Sukuk: An attractive way to develop Islamic finance in Turkey

Turkey has amended its capital market law in a drive to spur investments from the Middle East. BURAK GENCOGLU and ALI CEYLAN discuss this new foreign policy approach.

During the last decade, Turkey developed strong relations with its neighbors and the Middle Eastern countries. Having attracted foreign investors from these countries, Turkey had a fundamental necessity to amend its financial system and make the system appealing for its Muslim neighbours in the Middle East.

As a result of this new foreign policy approach, the Capital Markets Board of Turkey (CMB) enforced a communiqué, the 'Communiqué Serial III no 43 on principals regarding lease certificates and asset leasing companies', on the 1st April 2010, introducing Sukuk to the Turkish market.

The new investment tool formed by the Communiqué is similar to a Sukuk instrument. However it is called a 'lease certificate'.

Sukuk can basically be defined as an economic tool similar to bonds but having no interest return. Sukuk is asset-backed and shows the ownership of an asset or its earnings. Unlike bonds, the issuer of the Sukuk is not under a contractual obligation to pay the Sukukholder an interest and the principle.

The Sukukholder obtains a proportional ownership on the underlying asset which backs the certificates and holders have proportional claims on the revenues generated by the assets. Apart from all these features, Sukuk is strictly distinguished from conventional bonds by making the Sukuk possessors bear the losses along with their rights to share the profits.

How does the Turkish system work?

Lease certificates provide a financing resource for companies (resource companies) through an asset leasing company (ALC) and by using the 'transfer-lease-take over' process. Article 3 of the communiqué defines the meaning of a resource company, lease certificate and ALC, among the other terms used in the text of the communiqué:

a) Lease certificate is the name used for Sukuk in the communiqué. These certificates can only be issued by an ALC, which can be incorporated by a resource company.

b) A resource company is a joint company which transfers its assets to the ALC to lease them back from the ALC.

c) An ALC is a joint stock company which can only be incorporated by intermediary institutions, banks and resource companies exclusively for issuing lease certificates.

> ***"The communiqué's most significant weakness was not to deal with exemptions or decreases regarding taxes and charges which arose from the transfer of the assets"***

Firstly, a resource company incorporates an ALC which should only serve for issuing lease certificates.

An ALC has a similar function to a special purpose vehicle. The communiqué imposes obligations on an ALC to include specific provisions into its articles of incorporation. For instance, an ALC cannot deal with any activity other than specified in the first paragraph of article 5 of the communiqué, or an ALC should include a provision in its articles of incorporation which states that it must establish a pre-emption right on the title deed in favor of the resource company or it cannot use loans, cannot become indebted or establish right in rem in favour of third parties on the assets owned by it.

All these special terms stipulated in the communiqué have an important function to protect the investor.

Although the communiqué formed a new type of investment instrument there were several features open to a high level of criticism. For instance, the communiqué did not deal with exemptions or decreases concerning taxes and charges which should be paid upon the transfer of the assets from a resource company to the ALC.

Former weaknesses of the communiqué

The communiqué's most significant weakness was not to deal with exemptions or decreases regarding taxes and charges which arose from the transfer of the assets. Since a real estate transaction involves a 3.3% land registry fee and 18% VAT (because of its commercial character) there was an initial 21.3 % burden on the potential investor which made the leasing certificates an inefficient tool for profit gain.

Law no 6111 and lease certificates

In consequence of the abovementioned criticism regarding the amendments needed to be made for Sukuk transactions, the well known Law 6111 (the 'Law' or the 'Act') was enacted on the 13th February 2011, which deals with lease certificates in its various articles.

As mentioned above, the resource company which needs to create funds cannot issue lease certificates itself but can do it

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through an ALC. Therefore, a transaction of transferring assets is inevitable. The Law solves the problem of tax and charge costs to be incurred from these transactions by recognizing exceptions and decreases in several regulations.

VAT exception

The Law regulates the exemptions to VAT and brings VAT exceptions to the transfer of assets to an ALC, the lease of these assets by an ALC and their transfer back to the resource company. The Law also amends the VAT Act and provides an exemption for the delivery of lease certificates. In other words, a potential Sukuk transaction in Turkey is now free of VAT.

Corporate tax exception

The new form of the corporate tax law entitles the corporations to a 100% exception for the revenues obtained through the transfer transactions of real estate from resource companies to ALCs.

Stamp duty exception

Article 83 of the Law provides stamp duty exemptions for transferring assets to ALCs, transfer of these assets back to resource companies by ALCs, and papers issued against the lease of these assets by ALCs. Lease certificates themselves are exempted from stamp duty.

Withholding tax

Turkish Council of Ministers passed a decree numbered 2011/1854, which was published in the Official Gazette on the 29th June 2011. The decree imposes a 10% withholding tax on proceeds generated from lease certificates issued in Turkey. Furthermore, the decree stipulates gradual withholding tax rates from 0% to 10% (depending on maturity) on lease certificates issued outside Turkey.

- 10% from proceeds having a maturity date up to one year
- 7% from proceeds having a maturity date between one to three years
- 3% from proceeds having a maturity date between three to five years
- 0% from proceeds having a maturity date of five years and more

Banking and insurance transaction tax (BSMV)

If lease certificates issued in Turkish liras are (i) purchased or sold with a buy-back option (ii) sold before the maturity date, such earnings are subject to 1% BSMV tax.

Conclusion

The market for Sukuk and other Islamic financial instruments has potential to grow in Turkey due to its target to become a financial and economic center in the region. Therefore, Sukuk can be defined as an appropriate step to realize this objective.

The communiqué and subsequent amendments in the legislation have provided a friendly environment for Sukuk transactions.

It should be noted here that the latest improvements made by the Law 6111 particularly emphasize Turkey's desire to become one of the leading players in Islamic finance.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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