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TAXATION OF ISLAMIC BANKING PRODUCTS UNDER THE NIGERIAN LAWS: ISSUES, PROBLEMS AND PROSPECTS

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Abstract
After almost four decades of the revival of Islamic banking globally, and over twenty one years of promulgating Banks and Other Financial Institutions Decree (BOFID), a law that prepared legal ground for the operation of Islamic banking in Nigeria, the current three major laws that regulate Banking activities and Company's taxation in Nigeria-the Banks and Other Financial Institutions Act, the CBN Acts and the Companies Income Tax Act are yet to provide adequate guideline for the taxability of Islamic Finance. This is a lacuna in both the administration as well as the taxation of Islamic banking activities in Nigeria. This paper therefore addresses the issue of the taxability of Islamic banking products and the likely problems thereto under the Nigerian Law. Apart from other general solutions proffered, the paper ends with a recommendation that a model law and clear regulations on Non-Interest Finance be urgently put in place to take care of the tax aspect of Islamic Finance in Nigeria.

Keywords: Taxation, Islamic Banking, Nigerian Laws, Problems, Prospects.

Introduction

Islamic banking or Islamic finance is a term that reflects banking business or financial business that is not contradictory to the principles of Islamic law[1]. Islamic banking products are products of conventional banking, insurance and finance by "Islamizing and removing the features prohibited by *Shariah* and applying *shariah* principles to achieve the same or similar effects"[2]. The name Islamic bank, interest-free bank and profit-loss-sharing (PLS) banks have been accepted all over the world as being synonymous. However, the name to adopt depends on the nature of government and the religion of each nation[3]. Islamic banking aims to promote and develop the application of Islamic principles, law and traditions to the transactions, financial banking, related business and commercial affairs[4]. It promotes business and commercial activities that are

acceptable to and consistent with, *Shariah* principles, safeguarding the Islamic communities and societies from activities which are forbidden in Islam[5].

The distinguishing feature of Islamic finance is its prohibition of interest (usury). The Islamic financial system opposes all forms of investment involving activities that are deemed not to be compliant with *shariah* law. Islamic banks are the fundamental components of the Islamic financial system, carrying out the full range of banking activities in accordance with Islamic law[6]. The notion underlying the activity of Islamic bank is the principle of risk-sharing, known in Arabic as '*al-Ghum bil Ghurm'*[7]*.'* Islamic banks acts as partners, shares both the gains and the losses generated by their customers. Banks will guarantee their continued role over time by multiplying the number of customers (in order to share the risk) and by providing advice and support services in Management[8]. In a nutshell, the concept that the right to property should come from a person's own labour and the sanctity of contracts are core principles of Islamic finance. Risk sharing, prohibition of interest, pure debt security and the elimination of contractual ambiguity and other forms of exploitation are some of the implications of these principles[9].

After almost four decades of the revival of Islamic banking globally, and close to about twenty one years of promulgating a law that prepared legal ground for the operation of Islamic banking in Nigeria, apart from the issue of its legality or otherwise that has attracted series of arguments for and against, the issue of its taxability has not been adequately addressed.

Amongst those that argued in favour of the establishment of Islamic bank in Nigeria are, Abikan[10] in one of his papers, the 'Constitutionality of Islamic Banking in Nigeria'. In that paper, he argued that there is no section in the Nigerian Constitution that provided against Islamic banking, rather, all the Nigerian laws that have to do with banking allow for Interest-free banking system. This argument also found the favour of the then CBN governor Mallam Sanusi Lamido Sanusi in one of his papers 'The *Shariah* debate in Nigeria: Time for Reflection'. Others included Tabiun, "Abdulazeez[12] and Professor Yadudu[13]. Authors like Amos,[14] Lews[15] and Eghes[16] merely did an overview of the constitutionality of *shariah* legal system, criminal jurisdiction in Nigeria, what is making the Christians to be pessimistic about the establishment of Islamic banking and the appropriate regulations for the non-interest banking in Nigeria.

Notable amongst those that have argued against faith-based banking are Professor Agbede, Professor Nwabueze, Professor Ejobowah and Keyode Eso. According to them, the establishment of Islamic law and by extension establishment of Islamic banking amounts to promoting or adopting of Islam as a state religion which to them is against the provision of section 10 of the constitution of the Federal Republic of Nigeria which they have always interpreted as declaring Nigeria a secular state.

Save the effort of Abdulrazaq[17] in a newspaper article where he tried to look at the compatibility of Islamic banking product with conventional banking

products vis-à-vis the Nigerian tax laws, Hassan[18] and Bashir[19] who all tried to use their practical experiences in Jaiz bank as well as CBN Nigeria to highlight the problem non interest banking is facing and lately Abdulrazaq and Olokooba[20] in one of their papers, "Tax Issue on Non-Interest Finance Transactions" where they tried to extract and examine issues that may likely arise in the non- interest finance in Nigeria, the taxation of Islamic banking in Nigeria has not been satisfactorily addressed. In order to come up with some workable solutions, this paper therefore attempts a product by product analysis of the common Islamic banking services in Nigeria with likely problems the taxability of such products may encounter under the Nigerian tax laws. It is presented in six parts with conceptual framework following this introduction. Part three focuses on the current status of Islamic banking in Nigeria. Issues, Problems and prospects in the Taxation of Islamic Banking Products under the Nigerian Laws are examined in part four, while part five contains the prospects of the taxation of Islamic banking under the Nigerian economy and the work ends in part six with conclusion and recommendations.

Conceptual Framework

This paper, examines the taxability of Islamic banking products in Nigeria. The effort in this direction is expected to clear the ambiguity on its taxability and or otherwise and the barriers thereto under the Nigerian law.

Current Status of Islamic Banking in Nigeria

The establishment of Islamic Banking system is no more news in Nigeria, so also is the effort of CBN in creating an enabling ground for Islamic banking system, by asserting that the Banks and Other Financial Institutions Act of 1991 as amended in Section 9, 23 and 52 provided for the establishment of interest-free banking in Nigeria. Furthermore, in recent times, there has been the move towards providing a framework for financial products in accordance with Islamic rules that will enable those who follow strict observance of Islamic Law to obtain financial benefits according to their belief. [21]

In 1991, the Banks and other Financial Institutions Decree (BOFID) was promulgated in Nigeria to pave way for the establishment of Profit and Loss Sharing (PLS) banking. Sequel to this, in 1992, two existing conventional banks were given provisional licenses to operate interest free banking and in 1999, Habib Nigeria Bank Limited started her interest-free banking window[22]. Further in 2005 the Central Bank of Nigeria, issued a guideline and directive for the operation of Non-interest banking. The Central Bank of Nigeria also on 21 June, 2011, issued new guidelines for the regulation and supervision of institutions offering non-interest financial services in Nigeria. The Central Bank of Nigeria stated that the emphasis of the guidelines is on non-interest financial institutions operating under the principles of Islamic commercial jurisprudence.

The guidelines, according to the Central Bank of Nigeria, are issued

pursuant to the non-interest banking regime under section 33(1)(b), of the Central Bank of Nigeria Act, 2007; section 23(1); 52, 55(2); 59(1)(a); 61 of the Banks and Other Financial Institutions Act, 1991(as amended), and section 4(1)(c) if the Regulation is on the scope of banking activities and ancillary Matters No. 3, 2010. This shall be read together with the provisions of other relevant sections of Banks and Other Financial Institutions Act 1991, Central Bank of Nigeria Act 2007, Companies and Allied Matters Act (CAMA), 1990 (as amended) and circulars/guidelines issued by the CBN from time to time.

Islamic banking has moved from a theoretical concept to embrace more than 100 banks operating in 40 countries with multi-billion dollar deposits world-wide. Nigeria is home to the largest Muslim population in sub-Saharan Africa, with around half of its 150 million people members of the Islamic faith[23]. It is also home to one of Africa's fastest growing consumer and corporate banking sectors. Thus given the population of Nigeria, the country can be the African hub for Islamic banking[24].

Without mincing words, the establishment of Islamic banking products is a means of product enhancement; they add value to the existing products so that they become more viable and appealing. Thus, conventional banking products may also be adopted with certain modifications to conform fully to Islamic values[25]. This type of action is not strange in Islam because, the second caliph, Umar was reported to have practiced *Sasanid* land tax system after the removal of injustice from its collection and administration. He therefore, left the land with the tenants attached to it and made it a common property of all the Muslims and imposed land tax otherwise known as *Kharaj* on it[26].

Amongst the common Islamic banking products in Nigeria are *Mudharabah* (Passive Partnership), *Musharaka* (Active Partnership), *Murabaha* (Commercial funding with profit margin), and *Wakala* (Profit Share Agency). However, in Nigeria today, there has not been a distinct provision in the Nigerian tax law for all these Islamic finance products. Hence, the general tendency will be that, the products may not be taxable; and that because they are religious products, the profits derived from the products are exempt. This is in accordance with section 23 (C) CITA 2004 and Section 19 (1) and paragraph 13 of the Third schedule of the PITA 2004 that exempts from tax, the income of any ecclesiastical venture provided such income is not derived from a trade or business. It is therefore not unlikely that the already established banks would soon join the band wagon and start devising and advertising many *Shariah* compliant financial products which forbid interest *vis-à-vis* the major aim and objective of business organization which is to make gain.

In order to clothe the guidelines with Islamic features, they further provide that Institutions Offering Islamic Financial Services (IIFS) may charge such commissions or fees as may be necessary in accordance with the principles under this model (Islamic model) and the funds received as commissions and fees shall constitute the bank's income and shall not be shared with depositors[27].

Similarly, in order to standardize the practice, the guidelines provide that there shall be compliance with prescribed Audit, Accounting and Disclosure Requirements such as the Nigerian Accounting Standards Board (NASB) and that where there is a conflict between the local and international standards, the provisions of the local standards issued by Nigerian Accounting Standards Board shall apply to the extent of the inconsistency[28]. The adoption of IFRS in Nigeria today does not negate this position.

Presumably, the commissions and fees which constitute the bank's income as well as the profit sharing investment accounts will be subject to Nigerian taxation. However, there is the need for answers to some germane questions, such as what taxation standards will apply to the products, would it be those of IFSB, AAOFI, NASB or those of the Chartered Institute of Taxation of Nigeria? Could it even be those of the Relevant Tax Authority who are empowered under both section 62 of Companies Income Tax Act LFN 2004 and section 52 Personal Income Tax Act LFN 2004 to require in writing that a taxpayer keeps such records, books and accounts as maybe considered adequate in such form and in such language as maybe specified in the said notice[29]? In a nutshell and considering the peculiar nature of the Nigerian tax law, will there be a reconciliatory ground for the survival of Islamic banking business in Nigeria which is basically a common law origin and how are the Islamic financial products to be taxed?

Issues and Problems in the Taxation of Islamic Banking Products Under The Nigerian Laws

In Nigeria, before an organization can function as a bank, it must be incorporated under part 'A' of the Companies and Allied Matters Act Cap C20 Laws of the Federation of Nigeria, 2004 at the Corporate Affairs Commission, as outlined in section 1(a) Banking Act, 969 . By law, no banking business shall be transacted in Nigeria except by a company duly incorporated in Nigeria which is in possession of a valid license granted by the Minister of Finance. Going by section 1, Nigerian Banking Act Cap C8 Laws of the Federation of Nigeria, (2004) this is a general requirement for the operation of any type of banking services in Nigeria. Not only that, it is further required of other conventional banks to pay company Tax payable at the rate of 30%. This is in addition to the payment of excess profit levy of 10%. Although from 1989, the excess profit levy payable by banks operating in Nigeria has increased to 15%. This is also contained in section 40(2) Companies Income Tax Act Cap C21 Laws of the Federation of Nigeria, (2004)

The major reason for Islamic banking products in an economy is to finance the liquidity needs of customers. This can be in form of, personal financing, cash lines, overdrafts and credit card. For this product to be taxable under the Nigerian tax law, the product will involve the sale and buy-back arrangement[30]. Therefore, both the federal or state tax authorities have to develop

a mechanism of dealing with these *Shariah* products as an agreement. Thus, where this arrangement is entered into, for example, "*Murabahah*" (Sale and deferred payment terms), the deference between the cash sale price and the deferred payment price is allocated to the period in the arrangement, the amount being allocated to each period is then taxed as if it were interest received by the "lender". The lender is also required to apportion the effective return in accordance with generally accepted Nigerian practice[31]. Invariably, the general principle of tax approach is to identify the nearest equivalent in traditional western business practice to tax. This is the difference between the purchase price and the sale price on '*Murabaha* (deferred sale contract) which is treated and taxable as interest. Similarly, where a profit share is paid, if it equates to interest, it is taxable as interest. However, before any profit is declared, it is required that the Islamic portion of the *Zakat* must first be deducted.

In the case of *Mudarabah* which is an equity financing contract, the often-quoted problem is the possibility of the loss of capital that is provided by the capital provider. The fact that the capital provider (*rabb al-mal*) is supposed to bear the financial loss renders this type of financing unpopular from the capital provider's perspective[32]. Therefore, if *Mudarabah* is in the hand of the tender, if not handled carefully, equitable distribution of profit and loss may not be achieved and in that wise it may sometimes amount to *riba.* To guide against this, it is humbly suggested that solutions can be borrowed from the existing arrangement in Malaysia, whereby the bank will provide capital, the customer works with the capital and the profits generated from the trade or project will be shared according to an agreed profit sharing ratio between the bank and the customer. Losses, if any, will be borne by the bank as capital provider, except in the event or negligence or fraud by the customer[33]. This sharing formula because it shares both gain and loss equitably cannot be called usury and it is not in any way against the Islamic trading principle since it cannot be called usury.

Another problem which is likely to arise according to Abdulrazaq,[34] is in the case of *Wakala* (Profit share agency) where money is pooled by various investors and lent out to traders for a share in their profit. Abdulrazaq[35] rhetorically asked, is the share of profits an interest payment in view of the fact that there is no co-ownership of the business for it to constitute a "true" share of profits? Or what is the "true" character where such money is lent interbank at an interest rate? He further asked can one bank legally share in the profit of another. To this the Malaysia experience in Islamic hedging product may also be the solution. Under this system, Bank A and Bank B will enter into two legs of sale transaction. The first leg is to create a fixed rate obligation and the second leg is to create floating rate obligation. Under the first leg, bank A sells asset to Bank B. Immediately thereafter, Bank A buys back the asset from Bank B with a fixed mark-up. The fixed mark-up rate obligation is thus "created" and is payable periodically throughout the tenure of the swap arrangement from Bank A to Bank

B. Therefore, the creation of fixed and floating profit rate would be achieved via 'commodity' *Murabahah* cum *Tawarruq* transaction[36].

Just like *Wakala*, the issue of *Musharaka* (diminishing share ownership) is not an easy bet either. A more *shariah* compliant tax interpretation would be in respect of this Islamic product which would be very similar to a venture capital purchase of equity which is then redeemed over an agreed period of time. The redemption of the equity would be a purchase and sale of shares at a possible gain which is exempt from capital gains tax. This also might result in complications where there is a constant and regular purchase and sale of shares as to raise the question whether the gain on the sale of share is a capital gain which is tax exempt or a trading profit which is taxable? The simple answer to this is that, the purpose of progressive redemption of shareholding was never intended in *Musharakah* or *Ijarah*[37].

Furthermore, another likely problem is the issue of risk of loss. On this, many were of the opinion that heavy burden of loss is more likely to be passed to the financier bank without similar burden on the creditor. However on this problem[38], Muhammed Taqi argued that it was a misconception because under *musharakah*, before the granting of any facilities, the banks and financial institution will study the feasibility of the proposed business for which funds are needed. Not only that, there will always be a diversified portfolio of *musharakah*.

Another problem in the taxability of Islamic banking in Nigeria is lack of adequate laws to regulate the system. Presently, due to the common law origin of Nigerian laws, there seems to be an unfair treatment of Islamic activities, Islamic banking inclusive. In fact, despite the introduction and full implementation of Islamic law since 1999 in the Northern part of Nigeria, *Shariah* is still categorized as part of customary law and it is governed by the same rules which provide for the application of customary law[39].

Thus, even though there has not been a statutorily enacted law to purely guide the taxability of the proposed Islamic banking system and its products in Nigeria, judging from its viability, when it becomes operative, the products are taxable, what is required is some sort of flexibility which will accommodate the conventional banking product but which will still give room for its Islamisation. This is not strange because even in some countries like Malaysia with similar legal system like Nigeria, the legal provision of banking business gives some flexibility to practitioners, regulators and *shariah* advisors to create and introduce unlimited Islamic banking business as long as these products and instruments are Islamic compliant[40]. In Islam, what is forbidden is *riba*, which means usury; and not trading[41].

Prospects in the Taxation of Islamic Banking under the Nigerian Economy

There is undoubtedly a huge potential for Islamic finance in the real economy in Nigeria[42]. It is in recognition of the benefits of Islamic banking that the Central Bank of Nigeria initiated actions to develop a regulatory and supervisory framework for Islamic (non-interest) banking in Nigeria. This includes the effort of the Federal Inland Revenue Services in evolving the best way to tax the product without infringing on the tenets of Islam as well as ensuring compliance with the Nigerian Tax Laws. The achievement of this, no doubt will create an enabling environment for attracting multibillion dollar global Islamic finance industry to Nigeria and also enable Nigerians benefit from *Shari'ah* compliant banking services and products with the resultant effect of revenue generation by government through tax.

According to Sanusi Lamido Sanusi the former Governor of the Central bank of Nigeria, Islamic banking which is asset linked in nature and an interest-free monetary system, is more likely to lead to monetary stability as compared to the interest-rate based system which is subject to fluctuations in interest rate levels[43]. If this is so, there is no doubt that such stability will aid and facilitate effective taxing system that may lead to equitable wealth re-distribution in Nigeria.

Furthermore, if countries like the United Kingdom with a predominantly Christian population of around 1.8 to 2.million[44] can introduce, practice and develop a workable tax policy for Non-Interest banking without any problem, countries like Nigeria which has a larger population of Muslims should not encounter any challenges. However, if there are ideas can be borrowed from UK and Malaysia which have developed substantial tax laws for non-interest banking system.

Similarly, since re-investment is never in any way against the *Shari'ah* economic principles, Islamic banking will aid and ensure adequate management of public fund and its taxability will ultimately lead to a rise in the living standard of the people and multiple reinvestments in the country's economy. Re-investment according to Akanbi[45], is in consonance with what happened during the time of the holy Prophet Muhammed (Peace be on him) when funds collected through *baitul mal* were used to fund state responsibilities and sometimes extended as loans to the Muslim *Ummah*.

Finally, considering the fact that since 1999 some states in Nigeria have been operating the Islamic legal system in both their civil as well as criminal jurisdictions, making Islamic banking product to fit into the exiting taxing laws may not be a major problem. What needs to be done is to study the current tax regimes for conventional banking, look at the tax implications for Islamic finance Institutions, remove any element of usury form it and apply the Nigerian law according to the provision of the Companies Income Tax Act.

Conclusion and Recommendations

From all the aforesaid, it could be gleaned that the tax aspect of Islamic banking is still a virgin area yet to be addressed by the Nigerian tax regime. Neither the Central bank of Nigeria law nor any other law that regulates company activities in Nigeria, for example, the Companies Income Tax Act Cap. C21 Laws of the Federation of Nigeria, 2004 (as amended 2007), and the Companies and Allied Matters Act, cap. C20 Laws of the Federation of Nigeria (2004) provides for the tax aspect of the Islamic financial products. The reason for this is not far from the peculiar nature of the Nigerian tax law which is basically, common law origin. However, now that the issue of Islamic banking is gaining momentum via series of efforts by the Nigerian tax authorities and Islamic scholars to fashion out laws for its taxability, the need to explore the likely problem and the likely solution to them cannot be said to be misplacement.

It is a fact devoid of fallacy that when fully introduced into the Nigerian financial industry, some challenges are bound to confront the taxability of the Islamic financial products. Among such challenges are issues of share of profits, issue of risk of loss and practicability / adaptability of Nigerian laws to accommodate the peculiarity of Islamic financial products. However, it is posited in this paper that with some flexibility and borrowing of ideas from countries that are already practicing Islamic banking, especially Malaysia, a large part of conventional banking products can also be accommodated in the Islamic banking system. This will not in any way alter the Islamic native of the products neither will it run against the Nigerian legal system or the Nigerian Tax Laws

In conclusion, since the Central Bank of Nigeria guidelines on Islamic banking as well as the Companies Income Tax Act provisions on taxation of Islamic financial products are presently inadequate, this paper recommends the following for better taxation of Islamic banking products under the Nigerian Tax Laws.

- Enactment of a model law that will provide for a comprehensive legal framework to regulate Islamic financial products in Nigeria.
- Review of Companies Income Tax Act and Bank and Other Financial Institutions Act to take care of the peculiarities in the taxation of Islamic banking products
- Constitution of Islamic Law and tax Law experts into a body to develop a practical approach to the mode of taxing Islamic banking products without infringing on Islamic tenets.
- As an immediate solution, this paper recommends the adoption of Malaysia and UK legal provisions on the common Islamic banking products. This adoption must also be with modification in order to conform to the Nigerian Legal System.

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