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Co-existence of Secular Taxation and *Syariah* Compliant Practices: A Contemporary Application

Loo Ern Chen¹, Anuar Muhammad² & Mohd Waliuddin Mohd Razali³

¹IPE Management School, Pole Paris Alternance Taman Tun Dr. Ismail, Kuala Lumpur,

²Faculty of Accountancy, Universiti Teknologi MARA Melaka Branch, Alor Gajah Campus,

KM26, Jalan Lendu, 78000 Alor Gajah Melaka, ³Faculty of Economic and Business, Universiti Malaysia Sarawak (UNIMAS), Kota Samarahan Sarawak

Email: anuar843@uitm.edu.my

Abstract

In Malaysia, the administration of *zakat* institutions comes under the respective individual State jurisdictions while that of secular taxes comes under the Federal Government. Unlike *Syariah-compliant* practices, certain aspects of secular tax practices are not *Syariah-compliant*. Despite these two fundamental diverse features, secular taxation and *Syariah-compliant* practices have been able to co-exist within the Malaysian fiscal system, made possible by the provisions in Federal secular tax codes and fiscal policies that accommodate *Syariah-compliant* transactions and arrangements, by explicitly excluding certain *Syariah-compliant* transactions and arrangements from falling under the ambit of the secular tax laws. In addition, parallel tax treatments based on the principles of tax neutrality and specific tax incentives for *Syariah-compliant* transactions and arrangements are provided.

Keywords: Secular Tax, *Syariah* Compliant, Zakat

Introduction

The Federation of Malaysia consists of the Federal Territories and thirteen States. Under the Federal Constitution, Islamic religious affairs come under the jurisdiction of the various States. Thus, the *zakat*¹ institutions are administered by thirteen respective states under their *Majlis Agama Islam Negeri* (State Islamic Religious Councils) and one for the Federal Territories. At the Federal level, acting as the intermediary between the Federal Government and the State Islamic Religious Councils is the Department of Awqaf, Zakat & Hajj (JAWHAR). Taxes that come under the jurisdiction of the Federal authority include direct taxes, such as income tax, real property gains tax and stamp duty. In spite of the separation of jurisdictions, both the *zakat* practices and secular taxes co-exist in the Malaysian fiscal system.

As such, the objectives of this paper are framed as below:

¹ MASB TRI-1 (2006) classifies *zakat* as an expense in the period in which it is incurred. *Zakat* is referred to as an Islamic levy (Ahmed & Zainuddin, 2017; Mighdad, 2019; Sarif, et. al 2020)

- i. Review the co-existence of secular taxation and *Syariah-compliant* practices particularly *zakat* in Malaysia.
- ii. Examine some direct tax incentives in the form of exemptions on *Syariah-compliant* income, and on expenses specially allowed for deductions in the determination of income tax.

It commences with the discourse on some *Syariah-compliant* financing of business ventures *vis-à-vis* provisions of the direct tax codes, *syariah-compliant* financing of purchases and usage of assets and treatments under secular direct taxes, basic elements of *zakat*, with particular emphasis on the practices in contemporary Malaysia, particularly on the types of *zakat*, the modes of assessment and the co-existence of *Syariah-compliant* transactions and arrangements, and the secular tax practices.

***Syariah* Compliant Transactions or Arrangements**

Interest (*Riba/usury*) is one of the elements under the secular conventional financial, monetary and fiscal system. Interest is a prefixed rate for the use of funds or capital. However, from the Islamic perspective, *usury* and the taking and paying of interest, no matter how small the quantum, is prohibited as there is no difference between interest and *usury* of *riba* (Akhtar, 1992). However, Suharto (2018) argued that there are some differences between interest and *riba* semantically even though both are prohibited. In order to adhere to the interest-free regime, *Syariah* compliant financial principles and practices have to be carefully distinguished from their conventional counterparts.

Interest-free does not mean cost-free. Capital will cost what it would earn in combination with an enterprise. The reward for capital is a share in profits and not interest (Azrak & Hazaa, 2021). Receiving a predetermined fixed rate of return (i.e., interest) based on the quantum of fund or capital provided is not *Syariah* compliant. However, receiving a predetermined fixed ratio on the return on capital employed (i.e., sharing of profit) is *Syariah* compliant. In the context of an interest-free, profits-sharing regime, transactions and arrangements need to be based on the *Syariah-compliant* models, such as the *Mudharabah* models (Fitri et. al, 2020).

Briefly, the *Mudharabah* (profit-sharing) model is a contract made between two parties, namely the investor (*Rabbul Mal*) who solely provides the capital and the entrepreneur (*Mudharib*) who solely manages the business. Profits are to be shared based on a pre-agreed ratio. Losses shall be borne entirely by the investor or capital provider unless it was due to negligence / misconduct by *Mudharib*. Under the *Musyarakah* (profit and loss sharing) model, an arrangement can be made between two or more parties. All parties would contribute capital either in cash or in kind and participate in the management of the venture. Profits will be shared based on a pre-agreed ratio, while losses will be borne on the basis of equity participation.

Under the *Mudharabah* model, the capital provider does not manage the venture while the entrepreneur is not the capital provider. Entrepreneurs are not entitled to any remuneration. As for the *Musyarakah* model, all capital providers can participate in the management.

Application of Provisions of Income Tax Act (ITA) 1967

Syariah-compliant profit and loss sharing models are forms of partnership and to some extent meet the definition of partnership under the ITA. Section 2(1) of ITA defines a partnership as “... an association of any kind (including joint ventures ...) between parties who have agreed to combine any of their rights, powers, property, labor or skill for the purpose of carrying on a business and sharing profits therefrom but excludes ... any association which is established pursuant to a scheme of financing in accordance with the principles of *Syariah*”.

Under the ITA, partners are chargeable to tax on their respective share of the partnership's profit. Losses are to be borne by partners in the same ratio as that for the sharing of profits and can be brought forward to the next financial year, which is not consistent with the *Mudharabah* models, and therefore not *Syariah* compliant. However, since the definition of partnership in the ITA explicitly excludes *Syariah-compliant* models, thus the secular tax treatment for partnership is not applicable to such *Syariah-compliant* models.

Financing of Purchases and Usage of Assets

Under the conventional financial system, any provision of funds in the form of loans or mortgages would attract the receipts and payments of interest or *riba*. To cater for interest-free financing, *Syariah* compliant models such as *Murabahah* (cost-plus sale or mark-up), *Bai' Bithaman Ajil* (deferred-payment sale), *Bai' Inah* (sale with immediate repurchase), *Ijarah* (leasing) and *Istisna* (purchase order) would require additional arrangements and instruments adhering to *Syariah* principles such as the existence of subject matter and agreement of the total price, which otherwise are not required under the conventional financing.

Application of Direct Taxes' Codes for Income Tax and Real Property Gains Tax

In relation to the transactions involving real properties, gains arising from any disposal would be chargeable to real property gains tax based on the holding period. However, in the context of a *Murabahah* arrangement involving real properties, any gain arising from the necessary additional *Syariah* compliant acquisition and disposal would not be chargeable to real property gains tax as the Real Property Gains Tax Act, 1976 (RPGTA) provides that “transactions in which disposal price is deemed equal to acquisition price”, thereby rendering a “no gain no loss” position on any disposal, and by extension, no real property gains tax is chargeable, regardless of the holding period.

In the case of other *Syariah* compliant financing, such as *Ijarah* (leasing) and in relation to income tax, Section 2(8) of the ITA provides that “... any reference ... to the disposal of an asset or a lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing ... which is in accordance with the principles of *Syariah* where such disposal is strictly required for the purpose of complying with those principles but will not be required in any other schemes of financing”.

Interest-free Transactions

In relation to interest and *riba*, both the ITA and the RPGTA do contain provisions to accommodate *Syariah-compliant* models. Based on the principle of tax neutrality, for *Syariah-compliant* transactions, Section 2(7) of ITA provides that any “... reference ... to interest shall apply, *mutatis mutandis*, to gains or profits received, and expenses incurred, in lieu of

interest, in transactions conducted in accordance with the *Syariah*". Thus, any *Syariah-compliant* receipts or payments in lieu of interest would be accorded similar tax treatments as for interest of either taxable or exempted.

Chargeability to Income Tax and Zakat

For companies and non-resident individuals, income tax would be chargeable on their respective chargeable income. As for resident individuals, personal relief, where applicable, would be deducted from the total income to arrive at the chargeable income. Thereafter, a scale rate would be applied to determine the tax chargeable.

Income tax treatments for Zakat Paid

Under the ITA, the payment of business *zakat* is allowed for deduction against aggregate income (subject to a maximum of 2.5 per cent of aggregate income). *Zakat* on earned income paid by resident individuals are set off against their secular personal income tax liabilities. For offshore companies, under the Labuan Business Activity Tax Act, 1990, any *zakat* paid are allowed to be set off as rebate against the income tax liabilities.

Chargeability of Zakat on Income and Wealth

Unlike taxes that are based on income or consumption expenditure, *zakat* is based on wealth and idle assets (Muhammad, 2019). However, in the Malaysian context, income such as salaries, wages, bonus, dividend, rental, royalty, ESOS, incentives are also zakatable (Pusat Pungutan Zakat, 2022). There are five conditions under which one is obliged to pay *zakat*, namely (i) a Muslim, (ii) who is independent (not enslaved), (iii) having complete ownership of wealth, (iv) in excess of *nisab*, and (v) over a duration of *haul* (duration of zakatable assets ownership) (Marzuki et. al. 2020) based on the Islamic lunar year. *Zakat* becomes obligatory when a Muslim individual fully owns and has control over his zakatable wealth; owns the productive property; owns *nisab*-fulfilling wealth (i.e., all zakatable wealth must reach a certain quantum), and owns such a quantum for a duration of one *haul* (year) As for business *zakat*, there need to be an intention to conduct business. Should a business be co-owned by Muslims and non-Muslims, *zakat* is only applicable based on the percentage of equity held by the Muslim co-owners (Pusat Pungutan Zakat, 2022).

Zakat institutions in Malaysia

In Malaysia, the *zakat* institutions come under the jurisdiction of the individual State Islamic Religious Council of the respective thirteen states and the Federal Territories. The *Pusat Pungutan Zakat MAIWP* lists the income and assets that are zakatable in Malaysia: namely *zakat* on (1) income; (2) business; (3) bank savings; (4) Employee's Provident Funds (EPF); (5) shares; (6) gold; (7) silver; (8) agriculture; (9) minerals; (10) livestock and (11) *fitrah*. The *Zakat Collection Centre* also listed *zakat harta*, whereby it is allowable to consolidate several types of *zakat* payments (e.g., on income; bank savings account, and EPF). *Qadha zakat* (*zakat* in arrears) is also payable.

Assessment of zakat on income (zakat pendapatan)

Zakat on income includes remunerations and receipts for the provision of services, such as salaries, wages, bonuses, gifts (*hibah*), allowance, honorarium, compensation, pension, and income from dividend, rental, royalty, seasonal business, and other income arising from a vocation. Income from a profession would be zakatable under business *zakat*.

There are two methods of assessing *zakat* on income. The first method is based on the gross income whereby when the zakatable gross income exceeds the *nisab* for the year (*haul*), *zakat* payable would be 2.5 percent on the zakatable amount. Under the second method, specific items are allowed for deductions against the gross income, whereby *zakat* will only be payable when the net amount exceeds the *nisab* (see Table 1). Assume that the gross income is RM54,000 and the total deduction amounting to RM28,820. Hence, the zakatable income will be RM25,180. Since the zakatable amount is greater than the current year's *nisab*, the annual *zakat* payable would be RM720.50.

Comparison between income tax and *zakat* on income

For income tax assessment, to arrive at the chargeable income of an individual, donations to approved institutions and personal relief are available, if applicable. The assessment of *zakat* on income bears few similarities but has several differences when compared with the assessment of income tax, particularly in respect of personal relief, which is available only to resident individuals.

Table 1

Illustration of the computation of zakat payable for the year 2021

		RM	RM
	Gross income		54,000
Deduct:	Allowable expenditure		
	Self	12,000	
	Wife/wives (RM5,000 each wife; maximum 4 wives)	5,000	
	Children (RM2,000 each: assumed 2 children)	4,000	
	Gifts to parents (a year)	1,200	
	EPF contributions	4,620	
	Education cost (self)	2,000	28,820
	Zakatable income (exceeded <i>nisab</i>)		25,180
	Assumption of <i>nisab</i> - RM20,361		
	Annual <i>zakat</i> payable: $RM28,820 \times 2.5\% = RM720.50$		

Under both income tax and *zakat* assessment (for the Wilayah Persekutuan), a personal relief of RM9,000 and RM12,000 for self are allowable. However, personal relief under *zakat* is different from one state to another. For example, Pusat Zakat Selangor (PZS) uses personal relief of RM10,750 in calculating *zakat* on income. In the case of income tax assessment, the maximum relief for wife/wives, if applicable is RM4,000, regardless of the number of wives, while for *zakat* assessment, the relief allowed is RM5,000 for each wife. As for child relief, under the *zakat* assessment, the relief is RM2,000 per child for children below 18 years old and RM5,000 for children above 18 years old and still studying, while for tax assessment the relief is RM8,000. For income tax assessment, relief for EPF contribution is consolidated with payment of life insurance premium, and subject to a maximum allowable deduction of RM7,000, which is not the case for *zakat* assessment.

Relief for contributions to organizations is not available for *zakat* assessment but for income tax assessment if such contributions qualify as donations to approved institutions, it is deductible from aggregate income. However, the total deduction is subject to a maximum of 10 percent of the said aggregate income. Gifts to parents are allowable relief for *zakat* but

not for tax assessment in 2021. In terms of rates, *zakat* due is at 2.5 percent of the zakatable amount, while for resident individuals, the income tax rate ranges from 0 to 30 percent (for the year of assessment 2021) (Lembaga Hasil Dalam Negeri, 2022)

Assessment of Business Zakat

Under the income tax code, gains or profits from the business are chargeable to tax. It is significant to note that income from exercising a profession would be zakatable under the business category, which is consistent with the income tax code. The business annual income statement and related documents would be the principal sources of information to be used to assess the income chargeable to tax. However, business *zakat* is not based on income, but rather on *Urud At-tijarah* (tradeable assets), and the principal sources of information for assessment are the statement of financial position and related documents. Although the bases for income tax on business and business *zakat* are vastly different, secular income tax codes do accommodate the payment of business *zakat* in the determination of the secular income tax liability restricted to 2.5% of the aggregate income.

For the assessment of business *zakat*, two methods may be used, namely the net working capital method (*Shar'iyah* method) and the net growing capital method (*urfiyyah* method). The net working capital method compares the amount of net current assets with the current year *nisab*; while the net growing capital method would compare the net equity of ownership with *nisab*. The adoption of either method would give rise to the same zakatable amount. *Zakat* will only be chargeable on the zakatable amount that exceeds the *nisab*. In the event that a business venture is jointly owned by both Muslims and non-Muslims, only the zakatable amounts attributable to the Muslim owners are chargeable to *zakat*.

For example, assuming as at 31 December 2021, a business entity's statement of financial position shows the following: current assets RM55,000; current liabilities RM15,000; non-current assets RM70,000; long-term liabilities RM42,000; and owners' equity RM68,000. The *nisab* for 2021 is RM14,083.

If the Muslims' ownership is 100 percent using the *Shar'iyah* method (net working capital method), *zakat* payable will be 2.5 percent of the net current assets of RM40,000. If the Muslims' ownership is 75 percent, the zakatable amount attributable to Muslims' ownership will be RM30,000 (75% x RM40,000) which exceeded the *nisab*. Hence *zakat* payable will be RM750 (2.5% x RM30,000). However, if the Muslims' ownership is only 25 percent, the zakatable amount attributable to Muslims' ownership will be RM10,000 (25% x RM40,000) which does not exceed the *nisab*. In this case, no *zakat* is payable. The net growing capital method will also produce similar *zakat* payable for the different ownership mentioned above.

Adjustments to Determine Appropriate Zakatable Amount

The above illustrations provide a broad framework for the determination of the zakatable amount. However, to be fully *Syariah* compliant, some adjustments may be necessary to arrive at the appropriate amount that is zakatable (Hamat, 2009; Ali, 2006; Abdul Rahman & Awang, 2003; Abdul Rahman, 2007).

Hamat (2009) elaborated on some items that are not *zakat* obligated, and thus have to be deducted, such as (i) *riba*, gambling, and liquor, which are non-permissible products; (ii) deposits for utilities, as these do not comply with the requirement of full right; (iii) financial debtors, based on the criteria that full ownership is with the debtors who have the freedom to manage the money to gain benefit from the loan; (iv) items where *zakat* already been imposed, this is to avoid 'double *zakat*'; (v) dormant stock and bad debts, as current assets must be productive; (vi) funds set up for charity, but classified under current assets and (vii) inventories where only finished goods are zakatable while raw materials and work-in-process are not. In addition, other items that should be deducted from the current assets are debts that are specifically doubtful, office supplies, deposits for the purchase of fixed assets, and prepaid expenses (Marzuki et. Al., 2020). Other adjustments include collateralized or encumbered fixed deposits and amounts in funds set up for charity (Abdul Rahman & Awang, 2003).

Zakat on EPF Withdrawal

An EPF member upon reaching 50 years old may withdraw 30 percent from his/her account, and upon reaching 55 years old may make a full withdrawal. For income tax assessment, the EPF is an "approved scheme" and any amount withdrawn by a member from his/her EPF account is not subject to income tax. However, in the case of *zakat*, upon withdrawal from one's EPF account, *zakat* would be payable at 2.5 percent but subjected to the completion of *nisab* only.

Zakat on bank Accounts and Shares

Savings accounts in banks are zakatable, based on the lowest balance in the accounts during the particular zakatable period (*haul*). Zakatable fixed deposits would be based on the capital sum. As for income tax, any capital sum deposited either in fixed deposits or savings accounts is not chargeable to tax. Both interest receipts on *non-Syariah* compliant deposits and returns on *Syariah* compliant deposits are exempted from income tax.

In the case of shares, no *zakat* is payable on shares of companies that had already paid business *zakat*. For shares not listed in the stock exchange, the dividends received are zakatable. As for shares of listed companies that have been held for more than a year, the zakatable value is based on the lowest share price during the zakatable period (*haul*). For shares that were acquired and sold during a zakatable period, *zakat* payable is based on profit on disposal of the shares (i.e., sales value minus cost of capital investment). The rate of *zakat* for both savings and shares is 2.5 percent.

For income tax assessment, unless a person is engaged in the business of trading in shares, gains on disposal of shares are capital gains, and not chargeable to tax. Any dividend income derived under the single tier system is exempted from income tax.

Qadha Zakat (zakat arrears)

Prior years' *zakat* arrears payable is known as *Qadha zakat*. Such arrears are payable at the similar rate of 2.5 per cent, and no penalty is imposed. However, in the case of income tax, any late payment is subject to penalties, depending on the duration between the date that the tax first becomes due and the actual date of payment.

Tax Incentives for *Syariah* Compliant Transactions or Arrangements

The scope of charge to income tax is applicable to gains or profits derived from Malaysia known as territorial basis. In the determination of income chargeable to income tax, only expenses that satisfy the relevant provisions of the ITA are allowed for deductions. For *Syariah* compliant transactions or arrangements, there are some tax incentives in the form of exemptions and deductions specially allowed, particularly by way of statutory orders and rules.²

Conclusion

The findings showed the harmonious practice between two different approaches where the Malaysian government has taken into consideration the need for Muslims in practicing their beliefs and provides an appropriate tax relief or rebate to compensate them in calculating tax. This is the manifestation where the *syariah*-compliant practices and secular taxation can be adapted to meet the specific requirement of the citizen.

In the context of secular tax and *Syariah-compliant* practices in contemporary Malaysia, there are fundamentally two unique features. Secular taxes come under the jurisdiction of the Federal Government, while that of *zakat* institutions are under the jurisdiction of the thirteen States and the Federal Territories. The secular tax principles and practices are fundamentally different from those that are *Syariah* compliant. In spite of these two fundamentally diverse features, the *zakat* institutions, which although not administered by the Federal Government, have become part of the Federal fiscal system under the administration of the Federal Government.

Basically, at the Federal level, a three-prone approach has been adopted to allow for the co-existence of the secular tax and *Syariah-compliant* practices. Although the *zakat* institutions are administered by the respective State Islamic Religious Councils, *zakat* paid is allowed either as a deduction or as a rebate from the secular income tax, which is administered by the Federal Government. Relevant provisions have been incorporated into the direct tax codes, either to exclude specific *Syariah-compliant* transactions or arrangements from falling within the ambit of these tax codes or to accord equal treatment to *Syariah-compliant* transactions or arrangements based on the principle of tax neutrality. Specific tax incentives, such as tax exemptions, special deductions, and double deductions are granted to *Syariah-compliant* transactions or arrangements.

Corresponding Author

Anuar Muhammad

Faculty of Accountancy, Universiti Teknologi MARA, Melaka Branch, Alor Gajah Campus, KM26, Jalan Lendu, 78000, Alor Gajah, Melaka, Malaysia

Email: anuar843@uitm.edu.my.

² Examples of such exemptions and deductions are: Income tax exemption in respect of profits from an investment received within three consecutive years on investments made between April 2016 and March 2019 through the investment account platform established by an Islamic bank to finance venture in Malaysia sponsored by an Islamic bank. [*Income Tax (Exemption) (No. 3) Order 2016*]; and Double deduction for expenditure on the issuance of a retail sukuk pursuant to the principle of *Murabahah* or *Bai' Bithaman Ajil* (based on the concept of *Tawarruq*), *Mudharabah*, *Musarakah*, *Istisna'* or any *Syariah* principle [*Income Tax (Deduction for Expenditure on Issuance of Retail Debenture and Retail Sukuk) Rules 2016*].

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