AVOIDING ANOTHER SUBPRIME MORTGAGE BUST THROUGH GREATER RISK AND PROFIT SHARING AND SOCIAL EQUITY IN HOME FINANCING: AN ANALYSIS OF ISLAMIC FINANCE AND ITS POTENTIAL AS A SUCCESSFUL ALTERNATIVE TO TRADITIONAL MORTGAGES IN THE UNITED STATES

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I. INTRODUCTION

On July 17, 2007, Bear Stearns Asset Management announced the collapse of two of its hedge funds as a result of bad bets on "risky subprime loans."[1] The announcement kicked off a series of woeful announcements by banks and mortgage investment companies about losses related to subprime mortgages (mortgages granted to persons with a less-than-perfect credit rating, generally defined as having a credit score below 620).[2] The turmoil—caused by declining U.S. housing prices, record foreclosures, and poorer-than-expected performance in structured financial products backed by subprime loans[3]—culminated in a global credit crunch that required several Central Banks to slash overnight lending rates and to infuse billions of dollars of extra cash into the economy to avoid an economic meltdown.[4] On August 9, 2007, the "European Central Bank add[ed] 94.8 Billion euros of one-day funds to money markets as European interbank lending drie[d] up amid concern about banks' subprime exposure[.]"[5] In September 2007, British mortgage lender Northern Rock sought emergency financial support from the Bank of England, sparking an old-fashioned bank run and forcing the British government to guarantee

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1. CNBC.com, *Two Bear Stearns Hedge Funds 'Essentially Worthless': CNBC*, July 17, 2007, http://www.cnbc.com/id/19807752.

2. For a more detailed explanation and definition of what a subprime mortgage is, *see* Bankrate.com, *Subprime Mortgages*, May 1, 2006, http://www.bankrate.com/brm/green/mtg/basics2-4a.asp.

3. BBC News, *What's Behind the Credit Crunch?*, Aug. 10, 2007, *available at* http://news.bbc.co.uk/1/hi/business/6940976.stm (analysis by Barnaby Martin).

4. Rachel Beck, *Overseas Stocks Also Have Risks*, ST. PAUL PIONEER PRESS, Oct. 26, 2007; *see also* Reuters, *CHRONOLOGY: The Credit Crunch of 2007*, Oct. 1, 2007, *available at* http://www.reuters.com/article/hotStocksNews/idUSCREDCHRONO20071001?sp=true.

5. Reuters, *supra* note 4. Financial institutions, in order to have money to lend and to pay withdrawals, generally receive loans from other financial institutions and directly from Central Banks. As financial institutions became increasingly averse to lending money to other financial institutions because of the increased credit risk associated with subprime mortgages, Central Banks were forced to pick up the slack. *See* Mike Dolan & Kirsten Donovan, *Bank-to-Bank Lending Freezes; Bankers Ask "Who's Next?"* Reuters.com, Mar. 17, 2008, *available at* http://www.reuters.com/article/newsOne/idUSL1710220420080317?sp=true.

all deposits at Northern Rock.[6] As of March 2008, major banks and insurers across the globe had either forecast or announced over $150 billion of write-downs and losses as a result of subprime mortgage loans.[7]

Yet, amidst the chaos, one area of the global financial market has remained unscathed. According to Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) senior financial analyst Khairul Nizam, "Islamic finance institutions have been protected from the global 'credit crunch[.]'"[8] The reason: "because the trading of subprime mortgages is against the principles of Sharia" Law.[9] Said Nizam, "The exposure to the subprime market in the U.S. is probably non-existent among the Islamic banks because mortgages are not supposed to be traded on Islamic principles. So the Islamic banks would have stayed away from these because of Sharia issues rather than credit issues[.]"[10] Thus, Islamic financial institutions avoided the credit crunch by managing to entirely avoid the subprime lending market altogether—a prudent decision indeed.

Although the complete avoidance of subprime mortgages may in hindsight seem like a prudent business decision, as late as mid-2006, a failure by financial institutions to capitalize on the subprime lending market would have appeared like a significant opportunity lost for business growth and profits.[11] However, as Nizam explains, the avoidance of the subprime lending market by Islamic financial institutions is not based on profit and loss calculations or business growth strategies, but is instead based on fundamental principles of Islam.[12] These fundamental principles are derived from Shariah Law—Islamic law as laid out by the Quran and the teachings of the Prophet Mohammed—and are the foundation of the fast-growing sector of finance known as Islamic Finance.[13] Thus, in order to understand

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6. *Id.*

7. Tanya Azarchs, *Subprime Writedowns: Is the Worst Over?*, BUSINESS WEEK, Mar. 13, 2008, http://www.businessweek.com/investor/content/mar2008/pi20080313_977654.htm.

8. Kippreport, *Islamic Banks 'Are Safe From Credit Crunch'*, Oct. 7, 2007, *available at* http://www.kippreport.com/kipp/2007/10/07/islamic-banks-are-safe-from-credit-crunch/?bnr=1 [hereinafter "Kippreport"]. *See also* N.C. Aizenman, *A Higher Law for Lending; Business is up at Islamic finance firms, which don't charge interest and weren't part of the mortgage debacle*, WASHINGTON POST, May 13, 2008 ("The mortgage industry may be in meltdown, but at least one class of lender appears to be flourishing: Islamic Finance[.]").

9. Kippreport, *supra* note 8.

10. *Id.*

11. *See* Les Christie, *Subprime Loans Failing Pre-Resets*, CNNMONEY.COM (Feb. 20, 2008), http://money.cnn.com/2008/02/20/real_estate/loans_failing_pre_resets (noting that even by late 2006, subprime mortgages "sold easily because they carried the promise of high yields.").

12. Kippreport, *supra* note 8.

13. KPMG, MAKING THE TRANSITION FROM NICHE TO MAINSTREAM: ISLAMIC BANKING AND FINANCE: A SNAPSHOT OF THE INDUSTRY AND ITS CHALLENGES TODAY 4

why Islamic financial institutions managed to completely avoid subprime mortgages, one must understand the basic principles that make Islamic financial modes separate and distinct from traditional Western financial modes.

II. STATEMENT OF PURPOSE

Islamic Finance is one of the fastest-growing and most dynamic areas in the global financial market.[14] Because Islamic Finance allows Muslims to conform to the Shariah, the Islamic financial model has become the preferred method of finance for many of the predominantly Muslim countries.[15] However, in countries that are not predominantly Muslim, Islamic Finance has been met with varying acceptance.[16] While there are many possible reasons to explain this variation in acceptance of Islamic Finance among predominantly non-Muslim countries, including differences in demographics and theological differences,[17] a major factor in the rate of acceptance of Islamic Finance is the ability to offer meaningful Sharia-

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(2006), *available at* http://www.us.kpmg.com/microsite/fslibrarydotcom/docs/ Islamic%20Banking%20and%20Finance%20-%20A%20Snapshot%20of%20the%20Industry%20and%20Its%20Challenges %20Today.pdf.

14. *Id.* at 2.

15. *See id*.

16. Ayman H. Abdel-Khaleq & Christopher F. Richardson, *New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings*, 7 CHI. J. INT'L L. 409, 417-19 (2007) ("Once largely restricted to the Middle East and Southeast Asia, Islamic finance and investment now permeate markets throughout Europe, Asia, and even the US.").

17. A demographic study by the Pew Research Center shows that there are roughly 2.35 million Muslims in the United States. Pew Research Center, MUSLIM AMERICANS: MIDDLE CLASS AND MOSTLY MAINSTREAM 3 (2007), *available at* http://pewresearch.org/assets/pdf/muslim-americans.pdf. Thus, Islamic Finance may be slower to develop in the United States because the market is not yet large enough to reach a critical mass where widespread Islamic financing is feasible. Furthermore, compared with other Western countries such as the U.K., Germany, and France, American Muslims are less concerned with their identity as Muslims and more concerned with assimilation into modern Western culture. *See id*. at 2-3. Accordingly, Islamic Finance as an extension of the greater Islamic Revival may be less important to American Muslims. Finally, and conversely, the difficulty in obtaining proper Islamic financing in non-Islamic countries has been recognized by Islamic clerics, who have provided some leeway. MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 19 (Cambridge University Press 2006) ("Some flexibility is given to Muslims living in non-Muslim lands. The *fatawa* (religious edicts) issued by Ayatullah Sistani (Iraq's most prominent Shi'i cleric) seem to accommodate many forms of conventional finance for those Muslims. . . . Likewise, the prominent Sunni jurist, Yusuf Al-Qaradawi, issued a similar *fatwa* allowing Muslims in North America to finance their home purchases with conventional mortgages . . . based on considerations [including] the rule of necessity.").

compliant products that are competitive with traditional Western financial products.[18] The chief argument of this Note is that the key to the latter, the ability to offer legitimate and competitive Islamic financial products, is the removal of legislative and regulatory hurdles that stem from incentive structures that are built around conventional Western financial models.

While this Note will begin with a brief explanation of Islamic Finance—including its origins and history, its defining features, its critical and emerging issues, and some of its basic transactional structures—the main focus of this Note will be to provide an example of how legal incentive structures in Western, predominantly non-Muslim countries, can hinder the competitiveness of Islamic financial products in those countries. Specifically, this Note will utilize the typical home purchase and financing transaction as a platform to contrast the Islamic financial models with the Western model, and to highlight, particularly with respect to the taxation of each model, how the incentives structured around the Western model create a distinct disadvantage for the Islamic financial model in terms of market competitiveness. Finally, this Note uses a tax reform act passed in the United Kingdom, dealing with the taxation of certain Islamic financial transactions, as an example of how to statutorily remove at least part of the disadvantage created by the typical Western tax incentive scheme and thus increase the efficiency and competitiveness of Islamic financial products.

III. OVERVIEW OF LEGAL AREA

A. Islamic Finance

1. Origins and History

Although the fundamental tenets and rules of Islamic Finance are as old as Islam itself, the modern form of Islamic Finance is relatively new.[19] Islamic Finance, in the modern sense, grew out of the broader Islamic Revival movement[20] that began roughly sometime in 1970s and signaled a reawakening of Muslim self-identity, evidenced by a growing adoption of Islamic culture, dress, terminology,

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18. See EL-GAMAL, *supra* note 17, at 21 (noting the tradeoff between legitimacy and efficiency when marketing Islamic financial products).

19. FRANK E. VOGEL & SAMUEL L. HAYES III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 4 (1998).

20. *See* CLEMENT M. HENRY & RODNEY WILSON, THE POLITICS OF ISLAMIC FINANCE 38-39 (2004); *See also* Haider Ala Hamoudi, *The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law*, 56 AM. J. COMP. L. 423, 452 (2008) (citing Mahmoud El-Gamal, *"Interest" and the Paradox of Contemporary Islamic Law and Finance*, 27 FORDHAM INT'L L.J. 108, 122 (2003)).

and traditional Muslim values.[21] Prior to this movement, when European colonial powers dominated almost the entire Islamic world, most countries adopted Western banking systems and commercial models and abandoned Islamic commercial practices.[22] Accordingly, as Professor Haider Ala Hamoudi argues, Islamic Finance is part of and is influenced by a more general desire to create a Muslim sphere of influence that is separate from the current dominant global and economic political order and "to restore some level of political and economic power to the Muslim world."[23]

Today, Islamic Finance is a:

> dynamic, fast-growing global phenomenon. [According to Industry estimates,] there are now about 300 Islamic financial institutions in 75 countries, holding assets estimated at more than US$300 billion, and another US$400 billion in financial investments.[24] Furthermore, the industry has grown at a rate of around 15% per year and should continue to grow considerably in the foreseeable future.[25]

Amazingly, in less than fifty years, Islamic Finance has transformed from an experiment to a niche industry and now seeks to become a mainstream alternative to traditional financial transactions.[26]

2. Defining Features of Islamic Finance—Shariah Compliance, Avoidance of Key Prohibitions, and Risk and Profit Sharing

The key difference between Islamic Finance and traditional Western finance is that, in addition to compliance with normal banking and finance regulations, Islamic financial institutions, products, and transactions must conform to the law of Shariah.[27] In order to demonstrate Shariah compliance, Islamic

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21. VOGEL & HAYES, *supra* note 19, at 4-5. The first Islamic Bank was formed in 1963 and was followed in 1971 by the Nasser Social Bank, as well as several other Islamic financial institutions that were developed in the seventies. *Id*. at 4.

22. *Id*.

23. Hamoudi, *supra* note 20, at 423-424; *See also* Hesham M. Sharawy, Note, *Understanding the Islamic Prohibition of Interest: A Guide to Aid Economic Cooperation Between the Islamic and Western Worlds*, 29 GA. J. INT'L & COMP. L. 153, 164-165 (2006) (explaining Islamic Finance as part of a broader Muslim "identity crisis").

24. KPMG, *supra* note 13, at 2.

25. *Id*.

26. *See* VOGEL & HAYES, *supra* note 19, at 4-5; *see also generally* KPMG, *supra* note 13.

27. KPMG, *supra* note 13, at 6; EL-GAMAL, *supra* note 17, at 1.

financial institutions employ Shariah Advisory Committees who issue fatawas[28] declaring that a specific product or transaction complies with the Shariah.[29] Shariah supervisory boards base their advice and opinions, or fatawa, on their readings and interpretations of: (1) the Qur'an, which Muslims believe to be the revealed word of God (Allah); (2) the Sunnah, which are practices instituted by Mohammad, the Prophet of Allah; (3) the consensus of Islamic scholars; and (4) the opinions of the classical jurists and their successors.[30] "Sponsors of Islamic financial projects rely on Shariah supervisory boards to monitor their undertakings to ensure—on their behalf and on behalf of their investors, their depositors, and their shareholders—that their financial transactions, policies, and procedures are in compliance with Islamic legal and religious precepts."[31] In addition, some countries where Islamic Finance comprises a large portion of overall financial activity, such as Pakistan or Malaysia, the country may have a government Shariah Advisory group.[32]

In essence, compliance with the Shariah is essentially a prohibition-driven exercise.[33] Specifically, in order to comply with Shariah law, a financial product or transaction must adhere to several basic prohibitions.[34] These prohibitions include: *riba*, *gharar*, *maysir*, and *haram*.[35] *Riba* is essentially a prohibition against borrowing or lending at interest.[36] *Gharar* is a prohibition against dealing in uncertainty.[37] *Maysir* prohibits gambling or excessive risk.[38] And the final prohibition is against investment in products or activities that are *haram* (forbidden), such as alcohol or pork products.[39] Thus, AAOIFI senior financial analyst Khairul Nizam points out,[40] Islamic financial institutions would be prohibited from dealing in subprime mortgages for multiple reasons: first, a

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28. Rushdi Siddiqui, *Shariah Compliance, Performance, and Conversion: The Case of the Dow Jones Islamic Market Index*, 7 CHI. J. INT'L L. 495, 496 (2007). As Siddiqui explains, "the root for the word *fatwa* (singular; *fatawa* is the plural) in Arabic comes from the designation *fata* for a strong and vital youth . . . [*A*]*fta* came to mean to clarify or explain. [Accordingly,] the word *fatwa* came to mean an answer or response to a difficult question of law." *Id.* at n.4 (citing RAGHIB AL-ISFAHANI & ABU AL-QASIM AL-HUSAYN IBN MUHAMMAD, MUFRADAT ALFAZ AL-QUR'AN 373 (Dar al-Qalam al-Tab'ah 1992)).

29. *Id.* at 496.

30. *Id*.

31. *Id.* at 496-97.

32. Ali Adnan Ibrahim, *The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration*, 23 AM. U. INT'L. L. REV. 661, 669 (2008).

33. EL-GAMAL, *supra* note 17, at 8.

34. *Id*.

35. KPMG, *supra* note 13, at 5.

36. *Id.*

37. *Id.*

38. *Id.*

39. *See* IBRAHIM WARDE, ISLAMIC FINANCE IN THE GLOBAL ECONOMY 142 (Columbia University Press 2000).

40. *See* Kippreport, *supra* note 8.

traditional mortgage in itself is based on lending at interest and would thus be prohibited for containing *riba*; second, a subprime mortgage could arguably be prohibited as *gharar* or *maysir*, because it could be viewed as uncertain or excessively risky.

a. Prohibition against *Riba* – The Promotion of Social Equity and Economic Fairness through Models of Risk and Profit Sharing

The first major prohibition of Islamic Finance—the most widely known and least understood prohibition[41]—is that of *riba*. Translated literally as an "increase,"[42] in the context of Islamic Finance, Muslim scholars have come to the general consensus that *riba* is a comprehensive term that includes interest on loans and accounts.[43] Broadly stated, the fundamental goal of prohibiting *riba* is "to prevent usurious conditions in exchanges and loans."[44]

There are many examples of the prohibition of *riba* in Islamic scriptures. The Qur'an itself specifically prohibits *riba* in at least eleven separate instances.[45] For example, the strongest passage touching on the Qur'anic prohibition of *riba* reads:

> Those who devour [riba] / Will not stand except /
> As stands one whom / The Evil One by his touch /

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41. *See* EL-GAMAL, *supra* note 17, at 8.

42. Barbara L. Seniawski, Note, *Riba Today: Social Equity, The Economy, and Doing Business Under Islamic Law*, 39 COLUM. J. TRANSNAT'L L. 701, 707 (2001) ("The root of the Arabic word *riba* (transliterated as the English-language letters r, b, and w) signifies 'increase.' The grammatical form of *riba*, a verbal noun, means 'excess, increase, augmentation, expansion or growth.'" (citation omitted)).

43. *Id*. at 707-08; Huda Ahmed, Note, *Not Interested In Interest? The Case for Equity-Based Financing in U.S. Banking Law*, 2 ENTREPREN. BUS. L.J. 479, 485 (2007). The prohibition against interest is not a purely Islamic phenomenon. There are also prohibitions against interest or usury in Judaism and Christianity. *See* Siddiqui, *supra* note 28, at 500 (citing numerous passages from the Old and New Testaments, as well as examples of historical criticisms of interest from prominent Christian theologians); *see also* Wayne A.M. Visser & Alastair McIntosh, *A Short Review of the Historical Critique of Usury*, 8 ACCT. BUS. & FIN. HIST. 175, 179 (1998), *available at* http://www.alastairmcintosh.com/articles/1998_usury.htm. The prohibitions in Judaism and Christianity were generally abandoned in the 15th century. Visser & McIntosh, *supra*, at 179. Proponents of Islamic Finance argue that the abandonment of the prohibition of interest does not mean that the prohibition has disappeared, but that the enforcement of the prohibition has been set aside in order to allow for the growth of modern capitalism without regard to the spiritual overtones inherent in one's method of earning a living. Siddiqui, *supra* note 28, at 500.

44. Seniawski, *supra* note 42, at 702.

45. Sharawy, *supra* note 23, at 162-163.

Hath driven to madness / That is because they say:
"[Sale] is like usury [riba]." / But Allah hath permitted [sale] /
And forbidden [riba]. / Allah will deprive / [Riba] of all blessing, /
But will give increase / For [voluntary] deeds of charity; /
For He loveth not / Creatures ungrateful And wicked.[46]

The Qur'an goes on to warn:

That they took [riba], / Though they were forbidden; /
And that they devoured / Men's substance wrongfully /
We have prepared for those / Among them who reject Faith /
A grievous punishment.[47]

Authors Paul Mills and John Presley have noted that Islamic scripture places the taking of *riba* "on par with repeated adultery, and more sinful than maternal incest[,]" both of which are punishable by death in Islamic criminal law.[48]

The reasoning most often given for the *riba* prohibition is that lending money at interest is a predatory and exploitative practice where one party is unjustly enriched at the expense of the other party.[49] Other reasons given for the *riba* prohibition are that it prevents parties from contracting on equal terms and that overall risk in these transactions is unevenly distributed.[50] Islamic Scholar Ziaul Haque describes *riba* as:

> an inequitable social and economic system which destroys unity and solidarity of a community by creating classes of moneylenders, usurers, hoarders and merchants who own the basic means or production like land and capital, and exploit the common masses who lack these resources and virtually depend on them for their livelihood and existence.[51]

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46. Seniawski, *supra* note 42, at 703 (alteration in original) (quoting THE MEANING OF THE HOLY QUR'AN, II:275-76 (Abdullah Yusuf Ali trans., new rev'd ed. 1991) [herinafter HOLY QUR'AN]).

47. *Id*. at 703 n.7 (quoting HOLY QUR'AN, IV:161).

48. *See* PAUL S. MILLS & JOHN R. PRESLEY, ISLAMIC FINANCE: THEORY AND PRACTICE 7-9 (Palgrave Macmillan 1999) [hereinafter MILLS & PRESLEY]; *see also* Daniel Klein, Comment, *The Islamic and Jewish Laws of Usury: A Bridge to Commercial Growth and Peace in the Middle East*, 23 DENV. J. INT'L L. & POL'Y 535, 537 ("In one [hadith], it is reported that the Prophet 'equated the taking and giving of interest to committing adultery thirty-six times, or being guilty of incest with one's own mother.'").

49. Ahmed, *supra* note 43, at 485 (citing VIRGINIA B. MORRIS & BRIAN D. INGRAM, GUIDE TO UNDERSTANDING ISLAMIC INVESTING 10 (Karen Meldron & Mavis Mors eds., 2001)).

50. *Id*.

51. Seniawski, *supra* note 42, at 708-09 (quoting ZIAUL HAQUE, RIBA: THE MORAL ECONOMY OF USURY, INTEREST AND PROFIT 5 (2d ed. 1995)).

The *riba* prohibition reflects the Islamic view that accumulating wealth through passively earning interest is not a legitimate mode of "work," because it is not the product of labor and risk-taking.[52] Further, Islam views charging interest in the common lender-borrower transaction as inequitable, because:

> [w]hen a lender charges interest for capital, he receives a reward without adding his labor and without regard to the success or failure of the borrower's venture. The benefit of the loan to the lender is certain while the benefit of the capital to the borrower is uncertain. Islam view these transactions as necessarily including unfair allocations of risk and justifying reward for a passively acquired return on capital.[53]

According to these scholars, *riba* is therefore "exploitive vis-a-vis the borrower," and prohibiting *riba* limits the disparity between parties in financial transactions and promotes social equity.[54]

In addition to the social justice rationale, Islamic scholars have also offered economic critiques of interest that support the prohibition of *riba*.[55] Scholars have argued that the unjust allocation of risk between borrower and lender creates a "penalty upon entrepreneurial initiative."[56] Islamic scholars believe that, in a truly competitive market, it is unlikely that an investment could result in profits that would cover interest expenses.[57] Because capital would be unproductive without entrepreneurial input, the disincentive to create wealth would hinder economic growth.[58]

b. Prohibition Against *Gharar*—The Promotion of Prudence

Another key feature of Islamic finance is the prohibition of *gharar*. *Gharar* has been defined as "the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin

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52. *See* Sharawy, *supra* note 23, at 161.

53. Chian Wu, Note, *Islamic Banking: Signs of Sustainable Growth*, 16 MINN. J. INT'L L. 233, 236 (2007). Of course, the lender bears the risk of the borrower's default, although this risk is generally mitigated to a large extent by collateral requirements and other debt covenants. *See generally* JOHN FRANCIS HILSON & JEFFREY S. TURNER, ASSET-BASED LENDING: A PRACTICAL GUIDE TO SECURED FINANCING (5th ed. 2004). On the other hand, if the risk is not mitigated, then the lender may be in violation of *gharar* or *maysir* because the investment could be unduly risky or speculative.

54. Wu, *supra* note 53, at 236. *See also* VOGEL & HAYES, *supra* note 19, at 83-84.

55. MILLS & PRESLEY, *supra* note 48, at 11-12.

56. *Id*. at 10.

57. *Id*. at 11.

58. *Id.*

to gambling."[59] According to attorneys Umar F. Moghul and Arshad A. Ahmed, "gharar may be best understood as ignorance of the material attributes of a transaction, such as the availability or existence of the subject matter, its qualities, quantity, deliverability, and the amount, terms, and timing of payment."[60] The classical prohibition of *gharar* rests "largely on the basis of Prophetic statements forbidding the sale of unripe fruit on a tree, the sperm of a stallion, the fetus of a camel, grapes until they are black, or grain until it is strong."[61]

Because complete contract language is impossible, some measure of risk and uncertainty is always present in contracts. Therefore, Islamic "jurists [have] distinguished between major or excessive *gharar*, which invalidates contracts, and minor *gharar*[.]"[62] In determining whether *gharar* will invalidate a particular contract, Professor Al-Darir lists four conditions: (1) *gharar* must be excessive—minor uncertainty will not affect the contract; (2) the potentially affected contract must be a sale and not a gift; (3) the *gharar* must affect the principal components of the transaction; and (4) if the contract containing *gharar* meets a need that cannot otherwise be met, the contract will not be deemed invalid based on that *gharar*.[63]

"In contemporary financial transactions, the two areas where *gharar* most profoundly affects common practice are insurance and financial derivatives."[64] Regarding insurance, Islamic "[j]urists often argue against the [conventional] financial insurance contract, where premia are paid regularly to the insurance company and the insured receives compensation for any insured losses in the event

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59. EL-GAMAL, *supra* note 17, at 58 (quoting W. AL-ZUHAYLI, AL-FIQH AL-ISLAMI WA ADILLUATUH 2408-2411 (Dar Al-Qalam, Damascus, 1997).

60. Umar F. Moghul & Arshad A. Ahmed, *Contractual Forms In Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) LTD. v. Symphony Gems N.V. & ORS.: A First Impression of Islamic Finance*, 27 FORDHAM INT'L L.J. 150, 171 (2003).

61. Hamoudi, *supra* note 20, at 441. "Many classical examples of *Gharar* were provided explicitly in the Hadıth [oral traditions relating to the words and deeds of the Islamic prophet Muhammad]. "They include the sale of fish in the sea, birds in the sky, an unborn calf in its mother's womb, a runaway animal, the semen and unfertilized eggs of camels, un-ripened fruits on the tree, etc. All such cases involve the sale of an item which may or may not exist . . . [because, for instance,] the fish in the sea may never be caught, the calf may be still-born, and the fruits may never ripen." MAHMOUD A. EL-GAMAL, A BASIC GUIDE TO CONTEMPORARY ISLAMIC BANKING AND FINANCE 7 (June 2000), *available at* http://www.ruf.rice.edu/~elgamal/files/primer.pdf.

62. EL-GAMAL, *supra* note 17, at 58.

63. *Id*. at 58-59. Two transactions that are not invalidated by gharar on account of the fourth condition are salam (forward contracts) and istisna (commissioned manufacturing). EL-GAMAL, *supra* note 61, at 17. Salam is an exception that requires a forward contract with advanced payment in full and delivery of a well-defined good at a specific time. *Id.* The salam contract is based on necessity, and allows a farmer to buy seeds, for example. *Id.* Istisna is an exception for periodic payment of costs on a long-term manufacturing contract. *Id.* In the past, the istisna contract has been used to finance the building of schools. *Id.*

64. *See* EL-GAMAL, *supra* note 61, at 7.

of a loss. In this case, the jurists argue that [the contract is overly speculative because] the insured may collect a large sum of money after paying only one monthly premium. On the other hand, the insured may also make many monthly payments without ever collecting any money from the insurance company."[65] Moreover, because "insurance" or "security" itself can neither be bought nor sold, presumably because of a lack of tangibility of definiteness, the contract is void as containing *gharar*.[66] Regarding derivatives, "[t]he other set of relevant contracts which are rendered invalid because of *gharar* are forwards, futures, options, and other derivative securities. Forwards and futures involve *gharar* since the object of the sale may not exist at the time the trade is to be executed."[67]

3. Developing and Marketing Islamic Financial Products—The Delicate Balance Between Efficiency and Legitimacy

At the center of the development and marketing of Islamic financial products is the tension between perceived legitimacy and efficiency or competitiveness.[68] This tension is recognizable in two ways—internally and externally. First, as to internal tension, the relative infancy of Islamic Finance means that there is still much new development and also a lack of standardization.[69] This lack of standardization creates room for varying interpretations amongst Shariah scholars and advisors and, therefore, leaves the industry vulnerable to a type of advisory arbitrage—shopping around amongst Shariah Advisors to find one who will approve a financial product.[70] Second, as to external tension, "Islamic financing transactions must be integrated with and adapted to the overall legal and regulatory framework of the prospective jurisdiction in which the transaction will take place. Islamic financial services, in most jurisdictions, are subject to state or federal law."[71] "[These services] must conform, for instance, to consumer protection laws, as well as to banking [and securities] regulations."[72]

In terms of internal tension, remembering that Shariah compliance is driven, in most cases, by the approval of Advisory Committees, which are dispersed and generally employed by the various financial institutions for which they serve, it

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65. *Id.*
66. *Id*. at 7-8.
67. *Id.* at 8.
68. *Id.*
69. KPMG, *supra* note 13, at 6 (acknowledging "the need for a standardized legal, accounting, regulatory, and Sharia'a supervisory framework"); *see also* Ibrahim, *supra* note 32, at 668-670.
70. *See* KPMG, *supra* note 13, at 6; *see also* Ibrahim, *supra* note 32, at 668.
71. Dr. Kilian Bälz, *Islamic Finance for European Muslims: The Diversity Management of Shariah-Compliant Transactions*, 7 CHI. J. INT'L L. 551, 552 (2007).
72. *Id*. at 555.

is easy to see how the same set of circumstances may lead to different compliance outcomes due to the differences of opinion of Shariah Advisors. *Riba*, for example, is an especially contentious issue, both as to what constitutes *riba* and exactly which products contain *riba*.[73] Over time, Shariah advisors have developed modes of interpretation that help to define the various prohibitions and help determine whether certain products are free of such prohibitions.[74] However, there is still a significant lack of standardization in the industry, which creates many challenges.[75]

One of the most serious issues created by the lack of standardization in the Islamic Finance industry is the issue of advisory arbitrage.[76] Advisory arbitrage refers to the practice of creating a financial product or instrument and then shopping around for an advisor who is willing to issue a *fatwa* in support of the product.[77] The risk inherent to such arbitrage is that a financial product that pushes the limits of acceptability could be viewed as disingenuous, thus threatening commercial acceptance of the product and perhaps even the acceptance of Islamic Finance in general.[78] In some cases, an Islamic financial institution will be able to get a *fatwa* in support of their product only to have a different Shariah Advisor issue a *fatwa* against the product.[79] This sort of confusion and uncertainty creates hesitation by consumers, and threatens the growth of Islamic Finance as an industry.[80]

In addition to the internal tension of advisory arbitrage, there is an external tension relating to Islamic regulations and their interactions with state or federal regulations, for instance taxation regulations.[81] This external tension is often solved by "Shariah arbitrage."[82] Shariah arbitrage also highlights the delicate balancing act faced by Islamic financial institutions looking to expand their offerings and increase their customer base.[83] On one hand, in order to gain customers, Islamic financial institutions must offer products that customers will understand and that are also

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73. *See* MAHMOUD A. EL-GAMAL, LIMITS AND DANGERS OF SHARIA ARBITRAGE 2, http://www.nubank.com/islamic/Arbitrage.pdf.

74. *See generally id.*

75. KPMG, *supra* note 13, at 6, 20.

76. *Id.* at 6.

77. *Id.*; *see also* Ibrahim, *supra* note 32, at 668.

78. *See* Ibrahim, *supra* note 32, at 668; *see also* EL-GAMAL, *supra* note 17, at 20-21.

79. *See, e.g.,* Stephen Lange Ranzini, *Islamic Finance (Finally) Taking Root in North America*, ISLAMIC FINANCE NEWS, Mar. 30, 2007, at 11, *available at* http://www.universityislamicfinancial.com/file/News/Islamicfinanceneews.03.30.2007.pdf ("Guidance has a *fatwa* from leading scholars, however some *fatwa* against their products have been issued by other scholars . . . .").

80. *Random Fatwas Confounding Markets, Slowing Economy*, ARAB NEWS, Aug. 17, 2005, *available at* http://www.arabnews.com/?page=1§ion=0&article=68562&d=17&m=8&y=2005.

81. *See* EL-GAMAL, *supra* note 17, at 2, 20-21. *See also* Moghul & Ahmed, *supra* note 60, at 191.

82. *See* EL-GAMAL, *supra* note 17, at 1-2, 20-21.

83. *See id*.

competitive in the global financial marketplace (efficiency).[84] Islamic financial institutions have historically tried to accomplish this goal by starting with a traditional financial product, such as a mortgage, and modifying the product to remove any prohibited aspects (i.e. *riba*).[85] Yet, on the other hand, if an Islamic financial product too closely resembles a traditional product—for instance, an "interest-free mortgage" that replaces interest with monthly fees that correspond exactly to an amortization schedule based on the market interest rate—then customers may view the "Islamic" designation as a mere marketing gimmick and not a legitimately Shariah-compliant alternative.[86]

Furthermore, particularly in non-Muslim Western countries, legal, regulatory, and tax issues can make the creation of legitimate Shariah-compliant alternatives even more difficult, because the further a financial product strays from traditional product offerings, the more difficult it becomes to fit the product within the existing legal framework.[87] Islamic financial institutions in Western countries may find that a specific product or transaction is prohibited by existing laws, or falls outside current legal parameters and is thus subject to uncertain regulation.[88] The product or transaction may also suffer from double taxation or may not receive the benefit of tax deductions a similar traditional product may receive, thereby reducing its competitiveness.[89] Thus, Western legal and regulatory structures, which are built around traditional financial products and transactions, provide a substantial barrier to the growth of Islamic Finance, and a Western country's legislative and administrative responses to Islamic Finance can have a profound effect on the ability of Islamic financial institutions to provide meaningful Shariah-compliant alternatives to the relevant market in that country.[90]

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84. *See id*.
85. *See id*.
86. *See id*.
87. Bälz, *supra* note 71, at 555.
88. *Id*.
89. *Id*.
90. *See* Moghul & Ahmed, *supra* note 60, at 191.

> External pressures, especially those arising out of the desire for favorable tax treatment, are known to influence the way Islamic financial transactions are documented. As perhaps can be expected, parties prefer favorable tax treatment, such as having the ability to deduct interest payments from taxable income, although this may, in many, but not necessarily all cases, result in less substantive adherence to the Shari'ah . . . . [T]he tension of arguing to one party, such as the retail public, that an instrument is not interest-bearing, while asserting to tax regulators that it is, poses serious ethical concerns for jurists and leads to incoherent rulings and internal dissonance.

Id.

4. Common Structures: *Murabaha* and *Musharaka*

While standardization, or lack thereof, is a critical issue of Islamic Finance, over time Islamic financial institutions have developed several Shariah-compliant products that are fairly standardized.[91]

> A number of different investment vehicles have been developed over the years and approved by Shariah scholars (although not all structures or permutations thereof are accepted by all schools of Islamic jurisprudence). These include, among others, financial instruments such as *murabaha* (cost-plus financing), *ijara* (lease), *musharaka* (partnership), *mudaraba* (sweat capital), *wakala* (investment agency), and *istisna'a* (construction/engineering and procurement contract).[92]

Each of these products represent means of financing transactions or investments while avoiding the Islamic prohibitions (mainly *riba* and *gharar*).[93] However, a survey of these standardized products, particularly in the context of home mortgages, makes it clear that there is a real spectrum between those products that avoid the prohibition of *riba* and *gharar* in form, and those that avoid the prohibitions in substance.

There are myriad investment vehicles and transaction structures and hybrids of these structures now available within Islamic Finance, and it is beyond the scope of this Note to analyze every one of them. Instead, this Note will focus on two main types of contracts used in Islamic Finance: mark-up sales or cost-plus financing (*murabaha*) and partnerships (*musharaka* or diminishing *musharaka*).[94] The reason this Note will focus on these two types of contracts is twofold. First, these contracts are sufficient to illustrate the contrast between efficiency and legitimacy, as this Note will show. Second, these contracts are available in the United States as methods of home financing in the alternative to conventional mortgages.[95]

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91. KPMG, *supra* note 13, at 6, 20 (discussing issue of standardization in Islamic Finance); *See* Abdel-Khaleq & Richardson, *supra* note 16, at 411-12 (listing Islamic investment vehicles).

92. *Id*.

93. *Id.*

94. As the reader will note, one characteristic of Islamic Finance and its origins in the greater Islamic Revival movement is that all Islamic financial products have Arabic names. *See* EL-GAMAL, *supra* note 17, at 12.

95. Several banks in the United States now offer Islamic Home Finance Products. These banks include: Guidance Residential (http://www.guidanceresidential.com/), University Islamic Fin. Corp. (http://www.universityislamicfinancial.com/), Devon Bank of Chicago (http://www.devonbank.com/islamic/index.html), and La Riba American

a. *Murabaha* (Cost-Plus Financing)

A *murabaha* transaction is a deferred payment sale that resembles an installment sales contract.[96] A business owner who chooses the *murabaha* method of financing will have a bank acquire title to the desired property or asset from the seller.[97] The bank will then transfer title to the business owner, either at the initial closing or at a later agreed-upon date.[98] This transaction allows the seller and business owner to come to a mutual agreement on a markup over the actual asset price, and allows the business owner to make payments over a period of time.[99] *Murabaha* transactions are usually only used for short-term financing.[100] *Murabaha* is also the most common Islamic financial contract form.[101]

The *murabaha* transaction is deemed acceptable because it requires an intermediate step where the money borrowed is either used for the purchase of goods or services or is used to invest in a business venture.[102] It is better understood if broken into two steps. In the first step, the money is borrowed to finance the purchase of an asset or land.[103] In the second step, that land or asset is used to produce profit, a portion of which is returned to the lender along with periodic payments on the principal.[104] The profit amount returned to the bank is an agreed-upon rate that is predetermined before the parties enter into the transaction.[105] The profit rate is similar to an interest rate, but technically different because it is actually an investment return on the asset or land purchase.[106] Historically, Islamic scholars have made several arguments in support of the mark-up in such a deferred payment sale (in contrast to interest on a loan).[107] Many of the arguments in support of *murabaha* were similar to arguments made in support of charging interest (e.g. the

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Finance House (http://www.lariba.com/). For more information on the various offerings by each bank, please visit each bank's individual website.

96. ABDULKADER THOMAS, METHODS OF ISLAMIC HOME FINANCE 5 (2001), *available at* http://www.djindexes.com/mdsidx/downloads/thomas.pdf.

97. *Id*.

98. *Id.*

99. *Id.*

100. Christopher F. Richardson, *Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field*, 42 TEX. INT'L L.J. 119, 130 (2006).

101. *Id*.

102. *See id*.

103. *Id*.

104. THOMAS, *supra* note 96, at 7.

105. *Id*.

106. *Id*.

107. ABDULLAH SAEED, ISLAMIC BANKING AND INTEREST: A STUDY OF THE PROHIBITION OF RIBA AND ITS CONTEMPORARY INTERPRETATION 79 (BRILL 1999).

time value of money and the risk associated with inflation).[108] However, scholars viewed a mark-up in a deferred payment sale as more legitimate than a loan at interest because a deferred payment sale includes some form of commercial activity.[109]

Currently, the rationale as to why the *murabaha* transaction, while on its face may appear the same as a traditional loan, is considered acceptable, is because the bank shares the risk in the transaction by owning the asset for a period of time.[110] In theory, there is always the chance that the customer will refuse to purchase the product, and the bank will be stuck holding the asset.[111] Further, the bank must also carry the risk and costs associated with maintaining the asset while the bank is in possession of the asset.[112]

Notice that, however, in terms of risk and profit sharing, the bank or lender/seller in the *murabaha* transaction only holds the risk in between the two sales. Of course, the bank can (and does) minimize this risk by conducting the two sales within a short period or even simultaneously.[113] Thus, although the *murabaha* transaction is technically compliant with Sharia, it should be viewed as a less-than-ideal Islamic financial transaction, that is to say, it is less legitimate (in the sense of being further from the ideals of Islamic Finance, not in terms of compliance) than some other Islamic financial transactions.[114]

In the homeownership context, the process for a *murabaha* financing transaction is as follows: the prospective homebuyer first identifies a desired property.[115] Then, the Islamic Finance institution purchases the property and promptly sells the property to the homebuyer at a marked up price.[116] At this point, the homebuyer makes an initial down payment and takes full title to the property.[117]

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108. *Id*.

109. *Id.* at 79-80.

110. Kelly Holden, Note, *Islamic Finance: "Legal Hypocracy" Moot Point, Problematic Future Bigger Concern*, 25 B.U. INT'L L. J. 341, 349 (2007).

111. *Id.*

112. Andreas Junius, *Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles*, 7 CHI. J. INT'L L. 537, 539 (2007).

113. *See* EL-GAMAL, *supra* note 17, at 67-68.

114. Jason C.T. Chuah, *Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law*, 27 NW. J. INT'L L. & BUS. 137, 149-150 (2006) (quoting El-Gamal, *supra* note 20, at 128) ("*murabaha* is a borderline transaction and a slight departure from the prescribed procedure makes it step on the prohibited area of interest-based financing.").

115. University Islamic Financial Corp., *Home Finance*, http://www.universityislamicfinancial.com/homefinance.html (last visited Sept. 15, 2008) (discussing *Murabaha*).

116. *Id.*

117. *Id.*

The homebuyer then makes monthly installment payments, which include payment on profit from the mark up and payment toward the principal on the home.[118]

b. *Musharaka* or *Musharaka Mutinaqiza* (Partnership or Diminishing Partnership)

A *musharaka* is a partnership, or "profit-and-loss sharing arrangement," and is used as a common financing method in the Islamic financial markets.[119] *Musharaka* is equity-based, and involves two or more parties, all of whom contribute capital and share the profits and losses of the operations in proportion to their respective contributions.[120] In this sense, *musharaka* is similar to a partnership in the U.S. legal system.[121] Banks use this type of contract in long-term investment projects.[122] Both parties have the right to participate in the management of the partnership, if they so choose.[123] "One type of *musharaka* is *musharaka mutinaqiza* (diminishing partnership), in which the financing agency and the investing customer are both owners of real estate. The periodic payments made by the customer are divided into a rental payment and a buyout payment. The contract terminates when the ownership of the property is completely transferred to the customer."[124]

In the home financing context, a diminishing *musharaka* agreement is used.[125] In a typical diminishing *musharaka* agreement, the prospective homebuyer approaches an Islamic Finance institution and forms a partnership.[126] The partnership then buys the home, and shares in the venture are split between the partners—the homebuyer and the finance institution—according to each partner's down payment.[127] The homebuyer then makes monthly payments to the partnership.[128] Part of the payment is a utility fee for the use of the home, and part

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118. *Id*.

119. V. Sundararajan & Luca Errico, *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead* 20-21 (Int'l Monetary Fund, Working Paper No. WP/02/192, 2002), *available at* www.imf.org/external/pubs/ft/wp/2002/wp02192.pdf; *See also* Hussain G. Rammal, *Financing Through Musharaka: Principles and Applications*, http://www.westga.edu/~bquest/2004/musharaka.htm (last visited Sept. 8, 2008).

120. Sundararajan & Errico, *supra* note 119, at 21.

121. *See id.*

122. *Id*.

123. *Id*.

124. Babback Sabahi*, Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for U.S. Financial Institutions*, 24 ANN. REV. BANKING & FIN. L. 487, 493 (2005).

125. Rammal, *supra* note 119.

126. *Id*.

127. *Id*.

128. *Id*.

of the payment goes toward buying out the finance institution and increasing the homebuyer's share of the partnership.[129] Over the course of the arrangement, the homebuyer purchases the rest of the finance institution's shares and becomes sole owner of the partnership.[130]

B. A Brief Explanation of Conventional (Western) Financing and Incentive Schemes for Homeownership

Before analyzing the tax treatment of the Islamic home financing schemes above, it will be helpful to lay out the key concepts and incentives involved in conventional Western financing, particularly with respect to home financing. Conventional financing makes a key distinction between debt and equity.[131] With debt financing, the person providing the financing will receive repayment over time of the principal along with interest—either a fixed rate or a variable rate based on market rates—but the financier has no ownership or upside in the asset being financed.[132] Other than the risk of insolvency, the financier is relatively indifferent to the performance of the asset.[133] With equity financing, the financier purchases an ownership stake in the asset and takes on the risks and rewards of the asset.[134] An equity financier will not receive fixed payments, but will receive a proportionate share of any profits or losses generated by the asset.[135] Thus, an equity financier is more keenly interested in the ongoing performance of the asset, as it is directly tied to the performance of the financier's investment.[136] Of course, there are hybrid financial arrangements that retain characteristics of both debt and equity; however, it is useful to start with the two extremes. Furthermore, particularly with regard to taxation, the law continues to maintain an "all-or-nothing" approach to the characterization of a financial instrument as either debt or equity.[137]

1. A Typical Mortgage Financing Transaction

129. *Id*.
130. *Id*.
131. Mohammed Amin, *UK Taxation Of Islamic Finance – Where Are They Now?* 1, Nov. 20, 2006, *available at* http://pwc.blogs.com/islamicfinance/files/uk_taxation_of_islamic_finance_141207.pdf.
132. *Id*.
133. *Id*.
134. *Id*.
135. *Id*.
136. Amin, *supra* note 131.
137. DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS 1017 (CCH 2006).

In a conventional mortgage, the prospective homebuyer applies for a loan from a bank or a mortgage lender.[138] The lender then evaluates the creditworthiness of the prospective homebuyer, using a variety of means, but generally including the income, assets, and reported credit score of the prospective homebuyer.[139] Based on the evaluation, the lender will either accept or deny the prospective homebuyer's application.[140] If accepted, the homebuyer then purchases the home and becomes 100% owner, subject to the mortgage.[141] Over a period of years, the homebuyer makes monthly payments on the mortgage which include payment on both principal and interest, until the entire principal has been repaid.[142] Because the homebuyer is at all times owner of the property, upon the sale of the home, the homeowner is entitled to all of the gain or profit.[143]

2. Tax Incentives in the United States

Over the years, U.S. Congress "has provide[d] substantial financial assistance through the Internal Revenue Code to taxpayers who own and occupy their principal residences."[144] This assistance is designed to further "important non-tax policy objectives such as encouraging investment in community, enhancing the stability of neighborhoods, and increasing the willingness of property owners to fund local schools through property taxes."[145] Understandably, the assistance, which has taken the form of various exclusions and deductions, has been based largely on the model for conventional home ownership and financing through traditional mortgages, as outlined above.[146] Specifically, the U.S. Congress has provided at least three major incentives for encouraging homeownership: (1) the deduction for mortgage interest on a taxpayer's primary residence; (2) the exclusion

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138. SurfRate.com, *Mortgage Application 101*, Jan. 14, 2008, http://www.surfrate.com/compare/home-loans/mortgage-application-101.html.

139. *See id*.

140. PriceWaterhouseCoopers, *Shared Ownership – A New Opportunity in Islamic Finance*, UK REAL ESTATE INSIGHTS, Jan. 2007, at 17, *available at* http://pwc.blogs.com/islamicfinance/files/uk_real_estate_insights_jan_2007.pdf

141. Joanna Slater, *Growing Interest: When Hedge Funds Meet Islamic Finance --- U.S. Firms Hire Scholars To Help Design Products; The 'Rent-a-Sheik' Issue*, Wall St. J., Aug. 9, 2007, at A1 (illustration comparing musharaka to conventional mortgage).

142. *See id*.; *see also* PriceWaterhouseCoopers, *supra* note 140 ("owner . . . [has] 100% beneficial ownership of the asset from the beginning").

143. *Id*.

144. John G. Steinkamp, *A Case for Federal Transfer Taxation*, 55 ARK. L. REV. 1, 32 (2002).

145. *Id*.

146. *See id.* at 32-42.

of the fair rental value of owner-occupied housing ("imputed rental income"); and (3) the exclusion of gain on the sale of a principal residence.[147]

First, the most widely utilized deduction is the qualified residence interest deduction, which allows the deduction for points and interest paid on mortgage used to secure a "qualified residence" (the taxpayer's primary residence and one additional residence).[148] The Internal Revenue Code allows for two different types of mortgages, both of which must be used to secure a qualified residence, that may qualify for interest deduction treatment—acquisition indebtedness and home equity indebtedness. For acquisition indebtedness ("indebtedness which-- (I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and (II) is secured by such residence"),[149] a taxpayer may deduct interest on up to $1 million of such indebtedness.[150] For home equity indebtedness (debt that does not qualify as acquisition indebtedness but is still secured by a qualified residence), a taxpayer may deduct interest on up to $100,000 of such indebtedness.[151]

Second, a "tax benefit of home ownership that often goes unnoticed is that the fair rental value of owner-occupied housing ('imputed rental income') is not included in income for federal income tax purposes."[152] Whereas "an investor in rental property must report the gross rent income that he realizes" from his tenants, a person who purchases a home and then lives in it—effectively becoming the simultaneous owner and tenant—does not have to pay taxes on the income that he is theoretically paying himself in rent.[153] Thus, stated in other terms, "the economic return in the case of an investment in owner-occupied housing is . . . realized . . . through the owner's rent-free personal occupancy."[154] Although there have been proposals to tax this imputed rental income, it is not taxed and is unlikely ever to be taxed.[155] At first glance, this may seem like a somewhat specious benefit,[156] but we

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147. *See id*.

148. *Id*. at 32; I.R.C. § 163(h)(2)(D); I.R.C. § 163(h)(4)(A) (defining a "Qualified Residence").

149. I.R.C. § 163(h)(3)(B)(i).

150. *Id.* § 163(h)(3)(B)(ii).

151. *Id.* § 163(h)(3)(C).

152. Steinkamp, *supra* note 144, at 38.

153. *Id*.

154. *Id*.

155. *See* Comm'r v. Indep. Life Ins. Co., 292 U.S. 371, 378-379 (1934) (holding that a statute did not impose a tax on the rental value of property occupied by its owner and suggesting that if such a tax were enacted it would not be sustained because "[t]he rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment").

156. *See* Thomas Chancellor, *Imputed Income and the Ideal Income Tax*, 67 OR. L. REV. 561, 609 (1988) (concluding that the exclusion of imputed rent is a benefit "[o]nly if one views owner-occupied housing as an investment").

will see the importance of the exclusion of imputed rental income in the case of a diminishing *musharaka* financing arrangement below.

Third, a major tax benefit afforded to homeowners is the exclusion of gain on the sale of a primary residence.[157] Normally, realized capital gains are generally "recognized" (i.e. subject to federal income taxation) when the property is sold or otherwise disposed of in a taxable disposition.[158] However, a special provision in the Code allows most taxpayers to avoid paying federal income tax on capital gains realized when they sell their principal residences.[159] Taxpayers can exclude up to $250,000 ($500,000 in the case of married couples filing joint returns)[160] of capital gains realized in qualifying dispositions of their principal residences, if they meet the two-year ownership and use requirements.[161] This exclusion is substantial, as a married couple that realizes a $500,000 gain on the sale of their principal residence and qualifies for the full exclusion will realize a permanent $75,000 federal tax savings.[162] "Additionally, if that couple purchases another home that also appreciates $500,000, they will be able to make use of the exclusion a second time after satisfying the two-year ownership and use requirements. Indeed, there is no limitation on the number of times taxpayers can utilize this exclusion."[163]

IV. ANALYSIS

A. Application of US Tax Incentive Scheme to Islamic Financing Structures

1. Taxation of *Murabaha*

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157. Steinkamp, *supra* note 144, at 41-42.
158. I.R.C. § 1001(a), (c); I.R.C. § 61; I.R.C. § 63.
159. *Id.* § 121.
160. *Id.* § 121(b).
161. The ownership and use requirements are set forth in I.R.C. § 121(a) ("Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.").
162. This calculation is based on a 15% long-term capital gains tax rate. The Job Growth and Tax Relief Reconciliation Act of 2003 lowered the top long-term capital gains rate from 20% to 15%, the lowest it has been since World War II. Deborah Kobes & Leonard E. Burman, *Preferential Capital Gains Tax Rates*, Jan. 19, 2004, *available at* http://www.taxpolicycenter.org/UploadedPDF/1000588_TaxFacts-011904.pdf [hereinafter Kobes & Burman]. The long-term capital gains rate is not scheduled to increase until after 2010, when it is set to revert back to 20%, barring any future legislation. George G. Jones & Mark A. Luscombe, *Capital Gains Planning: 2010 Sunset Date Begins to Matter*, WebCPA, Aug. 20, 2007, http://www.webcpa.com/article.cfm?articleid=25067.
163. *Id*.

The default comparison for a *murabaha* arrangement would be the traditional installment sale. On the side of the seller, the starting point would be Internal Revenue Code § 453.[164] On the side of the buyer, the tax treatment is trickier. Remembering that the goal is the deductibility of a portion of each installment payment as interest, taking advantage of the allowance of a deduction of interest on indebtedness of a qualified residence, this deductibility is not afforded specific statutory authority in the case of an installment payment where no interest is stated in the contract.[165] Furthermore, courts have held that "[t]he fact that the deferred payment sales price is greater than the cash sale price does not make interest of the difference."[166] Internal Revenue Code § 483 does allow for the characterization of "total unstated interest" in the case of installment sales.[167] However, under § 1275(b), §§ 483 and 1274 are inapplicable to transactions involving the sale or exchange of property which is for personal use (i.e. not substantially used in connection with a trade or business).[168] Thus, a *murabaha* arrangement on a principal residence would be for personal use and § 483 would not apply.

In summary, the *murabaha*, without more, would not be able to take advantage of the interest deduction on home indebtedness for a primary residence. However, the *murabaha*-financed homeowner would still be able to take advantage of the exclusion of imputed rental income as well as the exclusion of gain on the sale of a primary residence. Therefore, the *murabaha* transaction is only somewhat disadvantaged compared to conventional mortgage financing, although the home mortgage interest deduction is generally the largest deduction taken by the majority of itemizing taxpayers and the disadvantage should not be taken lightly. As shown below, though, there are possible ways around this interest problem.

2. Taxation of *Musharaka*

While the *murabaha* arrangement is in a disadvantageous starting position, so too is the *musharaka* agreement. In fact, as this Note will show, the *musharaka* is actually in a much worse position than the *murabaha*. A *musharaka* is essentially a partnership arrangement, which is a shared equity relationship between the financial institution and the homebuyer.[169] Thus, under a conventional Western financial model, at no point does the homebuyer have "indebtedness" on which to

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164. I.R.C. § 453.

165. Kingsford Co. v. Comm'r, 41 T.C. 646, 659 (1964); Elliott Paint & Varnish Co. v. Comm'r, 44 B.T.A. 241, 247 (1941); Appeal of Anderson & Co, 6 B.T.A. 713, 717 (1927).

166. *Elliott Paint*, 44 B.T.A. at 247.

167. I.R.C. § 483.

168. *Id.* § 1275(b).

169. *See supra* Section III(A)(4)(b) .

pay interest, and does not have a deduction.[170] Instead, the monthly payments from the homebuyer to the financial institution represent part increases in the homebuyer's share of the partnership and part rental payments for the use of the property.[171] It is possible under the Internal Revenue Code for a partner to engage in a transaction with a partnership, for instance to rent property from a partnership.[172] In such case, the rent payment would constitute rental income to the partnership, and would not be excludable as compared to imputed rental income in a conventional mortgage-financed situation.[173]

Because under a diminishing *musharaka* agreement, the home is owned by the partnership and not the homebuyer, the gain on the disposition of the asset would not be characterized as a gain on the sale of a principal residence (as it would fail the ownership and use test) and would, thus, not be eligible for the exclusion of gain from the sale under Internal Revenue Code § 121.[174] Worse still, the disposition of rental property from a partnership could be considered a passive activity, which would be subject to a much higher tax rate than a long-term capital gain.[175]

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170. *See supra* Section III(B).

171. *See supra* Section III(A)(4)(b).

172. According to the I.R.S:

> For certain transactions between a partner and his or her partnership, the partner is treated as not being a member of the partnership. These transactions include the following. (1) Performing services for, or transferring property to, a partnership if: (a) There is a related allocation and distribution to a partner, and (b) The entire transaction, when viewed together, is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner. (2) Transferring money or other property to a partnership if: (a) There is a related transfer of money or other property by the partnership to the contributing partner or another partner, and (b) The transfers together are properly characterized as a sale or exchange of property.

I.R.S. Publ'n. 541 (2008), *available at* http://www.irs.gov/publications/p541/ar02.html#d0e1010.

173. *See* I.R.C. § 707(a).

174. The Internal Revenue Service has rejected past attempts to exclude the gain on a sale of a primary residence if the residence was owned by a family limited partnership or partnership, as this arrangement would fail to meet the ownership test of I.R.C. § 121. *See* I.R.S. Priv. Ltr. Rul. 200029046 (Apr. 24, 2000); I.R.S. Priv. Ltr. Rul. 200119014 (Feb. 5, 2001) [hereinafter Private Letter Rulings].

175. Passive activity income does not receive the same favorable long-term capital gains treatment as a gain on the sale of a primary residence. I.R.C. § 469(c)(2), (c)(4). *See generally* Kobes & Burman, *supra* note 162 (for general principles relating to long-term capital gains).

In summary, the *musharaka* agreement would not receive the benefit of any of the tax incentives available to conventional mortgage-financed home owners. Because the homeowner does not pay interest, he is not afforded an interest deduction.[176] Because the homeowner pays rent to the partnership and the rent is not imputed to himself, the partnership and, thus, the homeowner cannot take advantage of the exclusion on imputed rental income.[177] Finally, because the property is owned by the partnership and not the individual homeowner, the homeowner cannot qualify for the exclusion of gain on the sale of a primary residence.[178] In short, the *musharaka* partner/homeowner is at a virtually complete tax disadvantage in comparison to conventional mortgage-financed homeowners.

B. The US Solution: Common Law Method for Avoiding Taxation and the Substance Over Form Doctrine

Above, this Note illustrated the tax disadvantages of an Islamic home finance transaction compared to a conventional mortgage-financed transaction. A taxpayer in the United States who wishes to overcome these tax disadvantages does have some recourse under the tax laws.[179] However, such a taxpayer does not have a specific statutory basis for accomplishing such a goal, but must instead rely on the "substance over form" doctrine, whereby the taxpayer asserts that the economic substance of the transaction is different from the form of the transaction, and thus, the tax treatment should be based on the substance of the transaction and not the form.[180]

A fundamental principle of the U.S. Federal income tax law is that taxation should be based upon the substance, and not the form, of transactions.[181] Yet, while the Commissioner is entitled to invoke this principle (for instance, in order to overrule sham transactions), a taxpayer's ability to do so is problematic.[182] At times the courts have accepted a taxpayer's assertion of the priority of substance. At other times, however, they have concluded that a taxpayer is bound by the form of his transaction.

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176. *See supra* Section III(B).

177. *Id*.

178. *See* Private Letter Rulings, *supra* note 174.

179. Kevin Conway & Suzanne Feese, *The Tax Dilemma in Islamic Finance*, INT'L TAX REV., July/Aug. 2007, at 20-21, *available at* http://apps.kslaw.com/Library/publication/InternationalTaxReview_IslamicFinance.pdf.

180. *Id*. at 21.

181. 1 BITTKER & LOKKEN, FED. TAXATION OF INCOME, ESTATES & GIFTS ¶ 4.3.3 (2d ed. 1989).

182. *Id*; *See, e.g.,* Comm'r v. Brown, 325 F.2d 313 (9th Cir. 1962) (refusing to consider a portion of the purchase price of a sale as constituting interest where the agreement of the parties was for a price without interest).

Traditionally, the starting position for any U.S. tax analysis of a transaction is the form of the transaction.[183] However, it is possible in some cases for a taxpayer to challenge the form of a transaction.[184] In such cases, the key for the taxpayer in successfully challenging the form of the transaction is to demonstrate that, in fact, the form of the transaction does not comport with its substance.[185] Yet, in many instances, a taxpayer may have an uphill battle to prove that the economic substance of a transaction varies from the form, or worse still, the taxpayer may be precluded from challenging the form of a transaction entirely.[186]

One such barrier to deviating from the form of a transaction is the so-called Danielson rule. The Danielson rule is a judicially-developed doctrine which holds that a taxpayer generally may not introduce evidence in a tax case that challenges the plain meaning of documents to which the taxpayer is a party, unless the evidence would be admissible in an action between the taxpayer and a party to the contract to alter the terms of the agreement or to demonstrate unenforceability due to mistake, undue influence, fraud, or duress.[187] The Danielson rule has been followed in several cases.[188]

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183. Conway & Feese, *supra* note 179, at 21.

184. *See, e.g.,* Comm'r v. F & R Lazarus & Co., 308 U.S. 252 (1939). There, the Court accepted a taxpayer's argument that what was in form a sale and leaseback of property for 99 years with an option to renew and purchase should in substance be treated as a mortgage loan, so that the taxpayer lessee was entitled to claim the depreciation deductions, again acknowledging that "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." *Id.* at 255. Importantly, in so concluding, the Court looked to extrinsic evidence and not the terms of the documents which apparently were absolute on their face. *Id*.

See also Comm'r v. Tex-Penn Oil Co., 300 U.S. 481 (1937). There, where a corporation and certain of its shareholders simultaneously sold their respective interests in certain leases to the same buyer, the Court permitted the corporate taxpayer to prove that, despite stated allocations in the documents, the transfer by the taxpayer of all of his assets to a new company was solely for stock so that it was entitled to tax-free reorganization treatment and that the cash stated to be receivable by it, in substance, was consideration attributable to the selling shareholders. *Id.*

185. *See* Taiyo Hawaii Co. v. Comm'r, 108 T.C. 590, 603 (1997) ("Petitioner has not shown that the form of the transaction did not comport with its substance").

186. *See* Bittker & Lokken, *supra* note 181, ¶ 4.3.3.

187. Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967) ("a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.").

188. *See* Comm'r v. Nat'l Alfalfa Dehydrating Milling Co., 417 U.S. 134, 137 (1974) ("while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, . . . and may not enjoy the benefit of some other route he may have chosen to follow but did

"Other courts, principally following the lead of the Tax Court, have adopted a taxpayer-favorable variation of the Danielson rule."[189] Under this rule, a taxpayer may introduce evidence inconsistent with a written agreement if there is "strong proof" that the substance of the transaction was inconsistent with the plain reading of the documents to which the taxpayer is a party.[190] Strong proof requires a showing of somewhat more than a preponderance of the evidence and somewhat less than the Danielson test.[191]

There is additional room for hope in proving substance over form for Islamic financial transactions. A number of cases in the debt/equity area take the position that the characterization of indebtedness as equity is purely a matter of substance over form and that, in such circumstances, the general rule that the taxpayer may not challenge the form in which a transaction is cast does not apply.[192] These cases add weight to the argument that so long as the taxpayer is arguing that the form of the transaction does not reflect its substance, the taxpayer may, in fact, challenge the form of a transaction.[193]

As the above cases illustrate, there is no shortage of attempts to reclassify certain transactions (particularly in terms of debt versus equity) in order to obtain favorable tax treatment. Further, as the reader will see, the United States is not the only country to wrestle with the distinction between debt and equity, and particularly the desire by taxpayers to have transactions with equity characteristics treated as debt to obtain favorable tax treatment. However, in the case of Islamic Finance – where the prohibition of *riba* eliminates an entire subset of financiers from the ability to take advantage of the deduction on interest without resorting to form over substance shenanigans – at least one country has made the prudent step toward putting these financiers on equal footing through statutory recognition and treatment of certain Islamic financial transactions.[194]

C. The UK Solution: Statutory Recognition of Islamic Financing Structures

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not." (citation omitted)); Johnson v. Comm'r, 720 F.2d 963, 964 (7th Cir. 1983) ("The taxpayer, having made his bed, must lie in it."); Don E. Williams Co. v. Comm., 429 US 569, 580 (1977) ("We do not indulge in speculating how the transaction might have been recast with a different tax result.").

189. 11 MERTENS LAW OF FED. INCOME TAX'N § 43:237 (2008).

190. *See, e.g.,* Schmitz v. Comm'r, 51 T.C. 306, 316 (1968), *aff'd sub nom.* Throndson v. Comm'r, 457 F.2d 1022 (9th Cir. 1972); *see also* Harvey Radio Labs., Inc. v. Comm'r, 470 F.2d 118, 119 (1st Cir. 1972).

191. *See* MERTENS *supra* note 189.

192. *See* J.A. Tobin Constr. Co. v. Comm'r, 85 T.C. 1005, 1022 (1985) (indicating that the substance-over-form test may be met when there is reliable indicia that the intrinsic economic nature of the transaction is in fact debt); *see also* Georgia-Pacific Corp. v. Comm'r, 63 T.C. 790, 798 (1975); LDS, Inc. v. Comm'r, T.C. Memo. 1986-293 (1986).

193. *See* MERTENS *supra* note 189.

194. *See* Amin, *supra* note 131, at 7-9.

1. Home Finance

While the United Kingdom does not provide a personal mortgage deduction, until 2003 the UK tax law still provided an obstacle to the competitiveness of Islamic mortgages that were structured as *murabaha*.[195] In the United Kingdom, the government charges a Stamp Duty on the sale of every property.[196] Because a *murabaha* transaction involves two sales (one to the bank and another to the home purchaser), Islamic mortgages were being double-taxed.[197] To resolve this issue, "the Financial Services Authority ("FSA")—[UK's equivalent of the Internal Revenue Service]—created a working group comprised of regulators, Shari'ah scholars, bankers, accountants, lawyers, and representatives of Muslim communities . . . [to discuss] how to integrate Islamic financing transactions into the English legal framework."[198] The result was a limited exemption from the Stamp Duty for "alternative property finance," which cancelled the double taxation of *murabaha*-structured mortgages.[199] The legislation was a success: in July 2002, only one financial institution in the UK offered Islamic mortgages; by the end of 2005, there were five banks in the UK offering Islamic mortgages.[200]

2. Interest on Business Debts

As in the United States, in the United Kingdom interest on business debts is deductible and therefore it is advantageous to attempt to classify any financing arrangement as debt rather than equity, in order to obtain tax relief.[201] Again, as in the United States, in the United Kingdom there are a number of different tax rules designed to prevent this, of which probably the most important in this context is found in the Income and Corporation Taxes Act of 1988 § 209(2)(e)(iii).[202] This states that any interest paid on "securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company's business or any part of it" is a distribution, which means

195. BBC, Sharia-compliant Mortgages, http://www.bbc.co.uk/religion/religions/islam/living/mortgages.shtml (last accessed Sept. 8, 2008).

196. *Id*.

197. *Id*. "Although the bank will normally own the house only for a moment, this suffices to trigger transfer taxes . . . under UK tax laws." Bälz, *supra* note 71, at 562.

198. *Id.* at 563.

199. Finance Act, 2003, c. 14, § 73 (Eng.).

200. BBC, *supra* note 195.

201. *See* Amin, *supra* note 131, at 1-2 (discussing deductibility of interest expense).

202. *Id*.; Income and Corporation Taxes Act, 1988, Ch. 1, § 209 (Eng.).

that it is not tax deductible and is treated instead as if it were a dividend payment to an equity provider.[203]

Recently, in response to the increase in demand for Islamic financial products and the creation of stand-alone Islamic Banks,[204] the United Kingdom created statutory authority for specific tax treatments of "alternative finance arrangements," which encompass Islamic Finance.[205] The statutory authority for tax treatment of such arrangements is contained within the Finance Act of 2005, §§ 46-57 inclusive and Schedule 2, which received royal assent on April 7, 2005,[206] as well as the amendments under the Finance Act of 2007.[207] The approach to such transactions is that the transactions must meet certain conditions if the profit elements are to receive the same beneficial tax treatment for UK tax purposes.[208] The goal is that the return on Islamic financial transactions is characterized as interest for tax purposes, and would thus be deductible by the payor, as opposed to a payment on capital, which would not receive such favorable tax treatment.[209]

If the transaction in question meets the conditions within §§ 46 to 57 of the Finance Act of 2005, then the return is characterized as alternative finance return, profit share return, or additional payments, each of which receive the same beneficial tax treatment as interest.[210] The conditions that must be satisfied are as follows: one of the parties to the arrangements must be a financial institution; the arrangements must be of the type and nature described in the legislation; and the alternative finance return or the profit share return must "equate, in substance, a return on investment of money at interest."[211] As to the first condition, a financial institution includes a bank, a UK building society, a wholly-owned subsidiary of the foregoing, certain persons authorized to carry on consumer credit or hire business in the UK or a non-UK person authorized to take deposits or other repayable funds from the public and grant credit on its own account.[212] If all of these conditions are met, then it is possible, with specific statutory authority, for several Islamic finance models, including *murabaha* and *musharaka*, to receive the same treatment as a traditional debt instrument (i.e. deductibility of interest/alternative finance return).[213]

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203. Income and Corporation Taxes Act 1988, Ch. 1, § 209 (Eng.).

204. "London has become the largest international center for Islamic finance outside the Muslim world . . . . The British government has been an active driver of this growth . . . . [T]he Islamic mortgage market, . . . by 2006, was valued at $950 million." Dr. Theodore Karasik, Frederic Wehrey & Steven Strom, *Islamic Finance in a Global Context: Opportunities and Challenges*, 7 CHI. J. INT'L L. 379, 389 (2007).

205. Finance Act, 2005, c. 7, § 46 (Eng.).

206. Finance Act, 2005, c. 7, §§ 46-57 & sched. 2 (Eng.).

207. Finance Act, 2007, c. 11, §§ 53-54 (Eng.).

208. Conway & Feese, *supra* note 179, at 21.

209. *See* Amin, *supra* note 131, at 8.

210. See *id.* at 8.

211. *Id.* at 7-8.

212. Finance Act, 2005, c. 7, § 46(2) (Eng.).

213. Amin, *supra* note 131, at 9-11.

In the case of a *murabaha* arrangement, the *murabaha* will fall within the Finance Act of 2005, Chapter 7 § 47 if it meets certain conditions. In order to fall under § 47, a financial institution[214] must purchase an asset (for the purpose of entering into a purchase and re-sale arrangement)[215] and then sell the asset to another person (at a markup).[216] At least part of the sale price must be payable on a deferred basis,[217] and "the difference between the sale price and the [re-sale] price equates, in substance, to the return on an investment of money at interest."[218] If the above conditions are met, the deferred installment payments will be deemed to include alternative finance return equal to the interest that would have been included in the installment if the effective return were the total interest payable on an arm's length loan by the financial institution to the person of an amount equal to the purchase price, and the installment were part repayment of the principal with interest.[219]

In the case of a *musharaka* arrangement, a *musharaka* will fall within the Finance Act of 2005, Chapter 7, § 47A (Alternative Finance Arrangements: Diminishing Shared Ownership) if it meets certain conditions.[220] A *musharaka* will be covered under the act if "(a) a financial institution acquires a beneficial interest in an asset, and (b) another person ("the eventual owner") – (i) also acquires a beneficial interest in the asset."[221]

> The eventual owner: (ii) is to make payments to the financial institution amounting in aggregate to the consideration paid for the acquisition of its beneficial interest, (iii) is to acquire the financial institution's beneficial interest (whether or not in stages) as a result of those payments, (iv) is to make other payments to the financial institution (whether in pursuance of a lease forming part of the arrangements, or otherwise), and (v) has the exclusive right to occupy or otherwise use the asset and (vi) is exclusively entitled to any income, profit or gain arising from or attributable to the asset (including, in particular, any increase in the asset's value).[222]

If the above conditions are met, § 47(A)(6) provides that such an arrangement will not be considered a partnership for tax purposes,[223] and that any payments that do

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214. Finance Act, 2005, ch. 7, § 47(1)(a) & (2)(a) (Eng.).
215. *Id*. § 47(2)(b).
216. *Id*. § 47(1)(b).
217. *Id.* § 47(1)(c).
218. *Id.* § 47(1)(d).
219. *Id.* § 47(7) & (8).
220. *Id*. § 47(A)
221. *Id.* § 47(A)(1).
222. *Id.*
223. *Id.* § 47(A)(6).

not constitute payments toward principal or "payments in respect of any arrangement fee or legal or other costs or expenses which the eventual owner is required under the arrangements to pay," will be considered alternative finance return.[224]

V. CONCLUSION

The variance in methods for tax treatment provides an excellent example of the precarious balance between being able to provide meaningful Shariah-compliant financial products (legitimacy) and being able to grow and offer Shariah-compliant products to a wide range of potential buyers by being competitive with conventional financial products (efficiency). Starting with the assumption that Islamic finance is more than the mere avoidance of specified prohibitions, and embodies a risk and profit sharing model that is a true alternative to Western commercial structures, it is clear that some Islamic financial structures are closer to embodying the ideal than others. Looking at the two structures outlined above, *murabaha* and *musharaka*, in the context of a home mortgage the *musharaka* is a more ideal risk and profit sharing arrangement. Of course, both models have been certified as Shariah-compliant and are offered in the United States.[225] However, while ownership is shared in both the *murabaha* and *musharaka*, in the *murabaha* approach, ownership is not simultaneous but sequential. Furthermore, under a *murabaha*, the financial institution owns the asset for a short period, and theoretically, could hold the asset for a mere instant before transferring ownership to the ultimate purchaser.[226] Thus, while a *murabaha* is Shariah-compliant, a *musharaka* arrangement, in which the financial institution and the ultimate purchaser enter into a partnership, more closely embodies the principles of risk and profit sharing.

Conversely, a *murabaha* arrangement is easier than the *musharaka* to implement in the United States because it is closer to the Western model, and thus easier to manipulate in order to obtain favorable tax treatment. It is an axiom of law and economics that the further a transaction strays from the default rules, the more transaction costs increase.[227] This can be thought of in two ways: first, legal and advisory fees increase due to the need for protection in absence of a default rule; and second, the probability of adverse results and rulings increase, and costs

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224. *Id.* § 47(A)(5).

225. *See supra* note 95 regarding U.S. financial institutions with Islamic financial product offerings.

226. *See* EL-GAMAL, *supra* note 17, at 67-68.

227. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 93 (1989) ("Lawmakers can minimize the costs of contracting by choosing the default that most parties would have wanted. If there are transaction costs of explicitly contracting on a contingency, the parties may prefer to leave the contract incomplete.").

associated with risk increase.[228] In this sense, a *murabaha* arrangement presumably would incur less transaction costs than a *musharaka*, allowing the *murabaha* to be more competitive with traditional mortgages than a *musharaka* from a purely cost-driven perspective. Thus, the conflict between the *murabaha* and the *musharaka* agreements, whereby the former is more efficient and competitive with conventional financial products and the latter is less efficient but more legitimate in terms of keeping with the fundamental ideals of Islamic Finance, illustrates a central tension in the growth of Islamic Finance, particularly in non-Muslim countries.

While the growth of Islamic Finance in the last four decades has been remarkable, the industry still faces many challenges. Islamic Finance represents a positive way in which Muslims can assert their identity and fulfill their ideals of living according to the Sharia. As such, the growth of Islamic Finance should be embraced and encouraged, not only in Islamic countries, but in Western countries that uphold the ideas of freedom of religion and pluralistic society. Further, Islamic Finance is a profitable endeavor, and in many ways—particularly the avoidance of risky or speculative investments as well as economic parity—could be considered superior to modes of conventional financing. Therefore, Western countries should seek to understand Islamic Finance and should proactively find ways to reduce the regulatory and legislative burden to allow for the growth of Islamic Finance. The United Kingdom has already taken several proactive steps—one of which has been illustrated in this Note—toward embracing Islamic Finance. Other Western countries would be wise to follow its lead.

228. *Id*. at 92-93.