Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999. pp.215-224

Islamic Finance in Malaysia

A Tax Perspective

Walid Hegazy*

ABSTRACT

In order to promote the role of Islamic finance in their robust economy, Malaysian lawmakers have passed several pieces of legislation providing incentives for the users of Islamic financial instruments and abetting the creation of a competitive, innovative, and active Islamic financial market. The Malaysian tax laws were recently amended to address the tax treatment of Islamic financial instruments. This article examines these amendments in an attempt to evaluate the efforts of the Malaysian tax legislator to provide the practice of Islamic finance with a suitable tax environment. In addition, this article offers an introductory analysis of the tax treatments of various Islamic financial instruments in Malaysia. It concludes that Islamic financial instruments deserve special tax treatment, and that the tax amendments discussed are too general to handle the diverse structures of Islamic financial instruments.

I. INTRODUCTION

Throughout the 1990s, Malaysia has enjoyed a robust economy joined by a high sustainable growth. This economic growth has set the Malaysian financial market as one of the world's most attractive markets. Islamic banks, along with conventional[i] banks, have participated actively in achieving this high rate of growth.[ii]

In order to promote the role of Islamic finance in the economy, Malaysian lawmakers have passed several pieces of legislation providing incentives for the users of Islamic financial instruments. Constant revision of banking, investment, and tax legislation was introduced to create a competitive, innovative and active Islamic financial market.[iii] For example, in 1983, the Islamic Banking Act (IBA) was passed to regulate the practice of Islamic modes of finance.

In 1993, the Malaysian central bank, Bank Negara, introduced new guidelines on the Interest-Free Banking Scheme (IFBS). The IFBS, in essence, is an open invitation for conventional banks in Malaysia to participate in the Islamic financial market. As a result of this policy, approximately 40 conventional banks are now offering Islamic financial instruments within their own framework.

More recently, tax laws were amended to address the tax treatment of Islamic financial instruments. This article examines these amendments in an attempt to evaluate the efforts of the Malaysian tax legislator to provide the practice of Islamic finance with a suitable tax environment. In addition, this article offers an introductory analysis of the tax treatments of various Islamic financial instruments in Malaysia. However, it is appropriate first to give a brief background of Islamic finance as a new and modern phenomenon.

II. ISLAMIC FINANCE: GENERAL BACKGROUND

Islamic finance is the application of different contractual and financial techniques to mobilize funds in the economy according to the principles of Islamic law. The criterion used to judge whether a transaction conforms to Islamic rules is the extent to which it involves one of the following "evils":

1. *riba* (interest);
2. *gharar* (speculative risk);
3. *akl al-mal bil-batil* (unjust enrichment); and
4. *ghubn* (damage, injury, fraud, lesion).

The contemporary history of financial institutions in most Muslim countries can be divided into three overlapping stages: imitation, disguise, and renaissance.[iv]

---

* Hegazy is a doctoral candidate at Harvard Law School in Cambridge, Mass.

The first stage began after the demise of the Ottoman Empire and continued into the colonial period. An effort in Muslim societies to mimic Western financial techniques, without any consideration for the pre-existing social, economic and cultural institutions, is observed.

During the second stage, Islamic financial institutions that emerged after the post-independence movements tended to cloak unchanged Western financial instruments in Islamic garb by using Islamic names. In short, there was no concrete effort to change the actual environment in which such Islamic practices were to be implemented.

The third stage is still in its formative course. There exists a sincere effort to return to true Islamic economic practices through new exploration of traditional Islamic financial doctrines. Also, there have been efforts to probe into modern and sophisticated financial techniques used by Western institutions.

Currently, Malaysia is considered to be in transition between the second and third stage. Attempts to reach the third stage are evident in the government's efforts to furnish Islamic financial institutions with appropriate tax regulations.

III. Amendments Addressing Islamic Finance

Malaysian tax legislators introduced different amendments to address the tax treatment of Islamic financial instruments. The amended tax laws are the Income Tax Act 1967 (ITA), the Stamp Act 1949 (SDA) and the Real Property Gains Tax (RPGT) Act 1976. The amendments are attempts by the Malaysian tax legislator to remove tax discrimination between the application of conventional instruments and Islamic instruments. These amendments and their impact on the tax treatment of Islamic instruments are examined below.

A. Amendments to the Income Tax Act

Section 2(7) was included as a new provision to address the tax treatment of Islamic income and income generated from Islamic financial instruments. Section 2(7) of the ITA states that:

> Any reference in this act to interest shall apply, *mutatis mutandis*, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah.[v]

Section 2(7) affects the tax treatment of Islamic income from the charging, deduction, tax exemption, and withholding tax perspectives.

First, the charging section of the ITA, Section 4, defines the scope of charge of the ITA as follows:

> Subject to this Act, the income upon which tax is chargeable under this Act in respect of:
>
> (a) gains or profits from a business, for whatever period of time carried on;
> (b) gains or profits from an employment;
> (c) dividends; interest or discount;
> (d) rent, royalties or premium;
> (e) pensions, annuities or other periodical payments not falling under any of the foregoing paragraphs;
> (f) and gains or profits not falling under any of the foregoing paragraphs.

Prior to the amendment of Section 2(7), profits or gains received from Islamic investments were covered under Section 4(a) in the case of business income. Gains or profits derived from a non-business Islamic source were taxed under Section 4(f) because they did not fall under any other categories. After the amendment of Section 2(7), gains or profits from Islamic business sources are still taxed under Section 4(a), while gains or profits from non-business Islamic sources are now taxed under Section 4(c) and are given the same treatment of non-business interest income.

Second, according to Section 33(1), a person can deduct from his gross income from a source all outgoings and expenses wholly and exclusively incurred in the production of that income from that source.[vi] Interest expenses are specified in Section 33(1)(a) as deductible expenses if the money borrowed is employed in the production of gross income from that source, or laid out on assets, or used or held for the production for that income from that source. Similar to interest expenses and based on Section 2(7), expenses incurred in producing income from Islamic sources (or "Islamic financing expenses") are tax deductible. Therefore, a person can deduct from his gross income from an Islamic financial instrument, all outgoings and expenses wholly and exclusively incurred during the production of that income from that instrument. Even prior to the introduction of Section 2(7), "Islamic income expenses" were covered under the general language of Section 33(1). In addition, as a result of Section 2(7), the restriction of Section 33(2) will apply to the deductibility of "Islamic financing expenses"; hence, if the money or asset obtained through Islamic financial instruments for business purposes is partly used for non-business operations, only the expenses on the portion used for the business can be deductible against gross income, and the other proportion of expenses applicable to the non-business operations is deductible against gross income from that non-business source.[vii]

Deductibility of "Islamic financing expenses" is also subject to the 1989 guidelines issued by the Inland Revenue Department on the application of interest restrictions and the deductibility of interest expense. Applying the guidelines on "Islamic financing expenses," funds or assets obtained through Islamic financing will be divided into income producing sources and non-income producing sources. Deductibility of such expenses will be restricted to income producing sources. Also, according to the guidelines, expenses on Islamic income will be restricted if any part of the financed funds or assets is reinvested for non-business purposes. The following formula will be used in calculating the amount of restricted "Islamic financing expenses":

Amount of restricted "Islamic financing expenses" =

$$\frac{[A \times B]}{C}$$

Where:

A	=	funds used for non-business purposes
B	=	monthly installment[viii]
C	=	total amount of Islamic funds or assets

Third, from the tax exemption perspective, gains or profits from an Islamic source are granted the same exemptions applicable to interest income such as:[ix]

1. the exemption granted in respect of interest from savings certificates issued by the government;
2. the exemption granted in respect of interest earned by a non-resident from banks and finance companies licensed under the Banking and Financial Institutions Act, 1989 (BAFIA)—this exemption is important given that conventional banks, regulated under the BAFIA, are now allowed to offer Islamic instruments; and
3. the exemption granted to "approved loans" which include among other items:
   a. loans or credits made to, or guaranteed by, the government, or a state government; and
   b. loans made by any person in an amount exceeding MYR 250 million.

Also, gains or profits from Islamic sources are subject to special income tax exemptions including:

1. profits from a deposit of MYR 5,000 deposited in any savings account with Bank Islam Malaysia Berhad (BIMB) granted by the Income Tax (Exemption)(No. 4) Order 1989; and
2. with effect from the 1997 year of assessment, exemption in respect of gains or profits from (i) a deposit of MYR 100,000 in any savings account for a calendar year, or (ii) a deposit in any investment account for a period not exceeding 12 months, under the IFBS with a bank or finance company licensed under the BAFIA or the IBA.

Fourth, according to the ITA, interest derived from Malaysia and paid or credited to a non-resident is subject to a 20% tax withholding deducted from interest. Interest paid to a resident is subject to 5% tax withholding. After the amendment of Section 2(7), this rule is applicable to gains and profits from Islamic sources.

B. Amendments to the Stamp Duty Act

Stamp duties are imposed on a large number of documents and contracts including a charge or a mortgage, and a conveyance, assignment or transfer. Generally, stamp duties are imposed on an *ad valorem* basis although specific stamp duties are levied on certain documents.

Item 32 of the First Schedule SDA lists the *ad valorem* rates levied on a conveyance, assignment, or sale; Item 27, on a charge or mortgage.[x] The tax base for a conveyance, assignment or sale is the value of the consideration or the market value of the property concerned; for a charge or mortgage, the amount of the financing or loan. The *ad valorem* rates for a charge or mortgage are generally lower.

Most of the Islamic financing in Malaysia involves back-to-back sale contracts. For instance, a *bai‘ bi-thaman ajil* (BBA) transaction is done in two steps: first, the Islamic financier purchases a property from the customer for cash price, and second, sells the same property back to the customer for a deferred higher price. In an attempt to streamline the tax treatment of both conventional financial instruments and Islamic financial instruments, the SDA was amended. Section 14A states that:

> Where it is shown that a principal or primary security secures the repayment of moneys provided under a scheme of financing made according to the Syariah, duty chargeable thereon shall be calculated on the principal amount provided by the financier or financing body.

Section 14A is effective from 1 October 1989; accordingly, Item 27 of the First Schedule was also amended to include an "agreement for financing under the Syariah." This means that Islamic financial instruments are treated in the same way as their counterpart conventional financial instruments, i.e. as a charge or mortgage rather than as a conveyance, assignment or sale.[xi]

In addition, with effect from 1 January 1996, the stamp duty on Islamic hire-purchase agreements is restricted to a fixed rate stamp duty of MYR 3.

To encourage the use of Islamic financial instruments, effective 1 January 1996, all instruments executed in connection with the conversion from conventional financing to Islamic financing are exempt from stamp duty taxes.

C. Amendments to the Real Property Gains Tax Act

According to the RPGT Act 1976, gains derived from the disposal of real property, or the disposal of shares in real property companies, are subject to RPGT. However, if the taxpayer's business is dealing in property, his gains from such business are subject to income tax and not RPGT.

In order to increase the attractiveness of the Islamic financial system, paragraph 3(g) was inserted into Schedule 2 of the RPGT Act to exempt the gains from the disposal of real property, as defined, by a person (i.e. customer) to an Islamic bank where that person is being financed by that bank "in accordance with Syariah."

However, the RPGT Act does not state whether the disposal of the same real property back to the customer, in the context of, say, a BBA transaction, is also exempt from RPGT. It could be argued that the BBA transaction should also be treated in the same manner as a charge or mortgage.[xii] Accordingly, the difference in price between the two sale contracts (representing the bank's profits) should be taxed under the ITA as business income and should not be subject to RPGT.[xiii]

IV. Current Tax Treatment of Islamic Financial Instruments

From a tax perspective, the prevailing Islamic instruments in Malaysia can be divided into three different categories:

1. instruments based on the concept of sale: Islamic sale contracts such as *bai‘ bi-thaman ajil* (credit sale), *murabaha* (mark-plus sale) and *istisna'* (pre-manufacturing sale);
2. instruments based on the concept of lease: Islamic lease contracts such as *ijara* (lease) and *ijara wa l-iqtina'* (hire purchase agreement); and
3. instruments based on the concept of partnership: Islamic partnership contracts such as *musharaka* (partnership) and *mudaraba* (sleeping partnership).

A. Islamic Sale Contracts

This category includes primarily three important contracts: BBA, *murabaha*, and *istisna'*. Significantly, more than 90% of Islamic financing in Malaysia is structured under BBA and *murabaha* contracts.

<u>1. General</u>

a. Bai‘ Bi-thaman Ajil

A BBA is a deferred payment sale under which a financier sells a product or equipment to one of its customers for a deferred price, usually higher than the market price, to be paid in the future on an installment basis or as a lump sum. In practice, however, many Islamic banks in Malaysia use a special structure of BBA as a legal artifice, Hila, to circumvent the prohibition of *riba*. This BBA structure involves a double sale in which a bank purchases a product from its customer for cash and then resells the same product back to the customer for a higher price on credit. It is clear that the aim of using this legal artifice is to achieve an unlawful result, that is, lending on interest. This structure is very similar to a type of sale known in Islamic doctrine as bay' al-'inah, which is prohibited under the Hanafi, Maliki, and Hanbali schools.[xiv]

> Example 1
> Mohammed Rafi who owns a piece of land (L) approaches Bank of Islam (BOI) to finance the construction of a MYR 1,000,000 textile factory on (L). BOI agrees to finance the construction of the textile factory under a BBA arrangement. According to this arrangement, BOI purchases (L) from Mohammed for MYR 1,000,000 paid in cash. Then BOI sells (L) back to Mohammed for MYR 1,200,000 to be paid in the future on an installment basis. In this BBA transaction, BOI earned a total amount of MYR 200,000 as profits, while Mohammed's expenses or costs of financing are MYR 200,000.

b. Murabaha

Murabaha is a mark-plus sale in which a bank acquires a specified product for the purpose of reselling it to one of its customers for a price that reflects the cost of acquiring the product plus a reasonable amount of profits for the bank. Usually, *murabaha* is associated with a BBA contract. This simple form of *murabaha* exposes the bank to great risk if the customer refuses to fulfil his promise to buy the product. To overcome this problem, a more practical form of *murabaha* known as *murabaha lil al-amer bil shira'* has developed. According to this arrangement, the customer is bound by his promise to buy the product from the bank. If the customer fails to fulfil his obligation to buy the product, it will have to compensate the bank for whatever damages are caused by its refusal to purchase the product. In most modern *murabaha*, banks pass their obligations arising from ownership to their customers.

> Example 2
> Mohammed Rafi approaches BOI to finance the purchase of specific textile equipment under the terms of *murabaha*. BOI purchases the specified equipment from the market for MYR 100,000. Subsequently, BOI resells the equipment to Mohammed, after adding to the price the shipping expenses plus a marginal amount of profits, for MYR 120,000 to be paid on an installment basis. In this *murabaha*, BOI's profits are MYR 20,000, while Mohammed's costs of financing are MYR 20,000.

c. Istisna'

Istisna' is a transaction in which a person (i.e. the buyer) places an order with a manufacturer (i.e. the seller) to produce, build or manufacture a specified product in exchange for a predetermined price. Once the product is manufactured according to specifications, the buyer will be bound to pay the manufacturer the predetermined price.[xv] It should be noted that the manufacturer might appoint or assign others to manufacture the product. The interest-free bank can play either the role of a money supplier or a manufacturer on behalf of its clients.

Istisna' aids in financing industrial projects by serving as a legal vehicle for the sale of future products, which is otherwise forbidden in Islam. Recently, some scholars such as Zarqa, Al-Salous and Zohiaili, have emphasized the significant role of *istisna'* as an additional long-term financial instrument.

> Example 3
> Mohammed Rafi approaches BOI to finance the construction of a housing complex for the workers of his textile factory. The total cost of the project is assumed to be MYR 1,000,000. BOI agrees to finance the project under the terms of *istisna'* in exchange for MYR 1,200,000. BOI appoints the Malaysia Engineering Company (MEC) to construct the complex for the price of MYR 1,000,000. After completion of the complex, Mohammed acquires the complex and pays BOI MYR 1,200,000 on an installment basis. Usually, the buyer pays at the beginning of the contract a small part of the price, 10% to 20%, as an advance payment to the bank.

2. Income tax

a. The Position of the Financier

As mentioned above,[xvi] Section 2(7) ITA grants profits and gains derived from conducting transactions in accordance with Islamic principles the same treatment as interest income.[xvii] Therefore, according to Section 4(a) ITA, the profits made by BOI in Examples 1, 2, and 3 will be taxed at the rate of 30% of chargeable income.

b. The Position of the Customer

According to Section 2(7) ITA, expenses incurred in producing income from Islamic investments are given the same treatment of interest expenses under the ITA. According to Section 33(1)(a) and Section 33(2), interest payment on borrowed money is a deductible expense if it is employed in the basis period in the production of gross income or laid out on the purchase of assets used, or held, for the production of gross income. As a result, Mohammed Rafi can deduct from his gross income the amount of money incurred as expenses in conducting any of the above-mentioned transactions provided that the conditions of Section 33(1)(a) and Section 33(2) are satisfied.[xviii]

In calculating the cost of financing, or the expenses that are deductible from the gross income from the relevant instrument, the following methods can be used:

1. In Example 1, the financing expenses consist of the difference between the price of (L) charged by the seller BOI in the second purchase agreement and the financing price paid for (L) by BOI in the first agreement.

   BBA's deductible financing expenses =
   Sale price – financing price =
   MYR 1,200,000 – MYR 1,000,000 =
   MYR 200,000

Mohammed Rafi, the buyer, can deduct MYR 200,000 as financing expenses incurred from producing business income from the textile factory.

2. In Example 2, the deductible expenses incurred by Mohammed Rafi, the buyer, is MYR 20,000 which is equivalent to the markup margin paid over the market price of the equipment.

   Murabaha's deductible financing expenses =
   Mark-plus price – market price =
   MYR 120,000 – MYR 100,000 =
   MYR 20,000

3. In Example 3, the deductible expenses will be the difference between the manufacturer price charged by the BOI and the cost price paid to MEC, the construction company, for the product.

   *Istisna'*s deductible financing expenses =
   Manufacturer price – cost price =
   MYR 1,200,000 – MYR 1,000,000 =
   MYR 200,000

3. Stamp Duty

In Example 1, the BBA transaction is considered to be an "agreement for financing under the Syariah." Accordingly, the stamp duty on this transaction is levied under Item 27 of the First Schedule SDA, and it will be imposed on the financing price (i.e. MYR 1,000,000). No further duties will be imposed on this transaction. The same rule is applicable to Examples 2 and 3.

4. Real Property Gains Tax

As mentioned above,[xix] the RPGT Act was amended to exempt the disposal of an asset by a customer to an Islamic bank under the financial scheme "in accordance with the Syariah law."[xx] Furthermore, in Example 1, it is arguable that BOI's gains from the disposal of (L) to the customer will also be exempt from RPGT, and they will be regarded as business income subject to income tax under the ITA.

B. Islamic Leasing Contracts

The category includes two important contracts: *ijara* and *ijara wa l-iqtina'* (hire-purchase agreement).

1. General

a. Ijara

According to most schools of thought, *ijara* is a contract under which a person (i.e. lessor) leases to another (i.e. lessee) a corporeal and determined object.[xxi]

Example 4

BOI leases ten agricultural machines worth MYR 1,000,000 to the Farming Company (FC) for a ten-year period against MYR 80,000 paid annually over the leasing period on an installment basis.

b. Ijara Wa l-Iqtina'

Ijara wa l-iqtina', known also as hire-purchase contract, is a lease with an option for the lessee to buy the leased object at the end of the leasing period. In practice, the lessor invests the installment amount in a portfolio account to allow the lessee to use the profits of this account to purchase the leased object at the end of the leasing period.

Example 5

BOI leases MYR 1,500,000 worth of agricultural machines to FC for a ten-year period against an annual rental of MYR 70,000. BOI keeps MYR 50,000 as rent and invests the remaining MYR 20,000 for FC in its leasing portfolio. This amount is invested according to *mudaraba* terms under which BOI is entitled to 30% of the profits and the other 70% is FC's share of profits. The average return on this investment is 10%. By the end of the ten-year rental period, FC will have paid an amount of MYR 500,000 as total rent. In addition, the investment account will have made MYR 200,000, the total return on investment during the ten-year period. This MYR 200,000 will be shared as MYR 140,000 for FC and MYR 60,000 for BOI.

FC's total payment =
Total rent + return from *mudaraba* account =
MYR 500,000 + MYR 140,000 =
MYR 640,000

If FC decides to exercise the option to buy the leased machines, it will need to pay another MYR 110,000 (i.e. MYR 750,000[xxii] – MYR 640,000).

2. Income Tax

In general, leasing income received by an individual or a company, of which the scope of business does not include leasing, is taxed under Section 4(d) ITA. Leasing income received by a leasing company is taxed under Section 4(a) ITA as business income at the rate of 30%. Before the amendment of Section 2(7), leasing income received by a financial institution, not in the leasing business, was taxed as non-business income under Section 4(d).

Section 2(7) ITA provides that gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah, are treated in the same way as interest income. Therefore, leasing income or expenses received or incurred by a financial institution from conducting *ijara* or *ijara wa l-iqtina'* should be taxed under Section 4(a) as business income.

a. The Position of the Lessor

Before the inclusion of Section 2(7), BOI's leasing income was assessed under Section 4(d). Accordingly, the expenses incurred in producing that income were deductible from that leasing income alone. Based on Section 2(7), BOI's leasing income from *ijara* and *ijara wa l-iqtina'* is treated as business income and, therefore, assessed under Section 4(a). There are two important consequences for considering leasing income as business income—where leasing income is assessed as non-business income, the lessor cannot carry forward losses to offset against income of subsequent years; in addition, the lessor cannot claim capital allowances.

b. The Position of the Lessee

In Example 4, Mohammed Rafi is allowed to deduct the rentals against his income from FC, for which the leased assets were used provided that the conditions of Section 33(1) are satisfied.

According to the theoretical model of *ijara wa l-iqtina'*, the lessee is not obligated to purchase the leased asset at the end of the leasing period. Assuming that case in Example 5, Mohammed Rafi will be allowed to deduct the rentals against his business income provided that the conditions of Section 33(1) are satisfied. In practice, however, some hire purchase agreements contain provisions to eliminate or minimize the lessee's option to refuse to purchase the leased asset at the end of the leasing period. In these types of hire-purchase agreements, the lessor loses the right to depreciate the leased assets.[xxiii]

<u>3. Stamp Duty</u>

If *ijara* is considered to be an "agreement for financing under the Syariah," stamp duty is levied under Item 27 of the First Schedule SDA.

A fixed duty of MYR 3 is levied on *ijara wa l-iqtina'*.

C. Islamic Partnership Contracts

<u>1. General</u>

a. Musharaka

This is a mode of financing based on equity participation in which the partners jointly use their capital to generate profits. The partners freely decide the percentage of profit or loss to be shared. Unlike *mudaraba*, *musharaka* allows both parties to participate in the management of the partnership. Currently, *musharaka* is not an attractive mode of financing for Islamic banks. According to the principles of *musharaka*, the partner providing the capital, the financier, cannot demand collateral to guarantee his capital. This exposes Islamic banks to the risk of losing their capital in case the company fails.

> <u>Example 6</u>
> Mohammed Rafi and BOI enter into a *musharaka* agreement to form a joint company for producing agricultural products. Under the terms of the agreement, BOI provides MYR 500,000, which is 100% of the capital required to found and operate the company. Mohammed Rafi, on the other hand, provides the land on which the company is to be established. The profits generated from the company are to be shared between Mohammed Rafi and BOI in the ratio of 65% and 35%.

b. Mudaraba

This is a sleeping partnership in which the supplier of capital gets to share a specific percentage with the entrepreneur or user of capital. The user of capital uses his expertise, ideas, or skills to maximize profits. In case of losses, however, the supplier of capital will have to share in these losses whereas the user of capital provides his time and effort. The bank can act as both the supplier of capital on one side and user of capital on the other side. Similar to *musharaka*, *mudaraba* implies profit- and loss-sharing between the financier (sahib al mal), the bank in this case, and the entrepreneur (*mudarib*)—a relationship not admitting a demand for collateral.[xxiv]

> <u>Example 7</u>
> Mohammed Rafi decides to invest an amount of MYR 2,000,000 in a *mudaraba* account with his bank BOI for a one-year period. Profits generated from the *mudaraba* account are to be shared between BOI and Mohammed Rafi in the ratio of 30% and 70%. At the end of the year, the return on the account was a total amount of MYR 500,000. BOI's share is 150,000, while Mohammed Rafi's share is 350,000.

<u>2. Income tax</u>

a. Musharaka

The ITA does not treat a partnership as a separate taxable entity. Consequently, each partner will be assessed separately on his share of the partnership income. The partner's share will be computed under Section 55(5) ITA. BOI can argue that the partnership constitutes an instrument of financing in accordance with Syariah. Therefore, according to Section 2(7), the profits received in respect of that instrument should be treated as interest income for ITA purposes. Based on the same argument, Mohammed Rafi, the customer, can claim the right to treat the expenses incurred in this transaction as deductible interest expenses.

b. Mudaraba

The MYR 150,000 of profit received by BOI will be treated as interest business income and therefore taxed at a rate of 30%.

The tax treatment of the MYR 350,000 of profit received by Mohammed Rafi will vary as follows:

1. If Mohammed Rafi is a non-resident individual and BOI is a bank or a finance company licensed under the BAFIA, the income will be exempt from any taxes.
2. If Mohammed Rafi is a resident individual and the MYR 2,000,000 were invested in a savings account for a calendar year under the IFBS, only the interestdividend (i.e. return) attributable to the principal sum of MYR 1,900,000[xxv] is taxable under Section 4(c) as non-business income as follows:

Principal amount	MYR 1,900,000
Taxable return @ 25%	MYR 475,000
Mohammed Rafi's share of taxable return @ 70%	MYR 332,500

3. If Mohammed Rafi is a resident individual and the MYR 2,000,000 were invested in an investment account for a period not exceeding 12 months under the IFBS, the return from this investment will be exempt from income tax.

3. Stamp Duty

If the *musharaka* and *mudaraba* contracts in Examples 6 and 7 are considered to be "agreement[s] for financing under the Syariah," stamp duties should be levied under Item 27 of the First Schedule SDA.

V. CONCLUSION

In spite of existing difficulties, Islamic finance has grown rapidly within a very short period. The main challenge for Islamic finance as a new phenomenon is the lack of integration between its theoretical background and its implementation. In other words, Islamic finance suffers from the lack of a comprehensive strategy to connect theory with practice by providing the proper environment in which it can expand.

Islamic financial instruments are genuine alternatives to interest-bearing financial instruments based on economic equity, justice, and social-moral values. The function of these alternatives requires the implementation of a distinctive framework, including banking and tax regulations. Each Islamic financial instrument needs to be examined differently from the accounting and tax perspectives.

Malaysia has undergone important steps to provide Islamic finance with appropriate banking and tax regulations. These regulations have succeeded in presenting the Islamic financial system as a strong competitor to the conventional financial system.

However, the tax amendments that address Islamic finance are rather too general to handle the diverse structures of Islamic financial instruments. Islamic financial instruments deserve special tax treatment which cannot be provided through general provisions such as Section 2(7) ITA or Section 14A SDA.[xxvi] For example, Section 2(7) does not provide a special treatment for Islamic financial instruments; rather, it ignores the different and inherent nature of Islamic instruments by treating them in the same manner as interest-bearing instruments.

[i] Or "secular."

[ii] Malaysia has a dual banking system, which consists of Islamic banks and conventional banks.

[iii] Pakistan is another example of an innovative Islamic financial market.

[iv] The practice of Islamic banking in modern times is approximately 30 years old. The first Islamic bank was established in a small town in Egypt called Mit Ghamr in 1963. This bank worked as a social welfare organization of which the basic tools were interest-free loans granted to the poor when faced with exceptional expenses caused by illness, weddings, or funerals. Saleh, Nabil, *Unlawful Gain and Legitimate Profit in Islamic Law* (London: Graham & Trotman, 1992), at 108.

[v] Editorial note: This is the spelling used in Malaysia's legislation, although the spelling is *Shari'ah* in the general literature.

[vi] Sec. 33 provides that:

(1) Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including –
    (a) subject to subsection (2), any sum payable for that period (or for any part of that period) by way of interest upon any money borrowed by that person and
        (i) employed in that period in the production of gross income from that source; or
        (ii) laid out on assets used or held in that period for the production of gross income from that source;
    (b) rent payable for that period (or for any part of that period) by that person in respect of any land or building or part thereof occupied by him in that period for the purpose of producing gross income from that source ...

[vii] Singh, Veerinderjeet. Malaysian Taxation, Administrative & Technical Aspects (Malaysia: Longman, 1993), at 504.

[viii] In most popular Islamic financial instruments, financing expenses are paid on an installment basis.

[ix] Such exemptions were not available for customers of Islamic finance before the inception of Section 2(7).

[x] This includes an agreement for a charge or mortgage, especially in the case when the security is a piece of real property for which separate title has not been issued.

[xi] According to the explanation of Sec. 14A SDA provided by Fadzil Yusoff, the General Manager of BIMB, the stamp duty will be imposed only once on the amount stated in the first agreement (i.e. the financing price) and not on the amount stated in the second purchase agreement (i.e. the sale price = the financing price + the bank's profits). Yusoff, Fadzil, "The Legal Aspects of Islamic Banking in Malaysia," *Symposium of the Malaysian Experience in Islamic Banking* (Kuwait: March 1996), at 12.

[xii] This is the treatment accorded by the SDA. *Supra* III.B.

[xiii] *Supra* III.A.

[xiv] The Shafi'i is the only school that allows this sale by focusing on the validity of the form and disregarding the intention of the parties. Al-Mawsu'ah Al-Fiohiyah, Chapter 9, *Wazarat, Al-Awqaf wa-al-Shuun al-Islamiyah*, 1993, at 95-97.

[xv] According to Abu Yusif, a Hanafi scholar, *istisna'* is a binding contract for both parties.

[xvi] *Supra* III.A.

[xvii] Gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Islamic law are accorded the same treatment as interest earned or incurred for the purposes of Sec. 4(a) and Sec. 4(c), as the case may be.

[xviii] These conditions are: that the money borrowed is employed in the basis period in the production of gross income from that source; or that the money borrowed is laid out on assets used or held in that period for the production of gross income from that source.

[xix] *Supra* III.C.

[xx] Sched. 2, Para. 3(g) RPGT Act.

[xxi] Ibn Rushd considers Ijara as a sale of usufruct of a corporeal object for a specific period. See *supra* note 4, at 120.

[xxii] The machines are depreciated at the rate of 5% p.a. Hence, MYR 1,500,000 – [5% p.a. x 10 years x MYR 1,500,000] = MYR 750,000.

[xxiii] In Pakistan, a depreciation is allowed to the lessee on the initial value of the assets (the amount for which the assets would have been sold for cash).

[xxiv] For instance, Faisal Islamic Bank in Egypt commonly financed projects during the 1980s through *Mudaraba* contracts. Because the *mudarib* did not have to guarantee the acquired funds, Faisal Bank was often

deceived by the *mudarib* into taking full responsibility for a loss whenever the latter claimed that the invested capital had been lost. As a result of numerous losses during the 1980s, Faisal Bank shifted from using *Mudaraba* contracts to Murabaha contracts, which were considered less precarious.

[xxv] Being MYR 2,000,000 – MYR 100,000.

[xxvi] In this regard, Pakistan can serve as a model for other countries to follow. The Pakistani legislator was aware of the need to address Islamic financial instruments on a detailed level. For example, the Pakistani Income Tax Ordinance, 1979 contains special provisions addressing the income tax treatment of some Islamic instruments, such as *Mudaraba* and Ijara.