any investor can encash their share in the fund at any time (possibly subject to penalties). Given the size of these funds (most are well in excess of £100M), individual encashments can usually be wholly met from the monthly rental income.

The challenge faced by 1st Ethical was three-fold. Firstly, to ensure that the Property Funds were Shariah-Compliant, secondly to ascertain what level of Zakat liability was payable on assets held within the fund. Thirdly, to filter out any interest which may have been payable on cash-holdings waiting to be invested by the fund.

Shariah-Compliance – To assess the portfolio for Shariah-compliance, 1st Ethical utilised the fatwa by Mufti Mohammed Shafi (Father of Mufti Taqi Usmani) relating to rental properties. The fatwa is obtainable on request, however the key rules are contained in the following document which is provided to each 1st Ethical client partaking in this type of investment.

Explaining Shariah Compliance

Commercial Property Funds

Given the scarcity of dedicated shariah compliant investment funds, 1st Ethical have devised a set of criteria which can be applied to conventional commercial property funds in order to determine whether they meet shariah standards.

These criteria are based upon a fatwa given to 1st Ethical by Doctor Imran Usmani, from the Centre for Islamic Economics, division of Darul Uloom Karachi. Please contact 1st Ethical if you require a copy of this fatwa.

1st Ethical carry out regular periodic checks on property funds to ensure:

1. Funds have no gearing whatsoever
2. Funds do not predominantly invest in properties dedicated to a haram activity e.g. pubs, casinos, breweries etc. (less than 5% of properties in impermissible activities)
3. Funds have a low cash content. 1st Ethical select funds whose stated aim is to keep the cash content to 15% or below, as an annual average. Please note the short term cash content may vary considerably from the average.

1st Ethical only recommend funds which have been vetted in accordance with the above criteria. Should any of the funds we currently recommend change their policy in the future and either:

1. Start to gear the fund
2. Adopt a policy of investing in prohibited categories of property
3. Continually hold a cash content in excess of 33% for six months or more

1st Ethical will advise our clients to transfer these funds to another property provider.

Please also note that all funds hold their cash content in an interest bearing account. 1st Ethical offer a no charge service whereby we compute, on an annual basis the small amount of interest earned on the cash content of a fund so that clients can cleanse their profits by donating this amount to charity.

1st Ethical also offer a no charge Zakat calculation service, whereby we calculate the Zakat payable on the cash content of the fund. Our understanding of the shariah position is there is no Zakat payable on the portion of the fund directly invested in properties.

Please note 1st Ethical are unable to make these charity payments on behalf of clients. In order to make the payment yourself, please contact 1st Ethical on your Zakat anniversary date in order to obtain the relevant figures for your specific investment.

In case of query, 1st Ethical recommend you contact a shariah scholar of your choosing to ensure your understanding of the shariah accords with ours. Any decision to proceed with a 1st Ethical recommended investment confirms your acceptance of and agreement with the shariah criteria outlined within this document.

Zakah Liability – More information on this subject is contained within 1st Ethical's Guide to Understanding & Calculating Zakah which can be downloaded from www.1stethical.com.

The general rule on Zakah in this instance is as follows; any property purchased as an investment is not Zakatable although any rent received is Zakatable.

Interest Cleansing – As cash enters and leaves the property fund on a daily basis (possibly even more frequently), it is impossible to calculate the Interest accruing on a daily basis. Instead, 1st Ethical devised a formula which took into consideration average cash balances during the year and the interest rate paid on cash; this then allowed 1st Ethical to calculate the Interest due on client investments. This principle is taken from Mufti Taqi Usmani's book, 'An Introduction to Islamic Finance', where a similar process of cleansing is advocated.

MEDIUM-RISK

Investment opportunities in this risk category can be classified as follows;

- *Musharaka Investment (Islamic Venture Finance)*
- *General and specialised Unit Trusts/OEICs etc*

Musharaka

Musharaka aims to revive the true ideal of Islamic Finance, the precise method of trading utilised by the Prophet Mohammed (SAW) in his dealings with fellow traders. Specifically, with Hazrat Khadijah (R.A) who would supply Mohammed (SAW) with goods to sell in a foreign land. Once the goods had been sold and a profit made, it would be distributed between Mohammed (SAW) and Hazrat Khadija in a pre-agreed percentage. This exhibits true Islamic principles of trade.

Musharaka in its modern form is a strategic investment which allows the entrepreneurs with the most financially viable ventures in the Muslim Community to ascertain Halaal venture finance from Muslim investors/financiers in the UK. This system matches idle capital to viable business projects and links investment with returns.

CASE STUDY – The 1st Ethical Musharaka Fund

As a pilot project, 1st Ethical launched a Musharaka Fund in 2005. The fund faced three distinct challenges. Firstly, to attract sufficient capital from investors. Musharaka represented the purest form of equity financing without any blending of debt.

Secondly, to find a fund manager capable of conducting due diligence and monitoring ventures thereby ensuring the finance was only offered to viable projects, and those projects were then properly managed and dividends received.

Finally came the largest of all the challenges which was to create a system whereby viable business ventures could be attracted from the Muslim Community whilst simultaneously educating the community on the need to shun Bank debt. The central challenge for musharaka is to convert the mindset of Muslim Entrepreneurs into actively choosing a halaal equity option over what appears to be a much easier and cheaper, albeit Haraam debt-based option.

1st Ethical have to date (December 2006) succeeded in achieving the first two of the three aforementioned challenges. Sufficient investors were attracted to invest in Musharaka as well as a competent fund manager being appointed to

handle due diligence and monitoring of ventures. The third area though is where 1st Ethical is now concentrating its efforts; namely the attraction of viable business projects coupled with the challenge of educating the community on the true principles of Islamic Finance and by extension the importance of equity finance against debt finance.

The mechanics of the fund are such that each year the investors receive a percentage of the profits which have accrued from the ventures which have been invested in. In the case of a loss, the investor shares in this loss. At the 5 year interval, the entrepreneur is able to start repurchasing his shares from the financier and the investment enters the exit strategy stage. One of the key benefits of Musharaka is that it prevents Muslim entrepreneurs from having to resort to the Banks for start-up finance. In addition it keeps Muslim businessmen's excess funds within the Muslim community helping to strengthen and consolidate it.

The first Musharaka funds aims to provide venture finance for low-risk projects such as Dental practices, Optical practices and pharmacies as well as other relatively stable business ideas. The long-term intention is to provide venture finance for all Muslim businesses at all stages of development. The first year yielded an investor return of 14.67%.

General and specialised Unit Trusts/OEICs etc

Unit Trusts are a unitised, pooled investment which sell units to clients in exchange for pro-rata ownership of the underlying assets. In general, the assets tend to be of an equity nature eg shareholdings in UK companies or even overseas firms. As the investment is equity-based the value of units can go down as well as up. However each unit trust typically invests in a wide range of equities (often over 100 companies), and each unit-holder owns a pro-rata investment reflecting that pool of equities. This then hugely diversifies risk and reduces overall fluctuation levels of the fund. Unit Trusts are sold by countless firms in the UK. Investment Banks such as Merrill Lynch all the way across to Life Firms such as Norwich Union. An open-ended Investment company (OEIC) is a single-priced unit trust. Both Unit Trusts and OEIC's can be held under the Government's ISA (individual savings account) scheme, which allows tax-free income and capital-gains on the first £7000 invested.

Currently in the UK there is only one UK based Shariah-compliant unit trusts managed fund known as the HSBC Amanah Fund. 1st Ethical are licensed intermediaries to this fund.

There are also a number of offshore Shariah-compliant unit trusts both in the middle-east and Malaysia run by Islamic Banks which can be accessed from the UK.

HIGH-RISK

This category by definition is a highly niche area. Direct investment in the stock-market has always been deemed as high-risk. With the additional Shariah constraints in place, a narrower pool of stocks by definition implies an even higher-risk investment. The idea here is construct an equity portfolio consisting of various individual shareholdings which are both sharia-compliant and a good investment (though this can never be guaranteed). There are certain indices

which can be relied upon to provide a list of Shariah-compliant equities which can be invested. One such Index is the *Dow Jones Islamic Index*, available by subscription, it covers global equities and lists those which are Shariah-compliant.

CASE STUDY – Dow Jones Islamic Index & Fysche Crestar

In 2000, the Dow Jones Islamic Index was launched with a view to providing a listing of stocks globally which adhered to the principles of Shariah. The Index appointed Mufti Taqi Usmani as head of its Shariah board. The Index analyses, on a quarterly basis, all the World's main trading indices (such as FTSE, Dow Jones etc) and applies criteria by which it can identify all those companies which meet shariah criteria, in a manner similar to that which 1st Ethical adopts for property funds. This in turn allows any fund manager access to a wide range of halal companies which can then be considered alongside other factors such as the firm's management, the industry potential, government regulation, charging structure, timeframe for investment and so on.

At a retail level, Fysche Crestar have developed a bespoke Shariah-compliant offering for clients. The firm is a licensed stock brokerage in the UK and specialises in constructing a portfolio for clients directly in equities which are deemed Sharaih-compliant.

This case study concludes our review on the various different types of Shariah-compliant retail products and investments and their respective risk profiles. As previously mentioned, most investors will typically spread their capital according to their risk profile. It is also worthwhile stressing any advice given on the above

investments is a *criminal offence* unless the adviser is authorised and regulated by the financial services authority (FSA). What follows now is a synopsis on tax efficiency in investments and trusts.

TAX EFFICIENCY THROUGH TRUSTS

Trusts have long been the thorn in the side of the Tax Authorities due to their potential manipulation from a taxation perspective, thereby depriving the revenue of valuable income. In the current climate there are 2 types of Trusts which confer tax-exemption benefits (Income, Capital Gains and Inheritance tax). A lot of the aforementioned investments can either be held as stand alone shariah-compliant product or alternatively be held within the wrapper of the Trusts explained below. Working in this manner can generate great tax savings for many years. Broadly speaking we can segregate Trusts into 2 areas;

- **Onshore Pension Trusts**
- **Tax-specific offshore & onshore Trusts**

Onshore Pension Trusts – For most people a pension represents a vehicle into which funds are deposited and segregated for retirement purposes. The contribution attracts tax relief and grows within a tax privileged environment. All being well at retirement age (from age 55), sufficient funds will exist in the pot to allow a healthy chunk to be taken as tax-free cash and the remainder will continue to be paid as a regular pension. There is however a number of self-invested pension plans which allow the planholder to select their own investment within a pension wrapper. Many UK residents have exercised this option in recent years and ventured down the route of holding property in the Pension. There are many benefits and also some drawbacks of holding assets within pensions.

Benefits of assets/property in Pensions

- No Income Tax payable on any rental income received by the property in the Trust
- No Capital Gains tax on properties sold in Trust
- Mitigation from Inheritance Tax (this needs to be planned carefully)
- Protection from Creditors on liquidation, as trusts assets normally cannot be touched.

Key drawbacks to Pensions

- Funds cannot be used for personal use (until withdrawn in retirement).
- Lifetime limits now apply on maximum levels of tax relief ascertainable.
- Funds taxed as earned income when received in retirement (though upto 25% can be taken as tax-free cash).
- Administration burden of property purchases in particular via pension funds can lead to delays in completion on property.
- Banks are often unwilling to lend to pensions. Even if the bank is willing to lend funds, the new A-Day rules restrict Bank lending to 50% of fund assets.

Tax-specific offshore & onshore Trusts

The ever increasing tax burden, coupled with legal directives confirming that a citizen of the UK is not obliged to plan his/her affairs in manner in which they are most tax-efficient for the authorities, has led to a definitive increase in demand for advance tax mitigation strategies.

Whilst the Inland Revenue in recent years has cracked down hard on tax leakages, it is fair to say that careful study of the legislation coupled by qualified

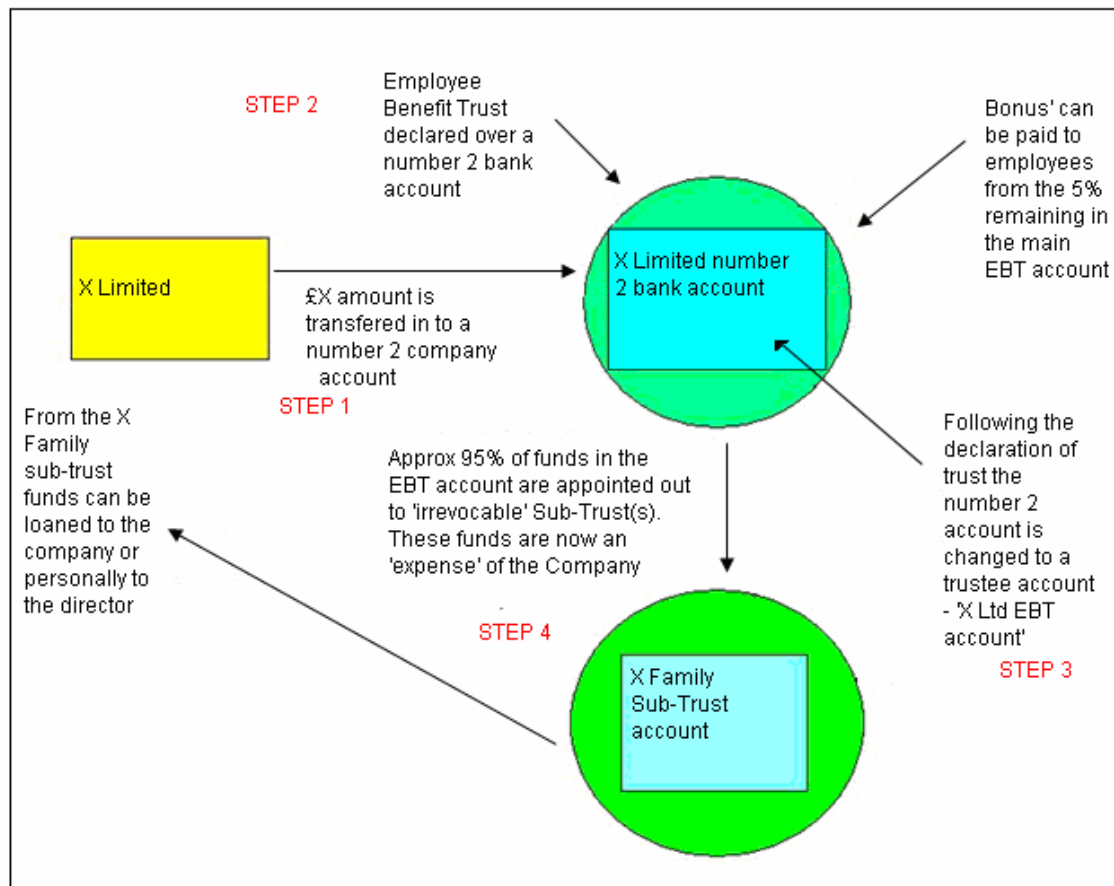
creative thinking can still yield impressive tax savings, through utilising Trust based tax solutions. Examples of such trusts are as follows;

Corporation Tax – UK firms are able to segregate funds in a stand alone trust (known as an Employee Benefit Trust) which is then used to remunerate employees. When the employee receives a bonus payment from the trust, the payment is subject to PAYE & N.I. At that point, the sponsoring employer receives a tax deduction in the accounts for the payment across. In recent years though, employers have exploited loopholes which in effect allow funds to be transferred into an EBT and claim a tax deduction whilst simultaneously then loaning the funds from within the EBT to Directors of the sponsoring company. That way, a tax deduction is gained and no PAYE/N.I is suffered. Though the laws of schedule 24 seek to retain asymmetry between corporation tax deductions and PAYE/N.I suffered, leading Barristers have found many avenues through which schedule 24 can be circumnavigated.

Capital Gains Tax – UK companies pay CGT in the form of corporation tax and on large gains are likely to pay tax at 30%. This tax can be planned around using a number of techniques such as Trust within an Isle of Man Trading

Partnership and EU Non-Discrimination. Perhaps the simplest form of mitigation though is using a Non-resident trust which is framed around section 86 IHTA. The Trust excludes 'participators' of the company as beneficiaries which allows a tax exempt transfer into the Trust. Thereafter the asset can be sold to a 3rd party purchaser and yields no CGT on sale as the asset is offshore. Once the Trust receives the sale proceeds, they can be loaned out indefinitely to the Directors of the company. This way, no CGT is paid and the directors personally benefit from the funds.

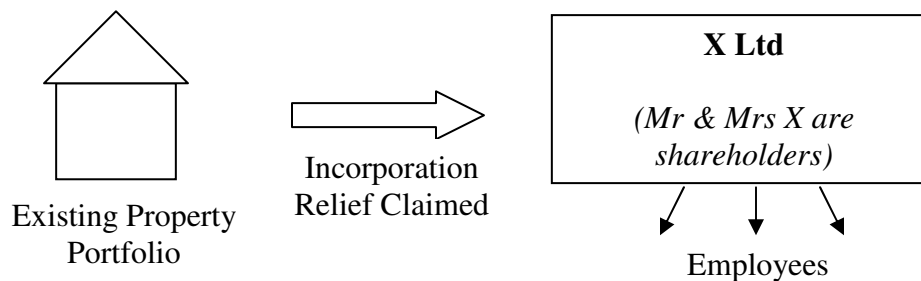
Employee Benefit Trust – Diagram



Non Resident Trust - Diagram

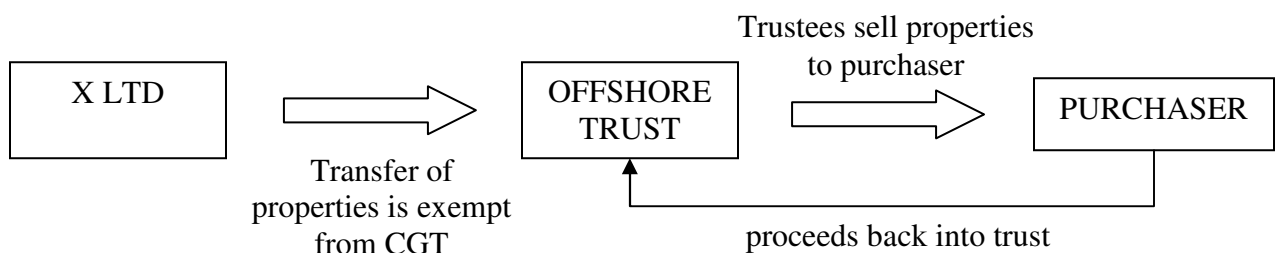
Step 1) Incorporation Relief

- Properties are transferred into newly formed company in exchange for shares
- Mr & Mrs X each own 50% shares in the company
- The company employs some workers
- No CGT payable as gain is rolled over into base cost of shares
- SDLT would normally be chargeable however we can utilize a Nominee Lease structure scheme, which will mitigate the SDLT completely.



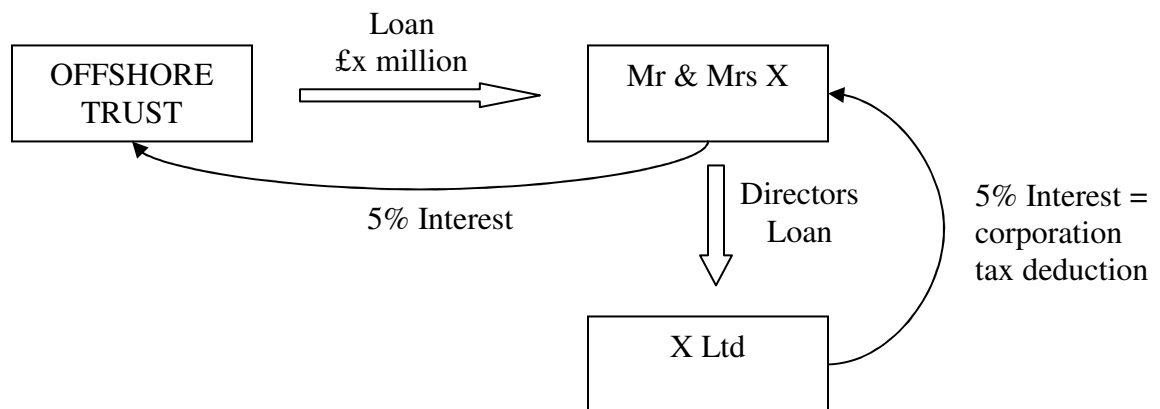
Step 2) Offshore Trust

- Offshore Trust is set up for the benefit of the company's employees
- Company then gifts all the properties into the offshore trust
- Trust acquires assets on a Nil Gain / Nil Loss basis, i.e. no CGT on transfer of assets
- Relief used is section 86 IHTA. The logic is that if an asset is placed in Trust genuinely for the benefit of the employees (excluding shareholders) then it is an exempt transfer.
- Trust then sells asset to purchaser and no CGT liability as Trust is offshore

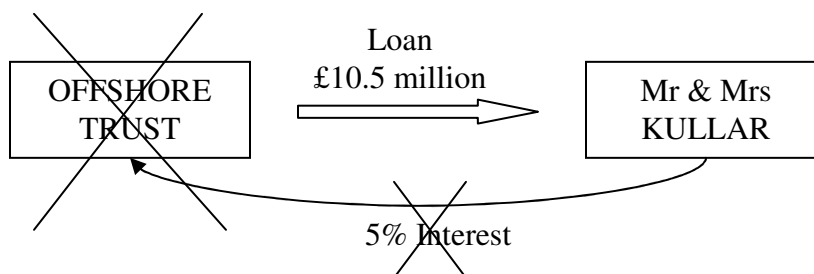


Step 3) Withdrawing Money

- Although the offshore trust is set for the benefit of the employees, the directors can still take loans from it.
- 5% interest is repayable to the trust on any loans, or alternatively a 2% tax charge is payable.
- Directors can then loan this money to X Ltd, which subsequently pays the 5% interest charge as a tax deductible expense.
- X Ltd can then re-invest money in further ventures.



- Directors can also decide to wind down the company at which point they become ex employees and the loan is effectively cancelled.
- As a result Mr & Mrs X can take the whole £10.5 million as a tax free lump sum
- Alternatively can leave company running, which has benefits from an Inheritance Tax point of view. I.e. trust is outside of Mr & Mrs X estate hence no IHT liable.



Inheritance Tax - Any UK citizen who holds an offshore company can avoid paying capital gains tax on the subsequent sale of the property as long as the proceeds are not remitted back to the UK and the citizen can prove their non-domiciled status (as most second generation Asians should be able to even if born in the UK). There is an additional advantage for many Asians in the UK on death in that any assets held outside the UK are not taxable by UK authorities due to the UK's double-tax arrangements with India & Pakistan. This is referred

to as non-Dom planning and is extremely valuable as part of an overall planning strategy.

SUMMARY & CONCLUSIONS

This paper has outlined the three key fundamental rules guiding Islamic Investment decisions when constructing a portfolio. Foremost amongst these rules is the bilateral prohibition on interest, which if ignored can result in a Declaration of War from Allah and his Messenger (SAW). We also analysed Islamic investment criteria concluding that Investment in various unethical concerns such as Alcohol, Gambling, Pornography etc is not permitted in Islam. Our third golden rule focused in the importance of ensuring transparency in transactions and the absence of Gharar (unacceptable levels of uncertainty).

We then took an in-depth look at the varying risk profiles of a client ranging from low risk, through medium and upto high risk, documenting along the way both the types of Investments available in that risk category and the providers of such investments. We analysed numerous case studies on UK financial institutions such as HSBC, Islamic Bank of Britain & 1st Ethical. We then concluded by looking at tax-efficiency vehicles within which the aforementioned investments can be held.

In summary a shariah compliant investment portfolio also requires consideration of factors which any conventional portfolio should consider. Foremost amongst these is the risk profile of the investor and the tax treatment of the assets. At face value therefore, the key difference therefore is simply the added filter of ensuring the underlying assets themselves are permitted under Shariah. However, there is a profound difference which can be achieved at a society wide level in terms of redistributing wealth more fairly, and reducing social problems, by moving away from interest based financing as well as shunning certain types of unethical investments.

We pray the Almighty is pleased with the paper, and it is a means through which we can gain His pleasure. If there are any errors they are solely from ourselves, whilst any guidance can only be from Allah (SWT).

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