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Integrating Islamic Principles of Taxation within China – An Analysis of its Impact on Corporate Earnings

İslami Vergilendirme İlkelerinin Çin'e Entegre Edilmesi - Kurumsal Kazançlar Üzerindeki Etkisinin Analizi

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ÖZ

Vergilendirme, şirketlerin vergi harcamalarını optimize etmeleri ve kazançları üzerindeki etkilerini en aza indirmeleri için önemli bir unsuru temsil etmektedir. Şirketler, ödenen toplam vergi miktarını en aza indirmek için kazanç dağıtımlarını optimize etmeyi amaçlamaktadır. İslami vergi sistemi, vergilerin kapsamı ve amacı bakımından dünya genelindeki geleneksel vergi sistemlerinden önemli ölçüde farklılık göstermektedir. Bu makale, İslami vergilendirmenin Çin'deki büyük şirketlerin kazançları ve vergilendirme düzeyleri üzerindeki etkisini değerlendirmektedir. Sonuçlar, faiz kazançlarının ve gelirle ilgili harcamaların İslami uyum için önemli ayırt edici faktörler olduğunu göstermektedir. Ayrıca araştırma bulguları, vergilendirme tutarlarını tahmin etmek ve bunları şirketler tarafından ödenen toplam vergi ile karşılaştırmak için bir yapay zeka çerçevesine entegre edilmiştir. Sonuçlara göre, şirketlerin genel olarak biraz daha yüksek oranlar ödeyebileceği, ancak şirketlerin çoğunluğu için vergilendirme seviyelerinin aynı kalacağı görülmüştür. Buna ek olarak, önemli faiz harcamaları olan şirketler, bu harcamaların diğer harcamalarla veya yükümlülüklerle ilişkili İslami uyumlu maliyetlerle mahsup edilmemesi durumunda daha yüksek vergilendirme ile karşılaşabilirler. Araştırmadan elde edilen sonuçlar, şirketlerin Çin'deki vergilendirme matrahlarını optimize etme fırsatlarına da işaret etmektedir.

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A B S T R A C T

Taxation represents a cornerstone for corporations to optimize their taxation expenditures and minimize their impact on their earnings. Corporations aim to optimize their earnings distributions to minimize the overall amount of tax paid. The Islamic taxation system differs substantially from conventional tax systems across the globe in terms of the scope and purpose of the taxes. The article evaluates the impact of Islamic taxation on the earnings and taxation levels of major corporations in China. The results indicate that interest earnings and expenditure concerning income are major distinguishing factors for Islamic compliance. The conclusions were then integrated into an artificial intelligence framework to estimate the taxation amounts and compare them with the total tax paid by the corporations. The results indicated that corporations may pay overall slightly higher rates but that for the majority of corporations, the taxation levels will remain identical. Amongst others, those corporations with significant interest expenditures may experience higher taxation if those expenditures are not set off by other expenditures or Islamic-compliant costs associated with liabilities. The results indicate the opportunities for corporations to optimize their taxation bases within China.

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1. Introduction

Allah presented a comprehensive economic system in the revelations of the Quran that covers all parts of economic life including the revenues of governments and taxation. The permanent sources of revenue for the State Treasury (Bait ul-Mal) shall support the compulsory expenditures of the Islamic state. These incorporate the revenues defined in Islamic law as Fai, Jizya Kharaj, Ushur and any income derived from public properties. The financial requirements of modern states require significantly more funds as compared to the past, and subsequently require significantly more funds than the Bait ul-Mal sources to cover all the needs and interests. This then transfers the obligation transfers from the permanent sources only to all Muslims. Allah obliged all Muslims to spend on the needs and interests of the Islamic state, and the failure of the spending leads to harm to Muslims, and both the State and Ummah shall avoid any harm to Muslims. To collect the funds, the State may impose taxes on Muslims to cover the obligatory expenditures, without achieving a surplus. This implies that the taxes should be solely taken away from the surplus of the wealth of people. This surplus is the excess of wealth that is left after the funds are spent on basic needs and luxuries according to a conventional standard of living (Coşgel, et al., 2009).

The Bait ul-Mal incorporates six areas that have to be spent on, and if the funds are insufficient, then taxes are imposed upon the Muslims. The first area is the expenditures for Jihad and any resources that are needed for it. The second area is the expenditure on the military. The third major area is the spending on the poor, needy and any wayfarers. Furthermore, the expenditures on wages of soldiers, civil servants, judges, teachers and other individuals that provide services for Ummah. Additionally, the expenditures caused by caring for the Ummah are also to be included. Finally, any emergencies related expenditures like for famines, earthquakes, floods and enemy attacks are to be covered (Revkin, 2020).

The first main expenditure part is the one for Jihad. The Islamic state is obliged to support a powerful and well-trained armed force. These forces should have the latest weapons to deter, subdue or prevent an enemy from launching an attack. If the Bait ul-Mal has sufficient funds, then these funds can be spent on Jihad and any associated requirements. Otherwise, the state has to spend on Jihad provided that it is obligatory. This also requires Muslims to contribute voluntarily to Jihad. If the voluntary contributions are not sufficient, then the State will impose additional taxes for the amount necessary but not more than is required (Kuran, 2020).

Concerning expenditures related to the military or any associated industries, this is compulsory as outlined by Allah. Jihad necessitates an army with modern weapons that require a solid manufacturing approach. Hence, the weapons industry has a strong connection with Jihad. The state has to undertake the production and development of vital weapons to ensure sufficient independence when focusing on its affairs. Furthermore, the weapons have to be under the control of the state and this requires the state to have sufficient production capacity and factories. This becomes obligatory for Muslims to support the state's requirement for funds.

The next obligation is the spending of funds on the poor, needy and the wayfarers. This is obliged upon Muslims in the form of Zakat and Sadaqah. As outlined before, if the funds are available then these funds are spent on these individuals. If there are shortcomings, then the State is required to support the individuals and raise taxes (Aziz & Abdullah, 2013).

Taxes are levied on the wealth of Muslims that exceeds their basic needs and any luxuries arising from a normal standard of living. An essential part is that the taxes are solely collected from the surplus wealth. This implies that spending that does not cause any hardship and exceeds the normal needs of an individual shall be subject to a wealth tax. The concept of income tax does not exist in Islam, and solely excess wealth is taxed but not income. States are generally not permitted to impose indirect taxes, such as the tax on sales of goods and services. Furthermore, no taxes shall be imposed on court fees, fees on petitions, and sales or registrations of land. This is because oppressive or illegal taxation is a form of prohibited injustice. The major concern concerning income taxes is that they may penalize the poor and vulnerable, as sales taxes on goods and services have a disproportionately negative effect on the poor as compared to the rich (AlLami, 2009).

If any taxes are collected more than the obligatory expenditure, then this is a form of injustice (Mazlama), and the Court of Unjust Acts has permission to investigate such acts of excessive taxation. This enables the court to abolish or lower the tax and return any excesses to the Muslims.

A key part of the Islamic taxation system is its simplified nature focusing entirely on the wealth tax. The wealth tax rate amounts to 2.5 % of the wealth of an individual, and these amount to various forms of taxes, such as revenues from public properties, wealth arising from properties that are subject to Zakat, booties (Fai), taxes on land (Kharaj) and head tax (Jizya) (Shemesh, 1958).

Islam focuses on funding the entire population and designates utilities that are indispensable for the community. This implies that the utilities shall be owned by the public and any revenues are administered for the benefit of the citizens. While the hadith solely focuses on water, pastures and fire as the main, analogy (qiyas) are utilized to cover all instances of community utilities that are indispensable. This implies that water sources, forests of firewood, livestock and other public utilities such as oil fields, electricity plants, lakes and gulfs may be considered to be utilized for the benefit of the public. There are administration charges that will be revenue for the state and any export-derived earnings.

Zakat is a wealth tax that requires Muslims to pay 2.5 % of their wealth for a year. These Zakat properties are kept in the state of Bait ul-Mal (state Treasury), and these funds are not spent on anything except for the eight categories that are outlined by the Quran. The tax shall be redistributed to the poor, the needy and those with debts that face hardship to repay (Weiss, 1986).

Booties (Fai) are revenues that originate when multiple economies are integrated concerning each other. This aspect of economies of the scale represents an important benefit of enhancing tax revenues, while also for individuals and corporations to be able to utilize the economies of scale.

The land tax (Kharaj) is calculated according to the quality of the land and the possible production capabilities of the land. This is important as the land provides the basis for how much tax is to be paid and is based on the ability to pay rather than solely the size of the land.

The jizya tax (head tax) applies to all mature, male-dhimmi that have the means to pay the tax. Women and children are not subject to the tax (Mansor, et al., 2019).

For corporations, the impact of such an Islamic tax depends on the business structure and activities, as well as the legal form. Islamic taxation law applies primarily on the individual level and considers the income derived by a corporation to be the income derived by the natural persons being the owner of the entity.

2. Taxation in China

Taxation in China is dealt with by the State Taxation Administration which is a government body to establish tax laws. The administration also set the tax rates for any type of company, but regional tax bureaus are responsible for the handling and collection of taxes. The individual taxation schemes apply to the entire nation but there are regional differences, such as those in free trade zones that affect the taxation rates. There are specific tax breaks for specific regions and industries, and some of the policies and changes to tax rates are first tested and trialled before they are expanded to entire nations. This has been observed in the special economic zones that had preferable tax rates for companies to set up their businesses and trade with each other (Li, 1991).

China has various forms of corporations, but most of the taxes applicable to the income of the company and any profit distribution to shareholders. The corporate income tax is the income tax, while the withholding tax is the tax on the distribution of profits. Additionally, taxes related to sales and turnover are the value-added tax (VAT), consumption tax, stamp tax and real estate tax. The VAT plays an important role as it taxes every transaction and is based on consumption. The consumption tax is a tax on the purchase of manufactured or imported consumables and luxury goods. The stamp tax represents a tax on legal documents, and the real estate tax focuses on the taxation of property.

The Chinese Business Tax (Corporate Income Tax – CIT) applies to any form of corporation in China, and levies a rate of 25 %. The tax rates for domestic and foreign companies were assimilated with the reforms in the Corporate Income Tax Law in 2008. The CIT is calculated on an accrual basis, which implies that the income and expenses are recorded at the time of earning or spending. The CIT is calculated on a monthly or quarterly basis and an annual reconciliation is conducted at the end of the year. This may either lead to a tax refund or an additional tax to be paid. The tax is based on the total income minus the allowable deductions. The allowable deductions include any business costs and expenditures that are concerning the income derived from the operations. Additionally, any adequate losses and taxes, such as property tax, stamp tax and charitable donations may be subtracted. Charitable donations are capped at 12 % of the total income, and this includes any depreciation of fixed assets. Additionally, any amortization of intangible assets (depreciation of non-physical assets) and any reductions based on local tax incentives may accept (Yan, 2009).

Such tax incentives are generally utilized in China to support investment into specific industries and regions and several tax reductions are available.

This includes a 20 % corporate income tax on companies with a profit of less than 1 million RMB, and a rate of 15 % for selected high-tech industries in certain cities, such as Beijing, Shanghai, Guangzhou and Shenzhen. The criteria and application requirements are outlined in the government regulations and companies that engage in multiple industries need to prepare these returns for each industry. Previously, the west of China experienced a 15 % income tax rate in certain industries, which was discontinued in 2021 (Chen, et al., 2021).

There are specific infrastructure projects, such as railways, harbours, highways, public transport and water resources, in addition to environmental protection projects have a scheme offering 3 years of exemption from the CIT, and then followed by another 3 years of a 50 % of CIT reduction.

The withholding tax (WT) is another tax that arises from the payments of China-obtained income by non-resident enterprises. In such instances, a 10 % tax is applied on payments and these have to be withheld before the remittance is conducted. This refers to dividends or other equity investment proceeds that are originating from China, and any interest, royalties or rent (Liu, et al., 2021).

The existence of double taxation treaties may provide an offset of these taxes and may declare that a rate lower than 10 % is to be used. Withholding taxes play a critical role in the repatriation of profits, and the most common way is the repatriation in the form of dividends. There are double taxation challenges that arise from this, as the CIT will be paid on profits and then another WT will be paid on the dividends. This increases the total tax on remittances, and the dividends may only be paid on accumulated profits, which are profits that have offset losses and where a 10%

part is paid into the capital reserve. An alternative is to pay profits as service fees or royalties, but these service fees and royalties are subject to VAT and WT. They can be deducted against the CIT, however (Liu & Lu, 2015).

There is no capital gains tax in China, and all capital gains are treated as conventional company income. The value-added tax (VAT) is a consumption tax, and the rate of VAT ranges from 6 to 16 % depending on the goods and services that are involved. The VAT was introduced in China in 1984 but is rather complex given the different rates and regional differences of it. Furthermore, there was a separate business tax for certain service sector sales. There were significant reforms between 2012 and 2016 but then expanded nationwide. Certain areas include the sale of agricultural products, contraceptive drugs and devices as well as antique books and exported services. The VAT rate applies to the domestic sales and imports of the majority of goods, but it also applies to repairs, replacements and processing services as well as the leasing of tangible assets (Sun, et al., 2020).

The lower rate of 10 % applies to agricultural products, food grains and vegetable oils, as any agricultural chemicals and printed and electronic media. The lower rate is also applied to service areas, which incur transportation, postal services, construction and real estate as well as basic telecommunication services.

The lowest rate applies to financial products, including loans, insurance and any other transfers, as well as research and consulting services. Additionally, cultural, sports and medical services only charge a rate of 6 %. Furthermore, the sale of intangible assets, such as trademarks, copyright and technology, is set at 6 %.

The VAT is calculated as the difference between the output VAT and the input VAT, which is applied based on the total applicable sales/invoices raised as compared to the VAT that has been invoiced to the company.

Individual corporations are required to obtain a VAT registration number from the local tax bureau. The minimum threshold that requires to obtain a VAT registration number is from 5,000 to 20,000 CNY in sales per month. China distinguishes between general VAT payers and small-scale payers. The distinction criterion depends on the annual taxable sales amount, but small-scale companies may experience benefits in registering as a general payers.

Such small-scale taxpayers are companies with a sales turnover of 800,000 RMB per year for commercial companies and 500,000 RMB for industrial companies. Commercial companies are those that sell goods, while industrial companies are those companies in the manufacturing space. There are additional exceptions such as for certain services where this limit is increased to 5 million RMB (Yan, 2009).

For small-scale companies, the VAT payment is calculated as a flat rate of 3 % of sales without any ability to deduct input VAT. This implies as well that they cannot issue VAT Fapiao to any Chinese clients.

For general taxpayers, the VAT rates range from 6 to 16 %, allowing companies to deduct the input VAT. There are corporations for which it makes sense to register for general status even if they have a low income. This implies that offsetting the input VAT can be very beneficial, and several corporations require that their suppliers can issue the VAT Fapiao.

The consumption tax (CT) is another form of sales-based tax that is applied to manufactured and imported consumables and luxury goods. The tax is based on the sale value of the item and the tax is calculated and paid monthly. Such consumption taxes vary from 1% to 56 %, depending on the item under consideration. Tobacco and alcohol are the highest-taxed items.

For example, cigarettes are taxed either 36 % or 56 % depending on the strength of it, while alcohol has a tax of 220-250 RMB/ton on beer, and white spirits encounter a 20 % tax, while others have 10 %. Gasoline has a CT of 1.52 RMB per litre, while cars have a CT ranging from 1 % to 40 % depending on the engine cylinder size.

The stamp tax or stamp duty is a tax levied on the various contracts, licenses and accounting books and this includes the purchases and sales contracts, as well as the transfer of property rights. Additionally, property leasing, engineering and design contracts as well as financial loans are affected by these taxes. The rates vary from 0.005% to 0.1 % based on the contract type.

The real estate tax is charged upon owners or users of property for commercial purposes. Residential property is not included for individual use, but tax does apply for the leasing of residential property. Real Estate Tax is charged at a rate of 1.2% of the purchase price of a property. There is a discount of 10% to 30% offered on this by most local governments. Additionally, Real Estate Tax is eligible for deduction from CIT (Chen, et al., 2021).

The land value appreciation tax applies to all transfers of land use rights for state-owned land or buildings. Any income earned from the transfer is taxed on a sliding scale depending on the total appreciation. This starts at 30% tax for an appreciation of less than 50% and increases to 60% tax for an appreciation above 200%. Costs incurred in the transfer, and also in the development of the land during ownership, can be deducted.

The Chinese taxation regulations are comprehensive and exhibit a strong progressive nature with several tax benefits for investments in certain sectors and regions. Chinese taxation regulations differentiate themselves from other regulations in that there are no separate capital gains taxes, but any income derived is taxed as ordinary income.

3. Tax Implications

When considering the Chinese taxation system, several aspects may be adapted to ensure that relevant corporations align with Islamic taxation principles. The first major difference is the adjustment for interest income and expenditure under Islamic taxation given that the charging of interest is forbidden in Islam. Additionally, the effect of intangibles and unusual items on the taxation levels and relevant tax exemptions have to be taken into account to comply with Islamic taxation principles.

To evaluate the impact of Islamic concepts in terms of their impact on the taxation arising for these corporations in China. The 621 largest Chinese enterprises encountered in the iShares MSCI China ETF were utilized for their comparison. This includes state-owned corporations such as Air China, the China Construction Bank and Bank of China, as well as major corporations such as Tencent, Alibaba and Netease. Additionally, there are smaller corporations such as Nongfu Springs and Yadea Group Holdings. These corporations represent a diverse group of various types and sizes of companies. The financial data of these corporations incorporated earnings and balance sheet-related information, such as income, research expenditure and tax expenditure amongst others. The earnings data are for the year 2021 and a comparison of ratios is outlined in several pair plot comparisons. Furthermore, an unsupervised clustering approach was utilized to distinguish the financial conditions of the corporations related to the impact of the tax. To determine the impact, the parameters are outlined in Table 1. The main objective is to cluster the enterprises and determine the features that have the strongest impact on the clustering performance.

Table 1: Unsupervised learning parameters for the clustering of the data.

Unsupervised Learning Features
Net PPE Vs Gross PPE
Gross PPE Vs Total Assets
Net Income Vs Interest Income
Tax Provision Vs Total Tax Payable
Goodwill And Other Intangible Assets Vs Total Assets
Tax Effect Of Unusual Items Vs Total Unusual Items
Total Tax Payable Vs Stockholders Equity

To analyze the clustering performance, Figure 1. outlines a comparison between the tax provisions versus the total payable tax, and the tax effect of unusual items versus the total unusual items. The tax provisions are estimates of the tax that shall be paid based on the income tax. This represents an important assessment of future tax expenditures and business progress expectations. The total tax payable is the amount of tax that is yet to be paid to the government and is a liability. This is in contrast to income tax expenses that are based on the earnings statement of the corporation. The tax provision versus the total tax payable indicates that there is a significant difference between the various corporations in terms of their payment schedules for taxes versus their provisions for the taxes to be paid. In terms of distinction, both clusters exhibit relatively similar behaviour without indicating major differences when it comes to the effect of unusual items on the tax.

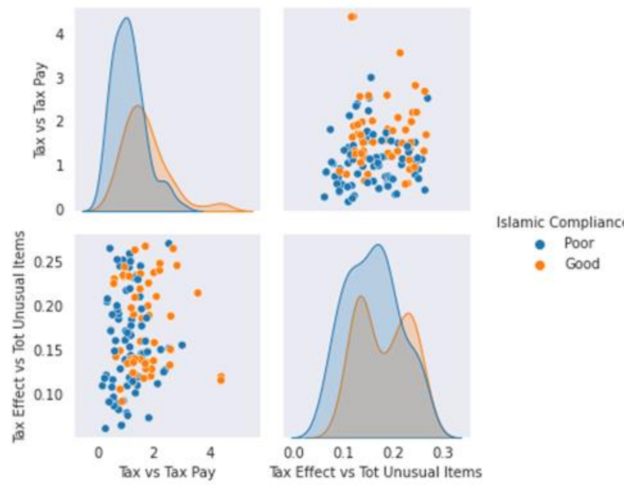

Figure 1: Comparison of ratios for tax provisions versus the total payable tax, and the tax effect of unusual items versus the total amount of unusual items.

Another occurrence arises when comparing the net income versus interest income, and the goodwill and unusual items as a ratio of the total assets (Figure 2). There is a significant distinction in terms of net income versus interest income where multiples of more than 75 indicate a clear distinction between those. This outlines the importance of the effect of interest on taxation amounts.

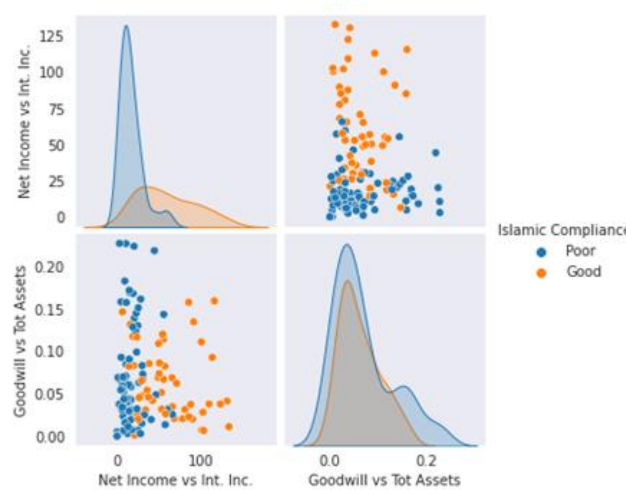

Figure 2: Comparison of ratios for net income versus interest income, and goodwill and other intangible assets as compared to the total amount of assets.

To evaluate in greater detail the impact of financial performance on the clustering. As exhibited in Figure 3, the cross-plot of gross PPE versus total assets and the tax provisions versus total tax liabilities. These exhibit strong differentiation with higher PPE amounts indicating stronger Islamic compliance as compared to those that have mostly intangibles and other goodwill items.

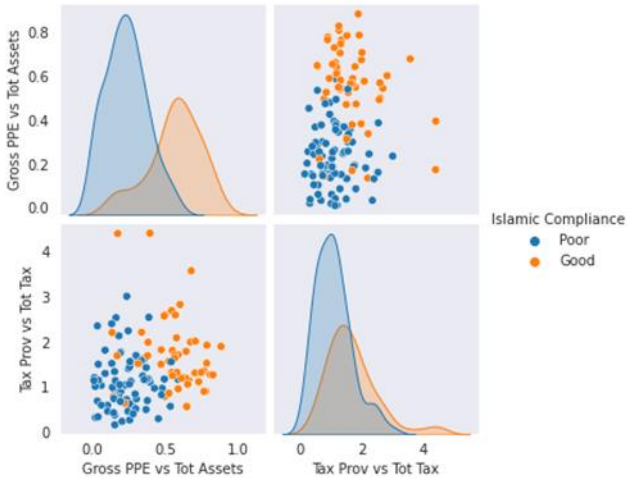

Figure 3: Comparison of ratios for gross PPE versus total assets, and tax provisions versus total tax liabilities.

The interpretation has to be performed together with analyzing Figure 4, which exhibits the total tax liabilities versus shareholder equity, and tax versus total unusual items. The differentiation in terms of both its impact on shareholder equity as well as total unusual items is relatively limited with the clustering being mostly mixed.

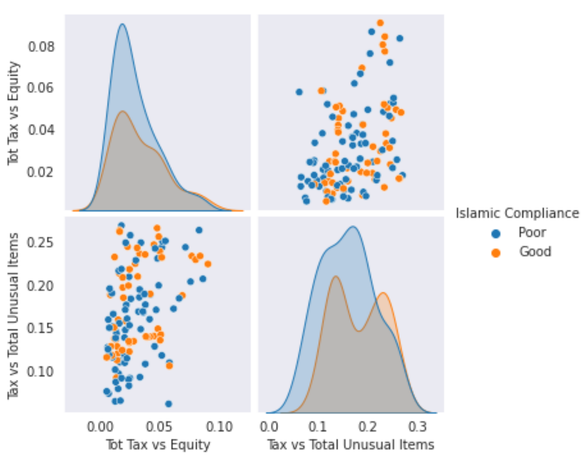

Figure 4: Comparison of ratios for the total tax payable versus stockholder equity, and the tax effect of unusual items versus the total amount of unusual items.

The final Figure 5 exhibits the net income versus interest income and total tax liabilities versus equity of the shareholders. There is a strong correlation between higher net income versus interest income, and the total tax liabilities as a matter of equity shareholders. This implies that there is no significant correlation between income versus interest expenditure and higher tax liabilities as compared to the equity of shareholders. This implies that the equity of shareholders and tax liability has a limited impact on the clustering, outlining the criticality of interest and the presence of physical assets for the distinction in terms of financial performance and its potential correlation with an Islamic tax.

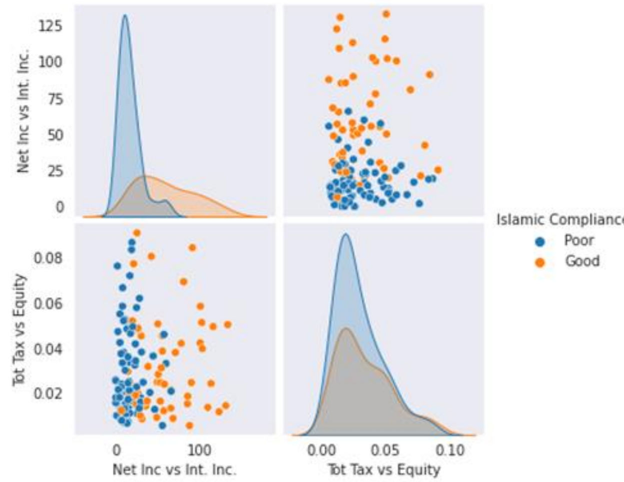

Figure 5: Comparison of ratios for net income versus interest income, and total tax liabilities, versus shareholder equity.

The clustering permits the distinction of corporations in terms of their compliance with Islamic taxation principles and their effect on their earnings. Given this distinction between the different enterprises in terms of their tax exposure as well as interest-related income features, this enables us to estimate the impact of Islamic taxation regulations on the tax liabilities of Chinese corporations.

The next step is to evaluate the impact of an Islamic taxation framework on corporate tax liabilities and its impact on earnings performance. To estimate the impact of tax liabilities arising from Islamic taxation principles, a deep learning framework for the estimation of tax liabilities was developed. The framework incorporates corporate earnings data, financial balance sheet assets, and associated tax liabilities and tax rates.

The comparison between the total taxes paid in terms of Islamic compliance, versus the existing total taxes paid is displayed in Figure 6. As outlined above, components such as interest expenditures and interest income have to be corrected to avoid conflict with the forbiddance of the charging of interest. As shown there is a general increase in the total amount of taxes that are being paid both for those with good Islamic compliance and those with poor. Generally, the total amount of tax is slightly increased. This is exhibited by the dissymmetry of the distribution shape around the center of a ratio of 1. For those with good Islamic compliance, this implies that they pay slightly more taxes, but several corporations have even lower tax expenditures as compared to current taxation expenditures.

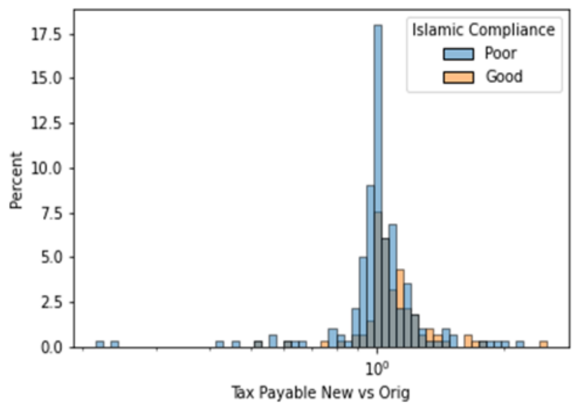

Figure 6: Histogram comparison plot of the ratio between Islamic compliance-based payable taxes versus the original total tax payable.

4. Conclusion

Income derived from taxation represents a cornerstone of the finances of governments and has a significant effect on ensuring that the operations of the government can be financed. For corporations, taxes represent expenditures that affect the income of these corporations, which can be either distributed to the owners or re-invested into the corporation. Governments aim to encourage or discourage various types of corporate activities utilizing tax regulations, which may have a significant impact on earnings potential. Conventional taxation is characterized by various regulations and implementations that aim to combine societal development objectives in addition to economic development and to support the collection of sufficient funds for the government. Islamic taxation presents a formalized taxation system that focuses strongly on the encouragement of good deeds and solely incurs taxes that are needed for the state. Chinese taxation incurs similarities with some of the principles of Islamic taxation but similarly aligns with general taxation principles across the world. Taxation incurred impacts caused by earnings components that are forbidden in Islamic law, such as interest, may significantly affect overall taxation levels. The research provides a comprehensive analysis of 500 major companies within China and assesses based on earnings and balance sheet-derived data via an unsupervised learning approach the main distinction between corporations adhering well to Islamic principles and those that do not.

The results indicate that interest earnings and expenditure concerning income are major distinguishing factors for Islamic compliance. The conclusions were then integrated into an artificial intelligence framework to estimate the taxation amounts and compare them with the total tax paid by the corporations. The results indicated that corporations may pay overall slightly higher rates but that for the majority of corporations, the taxation levels will remain identical. Amongst others, those corporations with significant interest expenditures may experience higher taxation if those expenditures are not set off by other expenditures or Islamic-compliant costs associated with liabilities. The results indicate the opportunities for corporations to optimize their taxation bases within China.

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