Islamic mode of financing: income be considered as turnover for levy of minimum tax: FBR

The Federal Board of Revenue (FBR) has informed banking industry that the net income from Islamic mode of financing ie Murabaha, Musawamah, Bai Muajjal, Bai Salam, Istisna, Tijarah, Istijrar financing and Tawarruq/Commodity Murabaha should be considered as turnover for levying minimum tax under Income Tax Ordinance, 2001.

According to income tax circular 1 of 2017 issued here on Monday, the FBR has issued explanation regarding interpretation of certain provisions of the Income Tax Ordinance 2001 in the context of Islamic banking. The FBR said that the Seventh Schedule, introduced in the Finance Act 2007, provides for the computation of the profit and gains for a banking company and the tax payable thereon. The Rule 3(1) of the Seventh Schedule stipulates that Sharia compliant banking shall not be accorded any special treatment in terms of reduction or addition to income and tax liability of banking companies subject to fulfillment of the requirement of filing the statement, certified by the auditors of the bank as per Rule 3(2), with the return of income tax.

In order to ensure implementation of principle stipulated in Rule (3) of the Seventh Schedule in letter and spirit, clarification regarding tax treatment of various Islamic banking products is warranted so that judicious and non-discriminatory treatment can be meted out to such Islamic banking products, the FBR maintained.

It has been reported to the Board that receipts on account of Islamic financing product namely Murabaha, being a transaction of sale and purchase of underlying goods, is treated as gross receipts for the purpose of levying minimum tax under section 113 of the Ordinance. In the light of the principle of tax neutrality as espoused in Rule 3(1), net income (as opposed to gross receipts) from Islamic mode of financing namely Murabaha, Musawamah, Bai Muajjal, Bai Salam, Istisna, Tijarah, Istijrar financing and Tawarruq/commodity Murabaha should be considered as turnover for the purpose of levying minimum tax under section 113 of the Income Tax Ordinance, 2001 provided the condition in Rule 3(2) is met which is a statement, certified by the auditors of the bank to be attached with the return disclosing the comparative position, the FBR said.

Islamic Financial Institutions also enter into Ijara for assets given on lease under Islamic mode. In terms of guideline laid down in Islamic Financial Accounting Standards (IFAS-2), gross rentals are accounted for in the accounts against which depreciation is charged on straight line basis over the lease period. As a result, net income from Ijara is recognised in the accounts. It has, however, been reported that assets given on Ijara have been treated as "finance lease" on certain grounds, and depreciation has been disallowed under Rule 1(a) of the Seventh Schedule. In this respect, it is observed that the rationale of placing restriction on claiming depreciation under Rule 1(a), upon the assets given on finance lease, has not been appreciated properly.

Banks are allowed depreciation on assets under section 22, in terms of Rule 1(a) of Seventh Schedule, therefore, banks can claim depreciation on assets given on lease including finance

lease. Since in respect of finance lease, the income recognised in the accounts is finance income, therefore, it has been provided in Rule 1(a) that depreciation would then not be allowable to the bank as lessor. In order to provide tax neutrality to asset(s) given on lease under Islamic mode vis-à-vis conventional mode, it is directed that, the profit implicit in the Ijara financing income be recognised for tax purposes as in the case of finance lease by other banking companies, provided that Islamic Banking Institutions fulfill the conditions as laid down in Rule 3(2) of the Seventh Schedule to the Income Tax Ordinance, 2001, the FBR added.