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Structuring Islamic Investment Funds

The Legal, Tax, and Regulatory Aspects

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ABSTRACT

Numerous legal and tax questions arise when structuring and effecting Islamic investment funds that will invest in the United States. Their answers must satisfy not only U.S. legal and tax considerations, but also the principles of the *sharīʿa*. The issues include the following: How can the investment fund be structured to avoid or minimize U.S. income taxation and to avoid U.S. estate and gift taxes? Will the fund be closed-ended or open-ended, and what legal steps must be taken to effect that decision? How can one assure that the offering of shares or other interests in the investment fund complies with applicable securities laws of the U.S. and the comparable laws of the non-U.S. countries where shares of the fund will be placed? In what offshore jurisdiction should the investment fund be organized, and what legal form should the fund take to secure the legal rights of the fund's investors and to assure that investors' shares will not be subject to the U.S. estate or gift tax? What approvals are required from the government of the home country of the investment fund sponsor and of the non-U.S. countries where investors will be sought? In addition to these core issues, numerous others must be addressed in the formation of a properly structured Islamic investment fund.

I. INTRODUCTION

Until the early 1990s, institutions and individuals wishing to invest capital in Islamically acceptable investment funds[i] had very few choices available to them. A high percentage of the then-offered Islamic investment funds invested in *murāba®a* transactions involving precious metals or other commodities. Few of such funds invested in investment objects physically located in the United States or other Western countries, and, as a consequence, the complex legal, tax, and other regulatory considerations arising from investing in the United States and in most other Western countries were not called into play.

In more recent years, existing and newly-established Islamic banks and other financial institutions in the Gulf area and elsewhere in the Islamic world have responded to the desire of Islamic investors for investment products that are as diversified and sophisticated—and offer the same kinds of risk/return opportunities—as investment products available to non-Islamic investors in secular Western countries. As a part of this response, Islamic financial institutions have established Islamically-acceptable investment funds aimed at investing in a wide variety of investment objects, including (a) leased equipment; (b) real estate; (c) venture capital; (d) publicly-traded shares of companies that have been screened for *sharīʿa* acceptability as to the nature of their businesses and of their equity and debt structures; (e) buy-outs of mature companies; and (f) financial instruments, such as participations in Islamically-structured financings.[ii]

Many of the investments by these new Islamic investment funds are located in the United States, with the result that a complex web of U.S. legal, tax, and regulatory considerations is applicable to such funds. Properly organizing an Islamic investment fund that will invest in the United States involves handling legal, tax, and regulatory considerations under (a) the laws of the United States, (b) the laws of the "home countries" of prospective investors, (c) the laws of the "home country" of the fund sponsor, and (d) the laws of the "offshore" jurisdiction where the fund will be organized. This is a complex and multi-faceted undertaking, which this paper will address only in summary form.

If the effort to structure an Islamic investment fund that will invest in U.S. investment objects is properly handled, the fund in question should operate smoothly and (assuming good investment decisions are made) should produce after-tax returns to its Islamic investors consistent with the returns targeted by the Islamic financial institution sponsoring the fund. On the other hand, if structuring the fund is not property handled, the results could be far less than satisfactory. As an example, if the U.S. tax considerations involved in establishing an Islamic

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investment fund are not carefully considered, the worst case result could be a U.S. federal income tax of as much as 54.5% of the *income* generated by the fund and, in the case of a natural person investor who dies while holding an interest in the fund, a U.S. estate tax at a rate of up to 55% of the value of the deceased investor's interest in the fund, which generally would include the *capital* the deceased investor invested in the fund.

As noted, this paper will provide a summary of the various legal, tax, regulatory, and practical considerations involved in structuring Islamic investment funds that will invest in U.S. investment objects. Because this is a summary of those considerations, there are numerous technical aspects that are not addressed here. Further, the authors have sought to make this paper readable—and therefore have avoided listing the "exceptions to the exceptions" of which we lawyers are so fond.

II. COMMENTS AS TO DISCUSSION OF *SHARĪᶜA* PRINCIPLES

At a number of points in this paper the application of *sharīᶜa* principles to issues relating to structuring Islamic investment funds will be discussed. The authors are amateurs, not experts, as to *sharīᶜa* matters. Their knowledge of this subject has been gained by working with the *Sharīᶜa* Advisory Boards of various Islamic banks and other institutions in structuring Islamic investment funds and handling Islamically-acceptable transactions, as well as from discussing such matters with qualified *sharīᶜa* scholars. Accordingly, the authors' discussions in this paper of *sharīᶜa* principles and their applications to various aspects of Islamic investment funds are presented in all humility, with the foreknowledge that certain qualified *sharīᶜa* scholars may take issue with various aspects of these discussions.

With that cautionary note, certain general statements as to *sharīᶜa* principles applicable to Islamic investment funds, in addition to such basic rules as the *sharīᶜa* ban on making money on money, may be described as follows:

- Regardless of the form of investment, Islamic investors directly (or indirectly through a share in the investment fund vehicle) must have an ownership interest in the *assets* in which an investment fund invests or the usufruct of such assets.
- The *sharīᶜa* is informed by notions of fairness and equity; for example, except under limited circumstances, an investor cannot be deprived of his ownership interest in an asset by forcing him to sell that interest. Even if an investor is willing by contract to forego an interest in an asset, this may not be permitted if the interest is regarded by a *Sharīᶜa* Advisory Board as an "inalienable right."
- Binding bilateral agreements to buy and sell assets at a predetermined price are generally not permitted.
- Parity is required; investors must share the risks of a venture equally. Having different classes of shares in the same investment pool, with different payment priorities and liquidation preferences, is not allowed.
- Different contractual obligations and rights in an investment object cannot run concurrently. In practice, this means thinking carefully about what agreements are required in connection with an investment fund and the way in which it will invest, segregating rights and obligations among the agreements, and sequencing the agreements in a particular way. For example, in a sale-leaseback transaction, the sale agreement cannot refer to the lease, because the lease must be an independent transaction that will occur at a future time.
- Under *sharīᶜa* principles, guaranties are supposed to be altruistic. A guarantor is understood to be a "white knight" who helps out a needy person. Accordingly, a guarantor is not permitted to accept compensation for giving his guaranty, nor can his guaranty go beyond the basic obligation that is guaranteed.
- Transparency is favored. Fees and mark-ups taken by parties involved with a properly structured Islamic investment fund must be disclosed.

Because U.S. law and the *sharīᶜa* share the philosophy that what is not prohibited is permitted, it is often possible to reconcile U.S. and *sharīᶜa* legal requirements to give Islamic returns that are comparable to those available in the secular market. Sometimes, however, conflicts arise between U.S. and *sharīᶜa* requirements that cannot be resolved easily. For example, in certain financing contexts *sharīᶜa* principles dictate the creation of an agency relationship, but such a relationship could give rise to an undesirable U.S. tax result.

III. BASIC ISSUES: ORGANIZATION OF ISLAMIC INVESTMENT FUNDS

There are a number of fundamental questions that must be answered when contemplating the organization of an Islamic investment fund. These include:

- In which country or jurisdiction should the fund be organized?
- How should the fund be structured, taking into account both tax and commercial considerations?
- Who will be responsible for identifying and managing the investments of the fund?
- Who will provide necessary administrative support for the fund?
- Who will market the shares or units in the fund?
- To whom will shares or units in the fund be marketed, and how?
- What approvals must be obtained from government authorities in the home country of the investment fund sponsor and in the non-U.S. countries where investors will be sought (*e.g.,* approval of the applicable Ministry of Finance and/or Commerce)?

In addition to these core issues, numerous other legal matters must be addressed in the formation of a properly-structured Islamic investment fund, including legal aspects of effecting basic business decisions for the fund (for example, drafting proper and enforceable agreements with third party investment managers, financial advisors, placement agents, and others providing services to the fund).

A. Where should the fund be organized? Issues as to Offshore Jurisdiction Alternatives

For purposes of this paper, the authors will assume that the fund will invest in investment objects (such as real estate, leased equipment, and the like) physically located in the United States. We will also assume that the investors in the fund will be natural persons or institutions resident or organized in the Gulf Cooperation Council ("GCC") countries of the Middle East.[iii] In many instances, investors from such "home countries" invest in funds of the type under consideration here at least in part in order not to have "all of their eggs" in the Middle Eastern "basket"—both as a matter of economic risk and of perceived political risk. For this reason, we will assume here that the fund in question will not be based or organized in any GCC country but, rather, will be an "offshore" legal entity organized outside of the investors' home countries and outside the United States, where the investment objects of the fund will be located.[iv]

Once it is determined that the fund will not be based in the investors' home countries or in the United States, there are numerous "offshore" jurisdiction alternatives available to be considered, including "European" offshore fund jurisdictions (such as Luxembourg, Ireland, and the Channel Islands); Bermuda; "mainstream" Caribbean offshore jurisdictions (such as the Cayman Islands, the British Virgin Islands, and the Netherlands Antilles); and offshore jurisdictions which to some extent may be considered in the category of exotica (such as the Turks and Caicos Islands, Gibraltar, Malta, Madeira, and Cypress).[v] In the past, certain offshore jurisdictions such as the Netherlands Antilles and the British Virgin Islands enjoyed tax benefits as to investing in the United States, arising out of the application to such jurisdictions of versions of the income tax treaties between their respective "mother" countries (i.e., The Netherlands and the United Kingdom) and the United States.

As a result of termination of treaties, the enactment of the branch profits tax provisions of the U.S. Internal Revenue Code (hereafter, the "U.S. Tax Code"),[vi] the U.S. Treasury Department's ongoing attack on "treaty shopping," and other factors, it is the authors' view that it is no longer advisable to choose a non-U.S. jurisdiction that has a favorable income tax treaty with the United States, organize a "letterbox" fund corporation in that treaty-favored jurisdiction, and then seek to have the fund claim the benefits of the tax treaty to which the United States and the non-U.S. jurisdiction are parties. Particularly given that conclusion, it is fair to say there is no one "correct" answer as to which offshore jurisdiction should be used as the place of organization for a fund of the type in question here. Rather, determining the place of organization for such a fund will depend on making a judgment as to a number of issues pertaining to particular jurisdictions, including:

- The overall reputation of the jurisdiction.
- The degree of proven reliability and flexibility of local company, partnership, and other commercial laws.
- The quality and level of fees of local professionals (lawyers, auditors, and others) who will be associated to form and maintain the fund.
- The quality of the local infrastructure of the jurisdiction (including availability of reliable telephone and telefax service, e-mail, convenient air travel, and the like).
- Presence in the jurisdiction of substantial and reliable banks.
- The extent of local taxes and/or other governmental fees that will be applicable to a fund organized in the jurisdiction.
- The nature and extent of local regulation of investment funds.

- The extent to which corporate and other decision-making actions of a fund must physically take place within the offshore jurisdiction.
- Whether there is a local stock exchange (assuming there is a potential for trading the shares or units of the fund in the public markets).

B. How should the fund be structured?

How the fund should be structured (i.e., as a corporation, a unit trust, a limited liability company, a limited partnership, or the like) depends in large part on the nature and location of the fund's intended investments and the tax considerations that arise from making investments of the intended kind. Certain of the tax considerations involved are discussed below in Sections 4 and 5 of this paper.

Beside tax issues, there are a number of other basic considerations in deciding how a fund should be structured. One of those issues is whether the fund will be a closed-end fund (i.e., a fund which will admit investors only once or a very limited number of times, which will have a stated duration and which will not make ongoing provision for investors to have their shares or units redeemed by the fund) or an open-end fund (i.e., a fund which will admit investors on a regular basis, will have either no stated duration or at least will be long-term in nature, and which will provide investors the opportunity to have their shares or units redeemed by the fund periodically at the then-applicable net asset value of such shares or units). A closed-end fund could take the form of a corporation, a limited liability company, a limited partnership or certain other legal forms. An open-end fund typically would be in the form of a unit trust or in the form of a corporation where applicable company law permits regular redemptions of corporate shares.

Another significant issue as to how an investment fund should be structured relates to the transferability of shares or units in the fund in question. As discussed more fully below, it is generally highly advisable to restrict the offering, issuance and transferability of shares and units in an offshore investment fund so that such shares or units cannot be offered, issued, or transferred to a "U.S. person"[vii]—given that the offer, issuance, or transfer of shares or units to a U.S. person would call into play the full array of U.S. securities laws relating to registration and offering of securities. Similar securities law considerations may suggest prohibitions on the offering, issuance, or transfer of shares or units to investors resident or organized in industrialized Western countries other than the United States, most of which have securities laws of their own that would apply to the offering, issuance, or transfer of shares or units in a fund to investors resident or organized in such countries.

Going beyond securities law considerations as to the issuance or transferability of shares or units in a fund, certain types of U.S. tax planning for a fund require (for example) that related or affiliated investors cannot hold more than a specified percentage of the outstanding shares or units of the fund. Where the desired tax consequences of an investment fund depend upon prohibiting concentration of ownership in the hands of a single investor or a limited number of unrelated or related investors or upon other fund ownership rules, it obviously is desirable to restrict issuance and transferability of shares or units in the fund to investors whose ownership and/or whose relationships and affiliations with other fund investors would not cause the fund to fail to qualify for the tax results intended by its tax planners.

Beyond Islamic considerations as to a fund's investment policy, other investment considerations will dictate how a fund should be structured. For example, it is often considered desirable for a fund to be structured with restrictions on short-term trading of its intended investment objects, to be structured so that the fund will not invest more than a certain stated percentage of its capital in any one type of investment, to prohibit or limit the extent to which the fund may invest its capital in other investment funds, and the like.

C. Who will be responsible for identifying, acquiring, and managing the investments of the fund, and how will the manager be compensated?

Another major issue that must be addressed in structuring any investment fund is who will be responsible for locating desirable investments for the fund, acquiring the investments on behalf of the fund, and thereafter managing them—and how will that person or entity be compensated. If a fund is in the form of an offshore corporation, the Board of Directors of the fund corporation will, of course, have final authority as to management of the corporation, including the management of its investments. In most cases, where an investment fund has a sponsor based thousands of miles from the United States in a GCC country of the Middle East, the fund will enter into a management contract with a U.S.-based investment manager under which, subject to the overall direction of the fund's Board of Directors (or the equivalent of such a Board, in the case of a fund that is not in corporate form), the investment manager will have the obligation to identify, execute, and manage the investments of the fund.

In the case of an Islamic investment fund, the agreement between the fund and the U.S. investment manager should contain clear guidelines as to the Islamic principles that the investment manager must follow. Even with such principles specified, there will be variation from one type of investment fund to another as to the degree of discretion that should be granted to the investment manager in actually acquiring investments for the fund. If, for example, the investment fund is aimed at investing in shares of U.S. corporations that are publicly-traded on a U.S. stock exchange or NASDAQ, the "home country" Board of Directors of the fund may be willing in the management agreement to grant the investment manager discretion to make investments on behalf of the fund, subject only to its prescribed Islamic "screens" (a) as to the type of industries in which the fund may invest and (b) as to the degree of permissible debt capitalization of investee companies. The management agreement might also contain further non-Islamic investment rules relating to the degree to which investments of the fund may be concentrated in one particular industry sector, or the like.

On the other hand, if, for example, an investment fund will invest in U.S. real estate or controlling interests in U.S. business corporations, it is highly unlikely that the fund's Board of Directors (or its equivalent in a fund not organized as a corporation) would be willing (or well advised) to give the U.S. manager authority actually to go forward with any specific investment without the detailed review and approval by the Board and by the fund's *sharīʿa* advisors of each proposed investment and of the manner in which the investment will be acquired and, perhaps, financed. This follows, not only from the complexity of real estate and "private equity" investments, but also from the fact that investments of these types typically involve more specialized *sharīʿa* concerns than the more generalized "Islamic screens" for investments in shares of publicly-traded corporations. In particular, it should be noted that the *sharīʿa* rules applicable to acquiring and holding a controlling share interest in a venture or company are markedly different from the rules applicable to acquiring a minority "portfolio" investment interest in shares of a publicly-traded company.

As to the compensation of a U.S. investment manager by an offshore Islamic investment fund, arrangements vary from one type of investment object to another. Given the highly competitive nature of "money management" in the United States, an Islamic investment fund aimed at investing in Islamically-acceptable shares of publicly-traded U.S. corporations likely could negotiate a management fee based on a quite low percentage of the market value of the fund, as in effect from time to time. Because of the special Islamic considerations involved, such a fee might be slightly higher than fees paid to U.S. money managers who manage secular mutual funds. However, it is likely that a first quality U.S. investment manager would be willing to manage an Islamic fund of a reasonable size aimed at investing in shares of U.S. publicly-traded corporations without being given an incentive fee arrangement.

By contrast, where an Islamic investment fund will invest in such investment objects as U.S. real estate or U.S. private equity situations, it is highly likely that the U.S. investment manager will propose to charge a periodic fee based on the amount of capital committed by (or to) the fund, as well as an incentive fee, which will be in the form of a percentage of the fund's realized profits. Such an incentive fee would typically be payable only after the investors have received from the fund (a) a return of all of their invested capital and (b) a specified "hurdle" rate of return on that invested capital.

In many cases, U.S. investment managers will wish to receive such an incentive fee in a way that will allow them, for U.S. tax purposes, to have this amount taxable at the more favorable, long-term U.S. capital gains tax rate applicable to natural persons, rather than receiving fee income that will be subject to taxation at higher U.S. "ordinary income" rates. Structuring incentive fee arrangements for U.S. investment managers to achieve this tax result may give rise to *sharīʿa* concerns if the incentive fee claim of the U.S. investment manager to a share of the fund's profits is (to use a typical example) in the form of a preferential partnership return having a priority over the partnership rights of the other fund investors. In some instances, *sharīʿa* advisors are willing to approve incentive fees payable to investment managers that are structured in the form of a priority capital gains partnership return to the manager, after provision for an initial, "lock step" distribution to all investors, on the theory that this structuring was done to satisfy the tax concerns of the manager and that the manager, in fact, is being paid an Islamically-acceptable profit share or fee for his/its services as a *mu∞ārib*.

D. Who will provide necessary administrative support for the fund?

Each offshore Islamic investment fund will need certain types of administrative support, including an independent auditing firm, a tax return preparer, a firm that can prepare and make all required government filings (including filings in the offshore jurisdiction that is employed as well as the United States), a reliable bank that will provide all required banking services (including Islamically-acceptable short-term investments, such as *murāba®a* investments), and a sophisticated law firm in the offshore jurisdiction accustomed to dealing with investment fund issues.

Beyond these basic administrative services, depending on the types of investments to be made by a particular fund, other services may be required. For example, in the case of an investment fund that will invest in publicly traded securities, it will be necessary to employ a brokerage firm and a custodian to hold the securities portfolio of the fund in safe keeping. If a fund will invest in real estate, it will not only typically utilize an investment manager to source, effect, and provide overall asset management services; it will also often need to have on-site property managers at each of its properties. In such a case, an issue will be whether the fund should out-source these property management services or directly employ property managers itself.

Investment funds also will typically employ share transfer agents, both in the case of closed-end and open-end funds. Where a fund is open-end in nature, the fund likely will employ the same agent to handle redemptions of its shares when investors exercise their redemption rights, in accordance with the fund's governing instruments.

E. Who will market the shares or units in the fund?

Each investment fund sponsor will have in mind a target market of investors for shares in its fund. This certainly will be the case with sponsors of Islamic investment funds who/which will focus on institutional and private investors that are either insistent upon, or interested in, Islamically acceptable investment proposals. The shares or units of all existing Islamic investment funds known to the authors were placed privately with investors, rather than involving a public offering of such securities. It is likely that this private placement approach will continue, for the foreseeable future, for Islamic investment funds.

In a private placement of shares or units in an Islamic investment fund, the practical issue that must be faced is whether the placement effort will be undertaken solely by the fund sponsor (which generally will be an Islamic bank or other financial institution) or, in whole or in part, through the services of a third party placement agent. In either case, Islamic investment funds typically provide for investors to pay to the fund sponsor an "organization and placement fee," often in the range of 1% to 2% of the funds committed by each investor. Usually this fee is payable by the investors, in addition to the amount of capital they commit to the fund, and provision is made to allow the fund sponsor to share the fee with a third party placement agent.

Depending on the country or countries in which shares or units in an Islamic investment fund will be placed, there may be a necessity for the sponsor or placement agent to register with the local government or for the offering materials as to the fund to be approved by the local government before placement efforts are undertaken in the country in question. The requirements of local laws in these respects should be determined before any placing efforts are undertaken in a particular country.

F. To whom will shares or units in the fund be marketed and through what methods?

Securities laws and laws of similar import will strongly affect considerations regarding to whom shares or units in an investment fund will be marketed and how the placement effort should be undertaken. Speaking generally, if no shares or units in an investment fund are ever offered to U.S.-based investors, the principles of Regulation S under the U.S. Securities Act of 1933, as amended, clearly provide that the investment fund will not be required to register its shares or units with the U.S. Securities and Exchange Commission (the "SEC"). Given the complexity of making a proper registration with the SEC, this is a desirable result. Accordingly, the legal documentation under which an offshore Islamic investment fund is established generally should contain specific, strict provisions prohibiting any U.S.-based investor from acquiring any shares or units in the fund during its placement period, as well as prohibiting a post-placement transfer of shares or units from an original investor to the U.S.-based investor.

Going beyond the registration requirements of the U.S. securities laws, which, as indicated, happily can be avoided by assuring that no U.S.-based investor acquires shares in the offshore Islamic investment fund, there are other U.S. securities law considerations that are called into play. Specifically, where an offshore investment fund (even one having only non-U.S. investors) will invest in U.S. situs investment objects, employ U.S. investment managers and professionals, and have other contacts with the United States, it is not possible to say with certainty that the so-called "anti-fraud" provisions of Regulation 10-b5 under the U.S. Securities and Exchange Act of 1934, as amended, will not be applicable.[viii]

This means that a well-advised sponsor of an offshore Islamic investment fund that will make investments and/or have other contacts in the United States will assure that the placement documentation for the fund is drafted to give prospective investors a very clear, "U.S. standard" description of the fund, the legal rights of investors in the fund, the nature of the investments that the fund will make, the "track record" of the fund sponsor and the fund investment manager, the risks involved in investing in the fund, conflicts of interests that may be involved as between investors and the fund sponsor and manager, the nature and amount of all fees payable to the fund sponsor and manager, and other matters that would be material to an investor in making a decision to invest in the fund. (The authors are aware that the statement made above to the effect that placement documentation for an offshore Islamic investment fund should be prepared to the level of the "U.S. standard" may be met in some quarters with concern, concern that typically would arise from familiarity with overly-lengthy, repetitive, and complex prospectuses and other placement documentation that are sometimes seen in the U.S. securities market. In the authors' view, first quality placement documentation meeting the "U.S. standard" can be prepared and presented in a reasonable manner. Moreover, the authors' experience is that prospective investors in the Middle East appreciate professional, first quality placement documentation and, through the efforts of many involved in the Islamic investment field, have come to expect placement documentation of this quality.)

The issues presented by the U.S. securities laws when an offshore Islamic investment fund will invest in the United States, or otherwise have significant contacts there, are not the only securities law issues involved in placing interests in an Islamic investment fund with investors in GCC countries. Rather these countries in the Middle East themselves often have securities laws, or laws of similar import, which must be observed.

As a general matter, the regulatory environment regarding offering investments in the Middle East is uncertain. Areas of concern are a general lack of clarity in applicable laws as to the placement of fund investments with local investors and inconsistent enforcement of such laws. In the GCC, the Bahrain Monetary Agency is given notably high marks as a bank and investment regulator, however.

Generally, securities cannot be issued or offered for subscription or sale in the member countries of the GCC without the permission of the Ministry of Commerce or another, comparable regulatory body of the country in which the placement will occur. No explicit private placement exception exists in the laws of any of the GCC countries.

Most Middle East countries do not have a clear regulatory scheme governing the registration of the contents of fund offering documents. Moreover, no statutory antifraud provisions with clear disclosure standards are found in the laws of Middle East countries. In some countries it is a requirement that all investment offerings must be placed through licensed local entities or entities whose corporate or charter objects permit investment placement activities.

Because offshore offerings in the Middle East in many cases are subject to an uncertain legal environment, self-regulation, "staying with the herd," and monitoring the local situation closely are essential. In no case should an offering be made in a GCC country though public means, such as newspaper advertisements, public solicitations, or the like.

IV. Overview of U.S. Tax Considerations: Islamic Investment Funds Investing in the U.S.

Any investment by an offshore Islamic investment fund in U.S.-situs investment objects will call into play the U.S. tax laws. Obviously, in order to attract investors, such a fund must produce a competitive *after-tax* return to its investors. In order to do so, U.S. tax must be minimized or avoided at two stages, namely (a) while each particular U.S. investment is held by the investment fund, and (b) when that investment is sold and the sales proceeds are repatriated from the United States. The following is a very summary description of the basic U.S. income tax rules and their general application to offshore investment funds, followed in Section 5 by a more specific discussion of the application of such rules to offshore Islamic investment funds that invest in U.S.-situs leased equipment.

A. Focus on Private Sector, Non-Charitable Islamic Investors, Not Government Agency Investors or Charitable Foundation Investors

It should be noted that the tax discussion that follows addresses only the tax consequences of investments in offshore Islamic investment funds by private sector, non-charitable investors. Under U.S. law, investments in the United States by "integral parts" of non-U.S. governments and by certain "controlled entities" of non-U.S. governments are entitled to a special, limited exemption from U.S. taxation, which generally applies in the case of U.S. investments in stocks, bonds, or other securities that do not constitute "commercial activities."[ix] (Examples of "integral parts of non-U.S. governments that are entitled to the indicated limited exemption from U.S. tax on their U.S. investments are the Kuwait Investment Authority and the Abu Dhabi Investment Authority.) The U.S. tax rules applicable to investments in the United States by such non-U.S. governments or their controlled entities is beyond the scope of this paper.

Also under U.S. law, properly structured non-U.S. Islamic charitable, religious, or educational foundations, bequests, trusts, or estates could enjoy a tax exemption for certain types of U.S. income they might derive from U.S. investments. As with U.S. investments by non-U.S. governments and their controlled, non-commercial entities, the U.S. tax rules governing the exemption or non-exemption from U.S. income tax applicable to U.S.-source investment income earned by such non-U.S. Islamic "charitable" entities is also beyond the scope of this paper.

B. U.S. Tax Treaties and International Tax Planning

The United States is a party to income tax treaties with a large number of other countries. Such tax treaties (often called "double taxation agreements") are generally aimed at preventing double taxation (i.e., taxation both by the United States and by the other "treaty country") (1) of income that a U.S. person may derive from sources in the other treaty county and (2) of income that a person or legal entity based in the treaty country may earn from sources within the United States. The United States does not have an income tax treaty with any GCC member country—quite likely because, while such countries typically impose a tax on income that a U.S. person or legal entity may derive from the GCC country, such countries do not have an income tax that applies to their own natural person residents or to corporations owned by them.

Income tax treaties play a major role in structuring investments in the United States by persons entitled to the benefit of such a treaty. Given that the United States does not have a treaty with any GCC member country, the only possibility for utilizing an income tax treaty in planning for an offshore investment fund owned by Islamic investors from countries in the GCC would be to organize the investment fund corporation (or another legal entity that may be utilized as the fund) in a country that does have a favorable income tax treaty with the United States. As noted above, such an effort is fraught with potentially adverse tax consequences.

For one thing, the United States has an income tax treaty only with countries that themselves have an income tax system. Obviously, it would make no sense to base an investment fund in a specific country, in an effort to avoid United States tax on the earnings of the fund—and, as a result, subject the fund's earnings to treaty country taxation that might even exceed otherwise applicable U.S. taxes. Further, even if the treaty country tax rules would allow special steps to be taken so that the treaty country's own taxes would not apply to U.S. source income earned by an investment fund based in that country, attempted utilization of the tax treaty in question between the United States and the treaty country "home" of the investment fund would be subject to challenge by the U.S. taxing authorities who, as noted above, are engaged in a war against this type of tax planning, which is typically referred to as "treaty shopping," and the tax treaty benefits would also be subject to challenge under the U.S. "branch profits tax" rules.[x]

In the authors' view, given these risks, it is much preferable to structure an offshore Islamic investment fund utilizing the opportunities available under internal U.S. tax law, rather than attempting to "treaty shop."

C. A Starting Point in Investment Fund Structure Planning: The U.S. Estate and Gift Taxes

In addition to its income tax, the United States has an estate tax and a gift tax. The estate tax applies to any "U.S. situs" assets that a non-U.S. natural person owns at the time of his death, and the gift tax applies to lifetime gifts by a non-U.S. natural person of "U.S. situs" assets. U.S. situs assets for estate tax purposes include, for example, interests in U.S. real estate, shares of U.S. corporations, and personal property (such as leased equipment) that is physically located in the United States. The U.S. gift tax does not consider intangible assets (such as shares of corporate stock) to have a U.S. situs.

The U.S. estate and gift tax rates are quite high, rising to 55% of the U.S. estate (or gift) of a non-U.S. person to the extent that the estate (or gift) has a value at the time of the person's death (or gift) of over U.S. $3 million. Moreover, as noted in Section 1, because of their application to the value of an investor's interest, the U.S. estate or gift tax generally applies to the actual *capital* invested in the United States by a non-U.S. natural person, not merely the *income* from an investment.

In the context of an offshore investment fund, the U.S. estate or gift tax could apply to a non-U.S. natural person investor's investment in the fund if the offshore fund structure were viewed by U.S. tax authorities as being "tax transparent," as could be the case with an offshore fund structured as a partnership or, potentially, as a unit trust. Fortunately, it is clear that if an offshore fund is structured as a non-U.S. corporation and appropriate corporate formalities are followed by the fund corporation,[xi] the U.S. estate or gift tax will not be applicable to shares in the fund corporation held by a non-U.S. natural person investor who gives such shares away during his lifetime or owns them at the time of his death. This is the case even though all of the assets of the offshore fund corporation are located in the United States. Also, the U.S. estate tax obviously does not apply to institutional investors (such as corporations, government agencies, and the like); such entities do not "die."

Because of the potentially devastating consequences of the U.S. estate or gift tax, with very rare exceptions offshore Islamic investment funds should be structured as non-U.S. corporations or as legal entities that the U.S. tax authorities will treat as non-U.S. corporations.

D. Basic U.S. Income Tax Rules: Islamic Investment Funds Structured as Non-U.S. Corporations

Generally, U.S. income tax rules divide the income that a non-U.S. fund corporation derives from U.S. sources into two categories, namely (1) income of the offshore fund corporation derived from a U.S. "trade or business," and (2) "passive" income (i.e., income not treated as "effectively connected" with a U.S. "trade or business" of the non-U.S. fund corporation). U.S.-source passive income for this purpose generally would include income from rents, royalties, interest, and dividends.

A non-U.S. fund corporation is subject to the regular U.S. corporate tax (now at a maximum rate of 35%) on its *net* income derived from a U.S. trade or business, with such net income being determined by deducting all ordinary and necessary expenses of the business, plus the non-cash allowable deduction for depreciation of business assets. In addition, when the after-corporate tax "earnings and profits" of the non-U.S. fund corporation are removed from the United States (or are deemed removed, under complicated rules), such after-corporate tax earnings and profits will be subject to an *additional* "branch profits" tax, at the rate of 30%. The application of the regular U.S. corporate tax at the 35% regular corporate rate *and* the application of the 30% branch profits tax on the 65% of that income remaining after the corporate tax has been paid results in a combined effective tax rate of 54.5%.

Obviously, virtually no U.S. investment could be expected to be so successful that, after application of a 54.5% tax, the remaining proceeds available to the Islamic investors would constitute an acceptable return to such investors. Plainly, then, it is essential to structure offshore Islamic investment funds so that the U.S. source income such funds derive will not be treated as effectively connected with a U.S. trade or business and subjected to this kind of double taxation.

In this context, it is obviously necessary to determine what type of activities or investments by a non-U.S. fund corporation are viewed by the U.S. tax authorities as giving rise to a U.S. "trade or business." Generally speaking, with certain notable exceptions (including an exception for trading in U.S. stocks and other securities[xii]), any considerable, continuous, and regular commercial activity[xiii] conducted in the United States by a non-U.S. fund corporation (acting through its non-U.S. officers or its U.S. agents) run a risk of being viewed by U.S. tax authorities as constituting a U.S. "trade or business" for this purpose. Further, under the Foreign Investment in Real Property Tax Act[xiv] provisions of the U.S. Tax Code, any gain realized by a non-U.S. investment fund from the sale of U.S. real property held directly by the offshore fund corporation will be deemed to be income effectively connected with a U.S. trade or business of the fund.

By contrast to the described taxation of the *net* amount of "trade or business" income realized by a non-U.S. fund corporation, the *gross* amount of U.S. source "passive" income (such as rents, royalties, interest, and dividends) realized by a non-U.S. fund corporation is subject to a 30% withholding tax. This 30% tax, on its face, appears to be a significant improvement over the potential 54.5% combined regular corporate and branch profits tax that could apply to "trade or business" income. However, it should be noted that the 30% withholding tax applies to the *gross* amount of "passive" income realized by a non-U.S. fund corporation, without allowance for deductions of any expenses related to the income in question.

E. An Important Tax Planning Tool: The "Portfolio Interest" Exemption from U.S. Withholding Tax

The U.S. tax law rules contain a special provision under which interest paid from U.S. sources to a non-U.S. entity, such as an offshore fund corporation, will be completely exempt from U.S. tax if the interest meets the technical requirements necessary for it to qualify as "portfolio interest." To qualify as portfolio interest, the instruments pursuant to which the interest is paid to an non-U.S. investor generally should be structured to be registered obligations, and the non-U.S. recipient must file with the payer of the interest a specific U.S. tax form, certifying that the recipient is, in fact, a non-U.S. entity.[xv]

Further, even if all formal requirements are satisfied to assure that interest being paid to a non-U.S. recipient qualifies as a tax-exempt "portfolio interest," the tax-exemption will not apply if such interest is paid to either of two categories of non-U.S. recipients. First, U.S.-source interest cannot qualify as tax-exempt "portfolio interest" if it is paid to a non-U.S. fund corporation (or other non-U.S. investor) which actually, or under complicated attribution of ownership rules, owns 10% or more of the voting stock of the U.S. corporation that pays the interest.[xvi] Second, interest paid from U.S.-sources to a non-U.S. bank[xvii] will not qualify as tax-exempt "portfolio interest" if the interest is paid pursuant to a loan made by a non-U.S. bank in the ordinary course of its banking business.

F. The Use of "Interest" in U.S. Tax Planning for Islamic Investors

Interest is generally a highly effective U.S. tax-planning tool for non-U.S. investors making U.S. investments. This follows because interest is generally a deductible expense in calculating the *net* income of a non-U.S. investor's U.S. trade or business that is subject to the U.S. corporate tax. Further, where "interest" can be structured to qualify as tax-exempt "portfolio interest," such interest can be paid out of the United States free of tax.

The obvious issue in the context of planning for Islamic investment funds is whether interest-bearing loans can ever be Islamically acceptable.[xviii] Based on numerous discussions that the authors have had with Islamic scholars, it appears that payments that U.S. tax authorities would characterize as "interest" for U.S. tax purposes can, under specific circumstances, be structured in a manner that is consistent with *sharīᶜa* principles.

For example, assume (1) that there is a non-U.S. holding company owned by an Islamic investor that owns 100% of the shares of a U.S. corporation ("USCo"), (2) that the offshore holding company has invested U.S. $1 million in the share capital of USCo, and (3) that USCo needs an additional U.S. $1 million to expand its business. Most *sharīᶜa* scholars apparently would agree that the Islamic investor could cause his non-U.S. investment company to lend the additional, required U.S. $1 million to its USCo subsidiary without violating Islamic principles. This follows because the loan in question would not place the "burden of interest" on anyone except USCo, which is wholly-owned by the Islamic investor's offshore holding company. In other words, lending "to one's self" appears to be permissible under *sharīᶜa* concepts. (Obviously, in the example described here, the interest paid by USCo to the "parent" offshore investment company would be subject to the 30% U.S. withholding tax because the Islamic investor's offshore investment company owns 10% or more (actually, 100%) of the voting stock of USCo.)

Taking the example a step further, assume (1) that eleven different Islamic investors, unrelated one to another, each own a separate non-U.S. investment company and (2) that each of these eleven offshore investment companies owns 9.09% of the shares of a specific USCo. Assume further that the USCo is in need of U.S. $1 million of additional capital and that each of the eleven Islamic investor-owned offshore corporations makes a loan to USCo in principal amount equal to 9.09% of U.S. $1 million (in other words, the percentage of the overall loan made by each of the eleven offshore investment corporations is exactly the same as the percentage of the shares of USCo owned by that offshore investment corporation). In this case, none of the offshore investment corporations would own 10% or more of the voting stock USCo and, accordingly, assuming that the technical requirements for "portfolio interest" were met, interest paid by USCo to each of the offshore investment corporations should be U.S. tax-exempt.[xix]

The question that arises is whether this more complicated structure would be Islamically acceptable. The authors have been advised by numerous *sharīᶜa* scholars that the described structure would be viewed for *sharīᶜa* purposes as acceptable "self-lending," on the theory that, because each of the offshore investment corporations would be making a loan directly in proportion to that offshore investment corporation's percentage share ownership in USCo, none of the offshore investment corporations would be placing the "burden of interest" on the ownership position of any of the other offshore investment corporations. This self-lending principle affords a number of opportunities for tax planning for non-U.S. Islamic investment funds.

The "portfolio interest" tax exemption also offers tax-planning opportunities in situations not involving self-lending from offshore Islamic investment corporations to USCos. For example, where an equipment lease provides by its terms that the lessee of the equipment will have acquired full ownership of the leased equipment if the lessee makes all of the required lease payments (and, in some cases, exercises a nominal, end-of-lease purchase option), U.S. tax authorities normally will view the equipment lease in question as being a financing, will treat part of each of the rental payments made by the lessee as "interest" for U.S. tax purposes, and will view the lessee as the "tax owner" of the equipment throughout the term of the lease. The *sharīᶜa* scholars and *Sharīᶜa* Advisory Boards with whom the authors have had discussions on this subject generally take the position that, if a lease is otherwise Islamically-acceptable,[xx] the fact that U.S. tax authorities choose to treat part of the rental payments as "interest" for U.S. tax purposes is irrelevant. This view of such equipment leases gives rise to structuring possibilities for Islamic equipment leasing funds, as discussed in more detail in Section 5 below.

V. Overview of Tax Structures for Islamic Equipment Leasing Funds

A. The Distinction between "*Ijāra Muntahīa bi-al-Tamlīk* Leases" and "Operating Leases"

As noted above in Section 4, where an equipment lease provides by its terms that the lessee of the equipment will become the owner of the equipment at such time as the lessee has made all of the specified rental payments and, under some leases, has exercised an end-of-lease purchase option for a nominal amount or made a "bullet" payment of the unpaid acquisition cost of the equipment, U.S. tax authorities generally will view the equipment lease in question as being a financing and will treat part of each of the rental payments made by the lessee as "interest" for U.S. tax purposes. Such an equipment lease is generally referred to as an "*ijāra muntahīa bi-al-tamlīk*." As also noted above, *sharīᶜa* experts with whom the authors have discussed such leases have generally taken the position that, if a lease is otherwise Islamically-acceptable, the fact the U.S. tax authorities choose to characterize part of the rental payments as "interest" for U.S. tax purposes is of no concern, insofar as the *sharīᶜa* analysis of such a lease is concerned.

By contrast to *ijāra muntahīa bi-al-tamlīk* leases, under the terms of an "operating lease," another, frequently-used type of equipment lease, the lessee of the equipment does not become the owner of the equipment after the lessee has made all lease payments that are required pursuant to the terms of the lease and does not have a nominal end-of-lease option to purchase the equipment. Rather, in the case of an operating lease, the lessor remains the owner of the equipment at the end of the lease term and is then faced with the need to "re-market" the equipment, either by leasing it to the same or another lessee or by selling it in the market. In the case of an operating lease, the lessor is viewed for U.S. tax purposes as the owner of the equipment and has the right to claim a depreciation deduction each year, as well as other ordinary and necessary business expenses, arriving at the lessor's *net* income which is subject to U.S. tax.

B. A Possible Structure for an Islamic Equipment Leasing Fund Holding Only Equipment Subject to *Ijāra Muntahīa bi-al-Tamlīk* Leases

As indicated above, U.S. tax authorities generally will treat part of each rental payment under an *ijāra muntahīa bi-al-tamlīk* lease as being interest for U.S. tax purposes. Moreover, as discussed in Section 4.5 regarding "portfolio interest," interest paid to a non-U.S. person or entity that qualifies as "portfolio interest" can be paid out of the United States free of U.S. tax. Most *ijāra muntahīa bi-al-tamlīk* leases for U.S. equipment are made under a U.S. domestic "market standard" lease form which does not contain the requisite formal language necessary for the interest element of the rental payments paid under such leases to satisfy the portfolio interest rules. Normally it would not be practical to try and amend individual equipment leases in order to include within the terms of such leases the language necessary to make the interest element paid as part of the rent thereunder qualify as portfolio interest.

Accordingly, given the practical inability to amend most standard equipment leases in order to make provision so that rental payments under such leases made to an Islamic offshore investment fund corporation will be free of U.S. tax, it is necessary to interpose between the lessee and the offshore fund a structure that will cause the payments to satisfy the requirements of being treated as portfolio interest. For example, *ijāra muntahīa bi-al-tamlīk* leases having terms that do not satisfy the requirements of the portfolio interest rules could be placed in a U.S. "pass-through trust,"[xxi] and the pass-through trust could issue "pass-through certificates" to the offshore fund corporation, with the pass-through certificates being drafted so that their terms do satisfy the requirements of the portfolio interest rules.

An alternative may be to have the equipment leases that, by their terms, do not satisfy the portfolio interest rules, held by a "special purpose corporation" (an "SPC"). In form, the SPC would "sell" the leased equipment to the offshore fund corporation, which would then lease the equipment back to the SPC (subject to the existing end-user leases) pursuant to the terms of a "master lease." The master lease would be written so as to contain the provisions required to satisfy the portfolio interest rules. Assuming this structural arrangement is handled in a proper manner, the payments under the master lease received by the offshore fund corporation should be exempt from U.S. tax under the portfolio interest provisions.

Beside the technical requirements necessary to satisfy the portfolio interest rules, so that the interest element payable under *ijāra muntahīa bi-al-tamlīk* leases can be received by the offshore fund corporation free of U.S. tax, it is essential with a lease structure of this kind to assure that the activities of the offshore fund corporation do not give rise to a "U.S. trade or business"—because the "trade or business" tax rules of the U.S. Tax Code "trump" the portfolio interest rules. Accordingly, if the offshore fund corporation's U.S. activities are viewed by the U.S. taxing authorities as causing the offshore fund corporation to be engaged in a U.S. trade or business, the consequence will be the application of the regular U.S. corporate tax rates (current maximum: 35%) and the U.S. branch profits tax (30%), for a total tax burden to the offshore fund corporation of 54.5%—even if the leases in question and all other aspects of the transaction *in form* satisfy the portfolio interest rules. In short, the "swing" in this situation is between a 0% tax rate and a potential overall tax rate of 54.5%.

It can be strongly argued that *ijāra muntahīa bi-al-tamlīk* finance leases are "securities" within the meaning of the U.S. Treasury Regulation that holds that no U.S. trade or business will arise when an offshore corporation effects transactions in the United States "in stocks or securities" for the offshore corporation's own account. If so, an offshore fund corporation would effectively fall into the "safe harbor" from being held to be engaged in a U.S. trade or business.[xxii] Nonetheless, given the potential 54.5% tax rate if this "safe harbor" is not applicable, prudence dictates that steps be taken to minimize the U.S. activities of an offshore fund corporation that invests in such U.S. leases. Such steps could include (a) having the offshore fund corporation enter into a "Master Purchase Agreement" with its U.S. leased equipment "originator" under which the originator would, from time to time, present to the offshore fund corporation at the fund's office *outside the United States* a description of leased equipment that is for sale, together with details concerning the leases related to that equipment, the credit strength of the lessees, etc., and

(b) having the offshore fund corporation review the materials presented by the originator *outside the United States* and likewise communicate all decisions as to whether it will purchase the equipment from *outside the United States*.

C. A Possible Structure for an Islamic Equipment Leasing Fund Holding Only Operating-Leased Equipment

When an offshore fund corporation purchases equipment subject to an operating lease, it is clear for U.S. tax purposes that the fund is acquiring the actual, U.S. situs equipment. As a consequence, the offshore fund corporation in such case does not have any possibility of arguing, as in the case of *ijāra muntahīa bi-al-tamlīk* finance leases, that what is being purchased is a "security" that satisfies the "no U.S. trade or business" safe harbor referred to above in Section 5.2. Further, the necessary activities to maintain, insure, and, ultimately, re-market the purchased equipment will be considered activities of the offshore fund corporation that owns the equipment. This will be the case even if such activities are conducted (in the case of maintenance and insurance) by the lessee pursuant to the operating lease or (in the case of re-marketing) by a leased equipment originator acting for the offshore fund corporation.

It appears quite likely that such activities would be sufficient to cause the offshore fund corporation to be engaged in a U.S. trade or business, if it directly owns the U.S. situs equipment that is leased to third parties pursuant to operating leases. As noted above, such treatment could result in a total tax rate of 54.5% on the *net* income realized by the offshore fund corporation from payments it receives under the operating leases and proceeds realized when it sells or otherwise re-markets the leased equipment, once the operating leases have terminated.

A much better structural approach where an offshore fund corporation will acquire equipment subject to operating leases is to form a U.S. corporation (a "USCo") to hold the leased equipment. The voting common stock of the USCo (constituting, for example, 2% of the total capital stock of the USCo) would be held by a party (perhaps the fund sponsor) unrelated to the Islamic investors who own the shares of the offshore investment fund corporation. The investment fund corporation would subscribe (for example) for 98% of the capital stock of the USCo, which would be in the form of non-voting common stock of the USCo. The party holding the voting common stock of the USCo and the offshore fund corporation would also provide capital to the USCo in the form of interest-bearing, "self-lending" loans to the USCo, made pro-rata to their respective percentage interests in the capital stock of the USCo. The promissory notes issued by the USCo to reflect the self-lending would be in registered form, and the other requirements of the portfolio interest rules with respect to such loans would be satisfied.

Taking this approach, the *net* income of the USCo holding the equipment that is subject to operating leases would be taxable at the regular U.S. corporate rates (current maximum: 35%). However, in arriving at the amount of *net* income of the USCo each year, the USCo would be entitled to deduct all of its ordinary and necessary business expenses, including interest paid on the registered promissory notes (assuming these notes are structured so as to qualify as "true debt"—and not as a form of equity of USCo, and assuming that the so-called "earnings stripping" rules of the U.S. Tax Code[xxiii] are not implicated), as well as depreciation on the leased equipment.

It would be necessary to do appropriate tax projections on the specific facts involved in a proposed fund to ascertain whether this structure would produce an acceptable after-tax return to the offshore fund corporation and its Islamic investors. However, in many cases of this type, it is likely that the U.S. corporate tax payable by the USCo while the equipment is held by it would be quite low. When the USCo sells its equipment after the operating leases have expired, the income realized by the USCo from realization of this "residual value" may bear an increased tax burden. Finally, when the USCo is completely liquidated and cash is paid out to the offshore fund corporation and to the party holding the (2%) voting common stock and a pro-rata part of the registered promissory notes, there should be no second level of corporate tax analogous to the branch profits tax.

In this described structure for holding equipment subject to operating leases, interest paid to the unrelated party holding the voting common stock of the USCo (2% of its total capital stock) and a registered promissory note of USCo (2% of the total principal amount of the USCo notes) would be subject to a 30% U.S. withholding tax, because such party would own 10% or more (actually, 100%) of the voting stock of USCo, the payer corporation. If the party subject to this tax is the sponsor of, or another service provider to, the offshore fund corporation, such party may find this tax cost acceptable.

VI. CONCLUSION

Even more innovative Islamic investment funds doubtless will be developed by Islamic banks and other Islamic financial institutions in the future. Where such funds will invest in the United States (or in other Western countries with complex legal, tax, and regulatory regimes), careful structuring will continue to be essential to achieving the desired investment results for Islamic investors.

[i] As used in this paper, the term "investment funds" refers to any type of collective or pooled investment arrangement.

[ii] In recent years, lawyers working in the area of Islamic finance have devised numerous innovative Islamically-acceptable financing structures, including *Sharī'a*-compliant financing arrangements functionally equivalent to mortgages on U.S. real property, LBO financings for corporate buyouts, and real estate development financing arrangements.

[iii] While this paper will focus on Islamic investment funds aimed at Middle Eastern investors based in the GCC countries, many of the concepts discussed here would be equally applicable to Islamic investment funds that seek investors resident or organized elsewhere in the Islamic world.

[iv] In certain instances fund sponsors consider it desirable to structure an investment fund to include special political emergency protective provisions, aimed at protecting the fund's assets from the potential adverse effects of a political emergency in the home country (or countries) of the fund's investors—which in this case would be the GCC countries of the Middle East. Analysis of such political emergency "failsafe" structures is beyond the scope of this paper. See generally, Knight & Doernberg, Structuring Foreign Investment in U.S. Real Estate, 2d ed. (Kluwer Law & Taxation Publishers, 1988), Chapter 18 ("Structuring to Protect U.S. Assets Against the Effects of Foreign Political Emergencies").

[v] In recent months, the Organization for Economic Cooperation and Development (the "OECD") has actively opposed jurisdictions it considers as engaged in "harmful tax competition." On June 26, 2000, the OECD Committee on Fiscal Affairs released a report identifying its "blacklist" of tax haven jurisdictions that, as of that date, had not cooperated with the OECD's two-year global campaign to stamp out what it views as harmful tax practices. See Goulder, "OECD Releases Tax Haven Blacklist," Tax Notes International p. 7 (July 3, 2000). In considering where to base an offshore fund legal entity, the status of a particular jurisdiction in this OECD crusade should be considered—as well as possible counter-measures the OECD might seek to impose against an offshore jurisdiction that has not "cooperated" with OECD efforts to eliminate "harmful tax practices."

[vi] U.S. Internal Revenue Code of 1986, as amended (hereafter, the "U.S. Tax Code"), Section 884.

[vii] Rule 902(k) promulgated under the U.S. Securities Act of 1933, as amended (the "Securities Act"), provides a "safe harbor" from registration under the Securities Act for offers (and issuances) of securities to persons other than "U.S. persons." "U.S. person" means: "(i) Any natural person resident in the United States; (ii) any partnership or corporation organized or incorporated under the laws of the United States; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the United States; (vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States; and (viii) any partnership or corporation if: (A) organized or incorporated under the laws of any foreign jurisdiction; and (B) formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a)) who are not natural persons, estates or trusts." 17 C.F.R. § 230.902 (k).

[viii] Rule 10b-5 provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange: (1) To employ any device, scheme or artifice to defraud, (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5. See generally, Lowenfels and Bromberg, "U.S. Securities Fraud Across the Border: Unpredictable Jurisdiction," 55-3 The Business Lawyer 975 (May 2000).

[ix] U.S. Tax Code, Section 892. For discussion of the tax rules pertaining to income realized by "integral parts" of non-U.S. governments and non-commercial "controlled entities of such governments," see Knight & Doernberg, Structuring Foreign Investment in U.S. Real Estate, 2d ed. (Kluwer Law and Taxation Publishers, 1988) at Section 7.12.

[x] U.S. Tax Code, Section 884.

[xi] See Fillman v. United States, 355 F.2d 632 (Ct. Cl. 1966).

[xii] U.S. Treasury Regulations § 1.864-2(c).

[xiii] See Rev. Rul. 73-522, 1973-2 C.B. 22. See generally, Isenbergh, "The 'Trade or Business' of Foreign Investors in the United States," 61 TAXES 972 (1983).

[xiv] U.S. Tax Code, Section 897. See generally, Knight & Doernberg, Structuring Foreign Investment in U.S. Real Estate, 2d ed. (Kluwer Law and Taxation Publishers, 1988).

[xv] U.S. Treasury Regulations § 1.871-14.

[xvi] U.S. Tax Code, Sections 871(h)(3)(B) and 881(c)(3)(B).

[xvii] U.S. Tax Code, Section 881(c)(3)(A). For a detailed analysis of the "foreign bank exception" to the portfolio interest tax exemption, see New York State Bar Ass'n Tax Section, "Report on the Bank Loan Exception to the Portfolio Interest Rules," reprinted in Highlights and Documents (Tax Analysts), Sept. 18, 1992, at p. 4499. It is not clear whether a typical Islamic bank would be viewed as a "bank" for purposes of the "foreign bank exception" to the portfolio interest tax exemption. In two recent technical advice memoranda, which are not binding on the U.S. Internal Revenue Service (the "IRS"), the IRS held that, for purposes of the foreign bank exception to the portfolio interest tax exemption, an entity must accept deposits in order to be considered a bank. See TAM 9822007, TAM 9822008.

[xviii] Certain liberal *Sharīʿa* scholars apparently view as forbidden only interest that is usurious or excessive. This paper treats *any* interest payment or receipt as inconsistent with *Sharīʿa* principles, however.

[xix] This assumes that the recipients of the interest do not fall within the "foreign bank exception" to the portfolio interest tax exemption, discussed above, and that the loans are not recharacterized as equity for U.S. tax purposes.

[xx] *Sharīʿa* principles are incompatible with typical provisions in many "market standard" U.S. equipment leases. To be Islamically acceptable (for example), equipment lease terms must require the lessor of the equipment to repair and maintain the equipment, an approach contrary to most standard U.S. equipment leases. As another example, typical U.S. lease provisions to the effect that a lessee of equipment must continue to make lease payments even if the equipment is destroyed are not permissible under the *Sharīʿa*. In order to establish an equipment-leasing fund consistent with Islamic principles, these sorts of *Sharīʿa*-offensive lease provisions must be obviated. See Vogel & Hayes, Islamic Law and Finance: Religion, Risk and Return (Kluwer Law International, 1998), pp. 143-145.

[xxi] U.S. Treasury Regulations § 1.871-14(d)(1).

[xxii] U.S. Treasury Regulations § 1.864-2(c).

[xxiii] U.S. Tax Code, Section 163(j).