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Latest French legal and tax framework developments

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The current situation of development of Islamic Finance and its potential for future

Introduction

■ Reasons for France's interest in Islamic Finance

- ↳ Immediate short-term reasons: need for liquidity
- ↳ Long-term reasons: interest for an alternative participating finance

■ France, a *Sharia-friendly* legal and tax environment

- ↳ Common principles
- ↳ Adequate general legal structures
- ↳ Dedicated law and regulations:
 - Mutual funds
 - *Sukuk*
 - *Murabaha* transactions
 - *Ijara* transactions
 - *Istisna'a* transactions

■ Practical implementations

- ↳ Financing public authorities (State and local authorities) and State-owned companies projects
- ↳ Financing of assets owned by public authorities (State, local authorities) and by State-owned companies
- ↳ Equity contribution into innovative SME
- ↳ Financing projects developed into the Euromed
- ↳ Real-estate financing and remunerated savings accounts for individuals



Reasons for France's interest in Islamic Finance

Immediate short-term reasons: need for liquidity

- Financial market crisis: credit crunch and lack of liquidity to finance the French economy
 - ↳ Will the credit and bond markets return to normal reduce appetite for Islamic Finance ?
 - ↳ Developing the idea of a Great *Sukuk* to finance capital expenditure of the State and local authorities without jeopardizing the French State's national debt



Reasons for France's interest in Islamic Finance

Long-term reasons: interest for an alternative participating finance

- **Integrating factor of a modern and moderated Islam: France concentrates the largest Muslim population in Europe (6 million)**
 - ↳ 3 times bigger than Muslim population in the UK
 - ↳ French secularism: neutrality of the State as regard to religions, without being atheistic

- **Islamic Finance: an alternative ethical source of financing**
 - ↳ Simplicity and practicality vs. unnecessary complexity
 - ↳ Long-term financing: matching maturity of long-term investment
 - ↳ Participative financing in the performance of the underlying assets: the financier acts as a partner of the company (higher remuneration) and the remuneration due by the company is only based on the cash-flows generated by the financed assets (lower risk)
 - ↳ Asset-based financing: financing based on tangible assets (project finance, shipping, car fleet, aircraft, goods, machinery) vs. financial assets (derivatives, CDO etc.), which limits the risk of bubbles and of excessive leverage
 - ↳ Transparency: *Sharia*-compliance of the financing provided that the use of funds be *Sharia*-compliant itself

France: A *Sharia*-friendly legal and tax environment

Common principles

- French and Islamic Laws: an analogous tradition sharing similar principles
 - ↳ Prohibition of remuneration by the mere lapse of time: *Riba*
 - ↳ Prohibition of speculation and uncertainty of situations: *Garhar, Maysir*
 - ↳ Prohibition of investments into specific activities: *haram* activities



France: A *Sharia*-friendly legal and tax environment

Adequate general legal structures

■ Existing legal structures suitable to Islamic finance concepts:

- ↳ *Ijarah* → Leasing regime applicable to moveable assets or real estate assets (crédit-bail regime of art. L.313-7 and seq.)
- ↳ *Mudarabah* → Participating loans (regime provided by articles L.313-13 and seq. of the French Monetary and Financial Code)
- ↳ *Sukuk* → Issue of bonds:
 - subordinated bonds (French Commercial Code, art. L. 228-97)
 - subordinated instruments (French Commercial Code, art. L. 228-37); and
 - ability to provide for an index-based remuneration (articles L. 112-2 and L. 112-3 of the French Monetary and Financial Code which allow for the indexation to the performance of the issuer of the interest paid to bondholders)
 - Implementation of a french equivalent to Anglo-saxon trust: *Fiducie*

■ Outside these existing structures: freedom to contract subject to:

- ↳ Compliance with French rules of public order
- ↳ Absence of tax discrepancy: conventional finance and Islamic finance need to be on an equal footing regarding tax law

France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations – Mutual funds

■ Mutual funds:

- ↳ France: largest mutual fund industry in Europe
- ↳ All types of mutual funds are present:
 - Equity/ equity-indexed
 - Debt/ debt-indexed
 - Venture capital
 - Real estate
- ↳ Recommendation of the AMF on 17 July 2007 authorizing mutual funds:
 - To have recourse to non-financial selection criteria (by developing, for example, index-based management on the basis of a *Sharia*-compliant index: Dow Jones Islamic Index, FTSE Islamic Global Index, S&P *Sharia* Index, etc.)
 - To clear the impure part of their dividends by making donations for the benefit of recognized public interest bodies (such as the *Institut du Monde Arabe*), up to a limit of 10%
 - To have recourse to the services of a *Sharia* board, subject to the autonomy of the management company remaining intact
- ↳ Consequence: BNPP obtained approval for a *Sharia*-compliant fund in July 2007



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Dedicated law and regulations - Sukuk

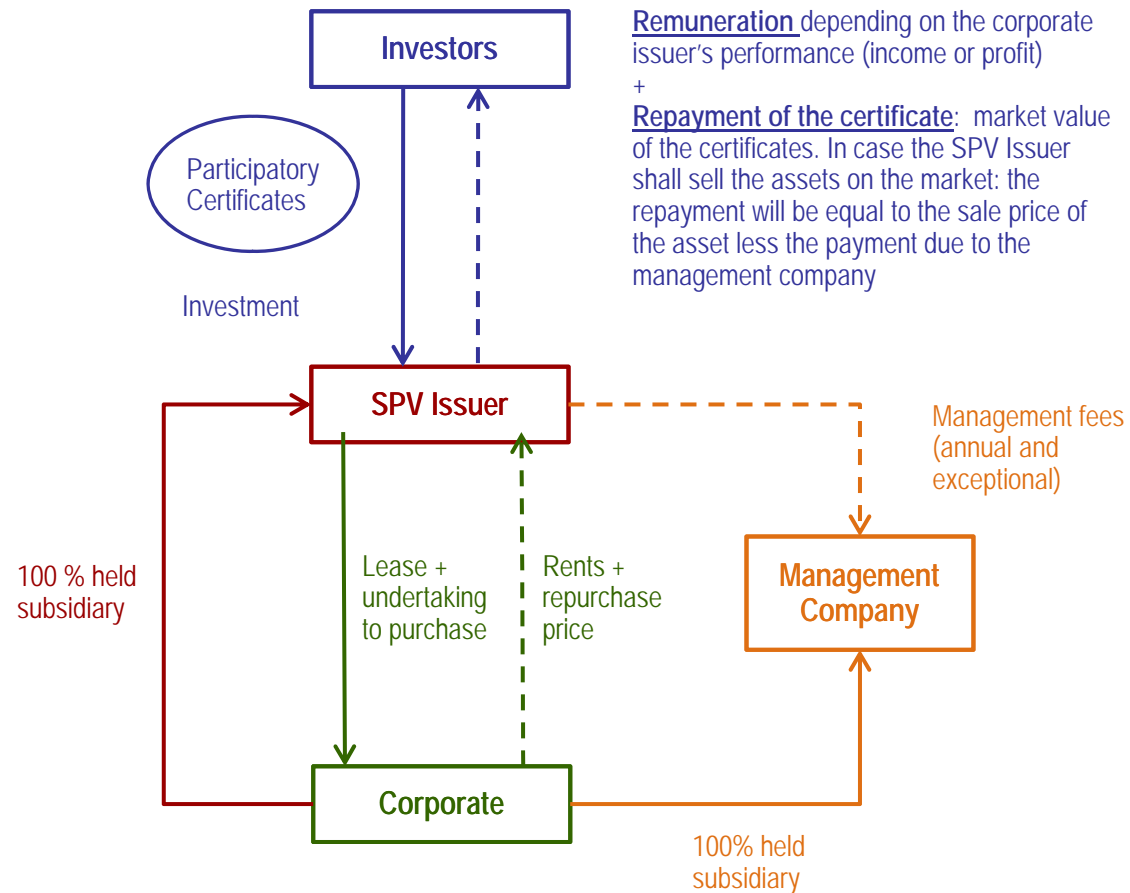
- 2 legal structures under French law have been validated by the AAOIFI in November 2010



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations - Sukuk

- Structure 1: Participatory Certificates
(all kind of assets financing)



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Dedicated law and regulations - Sukuk

■ Comments on SPV Issuer Structure

- The investors invest in specific assets held by a specific SPV which will be set up for the purpose of the investment. The SPV Issuer is a 100% held subsidiary of the Corporate.
- A Management Company will be responsible for the management of the financed assets. It will receive a small annual management fee.
- The SPV Issuer will lease the financed assets to the Corporate against payment of rents. At the maturity of the participatory certificates, the Corporate will undertake to purchase the leased assets from the SPV Issuer against payment to the SPV Issuer of a purchase price equal to the market value of the leased assets. The legal form of the participatory certificates will be bonds (obligations). Their economic characteristics would be similar to preferred shares.
- In case the Corporate fails to perform its purchase undertaking, the Management Company will take care, on behalf of the SPV Issuer, of disposing of the financed assets on the market and allocate the proceeds to the repayment of the investors, potentially with a loss or a gain if the market value of the financed assets is, respectively, less or higher than the amount initial subscribed by the investors.
- In the event a capital gain is realized upon the sale of the assets, the Management Company will receive an exceptional fee corresponding to most of the capital gain.



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Dedicated law and regulations - Sukuk

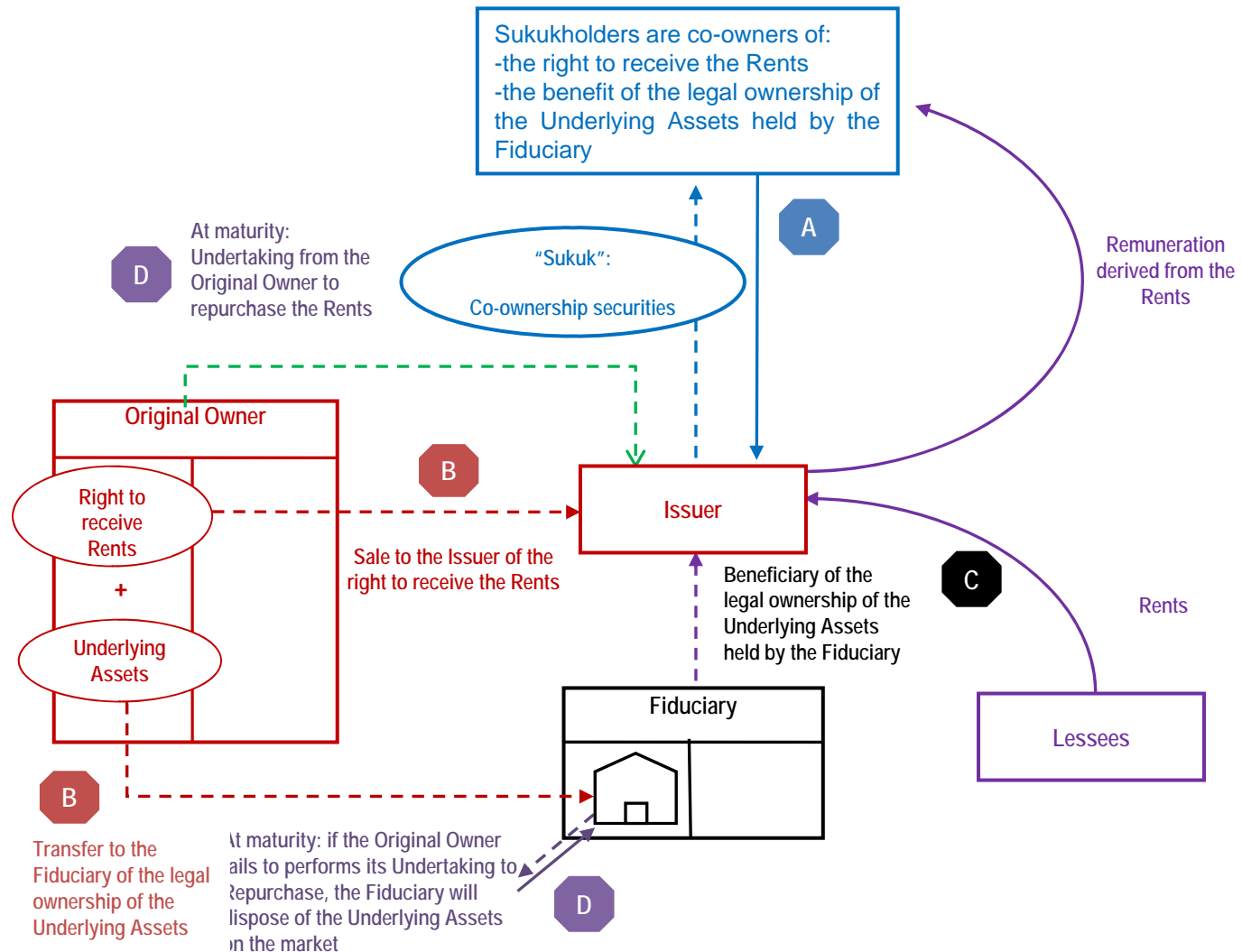
- Alternatively, participatory certificates could be structured as equity-linked bonds (*obligations donnant accès au capital*) under French law, allowing the investors to require the conversion of their bonds into shares and then become the shareholders of the SPV Issuer.
- The effective return paid by the SPV Issuer to the investors on the participatory certificates, after the payment by the SPV Issuer of the management fee to the Management Company, will be economically similar to the return received by regular bondholders.



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations - Sukuk

- Structure 2: Combination of ABS and Fiducie
(refinancing of real estate assets)



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations - Sukuk

■ Comments

↳ Issue of *Sukuk*

- A French regulated securitization vehicle (*fonds commun de titrisation*) will issue units representing the co-ownership rights of the investors in the assets owned by the vehicle (the Issuer).
- The assets owned by the Issuer (the *Sukuk* Assets) are:
 - ↳ the rights to receive the rental payments under the lease agreements related to the Underlying Assets, which will be sold by the Original Owner to the Issuer (the Rents), and
 - ↳ the benefit of the legal ownership of the Underlying Assets (including the related lease agreements) held by the Fiduciary.



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations - Sukuk

- ↳ Transfer of the *Sukuk* Assets by the Original Owner
 - On the same day and at the same time:
 - ↳ The Original Owner will sell directly to the Issuer its right to receive the Rents against payment of purchase price by the Issuer to the Original Owner, out of the proceeds raised by the *Sukuk* issuance, pursuant to the terms of the Transfer Agreement (see below);
 - ↳ The Original Owner will transfer the legal ownership of the Underlying Assets (including the related lease agreements) to the Fiduciary pursuant to the terms of the Fiduciary Agreement (see below), which will hold the Underlying Assets for the benefit of the Issuer, and therefore for the benefit of the *Sukuk*holders [given that the Issuer is a fund and as such has no legal personality].
 - The legal ownership right of the Fiduciary on the Underlying Assets will be registered (if the Underlying Assets are real estate assets or rights) at the land registry.
 - The Fiduciary will either manage the Underlying Assets itself during the term of the issuance or will sub-delegate its duties to a third party (provided that such third party is not the Original Owner or one of its affiliates).



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations - Sukuk

- As a result thereof, the Original Owner will no longer be the legal owner of the Rents and of the Underlying Assets, and the risks associated to these *Sukuk* Assets will be passed onto the Sukukholders.
- In particular, in the event of a total destruction of, or an expropriation related to, the Underlying Assets and in the event that the amount of the indemnity received from the insurance company or the State (as the case may be) is lower than the nominal amount of the *Sukuk*, the Sukukholders will bear the loss of the shortfall. Moreover, in the event of the bankruptcy of the Original Owner, the Sukukholders will not be creditors of the Original Owner and will be entitled to request the Issuer to dispose of the *Sukuk* Assets for their benefit.
- It will be highlighted in the Transaction Documents (see below) that the Sukukholders will subscribe to the *Sukuk* in consideration of them becoming the legal owner of the *Sukuk* Assets, i.e. directly of the Rents and indirectly (through the Fiduciary) of the Underlying Assets.



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Dedicated law and regulations - Sukuk

- ↳ During the term of the issuance of the *Sukuk*: Payment of the remuneration by the Issuer to the Sukukholders
 - Sukukholders will receive, as remuneration on the *Sukuk*, the Rents actually received by the Issuer from the assigned lessees.
- ↳ At maturity of the *Sukuk*: Repayment of the *Sukuk* by the Issuer
 - Normal scenario
 - ↳ At maturity, the Original Owner shall repurchase the *Sukuk* Assets for a purchase price equal to the then outstanding principal amount of the *Sukuk* pursuant to the Undertaking to Repurchase (see below).
 - ↳ Such purchase price will be used by the Issuer in order to repay the *Sukuk* at maturity.
 - ↳ If the Original Owner performs its obligations vis-à-vis the Issuer under the Undertaking to Repurchase, the Fiduciary will transfer the Underlying Assets back to the Original Owner.



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Dedicated law and regulations - Sukuk

- Original Owner event of default scenario
 - In the event that the Original Owner fails to perform its obligations vis-à-vis the Issuer under the Undertaking to Repurchase, the Fiduciary will dispose of the Underlying Assets on the market for their then available market value and the proceeds of such disposal will be allocated to the Issuer in order to repay the Sukukholders.
 - All, but only, the proceeds resulting from the disposal of the Underlying Assets (whether it is a loss or a gain given the nominal value of the *Sukuk* at issuance) will be allocated to the Sukukholders as repayment of the Sukuk and full discharge of the Issuer.



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations - Sukuk

- Tax treatment of *Sukuk* transactions and assimilated debt instruments such as indexed loans or bonds (Tax Instruction of 24 August 2010):
 - ↳ *Sukuk* are assimilated to debt instruments for tax purposes provided that they comply in particular with the four following requirements
 - *Sukuk* must rank senior to any shareholders of the SPV
 - *Sukuk* must not entitle the holders to any shareholders rights like voting rights in the SPV, right to liquidation surplus etc
 - Remuneration under *Sukuk* must be based on the assets' performance or on the results of the SPV and must be subject to a predetermined cap (Euribor, Libor), plus margin
 - When the value of the financed assets exceeds the par value of the *Sukuk* or the amount of the loan, the repayment may exceed the amount of the principal pursuant to the indexation rule provided for in the contract
 - ↳ As a result thereof, the remuneration under *Sukuk*:
 - is deductible from the taxable result of the SPV under similar conditions than interests (at expected profit rate)
 - is exempted from withholding tax when paid to non French tax residents (except in case of payment to non cooperative territories)



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Dedicated law and regulations - Sukuk

■ *Sukuk* :

- ↳ Recommendation of the AMF on 2 July 2008 for listing of the *Sukuk* on Euronext Paris:
 - *Sukuk* are assimilated to debt instruments and not equity
 - Acknowledges that *Sukuk* issues may be structured either
 - ↳ as asset-backed or
 - ↳ as asset-based
 - Provides information on level of disclosure to be set out in offering circulars;
 - A target remuneration ("expected profit rate") is indicated to the *Sukuk* holders
- ↳ Practical guide issued by NYSE-Euronext (2 July 2009) regarding the listing of *Sukuk* on Euronext
- ↳ Practical guide issued by AMF (October 2010) regarding the format of a *Sukuk* prospectus



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations – Murabaha transactions

- No immediate taxation of the *Murabaha* profit (Tax instruction of 24 August 2010)
 - ↳ Assimilation of *Murabaha* profit realized by the SPV (financier) to interest payments and therefore taxation of such profit on an accrual basis over the life of the transaction, notably provided that:
 - the *Murabaha* contract provides that the asset is acquired by the SPV with the intention to retransfer it to the investor within a short period of time not exceeding 6 months
 - the *Murabaha* contract mentions (i) the acquisition price by the SPV; (ii) the acquisition price by the investor; (iii) the distinction between the *Murabaha* profit corresponding to the remuneration for the purchase price being payable over the time and the consideration of the SPV for the intermediation service it provides. The *Murabaha* profit must be spread over the life of the transaction on an accrual basis for tax purposes, whatever the effective payments are, and strictly in accordance with the accounting treatment of the transaction and the payment schedule appended to the *Murabaha* contract

- **Absence of withholding tax**
 - ↳ If the SPV is not a French tax resident, *Murabaha* profit paid by a legal entity which is tax resident of France is exempted from withholding tax

France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations – Murabaha transactions

- ***Murabaha* over property**

The SPV will benefit of the regime applicable to the purchase of the real-estate assets for the purpose of resale provided by Article 1115 of the French general tax code pursuant to which the acquisition by the SPV of the real estate is subject to reduced registration duties at a global rate of 0.815% (instead of 5.09%)

- ***Murabaha* over shares in a property company**

Pursuant to the regime applicable to the purchase of real-estate assets for the purpose of resale provided by Article 1115 of the French general tax code, the acquisition of shares in real-estate companies by the SPV would not be subject to registration duties (instead of 5%). Only the subsequent sale to the investor would be taxable under the standard rules



France: A *Sharia*-friendly legal and tax environment

Dedicated law and regulations - Ijara and Istisna'a transactions

- Two new tax instructions of 24 August 2010 set forth the tax regime applicable to *Ijara* (lease) and *Istisna'a* (equivalent to the sale of property for future completion).
- With respect to *Ijara*, the instruction specifies that if the *Ijara* contract complies with the conditions of a leasing transaction as defined under the French law, all the legal regime and the administrative doctrine concerning leasing transactions will be applicable *mutatis mutandis* to *Ijara* transactions.
- With respect to *Istisna'a*, the instruction specifies that the income received by the financier as result of the deferred payment can be assimilated, for fiscal purposes, as interest payments.
- A useful clarification for project finance combining a construction phase (*Istisna'a*) and an operating phase (*Ijara*).



Practical implementations

- **Already relevant**

- ↳ More than 2 Billion Euros of private real-estate financing since 2006
- ↳ 3 French Banks have Islamic windows in Gulf countries. 3 banks have been licensed in the UK and can offer Islamic products in France on the basis of the European passport
- ↳ The Scor owns a *Retakaful* reinsurance company in Malaysia

- **Financing of projects developed by public authorities (State and local authorities) and state-owned companies**

- ↳ Highways
- ↳ Energy and sustainable development (utilities)
- ↳ Grand Paris: 35 Billion Euros investment



Practical implementations

- Financing of assets owned by public authorities (State and local authorities) and state-owned companies
 - ↳ Car fleet
 - ↳ Real-estate
 - ↳ TGV trains, underground, tramways
 - ↳ Airbus
- Equity contribution into innovative SME (70 clusters ("*pôles de compétitivité*")
- Financing projects developed into the Euromed
- Real-estate financing and remunerated savings accounts for individuals



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