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TECHNICAL COMPARISON BETWEEN BUSINESS ZAKAT AND TAX ON BUSINESS INCOME IN MALAYSIA

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Abstract

The focus of this paper is to demonstrate the technical comparison between business zakat and taxation. This paper aims to enhance the knowledge on the part of zakat assessment and the management of zakat as compared to the system of taxation in Malaysia. This is to minimise the misunderstandings that exist in paying zakat as an obligation and to enhance the responsibilities of a good citizen in paying taxes.

Introduction

There are five pillars in Islam which include syahadah, five times of prayers a day, zakat, fasting, and performing the hajj. Zakat stands as the third pillar of Islam. Basically, there are two types of zakat, namely zakat on wealth (zakat mal) and zakat on self (zakat fitr). Zakat on self is paid in the month of Ramadan before the celebration of Eidul Fitr (1 Syawal) which is a pious day in Islam whereby all Muslims celebrate the day after one month of fasting. The obligation is imposed to all Muslims who live in the whole year of Hijra until the end of Ramadan of that particular year.

On the other hand, the types of wealth on which zakat must be paid are monetary wealth, crops and livestock. Zakat on wealth is payable by a payer at any time of the year after holding the wealth for 12 months (haul). The zakatable wealth should exceed the exemption limit (nisab). Thus, the wealth is zakat at the rate of 2.5%.

Zakat on monetary wealth refers to gold, silver and trade goods. Examples of zakat of monetary wealth are zakat on savings, zakat on trade goods (business),

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business investment and personal property (http://ourworld.compuserve.com/homepages/Abewley/zakat2.html)

One of the parties obligated to pay zakat is by those who are involved in business. As such, all Muslim owned businesses are required to disburse zakat if all the requirements for zakat have been fulfilled. At the same time, these Muslim businessmen also need to pay tax liability for a particular year of assessment.

The practice of business zakat measurement in Malaysia involves several methods (Hamat, 2009). The most common methods are Growth Capital Approach and Working Capital Approach. The assessment of zakat in respect of both approaches is based on the Statement of Financial Position of a company. On the other hand, the assessment of tax liability for companies is based on the Statement of Comprehensive Income of such companies.

The initial objective of this paper is to demonstrate the assessment of business zakat as compared to the tax assessment. In addition, the justification for both assessments will be further clarified. Both business zakat and business tax assessment would involve adjustments whereby the initial sum will be subjected to addition or deduction. Such adjustment is based on zakat rules for zakat on business and tax rules for business income.

Business Zakat and Tax on Business Income in Malaysia

Zakat is one of the five pillars of Islam and the purpose of zakat is to regulate the wealth of Muslims for the welfare of the society. This pronouncement of compulsory act is closely related to the five time prayers and is reflected in the Quran. Those who have executed zakat are deemed to deserve the help, blessings and appreciation from Allah, the Al-Mighty God. Linguistically, zakat means growth, increase and purification of one's wealth. From the Syariah (Al-Quran, Hadith and Islamic jurisprudence), the term refers to the amount of money or kind which is taken from the specific types of wealth when it reaches a specific amount at a specific time and which must be spent on specific categories in specific ways.

Zakat is one of the most important elements in establishing social justice (Taheri, 2001). According to Clarke, Craig and Hamid (1996), zakat is essential as a social welfare levy imposed to members of the Islamic society who are wealthier and have more prosperous businesses than the others. Those with a certain level of accumulated wealth (nisab & haul) are obligated to pay zakat to purify themselves from the sins of greed.

The payer of zakat gains an increased faith in Allah, which makes him closer to Allah. As Allah, the Al-Mighty said in the Quran, "Take sadaqa from their wealth to purify and cleanse them" (99:103) and "But anything you give as zakat, seeking the Face of Allah-whoever does that will get back twice as much" (30:40).

However, tax as defined in the Oxford Dictionary is a contribution levied on the persons, property or business for the support of the government. It had been defined in Australian cases as “a compulsory exaction of money by a public authority for public purposes enforceable by law”. In another case, tax is defined as “the process of raising money for the purposes of the government by means of contributions from individual persons” (Singh, 2001, p. 2). The definition is also cited in the case of R vs. Barger (1908) and in Matthews vs. the Chicory Marketing Board (1938). Taxes are imposed solely to raise revenue in order to cover the operating and development expenditure and the provision of certain services by the state, and in the case of despotic monarchs the personal expenditure of the ruler (Hanson, 1972, p. 556). In Abbasi (as cited in Abu Bakar and Abdul Rahman, 2007) viewed state and tax as complementary and that one could not survive without the other.

Contribution of tax is essential for a country to be governed effectively. A democratic government needs to raise revenue, and one of the most effective means is through the imposition and collection of taxes (Singh, 2001). Taxes may be imposed on income earned, wealth or consumption (or expenditure). The tax collected is a source of income for the government to use in its administrative and development of the country.

Economists have categorised tax into two broad classifications, namely direct taxes and indirect taxes. Direct tax is a tax which is paid directly by those on whom it is levied while indirect tax is generally an addition to the price of a product service and is collected by an intermediary who will then pay it over to the tax authorities. Example of direct taxes are income tax, real property gains tax and estate duty. On the other hand, indirect taxes comprise of sales tax, service tax, excise duty, import and export duties and value added tax (Singh, 2001, p. 3).

Direct taxes are the main contributor to the country. Tax revenue will undoubtedly continue to be the main source of income for the Government of Malaysia as the country experiences rapid economic growth (Kasipillai, 2005). In 2008, 69% of the federal government revenue was from taxes. Out of this figure, corporate tax formed 31% while petroleum income tax stood at 23% and personal income tax at 14% (http://www.treasury.gov.my)

As for zakat, it applies to both the individuals and businesses. Thus, Muslim owners of trading enterprises (whether sole proprietors, partnerships and companies) are obligated to pay zakat not only on their personal wealth but also on their “articles of trade” (Clarke, Craig and Hamid, 1996). However, such obligations need not contradict with the Islamic philosophy (for instance, not to engage in a business which is forbidden in Islam).

Similarly, taxes in Malaysia are not confined to income tax per se (Mustapha and Sapiei, 2009). Taxes also apply to both individuals and businesses. Sole proprietorships, partnerships as well as companies are to be assessed for taxation in the particular year of assessment.

As mentioned before, zakat is a levy on accumulated wealth, or the net stock of assets. It differs from the predominant form of taxation in the Anglo-American world, which is levied on selected wealth increment or income. The wealth increment basis of taxation is disputed in principle and in practice due to the subjectivity in its calculation and its high level of discretion in interpretation and political manipulation. For business entities, rules embodied in income tax legislation concerning calculation of income for tax assessment purpose differ from the rules specified in the accounting standards to calculate income for financial reporting purposes. The greater the subjectivity of a tax base, the higher the possibility of a taxpayer to beat the system. A tax on accumulated wealth, in contrast, has a greater level of objectivity in its calculation and less room for discretion in terms of interpretation or political manipulation (Clarke, Craig and Hamid, 1996).

The obligation to pay zakat for business is mentioned in the Quran (2:267): "O you who believe! Spend (benevolently) of the good things that you earn and of what We have brought forth for you out of the earth, and do not aim at what is bad that you may spend (in alms) of it, while you would not take it yourselves unless you have its price lowered, and know that Allah is self-sufficient, praiseworthy".

Furthermore, zakat on business is an obligation only for the Muslim owners. As for non-Muslims businesses, when assessing zakat on business, the assessment is made on the business as a whole and only the amount paid for zakat will be proportionate to the Muslims' share of the business. The business must have full ownership of the current assets, i.e. having full rights over the assets. The criteria for full ownership are that the business has full physical control over the usage of the assets and that the assets are free of any encumbrances (Zuhayli, 1994). Thus, assets held for collateral is excluded from zakat (Clarke, Craig and Hamid, 1996). Next is nisab which is the minimum zakatable amount that is reached (approximately 85 grams of gold in valuation). Currently, the value is based on the market value of gold in the market. At the time of study, the nisab was RM10,429.20 meaning that, if the company's surplus assets exceeded the nisab amount, the whole sum will be assessed for zakat at the rate of 2.5%. Lastly, the haul should be completed, whereby the business has gone through a period of one Hijraa year (1 Hijraa year is equivalent to 354.5 days), which refers to the financial year of a company. Some advocates use the month of Ramadan (fasting month) as the closing financial year. However, companies in Malaysia still end their accounting period based on the solar year (365 days) as practised by ex-colonised countries.

Approaches for Business Zakat Assessment

The measurement of Business Zakat is based on the data from the statement of financial position (Hamat, 2009). Zakat is payable for the business irrespective of whether profit has been earned or unearned. As long as the business has positive working capital, paying zakat is compulsory. Furthermore, only surplus assets are subjected to zakat. This means that if the sum of the zakatable assets owned by the business is below the nisab at the time zakat is due (haul), that business does not have to pay zakat.

Awang and Abdul Rahman (2003) in their study on Pusat Zakat Selangor (PZS), highlighted two approaches which the centre adapted, namely Urfiyyah (Growth Model) and Syarr'iyyah (Working Capital Model). The former approach is also known as the Adjusted Growth capital which considers the equity of ownership in a particular company and other financial sources. The equation is as follows:

Equity + Long Term Equity – Fixed Asset – Non Current Asset +/- Adjustments

The latter approach is known as Syarr'iyyah (Working Capital) which considers current assets that deduct current liabilities and the necessary adjustments by adding or deducting clarified items by this equation (Hamat, 2009). Most zakat centres in Malaysia adapt this approach in measuring zakat including those from Terengganu, Kelantan, Johor, Negeri Sembilan, Melaka, Pahang and Pulau Pinang (Awang and Abdul Rahman, 2003). Working Capital Model is based on the following formula:

Current Asset – Current Liabilities +/- Adjustments

Either Working Capital or Growth is based on the information extracted from the Statement of Financial Position prepared by such business. Similar answers should be derived by using both approaches.

XYZ Company Sdn. Bhd.
Business Zakat Assessment for the year ended 31 December 2009

Growth Model	RM	Working Capital Model	RM
Capital/ Owners Equity	xxxx	Current Assets	xxxx
Add: Long Term Liabilities	xxxx	Less: Current Liabilities	(xxxx)
Less: Fixed Asset	xxxx		
Less: Non Current Assets	xxxx		
Net Worth of Current Assets (A)	xxxx	Net Worth of Current Assets (A)	xxxx

Figure 3.1: Assessment of Business Zakat Based on Growth Model and Working Capital Model

A and A in Figure 3.1 refers to the net worth of the current assets. The net worth of the current assets is subjected to further adjustments as per in Table 3.1.

Table 3.1

Current Assets (RM)	Explanation
Work In Progress (W-I-P)	W-I-P should be deducted from net worth of current assets since only finished goods are recognised as productive.
Raw Material	Raw material should also be deducted since only finished goods are recognised as productive.
Fixed Deposits with a licensed Bank, Collaterised	Encumbered Fixed Deposits with a licensed bank is deducted since it is not recognised as having full ownership. Normal fixed deposits are zakatable.
Interest on Fixed Deposit	Non-halal source of Income should be deducted.
Charity kind of fund	Fund formed for charity purposes; i.e. for education, and 'khairat' contained in assets should be excluded from zakat.
Dividend	Dividend which was paid by an invested company will be deducted from the net worth of current assets (if the dividend has been assessed earlier for zakat before being distributed) since zakat is not charged twice in the same period (haul).
Donation	Donation made by a company at the end of the accounting period (haul) needs to be re-added (assessed for zakat) since the donation will not affect the company's liquidity unless the donation is taken from charity fund.
RMxxxx (B)	

The current liabilities will however be subjected to the following adjustments:

Current Liabilities (RM)	Explanation
Hire Purchase	Need to be re-added because it is recognised as a source of business, having full ownership thus not allowable for deduction.
Bank Borrowings	Need to be re-added since it is a source of fund and recognised as full ownership.
Dividend payable	Need to be re-added since it is a business profit which needs to be assessed for zakat first before it is distributed to shareholders.
Trade loans	Need to be re-added since loan is classified as a source. Iman Syafie (one of the Islamic Scholars) argued that a loan tantamount to having full ownership.
RMxxxx (C)	

The total amount due for zakat = (A) + (B) + (C)
= RM xxxx (D)

Thus, amount subjected to zakat and nisab	RMxxxx
Equity Muslim, say	75%
Zakat liability (2.5% x D x 75%)	RMxxxx

An illustration of zakat assessment is shown in Figure 3.2:

XYZ Company Sdn. Bhd.
Business Zakat Assessment for the year ended 31 December 2009

Growth Model	RM	Working Capital Model	RM
Capital/ Owners Equity	7,163,134	Current Assets	13,346,235
Add: Long Term Liabilities	1,272,168	Less: Current Liabilities	8,633,850
Less: Fixed Asset	3,694,917		
Less: Non-Current Assets	28,000		
Net Worth of Current Assets (A)	4,712,385	Net Worth of Current Assets (A)	4,712,385

Net Worth of Current Asset obtained is RM4,712,385

Figure 3.2

Current Assets (RM)	Explanation
(7,320,276)	The sum should be deducted since it is non productive item.
(3,185)	Represents raw material, thus should be deducted (not in a form intended for sale).
2,928,110	Finished goods, thus should be added.
(937,802)	Represents fixed deposit with a licensed bank, deducted since considered as not having full ownership.
(63,371)	Interest on fixed deposit – non halal source of fund, thus deducted.
(5,396,524) (B)	

On the other hand, current liabilities will be subjected to the following adjustments:

Current Liabilities (RM)	Explanation
70,943	Hire purchase considered as source of business fund, thus re-added.
951,107	Bank borrowings: considered as source of fund and having full ownership.
3,600,000	Dividend payable, must be cleansed of zakat before being distributed.
RM4,622,050 (C)	

The total amount due for zakat = (A) + (B) + (C)
= RM 3,937,911 (D)

Thus, amount subjected to zakat and nisab	RM3,937,911
Equity Muslim, say	100%
Zakat liability (2.5% x D x 100%)	RM98,448

Approaches for Business Income Assessment

According to Hamat (2009), business tax deduction gains information from the statement of the comprehensive income. Choong (2009, p. 434) demonstrated the step by step approach for business tax computation. As opposed to zakat measurement, tax measurement will be subjected to principles of taxation that need to be followed. Income Tax Act 1967 specifies the principles of allowable and disallowable expenses for the purpose of tax computation. This will further minimise the chargeable amount to be taxed.

The principles of deductibility are derived from Section 33 and Section 34 of the Income Tax Act. Section 33 specifically mentioned about three criteria namely wholly and exclusively, incurred, and in the production of income. Wholly and exclusively test discussed at least three criteria namely quantum of money expended with the sole purpose of promoting the business or profit earning capacity. Secondly, such expense should be related to the principle of ordinary commercial dealing and should be direct purpose. The principle ignores the effect of disbursement. Incurred test relates to paid or payable, outgoing definitely committed although there is no actual disbursement and a liability must presently exist in order to be 'incurred'. Another test, production of income relates to the commencement of business and there is a direct connection between expense and income.

Section 34(2) of the Income Tax Act 1967 specifically mentioned about bad and doubtful debts. The amount for deduction to minimise the tax liability is restricted if specific debtors are identified. The deduction also applies if the debts are partly/ wholly irrecoverable. Such debts should be reasonably estimated to be bad then only are they allowable for deduction.

There are also principles enunciated in the case laws with regards to the deductibility of expenses (Choong, 2009, p. 253). Among the principles of deductibility is that such expenses should be revenue expenses whereas capital expense is not deductible. Revenue expense involves business process, working expenses, circulating capital and recurring, whereas capital expense includes initial expenditure in setting up an income earning asset connected to the business structure, improvement to an asset, fixed capital, and acquisition of income earning asset/ profit making apparatus. In Atherton v British Insulated & Helsby Ltd., it has been decided that an initial lump sum contribution to the staff pension fund was capital in nature thus not deductible for tax purposes. Furthermore, an expense which relates to the fixed capital is generally treated as capital expenditure while expenditure relating to circulating capital would be treated as revenue expenditure. The distinction between fixed capital and circulating capital would depend on the nature of trade in which it is incurred (Choong, 2009, p. 249). A motor vehicle would be a fixed capital to a manufacturing company but such expense would constitute a circulating capital to a car dealer.

An assessment of corporate tax is illustrated in Figure 4.1:

Computation of Tax Payable for the Year of Assessment 2009

	RM Less	RM Add	Remarks/ Notes
Net Profit before taxation		2,879,000	
Dividend	25,000		Separately assessed
Legal fees on income tax appeal		12,000	incurred after production of income
Provision of bad debts		250,000	not incurred
Repairs and maintenance:			
Widening of drains		140,000	
Replacing an old chimney		150,000	
Loss on sale of fixed asset		150,000	Capital Expenditure
Entrance fee		350,000	Initial Expense
Donation to Red Crescent Society		8,000	deduct at aggregate stage
Compensation		nil	Normal incidental expense
Advertisement		nil	Normal trading expense
Depreciation		350,005	Not outgoings
	25,000	4,289,005	
Set-off		(25,000)	
		4,264,005	
Less: Capital Allowance		(221,450)	
		4,042,555	
Add: Other source of income			
Dividend		25,000	
Aggregate Income		4,067,555	
Less: Approved Donation		(8,000)	
Chargeable Income		4,059,555	

Figure 4.1

The Income Tax payable for the Year of Assessment 2009 was 1,014,888.75. The corporate tax rate in 2009 was 25%; thus the chargeable income times tax rate was (4,059,555 x 25%) RM1,014,888.75.

Conclusion

Assessment of business zakat is based on the information contained in the statement of financial position of a business whereas assessment for taxation is based on the statement of comprehensive income of a company. Hence, a business needs to pay zakat regardless if the profits are earned or not, and the business should possess positive working capital (Hamat, 2009). On the other hand, business tax is obligated to be paid by companies should there be any chargeable income. Such obligation is taken into consideration after all the principles of deductibility of expenses are considered in arriving at the taxable figure.

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http://www.treasury.gov.my

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APPENDICES

Appendix A

Muslim Business Sdn. Bhd.
Extract of Statement of Financial Position as of
31 December 2009

	Note	RM
Property, Plant and Equipment		3,694,917
Investment	1	28,000
Current assets		
Inventories	2	7,323,461
Trade receivables		3,989,433
Other receivables		316,481
Fixed Deposits with a licensed bank	3	937,430
Cash and bank balances		779,430
Current Liabilities		
Trade payables		3,283,145
Other payables		421,733
Hire purchase creditors	4	70,943
Bank borrowings	5	951,107
Dividend payable		3,600,000
Taxation Payable	6	306,922
		8,633,850
Financed by:		
Share capital		1,000,000
Retained Profit		6,163,134
		7,163,134
Long Term and Deferred Liabilities:		
Term Loan	7	900,113
Hire purchase creditors		307,055
Deferred Taxation	8	65,000

Additional notes for Business Zakat Assessment:

1. **Investment** consists of golf club membership at costs RM28,000
2. **Inventories** comprise of work in progress RM7,320,276, raw material RM3,185 and finished goods RM2,928,111
3. **Deposits with licensed bank**
   Interest on fixed deposit amounted to RM937,802
4. **Hire Purchase Creditors**
   Amount relates to the following year liability is RM70,943
5. **Bank Borrowings**
   The whole sum is a source of fund to the company (RM951,107)
6. **Other relevant information**
   Interest on fixed deposits 2009 is RM63,371

Appendix B

Extract of Statement of Comprehensive Income for the year ending 31 December 2009:

Muslimah Business Sdn. Bhd. operates as a manufacturer of writing instruments since 1998. The following Statement of Comprehensive Income relates to the above business for the year ending 31 December 2009.

	Note	RM	RM
Sales			12,001,355
Less: Cost of sales			(5,401,350)
			6,600,005
Add: Dividend (gross)	1		25,000
			6,625,005
Less:			
Remuneration		1,200,550	
Professional charges	2	299,450	
Provision for bad debts	3	300,000	
Repairs and maintenance	4	399,850	
Loss on sale of fixed asset	5	150,000	
Entertainment		240,000	
Subscriptions	6	360,150	
Compensation	7	80,500	
Other Expenses	8	365,500	
Depreciation		350,005	(3,746,005)
Net Profit before taxation			2,879,000

Note 1: This refers to a Singapore dividend credited to the company's bank account in Malaysia. The dividend is exempted from Singapore income tax.

Note 2: The following is included in the professional charges:

	RM
Legal fees for handling income tax appeal	12,000
Staff recruitment charges paid to an employment agency	15,000
Valuation of land and building	72,000

Note 3: Included in the Provision for bad debts is General provision for bad debts amounting to RM250,000.

Note 4: Included under repairs and maintenance is the following expenses:

	RM
Widening of the drains around the factory area	140,000
Replacing an old chimney with an improved new chimney	150,000
Extending the porch at the factory to create a covered parking bay for the General Manager	25,000

Note 5: A piece of land was bought with a view to build a new warehouse. However, the project did not materialise and the land was subsequently sold at a loss of RM150,000.

Note 6: Included in the subscriptions is an entrance fee to a golf club and entrance fee to a trade association totalling to RM350,000. Another RM8,000 is for donation to the Red Crescent Society (an approved institution under the Income Tax Act (1967).

Note 7: Compensation – this sum was paid to an important client who sued the company for late delivery of a particular consignment of goods. The matter was settled out of court upon payment of an amount of RM80,000.

Note 8: Included in other expenses is advertisements amounting to RM250,000.

Total capital allowance for Year of Assessment 2009: RM 221,450
Total depreciation charged as at 31 December 2009: RM 350,005