IRTI Working Paper Series

WP# 1436

Revisiting Estimation Methods of Business Zakat and Related Tax Incentives

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Muharram 1436H | November, 2014

ISLAMIC RESEARCH AND TRAINING INSTITUTE
A MEMBER OF THE ISLAMIC DEVELOPMENT BANK GROUP

Islamic Economics and Finance Research Division

IRTI Working Paper 1436

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Abstract

The available zakat accounting standards as well as laws governing business zakat reflect a sort of consensus that adjusted net working capital of a business may be regarded as the base for computation of zakat liability. The second accepted alternative is the adjusted growth capital which essentially arrives at the same outcome, given the accounting equality between total assets and total liabilities and equity in the balance sheet of a business organization. The apparent consensus follows from fiqhi prescription of imposing zakat on urud al-tijarah or the inventory of goods available for trade. Some recent contributions to Islamic economics however, question the rationale underlying this method and argue that the objectives of the Shariah are better met by seeking recourse to alternative methods of zakat determination for business organizations. The present paper revisits the relevant issues. In the context of the Malaysian system of tax incentives, the paper also examines some suggested reforms.

JEL Classification Codes: H410, L310, L510, H200
Keywords: Philanthropic Institutions, Regulation, Governance, Taxation

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Revisiting Estimation Methods of Business Zakat and Related Tax Incentives [1]

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1. Introduction

Urud al-tijarah, according to Islamic jurists implies business inventory. There seems to be a consensus on treating business inventory as the zakat base for determination of zakat liability of a business organization. The consensus is rooted in a general agreement that many well-known Shariah scholars and jurists seem to have on this issue. Dr Yusuf Qaradhawi in chapter 4 of his treatise Fiqh Al-Zakat provides an exhaustive discussion on the evidence from the primary sources of Islamic law – the Quran and the Sunnah in favor of zakatability of business inventory and the existence of consensus (ijma) among the companions and followers of the Prophet (pbuh) on this issue. The views of the scholars are also reflected in the various laws of zakat and accounting standards that are currently in place to compute business zakat. While zakat laws in most countries are somewhat general in nature and leave the specifics of zakat determination to rules and regulations to be formulated later by designated state apparatus, in a few countries like Saudi Arabia, Pakistan and Sudan, zakat laws have explicitly covered the issue of business zakat. Following the laws, rules and regulations, standard setting bodies have issued accounting standards for computation of business zakat. The Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Malaysian Accounting Standards Board (MASB) have released FAS9 and FRS i-1 respectively for computation and reporting of zakat for Islamic financial institutions. For businesses in general, the Saudi Organization of Certified Public Accountants (SOCPA) and the Malaysian Accounting Standards Board (MASB) have released an Accounting Standard (AS-013) and a Technical Release (TR i-1) for zakat respectively. While the former deals primarily with reporting and disclosure, the latter explicitly identifies the adjusted net working capital of a business as the base for computation of zakat liability. The second accepted alternative is the adjusted growth capital which essentially arrives at the same outcome, given the accounting equality between total assets and total liabilities and equity in the balance sheet of a business organization. At the same time, some Islamic economists believe that the issue is far from settled. Khan (2013) argues that this approach does not handle the issue of zakat on business firms in a comprehensive manner and may lead to outcomes that run contrary to th objectives (maqasid) of Shariah itself. He suggests alternative ways of computing business zakat using net profits or total assets as zakat base. The latter suggestion is backed by Kahf

[1] This paper has been presented at the International Muamalat Entrepreneurship Conference (IMEC2014) held at Shah Alam, Malaysia on November 08, 2014

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(1989). Khan (2013) in fact raises a more fundamental question on the correctness of treating zakat laws as devotional laws with little room for change. In contrast he argues in favor of treating them as transactional laws and modify them in the light of contemporary realities. Other Islamic economists, such as, Sadeq (2002) and Zarqa (1997) have raised similar concerns in the past on the need for redefinition of several rules of zakat. While we generally empathize with their concerns, we subject the specific suggestions in the context of business zakat to scrutiny in terms of economic rationality and consistency in this paper. A common error made in the context of zakat is to undertake a comparison at a conceptual level with income tax and seek full or partial concessions on this basis. We revisit some of the suggestions made in this regard in the Malaysian context. The rest of the paper is organized as follows. Section 2 presents the basis and some relevant rules of zakat as presented by Qaradhawi and the so-called “orthodox” school. Section 3 examines some suggested alternative methods of computing business zakat. Section 4 presents a summary of the laws of zakat as they related to businesses. Section 5 presents a summary of accounting pronouncements related to business zakat. Section 6 takes a look at provision of tax benefits to incentivize zakat payment and examine a few suggestions in this regard. Section 7 concludes.

2. Fiqhi Basis of Business Zakat

Islamic jurists, such as, Qaradhawi see urud al-tijarah as the basis for levying business zakat. Urud al-tijarah, according to Islamic jurists implies business inventory, which means any commodities obtained for the purpose of resale for profit, except liquid monetary assets. Some jurists define 'urud al tijarah as anything that one buys in order to sell for profit. The following is the evidence from the Qur'an, the Sunnah and Ijma for zakat obligation on business inventory.

2.1. Evidence from Sources of Law

The holy Quran says: "O ye who believe, give of the good things which ye have honorably earned, and of the fruits of the earth which we have produced for you." (2: 267). Scholars interpret the words 'that you have earned' as things earned by means of trade, and the words 'that we have produced from the earth for you' as things earned by means of agriculture. This is supported by other verses about zakat that are general and therefore, include business assets, such as the verse: "and on their wealth and possessions there is the right for he who asked and he who is deprived," (51:19); and "Out of their goods take sadaqah so by it thou might purify and sanctify them." (9:103)

An often quoted tradition provides evidence for considering inventory of goods for sale as zakat base for businesses. Abu Daud reports from Samurah bin Jundub that " the Prophet (p) used to order us to pay al sadaqah out of what we have for sale." (Mukhtasar Al Sunan, Vol. 2, p.175)

Some other reports regarding practices of the companions are equally explanatory. Abu 'Ubaid reports from 'Abd al Qari, "I was appointed as treasurer at the time of 'Umar bin al Khattab. When the time of collection came, he used to calculate the assets of merchants, both present and absent assets, and then take zakat on them all, out of the assets that were present." (Al Muhalla, Vol. 6, p.34) There is a report from Abi 'Amr bin Hammas, from his father, who said "'Umar passed by me and said, 'Oh Hammas, pay the zakat due on your wealth.' I answered, I have no wealth except hides and bags.' 'Umar replied, 'Evaluate them and pay the zakat due on them.” (al Umm of al Shafi'i, Vol. 2, p. 38, Sunan al Baihaqi, Vol. 4, p.147) The author of al Mughni comments that "the likes of such a story are common, and none of the Companions negate this ruling, which implies a sort of ijma' on this matter." (Al Mughni, Vol. 3. p. 35) Al Baihaqi and Ibn Hazm report from Ibn 'Umar that "There is no zakat on housewares and cloths, except when they are used for trade." (Al Muhalla, Vol. 5, p. 234, and al Sunan al Kubra, Vol. 4, p. 147) Abu 'Ubaid also reports the obligation of zakat on trade from Ibn 'Abbas. (Al Amwal, p. 426) Abu 'Ubaid says, "all Muslims unanimously agree that trade assets are zakatable, and no other opinion is attributed to any of the knowledgeable people." (Al Amwal, p. 429)

2.2. Other Rules Governing Business Zakat

The following additional rules are derived by Islamic jurists regarding business zakat as compiled by Qaradhawi.

a. Trade assets are commodities obtained for the purpose of selling for profit. Changing the intention from selling for profit to personal use of an item would remove its zakatability. (Radd al Muhtar, Vol. 2, p. 19)
b. There should be no duplication in zakat on any item in one single zakat year, since the Prophet (p) said "There should be no duplication in sadaqah." (Al Amwal, p. 375)
c. Abu Ubaid reports the ways of calculating zakat as perceived by some of the great Followers. He quotes Maimun bin Mahran as saying, "When zakat is due, calculate the amount of money, add to it the value of inventory and the amount of debts on customers that you expect to be paid, sum the total, deduct whatever debts you owe to others and pay zakat on the net." Al Hasan al Basri says, "When zakat is due, one must add the amount of money, plus the value of inventory, plus the amount of debts, except the amount of hopeless debts, and pay zakat on the total." Ibrahim al Nakha'i indicates that one must evaluate one's trade assets and pay their zakat along with zakat due on one's other holdings." (Al Amwal, p. 426)
d. Fixed assets are not subject to zakat. The saying narrated by Samurah states that "the Prophet (p) used to ordain us to pay the sadaqah on what we designate for sale." Consequently, it is said that containers, cages, scales, machinery and tools are not included in zakatability. (Fath al Qadir, Vol. 1, p. 527)
e. There are multiple views on how to price of inventory for zakat purposes: The majority's view is to use current prices on the due dates of zakat. This is also reported from the Follower Jabir bin Zaid: Evaluation is done at the prices of the day zakat becomes due. Ibn Abbas is reported to have said that "It is allright to wait untill the merchandise is sold, and then the due zakat is paid according to the actual proceeds."(Al Amwal, p. 426) A third view is reported by Ibn Rushd without attribution to any specific jurist, which is to appraise the inventory at its purchase price.(Bidayad al Mujtahid, Vol. 1, p.260)

f. There are multiple views on whether to pay zakat in kind or in value. However, the view of Ibn Taimiyah is quite useful. When he was asked whether a merchant could pay zakat in kind or not, and he answered, "That depends. Some people say it is paid in kind always, others say it should always be in value, while the third opinion says it depends which is most beneficial and convenient method of payment for the payer, the receiver, and the collector in each particular case." "The last view, he continues, seems to be the most fair, i.e., zakat be paid in kind when it benefits the poor most or paid in value when this is better for him." (Fatawa Ibn Taimiyah, Vol. 1, p.299)
g. There are also the general conditions of zakatability, which are the same as those of zakatability of money, i.e. nisab, the passage of one full lunar year, the absence of debts and similar liabilities, and being in excess of essential needs.

3. Alternative Views on Basis of Business Zakat

Dr Qaradhawi belongs to what may be termed as the "orthodox" school which treats zakat as a form of devotional law *(`ibadah).* Therefore, the form and procedural details must remain intact as handed down. However, contemporary Islamic economists, such as, Akram Khan (2013) argue that zakat should be classified as a transactional law and not a devotional law. He is supported by other scholars [e.g. Sadeq (2002), and Zarqa (2007)] who have emphasized the need for ijtehad in the law of zakat. As Khan points out:

"Orthodox scholars oppose any reconsideration of the *zakah* law. The maximum concession they make is to accept *ijtehad* in cases that are not explicitly covered in the Qur'an or Traditions of the Prophet. While there is no doubt that the Traditions have sanctity, the Prophet made some decisions as head of state in a certain temporal context.' As a first step we should carefully identify the context of the Prophet's decisions. For decisions taken in the context of his own time, we should think of present-day solutions even though we find explicit Traditions of the Prophet available on the subject. This may appear iconoclastic but is necessary in achieving the overall objectives of the *Shari'ah.* A blind application of the Traditions can defeat the objectives of the *Shari'ah* itself."

Khan disagrees with the classical view of considering inventory or urud-al-tijarah as the zakat base. According to him, this approach does not handle the issue of *zakah* on business firms in a comprehensive manner. Some of the issues raised by him are as follows. First, there is the practical problem associated with valuation of inventory. There are several methods familiar to accountants (such as LIFO, FIFO, average and so on), and each of these would provide a different zakat base. However, we feel this can be easily resolved through appropriate accounting standards relating to valuation of inventory. As discussed before, Islamic jurists have voted in favor of alternative bases for inventory valuation, e.g. on the basis of prevailing market price, cost of acquiring the assets. Standard accountancy textbooks tell us that each of these methods have pros and cons and one of these may be used consistently.

Second, Khan asserts that there is no sound reason why zakat on business should be treated differently from zakat on agriculture. While, zakat on agriculture is on the output or income, zakat on business, according to the classical view, is on current assets irrespective of whether the business is profitable or not. It is perhaps unfair to impose zakat liability on a business even though it is incurring losses.

This suggestion seems to take a rather narrow view of the financials of a business organization restricting its wealth to the current year earnings. To be fair, similar to individual savings, “corporate savings” should also be zakatable and this brings us back to adjusted growth capital that would give same result as adjusted net current assets based on urud-al-tijarah. Agriculture in the traditional sense does not involve similar issues. Land itself is non-zakatable while the output is zakatable as and when it is reaped. If the farmer is able to meet all its life-expenses and able to hold a surplus for over a year (hawl), the same will be zakatable as individual savings. Of course, if agriculture is undertaken as a business, it should be treated as such for zakat purposes.

Third, Khan asserts that there is no sound basis for exempting fixed assets from zakat and imposing the same on current assets, while the fact remains that the business concern generates profit by use of all resources and not just by current assets. This also seems to backed by the view of Monzer Kahf (1989), a well-known contemporary scholar of the Fiqh of Zakat and the translator of Qaradhawi’s celebrated book on the subject.

There is merit in incentivizing productive investments or creation of productive assets. Given that tools of trade in a micro-economy have always been deemed free from zakat liability, there should be no issue in treating large plants, equipments and other fixed assets as non-zakatable in a modern large economy. There is also merit in disincentivizing individual savings (the component that takes the form of hoarding and not what gets transformed into productive assets) as well as corporate savings that is in the form of working capital. Such savings both at individual and corporate levels may take the form of or encourage unproductive hoarding, thereby, bringing down the economic efficiency of the individual, the organization and the economy.

The fairness, consistency or the lack of these inherent in the orthodox position may perhaps be explained better with a simplified model of a business organization. Let us say, a business firm is set up with its total assets in Year 0 valued at TA. We make the following assumptions:

- TA is financed entirely through Equity (EQ), with zero financial leverage.
- Current assets (CA) in the beginning are x percentage of TA (CA/TA= x)
- There are no current liabilities.
- The firm generates an ROA (=ROE) of k percent for n years.
- The firm has a 100% payout policy for n years.

It follows from the above that our firm would now experience zero growth in Profits (P = k*TA)

The zakat base every year under the three positions would be as follows:

1. Current Profits = P = k*TA
2. Total Assets = TA
3. Current Assets = CA = x*TA = x*EQ

The first position relies on an analogy with traditional agriculture where zakat base is equal to the current output net of costs or net profits (P). According to this traditional view of agriculture, land is cost-free (TA = 0) and zakat-free. If this assumption regarding traditional agriculture holds good, P as the zakat base will be a gross understatement. Indeed if agriculture is undertaken as a business, rules of the game will change.

The second position where zakat base is equal to TA is an overstatement. Shariah does provide exemption to the fixed assets and the basis for treating the CA only as zakatable is proved by the primary sources of fiqh as well as ijma of the companions.

Therefore, the third position where zakat base is equal to CA = x*TA = x*EQ is sound. It is not too difficult to find an economic rationale to this rule. Now that the firm management may reduce its zakat liability by using its current assets more efficiently it will be inclined to push x downwards over subsequent time periods. It will seek to reduce its investment in inventory by avoiding "unethical" hoarding and by enhancing its efficiency in all its operations – procurement, production and marketing. The operating cycle will tend to become shorter. Every dollar investment in CA will tend to generate more Sales (S). A higher current assets turnover (S/CA) will lead to an improvement in total assets turnover (S/TA) and eventually to a higher ROA and ROE. Given that ROA = P/TA = P/S (Profit Margin) * S/TA (Asset Turnover), the outcome of "subjecting CA and not TA to zakat" will be an improvement in operational efficiency and profitability of the business.

4. What the Laws Say about Business Zakat

Zakat laws in most countries are somewhat general in nature and leave the specifics of zakat determination to rules and regulations to be formulated later by designated state apparatus. In a few countries like Saudi Arabia, Pakistan and Sudan, zakat laws have explicitly covered the issue of business zakat.

4.1. Singapore: In Singapore, Sections 68-70 of the Administration of Muslim Law Act (2005) deal with zakat management by entrusting the task to the Majlis Ugama Islam Singapura (MUIS). Section 68 makes it obligatory on all Muslims in Singapore to pay zakat in accordance with the provisions of this Act. The next section empowers the Majlis to make rules for and regulate all matters in connection with the collection, administration and distribution of zakat; make rules to prescribe from time to time the amount of zakat to be paid by all Muslims in Singapore; and to provide for the method by which zakat shall be collected.

4.2. Indonesia: In Indonesia, the Zakat Act 2011 is a comprehensive law that treats zakat as a voluntary payment by the zakat payer. Article 21 of the law states that the zakat payer can either do self calculation of zakat obligation or seek help of the national zakat body

BAZNAS to calculate zakat obligation. Article 22 states that zakat paid to BAZNAS is deductable to taxable income.

4.3. Qatar: Qatar has a dedicated law for zakat that treats zakat as a voluntary payment. The law No. 8 of 1992 essentially creates a Fund that will receive zakat funds and other donations. It is silent on the method of computation of zakat. The law is more concerned about zakat utilization. It creates a separate account assigned for Zakat funds and stipulates that withdrawal from these funds shall be exclusively for lawful zakat expenditures. Further, the payer, donator or grantor of zakat funds may decide the aspect to which he would like his paid funds to be applied.

Saudi Arabia and Kuwait are the handful of countries in the world to have fully integrated zakat with income tax.

4.4. Kuwait: In Kuwait the "Law no. (46) of 2006 concerning zakat and contribution of public and closed shareholding companies in the state's budget" governs both zakat and income tax together. According to Article 1 of the Law, the Kuwaiti shareholding companies (closed) have to pay 1 % from their annual net profits to the state. Further, this Law allows these companies, when submitting the declarations of the due amount accompanied with their financial statements, to specify the percentage of zakat from the paid sum. There is no stipulation concerning the method of zakat computation and it is left to the company to decide what percentage of its due amount is to be contributed in the form of zakat and the balance as income tax.

4.5. Saudi Arabia: According to Saudi law, all business entities must register with the Department of Zakat and Income Tax (DZIT) under the Ministry of Finance and thus, are subjected to zakat. Zakat payable is computed on the net worth of natural or legal entities as 2.5 percent of zakat base (capital, retained earnings, certain reserves and net profits but excluding fixed assets) subject to fulfillment of conditions relating to threshold (Nisab) and continuous ownership for over one lunar year (Hawl). The zakat base is thus, equal to adjusted net working capital.

4.6. Pakistan: In Pakistan the Zakat and Ushr Ordinance, 1980 made zakat compulsory. However, it differentiated between two kinds of assets. On the first category of assets (Schedule 1) that are in the nature of financial assets, such as, bank deposits, unit trusts, government and corporate bonds, zakat is deducted compulsorily once a year at the rate of 2.5 percent on specified assets . Regarding all other zakatable assets including stock-in-trade of commercial undertakings, gold, silver, agricultural produce, precious metals (Schedule 2), the zakat payers are expected to pay zakat on-self-assessment basis to the zakat fund or to other eligible beneficiaries (mustahqueen). Zakat payable on stock-in-trade or inventory is calculated as 2.5% of the book value or of the market value (at the option of the zakat payer), as on the valuation date. Article 25 of the law provides certain tax concessions and asserts that "notwithstanding anything contained in any other law for the time being in force - in determining the tax liability of an assessee for an assessment year - under the Income Tax Ordinance, 1979 (XXXI of 1979), his total income shall be reduced by the amount paid by him to a Zakat Fund, during the income year relevant to that assessment year.

4.7. Sudan: In Sudan, the Zakat Act 2001 has made zakar compulsory (Article 16-1). For jointly held assets, such as, in case of business organization, zakat is levied on the property as a whole when it reaches the nisab (Article 17-2). Article 19 of the Act further states that zakat shall be levied on merchandize or trade inventory , after deduction of such obligations as may be specified by the regulations at the rate of 2.5%. Other conditions, such as, related to hawl, nisab will apply. Art.48 of the Act provides for tax-deduction of zakat paid. It states "when estimating the income tax of any person the zakat paid shall be deducted from his property assessed for income tax."

4.8. Malaysia: Zakat management like all religious matters in Malaysia is the reponsibility of each of its thirteen states and a prerogative of its ruler (sultan). Each state in Malaysia is empowered to enact its laws for governing Islamic matters including zakat. Consequently, the legal and regulatory environment and the institutional infrastructure that takes shape, displays great diversity. Table 1 below provides a snapshot of various laws governing Islamic matters in general and zakat in particular in the Malaysian states.

A major step in the institutionalization of zakat management in Malaysia has been the establishment of Zakat Centers as organised and professional bodies in several States as subsidiaries of the respective State Islamic Religious Councils. The establishment of the Zakat Collection Center Wilayah Persekutuan Kuala Lumpur (PPZ-MAIWP) in 1991, followed by the Selangor Zakat Center (PZS-MAIS) in 1992, the Pulau Pinang Zakat Management Center (PUZ-PP) in 1994, the Pahang Zakat Center (PZ-MAIP) and the Melaka Zakat Center (PZM) in 1996 and the Negeri Sembilan Zakat Center (PZ-MAINS) in 1998 have been major milestones for the professionalization of the zakat sector in Malaysia. However, not all States have embraced the idea of establishing Zakat Collection and Distribution Centers as organised and professional bodie. Six States (Kedah, Perlis, Kelantan, Terengganu, Perak and Johor) still maintain the conventional approach of managing zakat. For example in the State of Kedah, zakat management is controlled by a Department of Zakat which directly under the supervision of the Sultan. In other States, zakat management of the particular States are directly controlled by the Baitul-mal of the State Islamic Religious Council.

The diversity in law as well as in the infrastructure across the states in Malaysia has led to divergent zakat practices, especially in the matter of determination of business zakat. A study by Mohamed Abdul Wahab et al. (1995) found three methods of business zakat estimation being practiced in various states and institutions in Malaysia - current assets only; current assets plus profits from investments; and net working capital plus current profits. Another study by Nasir and Hassan (2005) with a similar objective found at least five methods recommended by zakat centers for companies to calculate the amount of their corporate zakat: the net assets (or working capital), net equity (growth model), net profit after tax, combined methods, and dividend methods.

Table 1: Zakat Laws in Malaysia

STATES	REGULATIONS ON ZAKAT
Wilayah Persekutuan	Administration of Islamic Law (Fitr & Zakat) Act 1952 & Administration of Islamic Law (Federal States) Act 1993
Selangor	Administration of Islamic Law (State of Selangor 2012) Enactment
Johor	Administration of Islamic (State of Johor) Enactment 2003
Perak	Administration of Islamic Law Enactment 1992
P.Pinang	Fitr and Zakat Collection Rules Pulau Pinang 1979
Pahang	Zakat & Fitr Methods 1970
Kelantan	State Religious Council & Enactment Majlis Agama Islam & Adat Melayu 1953
Kedah	Kedah Zakat Rules 1982
Malacca	Administration of Islamic Law Enactment Malacca 1959
Perlis	Administration of Islamic Law Enactment Perlis 1950

5. Accounting Pronouncements Relating to Business Zakat

Of the various pronouncements and standards released so far with respect to accounting for business zakat, four are worth mentioning. Two of these relate to zakat accounting for Islamic financial institutions. The first is the Financial Accounting Standard for zakat (FAS 9) released by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), a Bahrain-based accounting and auditing standard-setting body in 1999. The second is the "Financial Reporting Standard: Presentation of Financial Statements of Islamic Financial Institutions" (FRS i-1) released by the Malaysian Accounting Standard Board (MASB). The other two related to zakat accounting for businesses and companies in general. Saudi Arabia is also the first country to have formulated an Accounting Standard for Zakat (AS-013), issued by the Saudi Organization of Certified Public Accountants (SOCPA) in 1999. This was followed by a Technical Release (TR i-1) released by the MASB in 2006.

5.1. FAS 9: The FAS 9 by AAOIFI deals with three main areas: determining the zakat base, measuring the items included in the zakat base, and disclosing the amount of zakat in the Islamic bank's financial statements. It proposes two methods of zakat measurement: the net assets (net current assets) and the net invested funds (net owner equity) methods. The first method considers all cash, receivables net of doubtful debts, assets acquired for trading, and net financing assets (excluding unearned income) to be assets. Fixed assets and long-term investments are excluded. Thus, the zakatable amount is all assets minus the fixed assets, intangibles, current liabilities, and long-term investments. Under the second method, the invested funds include paid-up capital, reserves, general provisions (investment risks), retained earnings, net income, and long-term liabilities. Thus, the zakatable amount is total funds minus the net fixed assets, investment not acquired for trading, and any losses. With regards to assets valuation, paragraph 5 of this standard recommends that the cash equivalent value serve as the basis of valuing zakatable assets. Both the methods should lead to same outcome.

5.2. FRS i-1: The FRS i-1 by MASB focuses on presenting an IFI's financial statements that pays zakat. Thus, it merely includes definition of zakat, the provision of zakat as part of other liabilities and highlights the need for IFIs to disclose their zakat obligations.

5.3. AS-013: The AS-013 by SOCPA provides guidance on the recognition, measurement and presentation and disclosure of zakat by entities that pay zakat. This standard specifies requirements for measurement, presentation of zakat and its disclosure in the financial statements of for-profit enterprises. It however, does not include the standard method of calculating and determination of zakat, which is done in the light of provisions and rules of zakat and regulations governing them. It simply states that zakat provision must be measured consistently for each financial period separately and in accordance with the provisions and rules of zakat in the Kingdom.

5.4. TR i-1: The TR i-1 by MASB provides comprehensive guidance on the accounting treatment for zakat on business. According to MASB, the state has jurisdiction on matters pertaining to Shariah, and that issues regarding the zakat rate on business shall be referred to and determined by the relevant zakat authorities. The Technical Release mentioned two methods of determining zakat base recommended by the Malaysian Islamic Development Department (JAKIM) in Panduan Zakat di Malaysia, 2001: (a) Adjusted Working Capital method; or (b) Adjusted Growth method. The adjusted working capital method calculates zakat base as net current assets, adjusted for items that do not meet the conditions for zakat assets and liabilities.

Zakat base = Current Asset - Liabilities + / - Adjustments

The adjusted growth method calculates zakat base as owners' equity and long-term liabilities, deducted for property, plant and equipment and non-current assets, and adjusted for items that do not meet the conditions for zakat assets and liabilities as determined by the relevant zakat authorities.

Zakat base = Equity + Long Term Equity - Fixed Asset - Non Current Asset + / Adjustments

The method used for the determination of zakat base would be applied consistently from one period to another. Both methods would result in the same amount of zakat base. Although the Board propagated these two methods, an entity was advised to refer to its relevant zakat authorities on the method of determining zakat base applicable in its jurisdiction.

6. Tax Benefits with Business Zakat

Tax benefits in the form of tax deductibility as well as tax rebates have been variously used by different countries to incentivize zakat payment. Some countries, such as, Indonesia, Pakistan and Sudan, treat zakat at par with charity contributions made to voluntary organizations and provide tax relief in the form of allowing the same as a deduction to taxable income. The amount of zakat paid is adjusted against the taxable income and not against the tax payable. Others like Kuwait and Saudi Arabia provide for tax rebate, which means a reduction in the income tax liability by the full amount of zakat paid. Malaysia provides for tax rebate on zakat payment by individuals while tax deduction on zakat payment by businesses.

The difference between the two is explained below with a simple example. If I is the taxable income of an entity, t is the relevant income tax rate, and an entity pays zakat, the quantum of zakat being Z, then:

(1) in case of tax rebate, tax payable is reduced by the amount Z, is now equal to $(I*t – Z)$; and the after-tax income is equal to $\{I – (I*t – Z)\}$ or $\{I*(1-t) + Z\}$

(2) in case of tax deductibility, taxable income is reduced by Z; taxable income is equal to $(I – Z)$; tax payable is equal to $(I – Z)*t$; after-tax income is equal to $\{I – (I – Z)*t\}$ or $\{I*(1-t) + Z*t\}$

Thus, the income tax payable by the zakat payer gets reduced by Z in case of former, while it gets reduced by Z times the tax rate in case of latter. The tax factor thus, constitutes a powerful incentive for zakat collection.

While zakat and taxation are fully integrated in countries like Saudi Arabia and Kuwait, the same does not hold good in most other countries. Below we discuss the case of Malaysia in detail.

6.1 Tax Incentives in Malaysia

Taxation in Malaysia is managed by the Internal Revenue Board, an agency under the Ministry of Finance of the Federal Government. A wall of separation is carefully erected between zakat and income tax conceptually and for all practical purposes.

Zakat is the compulsory charitable giving by high-networth Muslims. It is a personal responsibility for Muslims. Income tax, on the other hand, refers to a charge imposed by government on the annual gains of a person, corporation or other taxable unit derived through work, business pursuits, investment and other services determine in accordance with the Income Tax Act of the country. A Muslim in Malaysia has to make two compulsory payments on the same source of income every year, namely income tax and zakat. Zakat is obligation to the Creator while tax is obligation to the Federal government. Failure to pay zakat as well as tax should invite punishment for the defaulter, even though the enforcement of the same is extremely weak in case of zakat-related default.

- For individual zakat and tax payers, zakat payment attracts full tax rebate under Section 6A(3) of the Income Tax Act, 1967; which means for every one ringgit of zakat given to the SIRC, the tax payable by the zakat payer is reduced by one ringgit during the same assessment year. Rebate is a deduction from tax payable. If zakat paid is less than tax payable then the balance must be paid to IRB. However, if zakat paid is more than tax payable then the difference cannot be claimed from IRB – Sec 6A(4)
- Offshore companies also enjoy the benefit of tax rebate. Zakat on business income paid by the Labuan offshore companies is given a rebate equivalent to the amount of business zakat paid to the religious authority. It is subject to a maximum of 3% of net profit or RM20,OOO.
- For onshore companies however, there is no rebate admissible. They however, enjoy the benefit of treating zakat paid as a tax-deductible expense. The tax-deduction allowed is subject to a maximum of 2.5% of the aggregate income – Sec 44(11A)
- In order to accord equal tax treatment between companies and trust bodies, zakat settled by cooperatives, trust bodies and societies is also allowed as a tax deduction up to 2.5% of the Aggregate Income.
- Zakat paid by Limited Liability Partnership (LLP) is also treated as tax deduction up to 2.5 % of the Aggregate Income.

Thus, zakat paid to the SIRCs are treated favorably by the IRB. The total tax payable is reduced when there is zakat paid during the year of assessment. However, the zakat must be paid to an appropriate religious authority established under any written law or any person authorized by such religious authority. (Sec 44-11A)

6.2. Suggested Reforms

It may be noted that the data used for business zakat accounting method and business tax deduction are different. Business zakat accounting uses data from the balance sheet, while business tax deduction gains information from the income statement. In other words, those methods demonstrate no relationship between business zakat accounting method and tax on business income due to the different sources of information usage. Zahri Hamat (2009) raises a pertinent issue, if the business zakat accounting depends on those methods, do entrepreneurs get benefits from the tax deduction allowable to them? He explains that zakat is payable on the business irrespective of whether profit has been earned or unearned if the business has positive working capital. The entrepreneurs would not utilize their benefits in two situations. The first situation is when their business suffers a loss but still has a positive working capital. The second situation is when tax deduction is smaller than the amount of business zakat paid.

According to the survey findings conducted by him involving 12 Malaysian scholars on business zakat accounting it was found that the scholars agreed on ijtihad as the basis of decisions in this domain. All of them felt that one of the alternatives for business zakat which could be considered is to use “business income” as the basis of estimating zakat liability. In this case, according to the scholars, "zakat on business income can be derived (qiyas) from zakat on agriculture yjeld. This opinion is in line with the position that business zakat accounting method can be changed according to the requirement of the current situation such as the conditions of economy and local laws. For them, this is one of the highly recommended options in order to harmonize business zakat accounting method and business tax deduction currently practiced in Malaysia. Therefore, if the business zakat accounting relies on the income base, the entrepreneurs can fully get benefits from tax deduction allowable to them under the section 44(11A) of the Income Tax Act 1967."

We have already discussed the fallacy in treating income as the zakat base in Section 3. The issue of lack of harmonization between business zakat accounting and taxation (they use information from two distinct sources - balance sheet and income statement) need not be and should not be resolved by making changes in the former, because the same has a sound Shariah basis. It can be easily resolved, if need be, by making changes in methods of taxation (tax deduction or tax rebate) and base them on specific items in the balance sheet or the income statement. Extending tax deduction or tax rebate is largely a state matter and does not involve any Shariah issues.

Further, it may be noted that zakat is payable on "accumulated" earnings of the business (minus productive fixed assets) while income tax is payable on "current" earnings of the business. Therefore, the case for extending tax benefits on income tax liability due to zakat payment does not stand on strong grounds. Indeed, it is rightly the prerogative of the Malaysian tax authorities to prescribe the tax benefits - magnitute (percentage of earnings) and form (rebate or deduction) - which need not bear any relationship with the zakat payment. Arguably, there seems to be a case in favor of enhancing the tax benefits (magnitude or form or both) to further incentivize zakat payments, since the current zakat collections fall far short of their potential.

7. Conclusion

The available zakat accounting standards as well as laws governing business zakat reflect a near- consensus that adjusted net working capital of a business may be regarded as the base for computation of zakat liability. The second accepted alternative is the adjusted growth capital which essentially arrives at the same outcome, given the accounting equality between total assets and total liabilities and equity in the balance sheet of a business organization. The apparent consensus follows from fiqhi prescription of imposing zakat on urud al-tijarah or the inventory of goods available for trade. Some recent contributions to Islamic economics however, question the rationale underlying this method and argue that the objectives of the Shariah are better met by seeking recourse to alternative methods of zakat determination for business organizations. The present paper revisits the relevant issues and finds that the method of treating adjusted net working capital as zakat base is not only in confirmity with views of "orthodox" scholars, but actually makes more economic sense. It reviews and undertakes an international comparison of zakat laws in terms of what they prescribe as proper methods of computation of business zakat and the tax benefits that payment of business zakat entails.

The views of the "orthodox" scholars are also reflected in the various laws of zakat and accounting standards that are currently in place to compute business zakat. While zakat laws in most countries are somewhat general in nature and leave the specifics of zakat determination to rules and regulations to be formulated later by designated state apparatus, in a few countries like Saudi Arabia, Pakistan and Sudan, zakat laws have explicitly covered the issue of business zakat. Following the laws, rules and regulations, standard setting bodies have issued accounting standards for computation of business zakat.

We also examine the recent clamour among some Islamic economists to redefine the zakat base. We subject the specific suggestions – specifically, of treating earnings as zakat base - to scrutiny in terms of economic rationality and consistency in this paper. We argue that the "orthodox" position is not only consistent, but makes enormous economic sense. Further, the issue of incentivizing zakat payment and that of lack of harmonization between business zakat accounting and taxation need not be and should not be resolved by making changes in the former, because the same has a sound Shariah basis. It can be easily resolved, if need be, by making changes in methods of taxation (tax deduction or tax rebate) and base them on specific items in the balance sheet or the income statement. Extending tax deduction or tax rebate is largely a state matter and does not involve any Shariah issues. it is rightly the prerogative of the Malaysian tax authorities to prescribe the tax benefits - magnitute (percentage of earnings) and form (rebate or deduction) - which need not bear any relationship with the zakat payment. Arguably, there seems to be a case in favor of enhancing the tax benefits (magnitude or form or both) to further incentivize zakat payments, since the current zakat collections fall far short of their potential.

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