

# **DETERMINING FACTORS IN PAYING ZAKAT ON BUSINESS INCOME: AN EXPLONATORY STUDIES**

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## **ABSTRACT**

**Zakat is synonym with purification. Purifying wealth is an obligatory to the Muslims through the payment of zakat. Unfortunately nowadays muslims are not aware on the obligation in contributing zakat especially zakat on business income. Previous study shows the collection of zakat for individual income is greater than zakat for business income. Most of the muslims company committed to pay tax which is an obligation as Malaysian citizens but lacking in paying zakat which is an obligation in Islam. This study attempt to look on the factors that contributes to the payment of zakat on business income. From the analysis, this study reveals that there is a relationship between compliance of zakat on business with muslims as Board of directors and majority shareholders.**

**Keyword : zakat on business income, wealth, obligatory**

## **1.0 INTRODUCTION**

The obligation of Zakat comprises one of the five pillars of Islam. It is the third pillar of Islam and therefore it is an act of Fardhu Ain. Zakat means both ‘purification’ and ‘growth’. An individual wealth and possessions are purified by setting aside a proportion for those in need. So, the act of giving zakat means purifying one’s wealth to gain Allah’s blessing to make it grow in goodness.

Islam requires Zakat to be collected from qualified contributors payers i.e. who own wealth, regardless of whether they are Zakat recipients or not. It is a religious obligation not requirement.

Firman Allah s.w.t., Surah Adz Dzariat: 19

*“ And in their wealth there is a due share fro the beggar and the deprived”.*

Another firman Allah s.w.t. in Surah Al Baqarah: 267

*“O ye who believe! Give of the good things which ye have (honourably) earned, and of the fruits of earth which We have produced for you....”*

Therefore we know that Zakat is obligatory to every Muslim who fulfills its conditions. One of the economic implications of Zakat is equitable distribution of income and wealth (Nik Mustapha, N.H., 2007). Zakat collection will be distributed among the needy so that each individual can be assured of a minimum standard of living. However, Islam imposes that every able Muslim needs to work for his livelihood. Zakat transfers are only to supplement the incomes of the poor.

Another implication of Zakat is it will enhance the consumption level of community since the marginal propensity to consume among the lower income level is higher than the upper income level. This positive change would boost the domestic aggregate demand and simultaneously will boost Malaysian economy.

To achieve both implications above, the effectiveness of the Zakat collection is very important. As we know, business is one of the activities that are most encouraging by Rasullullah s.a.w.. According to Rasullullah s.a.w., business provides 99% of the wealth in this world. If Zakat can be collected from all business with Muslim equity in Malaysia, than both important implication of Zakat discussed above can be easily be achieved.

According to the data by Pusat Pungutan Zakat, Wilayah Persekutuan, collection of Zakat on Business in Kuala Lumpur for year 2008 is only 14% from total collection from Pusat Zakat Wilayah Persekutuan compared to Zakat on Income is 67%. Given that business provides 99% of the wealth in the world, than the collection for Zakat on business should be more than Zakat on Income.

## **1.1 PROBLEM STATEMENT**

Zakat collection in Malaysia is still facing difficulties especially collection for Zakat on Business. Even though Zakat is a religious obligation and not requirement for muslims, the collection performance are still lack to help poor people in Malaysia.

From the collection of tax in Malaysia, business taxes are the main component for our country's tax income. However, it is not aligned with the Zakat on Business collection. As an example in year 2004, Lembaga Hasil Dalam Negeri (LHDN) reported tax from businesses contributed more than 50% from the total tax amount collected (Ahmad Radzuan, 2006). The result is contradicted with the report from Pusat Pungutan Zakat, Majlis Agama Islam Wilayah Persekutuan (PPZMAIWP) in 2005. In Wilayah Persekutuan, collection from Zakat on Income is 3 times or 381% more compared to collection of Zakat on Business. This scenario should not happen since Zakat on Business's commandment comes directly from Al Qur'an and thus, have more potential of collection (Abdul Rahim, 2005) as compared to Zakat on Income that only based on fatwa.

How this could happen in Malaysia? The Census in year 2000 shows approximately 60.4 percent of the total population are Muslims in Malaysia. Therefore the level of awareness

of Muslims in paying zakat on business income should be high since 60.4% of the populations are Muslims. However, referring to the result from PPZMAIWP above, literally the awareness in paying zakat on business income is still low.

Although we know that law enforcement on tax is more powerful compared to Zakat, thus this study tends to dig what are the factors that will leads to Zakat payment on business income. This study also attempts to verify the factors which affect the payment of Zakat on Business income made by the companies. The hypotheses predict that:

H<sub>1 (1-5)</sub> There is a linear relationship between payment of Zakat on Business income and Board of Directors, shareholders, profit, industry and size of the company.

## 2.0 LITERATURE REVIEW

Allah makes it lawful for Muslims to engage in business and to make profit; provided that they do not indulge in trading in commodities that are prohibited in Islam and that they observe ethical values in their transactions such as honesty. Since practicing trade is lawful, that is why Islam prescribes Zakat from the wealth of any nation used in trade and business exchange (Yusuf Qardawi, 1999).

Islamic jurisprudence explained the details of Zakat on business. Business goods are called by them 'urud at-tijara' which means anything obtained for the purpose of trade for profit, except liquid monetary assets. This definition includes machinery, furniture, clothing and land. Some jurists define as anything that one buys in order to sell for profit. Muslims who own business goods equal to the nisab of money or more at the end of zakat year must pay its due zakat. This zakat is levied on the principal and increments accruing above the principal. (Yusuf Qardawi, 1999). Details of this will be discussed in the method of calculation.

The following are the evidences of obligation towards Zakat on business (Yusuf Qardawi, 1999).

- a. From Sunnah - Abu Daud from Samura Ibn Jundub, " The Prophet used to order us to pay sadaqa from what we have for sale". To 'order' implies 'to oblige' and it is clear that the word sadaqa means zakat.
- b. From Ijma' – Abu Ubayd reports from Abdul-Qari, "I was appointed treasurer at the time of Umar Ibn Al-Khattab. When he paid stipends, he used to calculate the assets of merchants, both present and absent assets and they collect zakat on them all out of the assets that were presented.

There are 6 conditions that would make zakat on business is compulsory to on a person according to PPZ (Pusat Pungutan Zakat), MAIWP (Majlis Agama Islam Wilayah Persekutuan):

- i. Islam – The zakat payer must be a muslim.
- ii. Full ownership of assets
- iii. Nisab – minimum zakatable amount is more than or equivalent to the current price of 85 grams of gold.
- iv. Haul – passing of a complete year over the wealth.
- v. Independent – free not a slave.
- vi. Business intended – intention to gain profit from activities done.

When a person fulfills all the above conditions, the person must (wajib) pay zakat on business. Zakat on business rate is 2.5% of the zakatable asset when nisab and haul is reached.

If the owner of sole proprietor business is a muslim then the business must (wajib) pay zakat. However, for a company where the equities shared between muslims and non muslims, the zakat is only charged towards muslims portion only. Therefore, the calculation on muslim equity must be calculated first prior to the calculation of zakat amount.

There are two method to calculate Zakat on business as explained by PPZ (Pusat Pungutan Zakat), MAIWP (Majlis Agama Islam Wilayah Persekutuan):

- i. Method 1 – using Working capital, where  
 $(\text{Current Assets} - \text{Current Liabilities}) \times \text{Muslim equity portion} \times 2.5\%$
- ii. Method 2 – using Growth model, where  
 $(\text{Owner's equity} + \text{Long term liability} - \text{Fixed Assets} - \text{Non Current Assets}) \times \text{Muslim equity portion} \times 2.5\%$

According to the book “Panduan Zakat di Malaysia” published by The Department of Islamic Development Malaysia (JAKIM) in 2001, the said methods above are highly recommended methods to compute business zakat. However, most of the states use adjusted working capital method. The adjustments are deduction from current assets (such as non-permissible item, limited ownership), addition to current assets (such as donations for charitable purposes) and addition to current liabilities (such as non operation procedure payable and overdraft).

Summarized from the above, all companies in Malaysia with muslims portion of equities must (wajib) pay Zakat on business. Some companies argue that they do not have to pay zakat on business because majority of the Board of Directors or shareholders are non muslims. This statement is not acceptable although Company’s Act, 1965 determined that management of the company is under the Board of Directors; written in the Subject 76 Fourth Schedule of Company’s Act, 1965. This is because; the power of Board of Directors is still subject to the shareholders’ power that can voice out their right during

Annual General Meeting (Aisyah, B., 2002). For that reason, if the companies have muslims portion in the equities, they must (wajib) pay zakat on business. The action of payment must be voice out by the muslims shareholders supported by muslims Board of Directors.

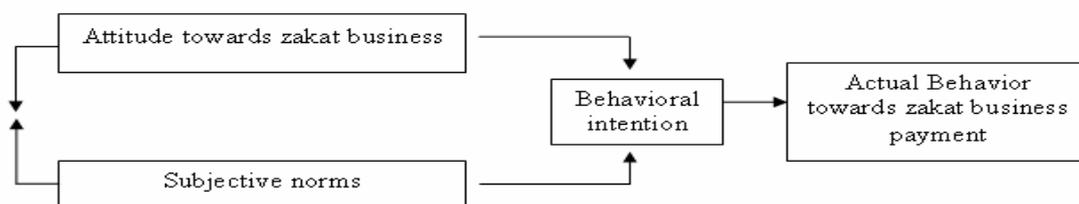
The Board of Directors who has given the trust by the shareholders and members to run the business are responsible to take the initiative to pay zakat on business. Should the Board of Directors do not have the mandate to use company's fund for zakat payment, a motion should have to be presented in the Annual General Meeting to obtain approvals from the shareholders or members to pay zakat.

### 3.0 RESEARCH METHODOLOGY

To achieve the objective, the model that will be used to test whether there is a relationship between zakat payment with member of Board of Directors, shareholders, corporate governance compliance, profit, industry, size and location of headquarters of the company exist or not is based on the model introduced by Ajzen and Fishbein, 1980 and developed by Ram al Jaffri and Kamil, 2007. This model is known as Theory of Reasoned Action.

The following is the model framework developed by Ram al Jaffri and Kamil, 2007 that will be used in this study:

Figure 3.1: Model Framework by Ram al Jaffri and Kamil, 2007



#### Independent variables

The specific related variables are chosen from the attitude towards zakat on business and subjective norms that lead to behavioral intention and directly will affect the actual behavior towards zakat on business payment.

We select the following independent variables referred to the variables that are normally use in the corporate governance disclosure from the previous studies such as studies done by Sh. Norhafiza et.al (2005) and Klapper and Love (2002). For the purpose of this study, we had agreed to choose the following as variables:

Attitude towards zakat on business:

- a. Board of Directors – how many percentage of muslims directors in the company. The category of the percentage is dividing into 4 i.e less than 25%, 25-50%, 51-75% and more than 75%.
- b. Shareholders – who are the majority shareholders of the company? This study divides them into three categories whether majority is held by company, individual-non muslims or individual muslims. Majority is considered as more than fifty percent (50%)

Subjective norms:

- c. Industry – The Company is under which industry in the syariah listed company.
- d. Size – Three category of size i.e small, medium and big company is based on the amount of total assets in the company.
- e. Profitability – Is the company making profit or not in the financial year. Although, irrespective whether the company making profit or not, the company is still obliged to pay zakat on business. According to Zahri Mamat (2009), if the business is having positive working capital they must pay zakat on business no matter whether they are making profit or not in the financial year. However, we still choose profit as variable, because the company might not pay zakat on business because they have short of money if the company is not making any profit.

The dependent variable is payment of zakat on business income; whether the company paid zakat on business income or not. The information whether the company paid zakat on business income are based on three sources, namely Income Statement of the company, advertisement in newspaper or business magazines and zakat administrators. Since most of zakat administrators do not disclose directly which company that already paid zakat on business income, the bulletin issued by them are referred to.

### **3.1 DATA COLLECTION**

The data was collected through content analysis (annual report) by retrieving from the Bursa Malaysia's website.

Our population is all syariah listed companies, listed on both Main and Second Board. As reported by the Syariah Advisory Council of the Securities Commission Malaysia in November 2009, there are 846 companies listed as Syariah Compliant Securities.

Syariah Advisory Council of the Securities Commission had approved a list of securities that can be classified as securities that syariah compliance. In order to classify the security as syariah compliance, Securities Commission will gather information of the company from a few sources such as annual report of the company, responses from the survey to get full information and from the interview with the management of the company. Securities Commission through Syariah Advisory Council will always monitors all the activities by the companies listed in Bursa Malaysia in order to determine the status from syariah perspectives.

Based on the population of syariah listed companies, our sample size will be 281 companies. We used systematic sampling selection where every 3<sup>rd</sup> company listed was selected. This sample size is derived based on the table suggested by Bartlett, Kotrlik, & Higgins (2001) whereby it has a 95% confidence level and a confidence interval of 3.

#### **4.0 FINDINGS AND ANALYSIS**

The data is analysed using Statistical Package for Social Science (SPSS) version 14.0. In order to meet the objectives of the study, descriptive statistics was initially employed. The use of descriptive statistics and also mann-whitney test are important to describe the phenomena of zakat on business payment. Logit regression analysis is also applied to achieve the objective of the study. The model used in this study is named as Zakat on Business Model is explained as follows:

##### **Zakat on Business Model**

$$\text{Log } y = b + ax_i + bx_{ii} + cx_{iii} + dx_{iv} + ex_v$$

where:

$x_i$  = Percentage of muslims directors in the company

$x_{ii}$  = Majority shareholder in the company

$x_{iii}$  = Type of industry.

$x_{iv}$  = Profitability of the company

$x_v$  =Size of the company

This section discusses the findings of the study and provides some conclusions based on descriptive statistical analysis on the data collected from the annual reports.

#### 4.1 Descriptive analysis on dependent variables (whether company paid zakat business or otherwise)

Table 4.1: Summary of overall data

		Payment			
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	yes	47	16.7	16.7	16.7
	no	234	83.3	83.3	100.0
Total		281	100.0	100.0	

Table 4.1 above shows the list of sample companies that either pays zakat or not. Our sample, as explained in the previous chapter consists of 281 companies listed in the syariah approval board. They are assumed to represent all syariah listed companies.

Zakat on business income model is estimated based on the dichotomous dependent variable whereby companies that pay zakat on business are coded as one (1), otherwise coded zero (0). By referring to Table 2, only 16.7% pay zakat business and 83.3% did not involve in paying zakat on business income. It indicates that the percentage of the awareness or knowledge on zakat business income is very low.

The result is aligned with the statement by Minister in Prime Minister Department, Dato' Dr Abdullah Md Zin, there are 80% of muslim bumiputera company's did not pay zakat on business. Only 20% company owned by muslims that registered with Registrar of Company (ROC) performed the responsibility to pay zakat.

##### 4.1.1 Descriptive analysis on independent variables.

Table 4.2: Summary of Independent variables

INDEPENDENT VARIABLES		Frequency	Percentage (%)
Board of Directors (percentage of muslim directors)	Less than 25%	122	43.4
	25-49%	89	31.7
	50-74%	40	14.2
	More than 75%	30	10.7
Shareholder (majority)	Company	210	74.7

<b>shareholder)</b>	Individual – non Muslims	65	23.1
	Individual – Muslims	6	2.1
<b>Type of Industry</b>	Consumer	43	15.3
	Industrial Product	91	32.4
	Constructions	15	5.3
	Services	57	20.3
	Properties	25	8.9
	Plantation	12	4.3
	Technology	35	12.5
	Infrastructure	2	0.7
<b>Company's making profit or loss</b>	Finance	1	0.4
	Profit	182	64.8
	Loss	99	35.2
<b>Size of company</b>	Small	20	7.1
	Medium	118	42
	Big	143	50.9

As outlined in the previous chapters, one of the objectives of this study is to determine the factors influencing the company to pay zakat on business. Table 4.2 summarizes our key independent variables.

The above table explained that 43.4% of the companies have less than 25% muslim as Board of Directors. 31.7% of the sample has 26-50% of muslims as Board of Directors. 51-75% of muslims directors only exist in 14.2% of the company and lastly only 10.7% of the company have muslims directors more than 75%. It concludes that the percentage of muslim as a directors in the company is very low in Malaysian scenario.

For majority shareholders, 74.7% from the sample belongs to company whereas 23.1% from the majority of the shareholders belongs to non-muslim. Only 2.1 % of the sample belongs to muslims.

In terms of industry, 15.3% of the sample is from consumer's industry, 32.4% is industrial product industry, 5.3% from construction industry, 20.3% from services industry, 8.9% from properties industry, 4.3% from plantation industry, 12.5% from technology industry, 0.7% from infrastructure industry and only 0.4% from finances industry. This shows that most of the company listed in the syariah approval list comes from consumer and services industry.

From the total sample, the head office of the companies is predominantly registered at Kuala Lumpur (37.4%). 33.1% head office of the companies located at Selangor. The rest is located at other states. Zakat Administrator should aggressively promote on the importance of zakat on business income. This is because previously only little promotion is being done which leads to lack of awareness among the companies. The collection of zakat on business income should be more than what they have been received. Hence, with a greater promotion it will leads to a greater collection in zakat on business income and increase the level of awareness of zakat on business income among the companies.

In terms of profit or loss incurred, 64.8% of the sample shows that most of the companies are making profit. Only 35.2% of the samples show otherwise. Furthermore, 7.1% of the sample is categorized as small size, 42% is considered as medium category and 50.9% is being categorized as big. Given these two independent variables, most of the company from the sample is large and making profit and hence the collection of zakat on business is expected to be more. However, what happen in reality is not as expected. Even though most of the company is a big company and earning greater profit, but the payment of zakat on business income is still poor.

Table 4.10: Relationship on independent variables between company that pay zakat or not

<b>Mann-Whitney Test</b>					
	<b>BOD</b>	<b>Shareholder</b>	<b>Industry</b>	<b>Profit</b>	<b>Size</b>
Mann-Whitney U	922.000	5006.000	4474.500	4998.500	5149.500
Wilcoxon W	28417.000	6134.000	31969.500	5986.500	32644.500
Z	-9.585	-1.284	-2.066	-1.523	-.772
Asymp. Sig (2-tailed)	.000	.199	.039	.128	.440

A Mann-Whitney test is used to determine if there are any significant differences between these independent variables for company that contribute zakat on business income or not. This test is used because the data distribution is not normal and ordinal in nature.

Table 4.10 shows that there is significant differences for only 2 independent variable which are muslims as the Board of Directors and industry. The company with higher percentage of muslims directors and industry have stronger response towards zakat payment. Perhaps the most plausible reasons can be proposed to explain the attitude on the payment of zakat on business income is because of board of director has the right and power in making decision in the company and environment of the industry could expose the company towards zakat payment.

## **4.2 LOGIT REGRESSION**

Before looking at the empirical results of this study, it would be best to highlight again the research question in this study. The question is:

***“What are the factors associated with the payment of zakat business income of a company?”***

In answering the above question, logit regression analysis is used to test the theoretical model in the equation discussed earlier. As the dependent variable is a dichotomous, a logit regression analysis was carried out to maximum likelihood estimating procedure where it applies a logarithmic transformation to the dependent variable. To test statistically whether compliance of zakat payment are influenced by muslims directors, majority shareholders, type of industry, profitability and size of the company, the logit zakat on business model was employed. The result is presented in Table 4.11.

Table 4.11: Summarizes of variables in the equation

		Variables in the Equation					
		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 <sup>a</sup>	BOD		.362	49.427	1	.000	.078
	Shareholder	.793	.492	2.595	1	.107	.452
	industry	-.167	.132	1.597	1	.206	1.181
	profit	-.222	.511	.188	1	.664	1.248
	size	-.662	.383	2.985	1	.084	1.939
	Constant	-6.604	2.018	10.705	1	.001	738.057

a. Variable(s) entered on step 1: BOD, Shareholder, CG, industry, HO, profit, size.

Therefore, zakat on business income model can be written as follows:

**Zakat on Business Model:**

$$\text{Log } y = -6.604 + 2.546x_i + .793x_{ii} + -.167x_{iii} + -.222x_{iv} - .662x_v$$

where:

$x_i$  = Percentage of muslims directors in the company

$x_{ii}$  = Majority shareholder in the company

$x_{iii}$  = Type of industry.

$x_{iv}$  = Profitability of the company

$x_v$  =Size of the company

The above summarizes the determinants of payment in zakat on business income of company in Malaysia. The majority shareholders, type of industry, profitability and size

of the company ( $x_{ii} - x_v$ ) shows that the p-value is more than 0.05 which is considered as not significant. Thus, we cannot prove statistically that all these variables have impact on zakat on business income of a company.

However, the position of muslims directors as Board of Directors,  $x_i$  is the only independent variable that significant and positively related to the payment in zakat on business income of a company. Indeed, there is a strong support to reveal that the larger percentage of muslims directors in a company, the more likely to pay zakat on business income.

## 5.1 CONCLUSIONS

Zakat on business is zakat that is obligatory to be paid on business property whether it is based on production, mining, fishing, shipping, supplying, and agriculture or service providing. Islam viewed business activities as important but considers necessary for the company to contribute back to the society in terms of zakat. The company that pays zakat on business wealth indicates their commitment to promote social justice and fulfill its social accountability to Allah s.w.t (Abdul Rahman, 2003). However, the current scenario in Malaysia shows that the collection of zakat business is still poor. Collection on zakat on income is normally more than collection for zakat on business in any zakat administrators in Malaysia.

This sample study is 30% from the total population (846 companies) of all syariah compliance listed companies. By using the systematic sampling, 281 companies were chosen. Cross-tabs analysis was conducted to look at the correlation matrix among the variable with the company that pay zakat on business or not. Next, mann-whitney test is done to look at the significant of the variables. Lastly, logistic regression analysis was conducted to examine whether the Muslims directors, majority shareholders, type of industry, profitability and size of the company are associated with payment of zakat by company or not.

From the analysis, this study reveals that there is a relationship between compliance of zakat on business with muslims as Board of directors, majority shareholders, profitability and size of company. The analysis enlighten that the compliance of zakat on business increased when there is an increase of muslims as board of directors in the company. Furthermore, as there are more muslims shareholders in the company, the tendency of the company to pay zakat business is very high. Lastly, when there is an increase of

company's size, more company will tend to pay zakat on business. Other independent variables such as industry and profitability of the company have no relationship with zakat on business payment.

With regards to the determinants of zakat on business collection, this study found that muslims directors and type of industry have a significant relationship with payment in zakat on business income. Further, logistic regression analysis was conducted to examine whether the independent variables are associated with the compliance of zakat on business by the companies or not. The empirical evidence proved that only Board of Directors has significant relationship with zakat on business payment. However, this study found that there is no significant relationship between zakat business payment and other independent variables; namely majority shareholders, type of industry, profitability and size of the company.