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### TAX SYSTEM AND ISLAMIC FINANCE IN NIGERIA: A PROGNOSIS

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#### **Abstract**

*The emergence of the adverse effect of the global economic meltdown forced serious minded countries to consider alternative form of finance. Such consideration was not limited to only develop economies like the United Kingdom, developing economies like Nigeria considered that too, by consolidating on an already existing legislation. The study's singular objective is to prognosize the present indications of the Federal Inland Revenue Services (FIRS) guidelines on Islamic Finance, by using models drawn from the guidelines to explain the tax implications. Interactions carried out on the staff of FIRS and Jaiz bank, coupled with the examinations of the FIRS guidelines on tax implication on Islamic Finance and annual reports and accounts of Jaiz bank informed the prognosis. The study concludes the guidelines issued by FIRS for tax purposes are indeed not without creating the possibility of challenges in future, however, it seeks to reduce the risk of economic double taxation and to provide taxable persons with clarity on tax treatment of Islamic finance products and services as demonstrated in global tax practices to stimulate economic growth and develop tax revenue.*

**Keywords:** Islamic Finance Taxation, Prognosis

#### **1.1 Introduction**

Decades ago, the then military government of the federal republic of Nigeria, promulgated the Banks and Other Financial Institutions Decrees (BOFID) 24 and 25 of 1991, now amended as Banks and Other Financial Institutions Act (BOFIA, 1991) which replaced the Banking Act of 1969. The decree ushered in the establishment of non-Interest banking in Nigeria. However, not until 1999, when keystone bank (former Habib bank and later Platinum Habib bank) introduced non-interest window banking, significant activities were not recorded (Umar, 2011; and Usman, 2003). Despite this effort displayed by the bank, sustaining the non-interest transaction initiative became a challenge due to the absence of framework on non-interest banking in Nigeria and the absence of persistent determination, until, the emergence of the adverse effect of the global economic meltdown. This situation forced serious minded countries to consider alternative form of finance (Oladimeji and Monisola, 2012; and Ethica, 2013). Such consideration was not limited to only develop economies like the United Kingdom, developing economies like Nigeria considered that too, by consolidating on an already existing legislation (Mustafa, Ibrahim, and Adewale 2011; Audu and Mika'ilu 2014).

In that regard, the Central Bank of Nigeria (CBN), (2011) by virtue of Section 33 (1) (b) of the CBN Act 2007; Sections 23(1) 52; 55(2); 59(1)(a); 61 of Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended) and Section 4(1)(c) of the Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010, and in the light of Companies and Allied Matters Act (CAMA) 1990 (as amended) issued the non-interest banking guidelines to regulate the Non-Interest Financial Institutions (NIFI) operating under the principles of Islamic Commercial Jurisprudence, which is one of the categories of Non-Interest Financial Institutions (NIFI) recognized by the guideline. Consequently, the first Islamic Financial Institution (Jaiz Bank) was granted its commercial licence by the CBN in November 2011. The bank commenced operations with only three branches in Kaduna State, Kano State and Abuja the federal capital of Nigeria. Today the bank has additional branches in Sokoto State; Gusau in Zamfara State; Maiduguri in Borno State; Gombe state; Bauch State; Katsina State with additional 2 branches in Kano State and 1 in Abuja. Besides Jaiz Bank, 1 microfinance bank was granted approval in principle and 2 Conventional Financial Institution (CFI) (Sterling Bank and Stanbic IBTC) were granted approval to operate non-interest finance windows based on Islamic jurisprudence.

As a result of this development, in pursuant of section 61 of the Federal Inland Revenue Service (Establishment) Act 2007, the Federal Inland Revenue Services (FIRS) of Nigeria, (2012) for the first time, issued a non-interest finance guideline for non-Interest Financial Institutions (NIFI) operating under the principles of

Islamic Commercial Jurisprudence or any other non-interest banking principle. This was captured in the information circular (2013) issued in pursuant to section 8(1)(c)&(d) of the Act. The regulation became necessary as Non-Interest Financial system is not provided for in current tax regimes in Nigeria and it is intended to provide an enabling framework in compliance with the CBN guidelines on Non-Interest Finance Transactions.

By virtue of the guideline issued by the FIRS, Nigeria is said to have a specialized tax system that seeks to provide a level playing field between Islamic Financial Institutions (IFI) and Conventional Financial Institutions (CFI) as demonstrated in global tax practices to stimulate economic growth and develop tax revenue. Also, it seeks to reduce the risk of economic double taxation and to provide taxable persons with clarity on tax treatment of Islamic finance products and services. The clarity on tax is influenced by the fact that, financing is backed by specific assets, these finance assets are equivalent to loans provided by CFI; (ii) Profit or income in the IFI is equivalent to interest in the CFI and financing is through sales, hiring, leasing or partnership instead of granting loan or overdraft facility to customers in CFI.

It is important to note here that, the period of operations in Jaiz , Sterling and Stanbic IBTC banks on Islamic finance is less than 3 years and as such the FIRS guideline which became enforceable in march, 2013 on non-interest finance transactions, is at best, in its rudimentary stage to reveal in depth the challenges of taxing Islamic finance in the same light with conventional finance but using different perspective. That notwithstanding profit or (income) generated during this period was subjected to all relevant taxes. It is within this context, the study seeks to prognosize the present indications of the Federal Inland Revenue Services (FIRS) guidelines on Islamic Finance using models drawn from the guidelines to explain these positions.

## **2.0 Review of Concepts**

### **2.1 Tax Issues in Islamic Finance**

Unlike conventional finance, Islamic finance is backed by specific assets. Financing is through sales, hiring, leasing or partnership instead of granting loan or overdraft facility to customers. In Nigeria, for the purpose of taxation, these finance assets are equivalent to loans provided by CFI. Also, profit or income in the Islamic Financial Institutions (IFI) is equivalent to interest in the Conventional Financial Institutions (CFI). The word equivalent is used because of the challenge posed by Islamic finance on conventional tax system. Consequently, to achieve taxation as a revenue source for the country the guideline issued by the Federal Inland Revenue Services (FIRS) (2013) tried to give definitions of conceptual

issues in Islamic finance and based on the definitions provided, the guide lines subjected income and profit from Islamic finance to relevant taxes.

## **2.2 Islamic Finance**

Islamic finance permits equity, trade, and lease-based transactions, but forbids debt (Ethica, 2013). It is the process of trading, investments, engaging and providing commercial activities according to the rules in Islam. According to Iqbal (1997), Islamic financial system (IFS) is a form of ethical investment and ethical lending model practised among Muslim countries and hinged on Islamic principles. All loans contacted under IFS are interest-free, gambling-free and haram-free. The ethical restrictions of IFS include but not limited to the prohibition on alcohol, gambling, deceit, speculative excesses and the rearing, sale, and consumption of pork. Institutions or organizations that operate Islamic finance system are referred to as Islamic Finance Institutions (IFI) or non-interest financial Institution (NIFI).

A Non-Interest Financial Institution (NIFI) is defined as a bank or Other Financial Institution (OFI) under the purview of the CBN, which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services are in accordance with Shari'ah principles and rules of Islamic commercial jurisprudence (CBN, 2011). However, it is important to note that, the practitioners and clients of IFS need not be Muslims, but they must be willing to abide by the theoretical framework, ethical restrictions and Islamic principles that guide the operations of Islamic banks, insurance firms, investment firms et cetera (Raimi, Shokunbi, Suara, and Fadipe, 2013).

The rules of Islamic commercial transactions are defined by Mudarabah, Musharakah, and Sukuk which are all equity based; Murabaha, Salam, and Istisna which are trade based and Ijarahs which are lease based (Ethica, 2013). On the other hand, Shari'ah principles are the normative underpinning for Islamic Finance principles that regulates Islamic commercial transactions. According to Ethica, (2013) these principles are basically 4 and are emphatic on the must for transactions in Islamic Finance to be:

i. **Free of Interest:** The Islamic ban on interest is not new. For centuries banned by Christians and Jews, the Shariah, or Islamic Law, prohibits paying or earning interest, irrespective of whether it is a soft, development loan or a monthly consumption loan. In fact the Vatican itself has said, "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service. Islam is concerned with the

well-being of society, sometimes at the immediate expense of the individual. A single interest-based loan may seem harmless, but an entire economy based on interest can have devastating consequences.

ii. **Risk sharing and Asset and Service Backing:** The central juristic principle in the Shariah that informs our concept of risk-sharing states: *al ghummbil ghurm* meaning there is no return without risk. Bankers know that the concept of risk sharing is common to all equity-based transactions. Islamic finance is no different, where profit and loss distribution is commensurate with investment proportions. Lending cash on interest is not the kind of risk sharing discussed here. In a conventional loan the bank doesn't directly involve itself in how the cash is spent. Even with a secured loan, in which the bank takes security and gets more involved, there is still no direct equity position. The bank still doesn't own anything. An Islamic bank, on the other hand, actually takes a direct equity position, or buys a particular asset and charges a premium through a trade or a lease. It uses risk mitigants, but not without first taking ownership risk.

iii. **Contractually certain.**

Contracts play a central role in Islam and the uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shari'ah. Contractual uncertainty happens when the basic prerequisite or integral of a contract is absent, such as the existence of the subject matter, the fixing of a delivery date, or the agreement on a price. Conventional insurance, interest, futures and options all contain an element of contractual uncertainty and are thus prohibited.

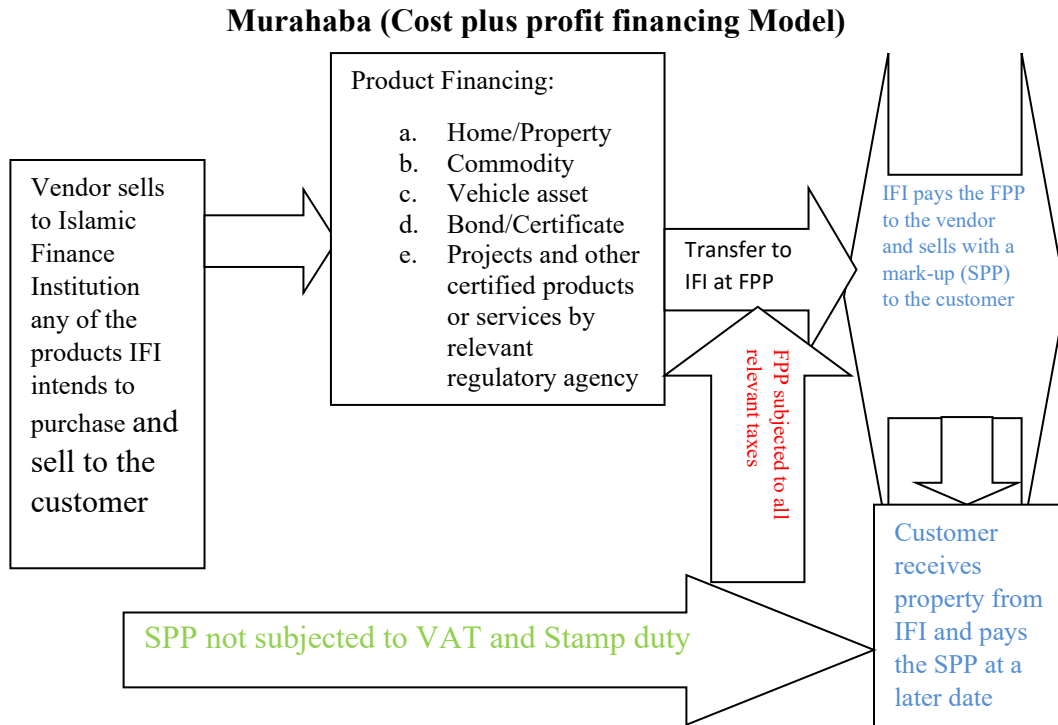
iv. **Ethical:** which means that there is no buying, selling, or trading in anything that is, in and of itself, impermissible according to the Shariah. Examples include dealing in conventional banking and insurance, gambling, alcohol, and tobacco.

This section presents these Islamic commercial transactions and their tax implication as shown in the FIRS regulation (2013) using models.

## **2.2i Murabaha (Cost plus Mark up)**

This is an agreement between an Islamic finance Institution (IFI) and a customer. The agreement is based on the finance of properties (assets); commodities; vehicle asset; bond/certificate; project and other certified products or services by relevant regulatory agencies. The financing process begins when the IFI buys from a vendor, the financing objectives (property/assets; commodity and etcetera) and sells with a mark-up to the customer. The process ends when the customer is granted the ease of paying the IFI at a later date other than the sale date. Murabaha is not a loan given on interest; it is a sale of a commodity for cash/deferred price (Ethica, 2013).

[  
 For the purpose of tax, the price paid to the vendor by the IFI is termed the first purchase price (FPP) and it is subject to all relevant taxes. The price the customer pays to the IFI is the FPP plus the mark-up and it's termed the second purchase price (SPP). The SPP is not subjected to value added tax (VAT) and stamp duty. Model 1 below shows the taxable income.



**Key:**

FPP = First purchase price                      IFI = Islamic Finance Institution  
 SPP = Second purchase price                    VAT = value added tax

**2.2ia Possibility of double taxation:** Taxes are collected within a particular accounting period. This is so because, the matching concept in accounting requires that revenues for a period be matched with expenses for the same period. Consequently, company income tax is collected after all expenses for the period are deducted from gross profit for the same period under assessment. However, the possibility of double taxation might arise in the murahaba finance process as the customer is allowed to pay the SPP at a later date other than the date of actual sale. This is so because, the FIRS guidelines did not clearly indicate that such later date must fall within the accounting period when the actual purchase of property or commodity was made by the IFI from the vendor. Or the IFI must

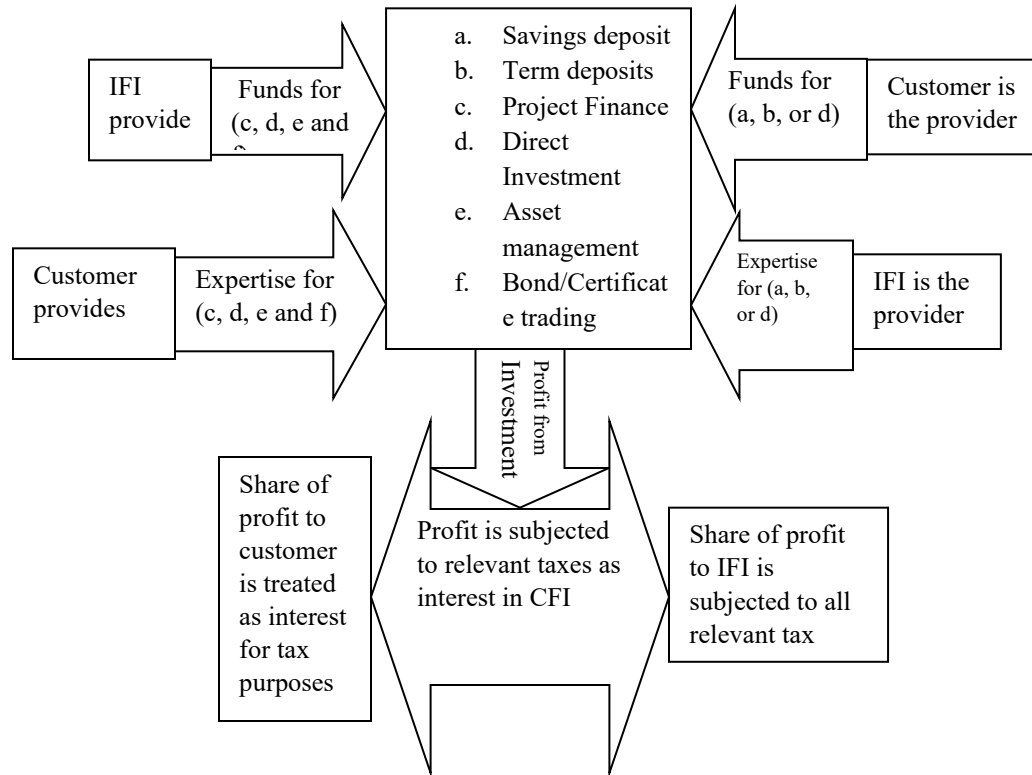
state clearly the transaction is treated according to exceptional cases in accrual method of entry in accounting that allows, when organization lay claims on cost of goods purchased for sale or produced for sale. The organization records the exact amount it sells in the period of the sale. Going by this explanations, this only implies that, payment made by customer in another period other than the accounting period of actual payment, means revenue from a previous accounting period will also be applied to pay or service expenses of the current accounting period, afterwards the profit for the current year of the IFI is subjected to tax.

### **2.2ii Mudaraba (Investment Partnership Financing)**

This is a kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner who is called the Rab-al-Maal while the management and work is an exclusive responsibility of the other, who is called Mudarib and the profits generated are shared in a predetermined ratio (Ethica, 2013).

The structure of mudaraba can be used for saving and term deposits; project finance; direct investments; asset management; bond or certificate trading. Mudaraba is an investment partnership financing that, allows the IFI to provide funds while the customer provides expertise and management of projects. It is also an investment partnership that allows the customer to provide funds to an appointed IFI in the nature of savings and term deposits. IFI provides expertise and management of such funds in a pre-agreed profit venture arrangement. The customer is entitle to the agreed ratio on any profit made as a result of employing the invested funds. In the same vein, the IFI is entitled to the pre-agreed profit resulting from managing the fund. However, for the purpose of tax, profits made from such invested funds are treated as interest similar to CFI and are subjected to all relevant taxes. Model 2 below shows the taxable income.

## Mudaraba (Investment Partnership Financing Model)



### Key:

IFI = Islamic Finance Institution

CFI = Conventional Finance Institution

### 2.2 iii Musharakah (Joint Venture Asset Financing)

Musharakah means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution (Ethica, 2013). The FIRS (2013) recognizes two types of joint venture asset financing:

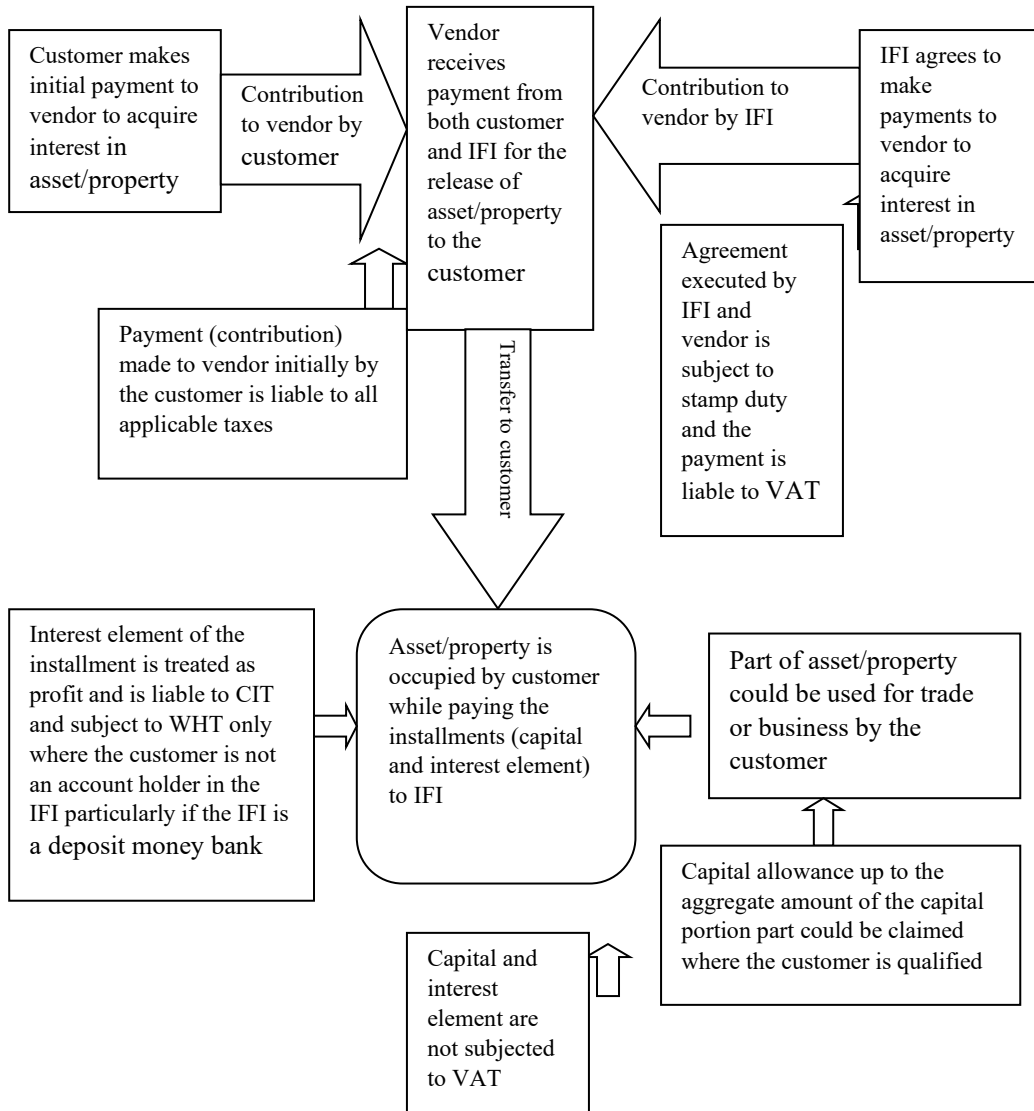
**2.2 iii (a) Diminishing Musharakah:** This is a joint venture agreement that allows both IFI and customer to provide capital for the finance of a project. Such contributions are towards transferring ownership to the customer after final payment to the IFI. The process begins when the customer transacts with a vendor for the acquisition of a beneficial interest in an asset/property owned by the vendor. The asset/property is purchased by the customer using joint funds (IFI and customer's fund). The customer pays in installment (capital plus rent) to the

financial institution amounting to aggregate to the consideration (funds) paid for the acquisition of the financial institution's beneficial interest in the asset/property. At this stage, the customer has the exclusive right to occupy and use the house whilst still making payments for the acquisition of the financial institution's beneficial interest in the asset/property. Finally, the customer acquires the financial institutions beneficial interest in the asset/property upon making the final payment.

For the purpose of tax, the initial transaction between customer and the vendor for the acquisition of its beneficial interest in the asset/property is liable to all applicable taxes. The agreement executed by the IFI and the vendor is subjected to stamp duty and this covers for subsequent transfer of ownership to the customer, exempting the customer from paying stamp duty. The amount paid by the IFI to the vendor is subjected to value added tax (VAT). However, the capital and interest elements of payments made by the customer to IFI are not liable to VAT. The interest element of the payments made by the customer to the IFI is treated as profit liable to company income tax act (CITA) in the hands of IFI. On the part of the customer, such interest is subjected to withholding tax deduction (WHT) where the customer is qualified. However, where the IFI is a deposit money bank, the customer will not be required to with hold tax from the interest element of the payment made to the bank, especially if the customer's periodic payments are deducted at source from the customer's account with the bank. More so, the customer can claim for capital allowance (only when qualified) up to the aggregate amount of the capital portion paid. This claim is due where any part of the property/asset is used for a trade or business.

**2.2   iii(b) Direct Investment Musharakah:** This is a joint enterprise that allows for direct investment finance (local purchase order, working capital and etcetera), project and bond asset finance. The enterprise is based on both IFI and customer contributing capital and expertise towards running the enterprise and sharing any profit there from according to the agreed sharing ratio. In the same vein, where there is an increase in co-owned assets, its benefits and profits are for all parties. All parties bear the loss in accordance with their capital contribution. The provision of tax in diminishing musharakah is applicable for the direct investment musharakah. Model 3 shows the taxable income.

### Musharakah (Joint Venture Asset Financing Model)



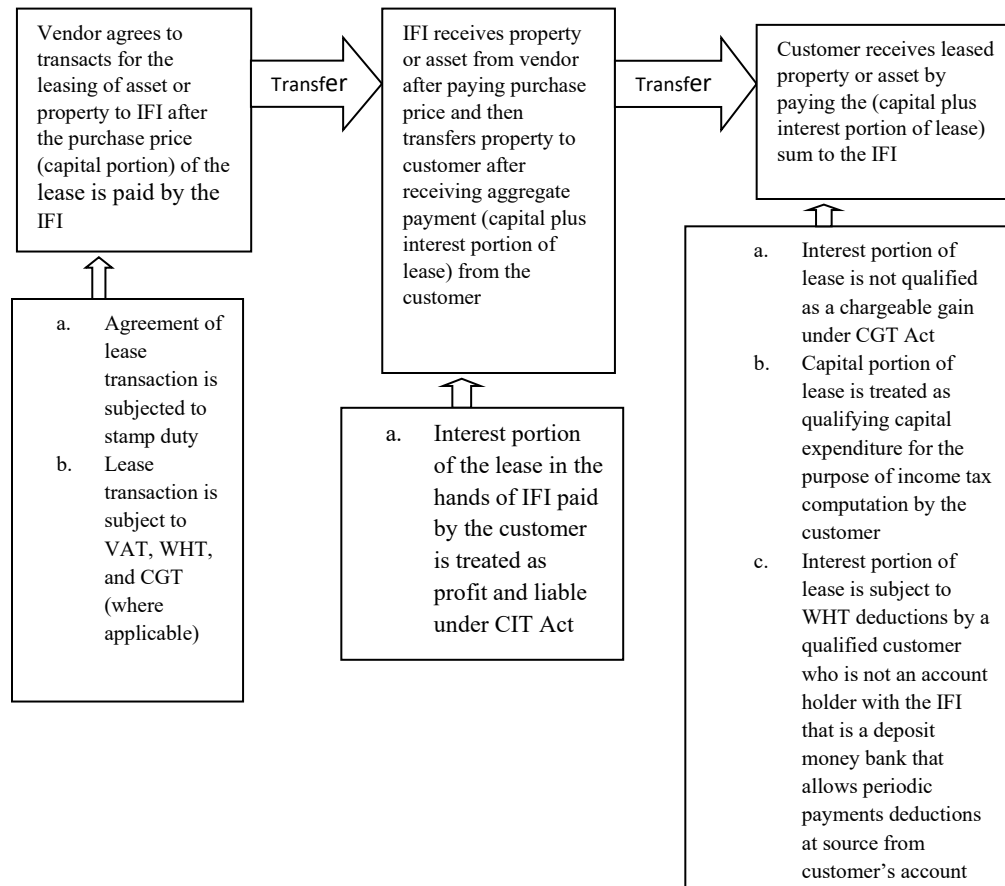
**Key:**

- IFI = Islamic Finance Institution
- CIT = Company Income Tax
- WHT = Withholding Tax

## **2.2 iv Ijarah (Lease Financing)**

This is a lease that allows an owner transfers a non-consumable assets usufruct to another person for an agreed period, at an agreed consideration (Ethica, 2013). It is also a lease agreement that allows the financing of asset and property by an IFI through a vendor for a customer. The process is conducted under the Generally Accepted Accounting Principles (GAAP) and as provided for in paragraph 18 of second schedule of the Company Income Tax Act (CITA, 2004) as amended. In the lease transaction, the purchase price paid to the vendor by the IFI is the capital portion of the lease payment while the interest portion is the difference between the purchase price paid by the IFI to the vendor and the aggregate amount of the lease payments to be made by the customer. For the purpose of tax, any transaction for the leasing of an asset or property between an IFI and a vendor is subjected to VAT, WHT, and CGT (where applicable) however, the interest portion of the lease payment shall not qualify as a chargeable gain under CGT Act. The agreement executed by the IFI and the vendor is subjected to stamp duties and it is deemed to cover the arrangement between the IFI and customer in respect of the asset or property. A customer of IFI while computing for income tax should treat the capital portion as qualifying capital expenditure. The interest element of the payment made by the customer to the IFI is considered profit liable to tax under CITA in the hands of the IFI. Also, the interest element is subjected to WHT deduction by a qualified customer under the WHT regulation only when the customer is not an account holder in the IFI being a deposit money bank that allows deduction at source of periodic payments from the customer's account. Model 4 shows the taxable income.

## Ijarah (Lease Financing Model)



### Key:

IFI = Islamic Finance Institution  
 VAT = Value added Tax

WHT = Withholding Tax  
 CGT = Capita Gain Tax

## 2.2 v. Sukuk (Islamic Bond Financing)

Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services (Ethica, 2013). Sukuk allows for Islamic bond financing. It is also assets backed investment certificates which represent proportionately beneficial ownership in the underlying asset. The asset is transferred to special purpose vehicle (SPV) to generate cash flow for distribution to sukuk holders after deduction of allowable expenses. Sukuk are also investment certificate similar to bonds that complies with Islamic jurisprudence where by the issuer makes contractual promise to buy back the bond at a future date at par value. It has the following features:

- Sukuk have a specified life (bond term)
- The issues of sukuk undertakes to:

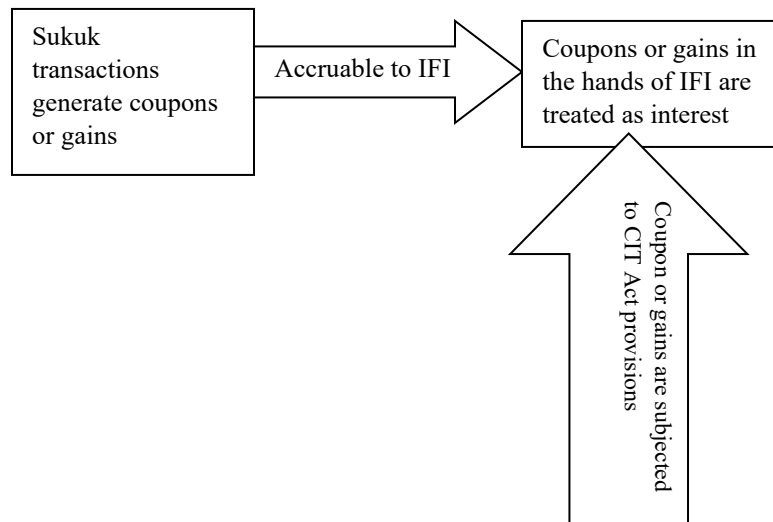
- a. Dispose at the end of the bond term of any bond assets which are still in the issuer's possession.
- b. Make repayment of the capital (the redemption payment) to the holder during or at the end of the bond term (whether or not in installment and
- c. Pay to the holder any additional surplus during or at the end of the bond term (additional payments).
- iii. The additional payments do not exceed a reasonable commercial return on loan capital.
- iv. The issuer arranges for the bond asset to be managed with a view to generating income sufficient to pay the redemption and additional payments.
- v. The holder is liable to transfer its rights under the arrangement to another person (who becomes the holder as a result of the transfer).
- vi. The arrangements are treated in accordance with International Accounting Standards wholly or partially as a financial liability of the issuer.

On the other hand, the sukuk process comprises of:

- a. Provision for its holder to pay a capital sum to another issuer
- b. Identifying assets or class of assets that the issuer acquire to generate income or gains directly (the bond assets).

For the purpose of tax, sukuk are treated as bonds and the coupon gains arising out of any arrangement under sukuk is treated as interest accruing to IFI and subjected to the provision of the CIT Act. Model 5 below shows the taxable income.

### Sukuk (Islamic Bond Financing Model)



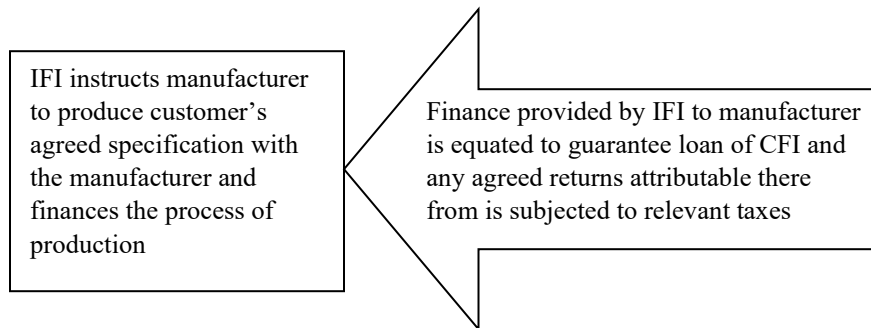
**Key:** CIT = Company Income Tax

## 2.2 vi Istisna (Building to order Financing)

Istisna is a sale transaction where a commodity is transacted before it comes into existence. It is an order to a manufacturer to manufacture a specific commodity for the purchaser. The manufacturer uses his own material to manufacture the required goods. In an Istisna, the price must be fixed with the consent of all parties involved. All other necessary specifications of the commodity must also be fully agreed on (Ethica, 2013).

This is also an agreement that allows the customer to demand for the production of some specified goods or commodities from a manufacturer and the IFI instructs the manufacturer to exactly that for the customer by providing the finance. For the purpose of tax, the finance provided by the IFI is equated in form to bank guarantee loan of CFI and the agreed returns attributable to the guarantee is subjected to relevant taxes. Model 6 below shows the taxable income.

### Istisna (Building to order financing Model)



#### Key:

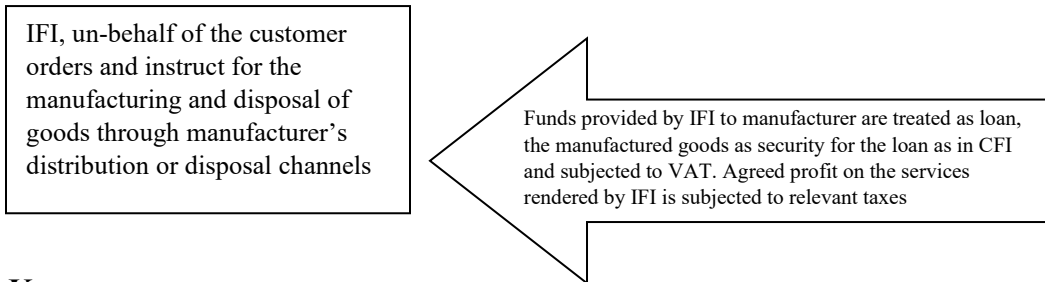
CFI = Conventional Financial Institution

IFI = Islamic Finance Institutions

## 2.2vi (a) Istisna (Building to Parallel financing)

In parallel Istisna the IFI, un-behalf of the customer orders and instruct for the manufacturing and disposal of goods through manufacturer's distribution or disposal channels. The funds are treated as loan, the manufactured goods as security for the loan as in CFI and subjected to VAT. Agreed profit on the services rendered by IFI is subjected to relevant taxes. Model 7 shows the taxable income.

### **Istisna (Building to Parallel financing Model)**



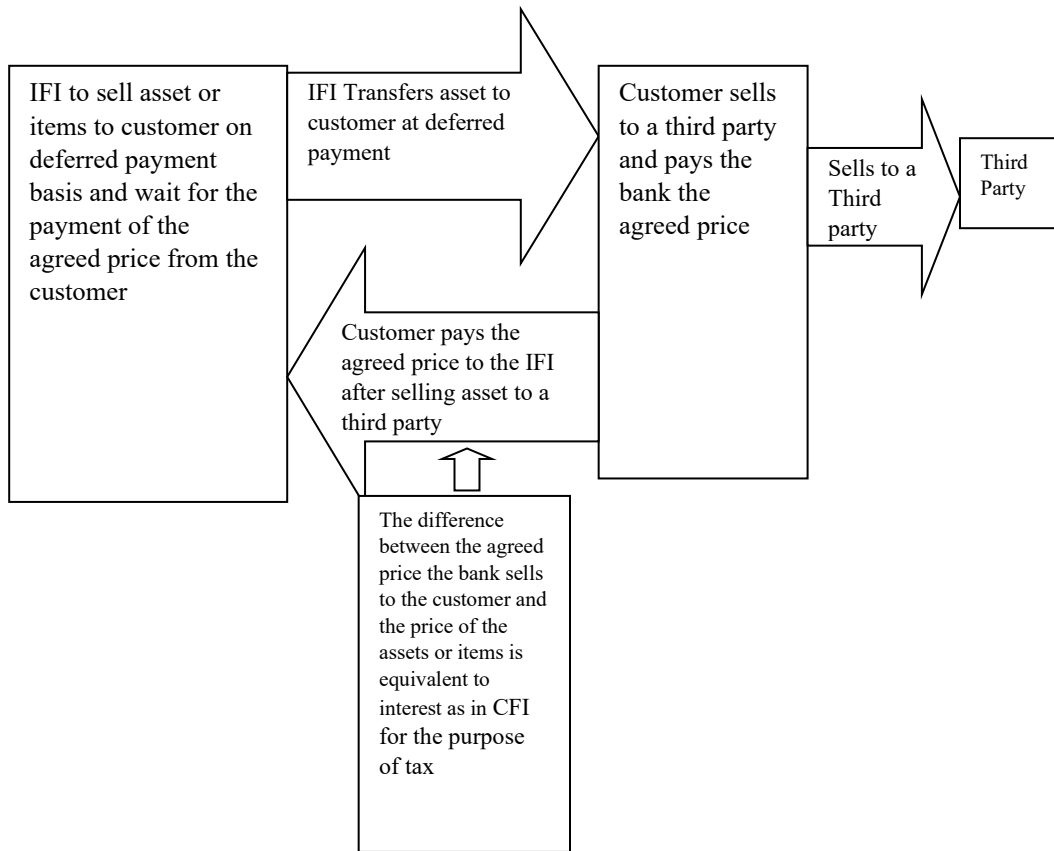
**Key:**

- IFI = Islamic Finance Institution
- CFI = Conventional Finance Institution
- VAT = Value Added Tax

#### **2.2 vii Tawarruq (Overdraft Financing)**

This agreement allows the IFI to sell asset or items to customer on deferred payment basis and customer sells to a third party and pays the bank the agreed price. The difference between the agreed price the bank sells to the customer and the price of the assets or items is equivalent to interest as in CFI for the purpose of tax. Model 8 shows the taxable income.

### Tawarruq (Overdraft Financing Model)



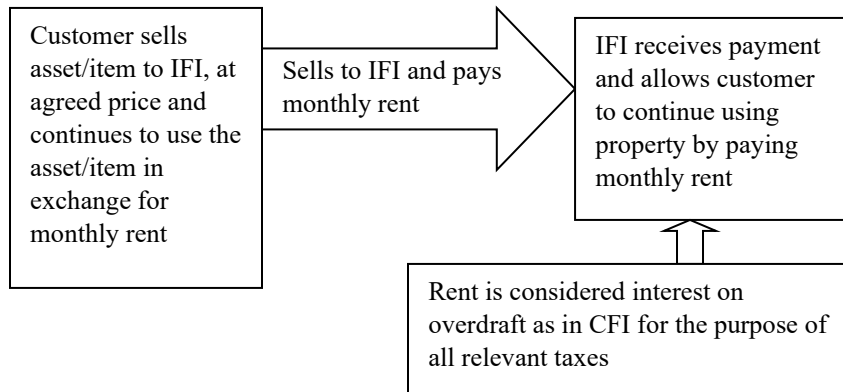
**Key:**

- IFI = Islamic Finance Institution
- CFI = Conventional Finance Institution

**2.2 vii (a) Tawarruq (Overdraft Financing in Exchange for Rent)**

Where the customer sells asset/item to IFI, at agreed price and continue to use the asset/item in exchange for monthly rent. The rent is considered interest on overdraft as in CFI for the purpose of all relevant taxes. Model 9 shows the taxable income.

### Tawarruq (Overdraft Financing in Exchange for Rent Model)



**Key:**

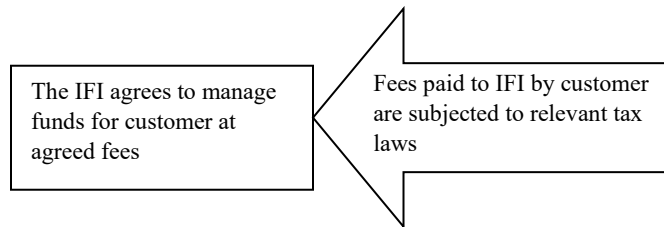
- IFI = Islamic Finance Institution
- CFI = Conventional Finance Institution

### 2.2 viii Wakala (Asset Management Financing)

According to Ethica, (2013), in a wakalah, the bank possessing excess liquidity as principal, appoints another bank as its agent to invest its money in various profitable, Shariah-compliant ventures. The invested funds become a part of the treasury pool of the bank receiving the investment. Before investing the funds in a business venture, the agent presents the principal with an offer for a probable investment opportunity where it discloses the amount to be invested, and the tenure and profit to be expected from the investment. If the principal accepts the agent's offer, the deal is executed. An agency fee is fixed for each deal between the agent and the principal and when the realized profit is greater than the amount expected, the agent is entitled to retain the amount that is in excess in addition to the pre-agreed agency fee. If the business venture suffers a loss as a result of the agent's negligence, the principal is entitled to the profit and any compensation for actual costs, expenses and the original investment.

For FIRS guidelines, (2013), wakala is an agency agreement between the IFI and the customer. The IFI is the fund manager in the agreement that is paid earned agreed fees. These fees are subjected to relevant tax laws. Model 10 below shows the taxable income.

### **Wakala (Asset Management Financing Model)**



**Key:** IFI = Islamic Financial Institution

### **3.1 Methodology**

The study has the singular objective of prognosizing the present indications of the Federal Inland Revenue Services (FIRS) guidelines on Islamic Finance using models drawn from the guidelines to explain these tax implications. To achieve that, interactions with the staff of FIRS, especially its regional office in Kaduna North local government are of Kaduna State as well as the staff of Jaiz bank in Abuja the federal capital of Nigeria and Kaduna State were carried out. Also, the FIRS guidelines and annual reports and accounts of the bank were examined.

### **4.1 Prognosis**

The interactions carried out on the staff of FIRS and Jaiz bank, coupled with the examinations of the FIRS guidelines on tax implication on Islamic Finance and annual reports and accounts of Jaiz bank informed the following prediction on how to some extent tax policies regulating Islamic Finance will further develop:

### **4.2 Murabaha (Cost plus Markup)**

In muharaba structure:

- i. The customer is granted the ease of paying the IFI at a later date other than the date of sale.

This situation might bring about the possibility of double taxation in the murahaba finance process as the process of payment could witness two tax periods. Secondly, the FIRS guidelines did not clearly indicate that such later date must fall within the accounting period when the actual purchase of property or commodity was made by the IFI from the vendor. This only implies that, payment made by customer in another period other than the accounting period of actual payment, translates to revenue from a previous accounting period applied to pay or service expenses of the current accounting period, afterwards the profit for the current year of the IFI is subjected to tax.



### **4.3 Mudaraba (Investment Partnership Financing)**

In mudaraba structure:

- i. Profits made from invested funds are treated as interest similar to CFI and are subjected to all relevant taxes.
- ii. Share of profit of the customer is also treated as interest for the purpose of tax.

The possibility of taxing the profit twice might arise. The question is when do FIRS tax the profit? Is it before or after profit sharing? As CIT applies when gross profit is arrive at.

### **4.4 Musharakah (Joint Venture Asset Financing)**

In the musharakah structure (Diminishing or direct investment finance):

- i. The initial transaction between customer and the vendor for the acquisition of its beneficial interest in the asset/property is liable to all applicable taxes.
- ii. The agreement executed by the IFI and the vendor is subjected to stamp duty and this covers for subsequent transfer of ownership to the customer, exempting the customer from paying stamp duty.
- iii. The amount paid by the IFI to the vendor is subjected to value added tax (VAT). However, the capital and interest elements of payments made by the customer to IFI are not liable to VAT.
- iv. The interest element of the payments made by the customer to the IFI is treated as profit liable to company income tax act (CITA) in the hands of IFI.
- v. On the part of the customer, such interest is subjected to withholding tax deduction (WHT) where the customer is qualified. However, where the IFI is a deposit money bank, the customer will not be required to withhold tax from the interest element of the payment made to the bank, especially if the customer's periodic payments are deducted at source from the customer's account in the bank. More so, the customer can claim for capital allowance (only when qualified) up to the aggregate amount of the capital portion paid. This claim is due where any part of the property/asset is used for a trade or business.

The complexity in the Musharakah transaction process is simplified to the extent of its tax implications. This might not pose possible challenges in the future.

### **4.5 Ijarah (Lease Financing)**

In the Ijarah structure:

- i. Any transaction for the leasing of an asset or property between an IFI and a vendor is subjected to VAT, WHT, and CGT (where applicable) however, the

interest portion of the lease payment shall not qualify as a chargeable gain under CGT Act.

- ii. The agreement executed by the IFI and the vendor is subjected to stamp duties and it is deemed to cover the arrangement between the IFI and customer in respect of the asset or property.
- iii. While computing for income tax, any customer of IFI should treat the capital portion as qualifying capital expenditure. The interest element of the payment made by the customer to the IFI is considered profit liable to tax under CITA in the hands of the IFI.
- iv. Also, the interest element is subjected to WHT deduction by a qualified customer under the WHT regulation only when the customer is not an account holder in the IFI being a deposit money bank that allows deduction at source of periodic payments from the customer's account.

The complexity in the Ijarah transaction process is simplified to the extent of its tax implications. This might not pose possible challenges in the future.

#### **4.6 Sukuk (Islamic Bond Financing)**

##### **In sukuk structure:**

- i. They are treated as bonds and the coupon gains arising out of any arrangement is treated as interest accruing to IFI and subjected to the provision of the CIT Act. The complexity in the Sukuk transaction process is not simplified to the extent of its tax implications. This might seriously create challenges in the future.

#### **4.7 Istisna (Building to order or parallel financing)**

##### **In the Istisna structure:**

- i. The finance provided by the IFI is equated in form to bank guarantee loan of CFI and the agreed returns attributable to the guarantee is subjected to relevant taxes.
- ii. The funds used for manufacturing goods are treated as loan, the manufactured goods as security for the loan as in CFI and subjected to VAT. Agreed profit on the services rendered by IFI is subjected to relevant taxes.

The complexity in the Istisna transaction process is simplified to the extent of its tax implications. This might not pose possible challenges in the future.

#### **4.8 Tawarruq (Overdraft and Exchange for Rent Financing)**

##### **In the Tawarruq structure:**

- i. The difference between the agreed price the bank sells to the customer and the price of the assets or items is equivalent to interest as in CFI for the purpose of tax.
- ii. Rent paid to the IFI by the customer for using the property is considered interest on overdraft as in CFI for the purpose of all relevant taxes

The clear definition of what is considered or termed interest in the Tawarruq transaction process is simplified to the extent of its tax implications. This might not pose possible challenges in the future.

#### **4.9 Wakala (Asset Management Financing)**

In the Wakala structure:

- i. The IFI is the fund manager in the agreement that is paid earned agreed fees. These fees are subjected to relevant tax laws.

The complexity in the Wakala transaction process is simplified to the extent of its tax implications. This might not pose possible challenges in the future.

#### **4.10 Implementation of FIRS guidelines in Jaiz Bank**

The guidelines implementation started on a right foot as the tax policies are actually drawn to facilitate Islamic Finance. This is so because the guidelines clearly define what is certain as an approved Islamic Finance transaction and what is not. In that wise, all the transactions that lead to income generations in the light of contractual agreements and services rendered were clearly shown in the 2012 annual report and accounts of the bank. The report revealed, deferred taxation on the loss made during the period. The deferred tax comprises the timing differences arising from the treatment of fixed assets for accounting purpose and taxation. Consequently, this gave rise to a deferred tax asset shown in the financial statements of the bank.

#### **5.1 Conclusions**

Nigeria has demonstrated its efforts towards alternative sources of finance based on Islamic jurisprudence backed by guidelines to tax any income generated there from. This study concludes that, though the guidelines issued by FIRS for tax purposes are indeed not without creating the possibility of challenges in future, however, it seeks to reduce the risk of economic double taxation and to provide taxable persons with clarity on tax treatment of Islamic finance products and services as demonstrated in global tax practices to stimulate economic growth and develop tax revenue.

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