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In This Issue

We discuss about the income tax treatment of Sharia-based financing activities and Sharia – based banking including for each type of activities and income respectively.

In addition, we also discuss the pass through concept governed under the new implementing regulations.

Islamic Finance – new MoF regulations on Sharia income tax

Income tax on Sharia-based commercial activities is governed by Government Regulation No.25/2009 (GR-25), dated 3 March 2009. However, this only covers very high level matters. In this regard, the Minister of Finance (MoF) released regulations No.136/PMK.03/2011 (MoF-136) and No.137/PMK.03/2011 (MoF-137), effective on 19 August 2011, as the implementing regulations for GR-25.

GR-25 – What's in it?

There are two main areas covered by GR 25:

1. Withholding tax

The withholding tax (WHT) applicable to Sharia-based business activities is similar to conventional WHT. For example, the tax treatment of interest also applies to compensation for use of a third party's fund not included in the category of company capital. This compensation may be in the form of the third party's right to production sharing, margin, or bonus, according to the approach of the Sharia transaction used.

2. Deductibility

The third party's right to profit sharing, the margin, and the loss from profit sharing shall constitute a deductible expense. The third party's right to profit

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sharing is not considered to be a dividend, on the basis that dividends are distributed according to capital investment in the business, which shows business ownership, while profit sharing is distributed in exchange for the use of the third party's fund for a certain period of time, which does not necessarily relate to its business ownership.

This regulation contributes significantly to the dispute over whether profit sharing can be interpreted as a dividend, and therefore as a non-deductible expense of the part of the debtor.

MoF-136 – Income Tax Treatment of Sharia-based Financing Activities

MoF-136 defines Sharia financing companies as non-bank financial institutions which conduct financing activities based on Sharia principles.

Sharia principles are defined as Islamic law principles based on a *Fatwa* (edict) that is issued by an institution authorised to issue a Sharia *Fatwa*. Therefore, taxpayers need to ensure that any structure used under a Sharia transaction is based on a *Fatwa*.

MoF-136 also provides definitions of the types of agreement and structures used in Sharia financing activities.

Tax treatment is summarised below:

Type of activity	Type of agreement	Tax treatment
Lease	*Ijarah*	Similar to Operating Lease
	Ijarah Muntahiyah Bittamlik (IMBT)	Similar to Financial Lease with Option Rights
Factoring	*Wakalah bil Ujrah*	Gain or fee is treated as interest
Consumer financing	*Murabahah*	Gain or profit margin is treated as interest
	Salam	
	Istishna'	
Credit card	Not specified	Fee or any other income is taxed in accordance with the Income Tax Law No.36/2008 (ITL)
Other Sharia-based financing		
Corporate financing	*Mudharabah*	Gain and/or profit sharing derived by financiers (*Shohibul maal*) is treated as interest
	Mudharabah Musytarakah	
	Musyarakah	

The deductibility of expenses is based on articles 6 and 9 of the ITL, including the gain and/or profit sharing payable by the financing company to the *Shohibul maal*, and the agreed amount in the Sharia agreement.

MoF-137 – Income Tax Treatment of Sharia Banking

In addition to providing definitions of Sharia Banking and Sharia Principles, MoF-137 also categorises banks' customers under three categories:

- Investor customers –customers who place their funds in a Sharia bank or Sharia business unit in the form of investment.
- Saving customers - customers who place their funds in a Sharia bank in the form of savings. Savings are defined as funds entrusted by the customer to the Sharia bank in the form of a demand deposit (giro), saving account, time deposit, or in some other similar form.
- Facility receiving customers (Debtor) –customers who receive a fund facility or other similar facility.

Unlike MoF-136, which defines the tax treatment based on type of activities, MoF-137 defines the tax treatment based on the type of income, and based on the recipient of the income. The tax treatment can be summarised as follows:

Type of income	Tax treatment	
	Bank	Investor/Depositor Customer
Bonus, profit sharing, and profit margin:		
- from a debtor transaction	Income is treated as interest	
- from a transaction other than a debtor transaction	Income is treated in accordance with the normal income tax regulations for the relevant transaction	
Bonus, profit sharing, and any other income from funds entrusted or placed, and funds placed offshore through an Indonesian Sharia bank or an Indonesian branch of an offshore Sharia bank		Income is treated as interest
Customer's income other than that covered by the previous point		Income is treated in accordance with the normal income tax regulations

Deductible expenses for Sharia banks are set out in articles 6 and 9 of the ITL, and include the bonus, profit sharing, and other fees payable by the bank to their Investors and Depositors, and the amount agreed in the Sharia agreement. Excluded from the deductible expenses is the depreciation expense in financing activities which use an IMBT agreement. This is similar to the rule for the lessor in finance lease transactions. It is worth noting that IMBT is defined and governed by PMK-136, but this does not mention the deductibility of depreciation expense under an IMBT agreement. Nevertheless, if the agreement type is the same, i.e. IMBT, one can reasonably rely on the same treatment for an IMBT transaction carried out by a non-bank Sharia financial institution.

A Pass Through Concept

Both MoF regulations also stipulate that if there is a transfer or lease of an asset which is required to fulfill the Sharia principle, the following rules apply:

- Transfer of an asset from a third party that is carried out merely to fulfill the Sharia principle in the financing activities by the financing companies does not fall under the definition of transfer of asset as stipulated in the ITL.
- The transfer of an asset as defined above will be considered to be directly from the third party to the financing companies'/banks' customer, who will be subject to normal income tax.

Under the Sharia principle, it is common to have back-to-back agreements which can legally be seen as a two leg transaction. For example, under a *Murabahah* financing of a house, the legal document is likely to show the transfer of the house from the third party to the bank, and transfer of the house from the bank to the customer. If this pass through concept is not applied, the 5% final income tax on the transfer of the house can potentially be imposed twice. Therefore, this clause is particularly useful in addressing this potential double taxation. The spirit is similar to that of Article 1A paragraph (1) b) and h) of Value Added Tax Law No.42/2009.

What's next?

Whilst we appreciate the progress represented by the implementing regulations in the area of Islamic finance, they only cover financing activities. No implementing regulation has been issued for other types of Islamic finance activities such as insurance. Considering that the new Accounting Standard for Sharia Insurance (PSAK 108) has been effective since 2010, and that the mechanism is quite different from conventional insurance, we are hoping that an implementing regulation in this area will also be issued in the near future.

In addition, these MoF regulations only govern Sharia transactions carried out by banks and financial institutions. The question remains of whether other types of company, such as an intermediary company in a *Sukuk* transaction, can rely on the same tax treatments under these regulations.

Apart from the regulation on Income Tax, an implementing regulation in the VAT area will also be useful, especially to cover the pass through concept as stipulated in the MoF 136 and MoF 137. Although the current VAT Law already governed about the pass through concept for delivery of goods, it has not covered the pass through concept for delivery of services and rentals.

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