

Blockchain combats tax evasion

A taxation system has a direct impact on the social and economic activities of nations. It is core to the social contract and represents a powerful tool to reduce inequalities and to reinforce the state's treasury, which utilizes tax revenues to implement social development programs and provide public services. Conceptually, taxes provide social equity, reduce poverty and increase the welfare of the poor. In Islam, Zakat is one of the main pillars and was referenced 32 times in the Quran. Yet, in all countries, developed or not, some citizens and corporates find ways to reduce their obligation or evade paying any tax. DR HUSAM YAGHI delves further.



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Islam implements taxation through a social finance instrument called Zakat to create a balance of wealth in society. This charitable instrument has two types: compulsory and voluntary. The voluntary Zakat is called Sadaqat, which has no fixed rate nor strict rules to adhere to, though Sadaqat is paid by the well-to-do Muslims and has an objective of encouraging Muslims to give to the less fortunate.

On the other hand, the compulsory Zakat is one of the main pillars in Islam and is governed by laws extracted from the Quran, and there are government bodies to manage the collection and distribution of funds. It is an important instrument to eradicate poverty and to create a social balance through a reduction in wealth concentration.

Muslims have a legal and religious obligation to pay Zakat for the support of the poor and for the legitimate functions of government. Thus, evading one's duty to pay Zakat is classified as a crime, yet evasion of tax is continually increasing and may not be considered abnormal. The effect of tax evasion is not only harmful to the economy, but it also derails the mission of aiding the poor. Therefore, the need for proper management of taxation is vital.

In Muslim countries, income shifting by corporates to reduce due Zakat has a negative impact estimated from US\$35 billion to as much as US\$160 billion per year, and evasion by wealthy individuals is estimated to cause additional revenue losses from US\$15 billion to US\$124 billion annually, while developing countries lose between US\$859 billion and US\$1.06 trillion, according to Global Financial ownership of an asset, an amount of money or property from an individual who meets the criteria as a contributor to someone who meets the criteria as a Zakat recipient. Here arises the need for a proper system to automate the management of all functions of the Islamic tax system: payment, collection and audit. Blockchain-based solutions could prove to be a worthy option to manage the calculation and collection of due taxes.

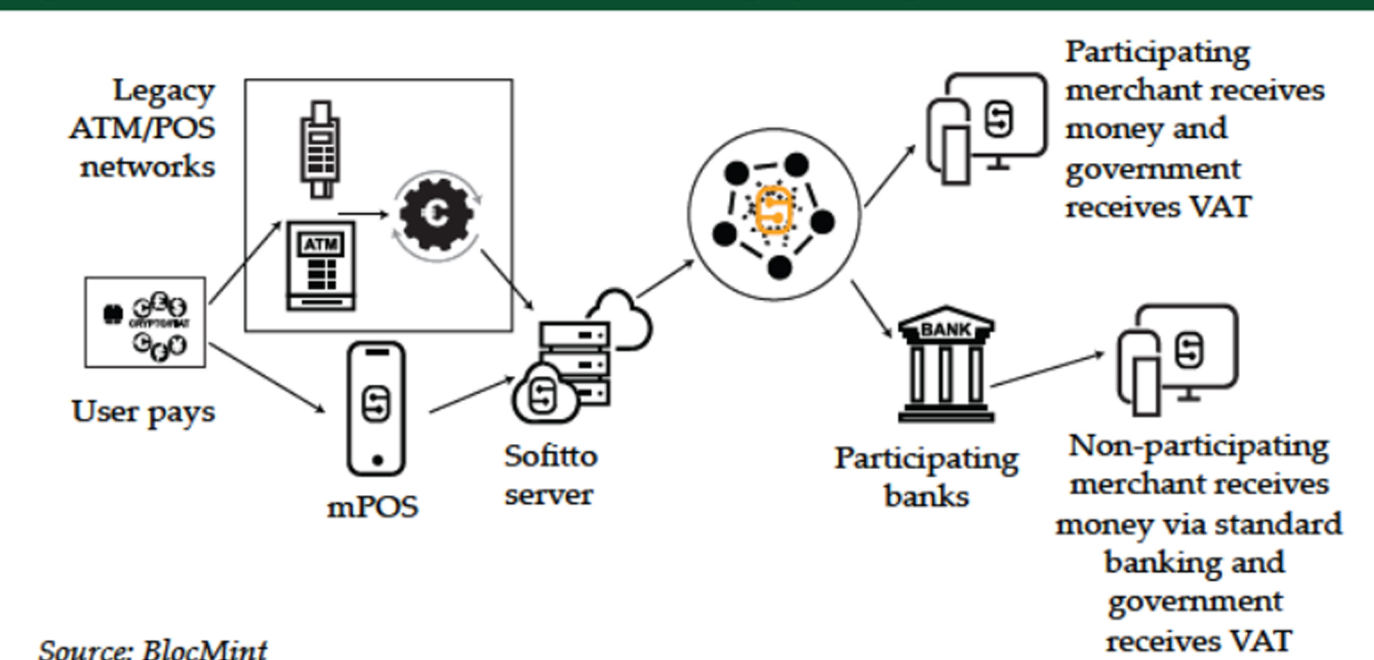
Blockchain is not a magic bullet to all the woes of inefficiency; it is a tool to improve efficiency and the public perception of the Zakat system

Blockchain can address those problems and has great potential for use across the entire Islamic finance landscape. For reference, blockchain is a decentralized ledger that may continuously grow as a list of records, transactions, value and/or programs in a transparent and immutable manner. It has ability to track where transactions are going, when they arrived and where they were used. It governs organizational inefficiency and corruption. It avails greater transparency and accountability.

The characteristics of blockchain are in alignment with the principles of Islamic finance. Blockchain is a perfect medium to incorporate and operationalize the Islamic values of justice, equality, trust and fairness into finance. Blockchain is Shariah compliant and could significantly lower the cost of tax compliance for corporations and governments alike.

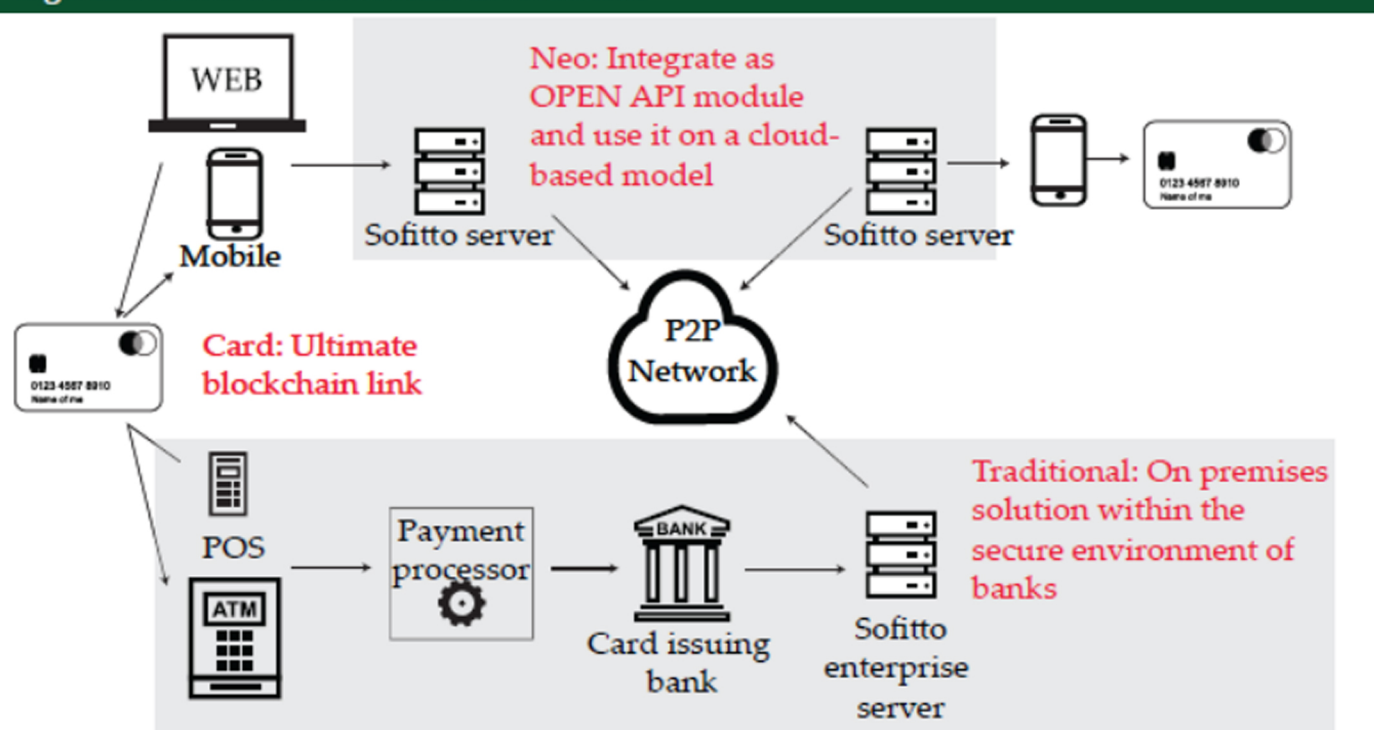
Blockchain supports self-executing programmed smart contracts to rationalize the complex processes and reduce the need for repetitive documentation between parties. There

Figure 1: Blockchain-based solution (Sofitto) to simplify management of VAT



Source: BlocMint

Figure 2: Sofitto's international card scheme



Source: BlocMint

Integrity. These figures are devastating and remedies are long overdue.

The size of tax evasion in Muslim countries could be attributed to the lack of clear legal mechanisms, a lack of transparency on how Zakat funds are distributed, the presence of vague regulations and the differing views of Islamic scholars — Shafi'i, Maliki, Hanbali or Hanafi. Table 1 shows the extent of tax evasion in select countries.

Admittedly, Islamic finance is complex because of the many requirements are also opportunities to bring greater certainty to tax management and reduce the risk of audits and disputes.

For long-term strategic planning, blockchain can be a driving factor in implementing real-time, automated tax processes for individuals and for small and large enterprises.

I had previously published a blockchain-based solution to simplify the management of value-added tax (VAT), see Figures 1 and 2. The solution was proposed to local corporates to track and document the VAT they pay on purchases of goods that would be resold, then receive a credit for the VAT paid on the tax return, ie the process of reconciliation.

From the collation, cleansing and verification of information to the preparation, validation and submission of returns, tax processes are largely paper-heavy and labor-intensive. As for VAT, the following is a list of potential benefits of a blockchain-based system:

- Real-time — both the buyer and seller have a copy of the VAT-related data,

which must be adhered to for Shariah compliance. Further, modern Islamic finance is still in its infancy in comparison to conventional finance, even though the roots of modern Islamic finance lie in the Islamic Golden Age, during which traders of the then-flourishing caliphate developed many different financial and economic models.

The Islamic finance industry is guided by the principles of trust, equality and fairness, and so is Zakat, which could be considered the transfer of

- leaving no space for differences.
- Single use — since the registration of a purchase is processed in real-time for both the buyer and seller, there is no possibility for the duplication of entries.
- Transparency — transactions executed by smart contracts are tamper-proof and transparent, which reduces the risk of fraud and mistakes.
- Digital signature — all transactions have to be digitally signed, making it more trustworthy and safer than a paper signature or e-mail approvals.
- Administrative efficiencies — the administrative burden of companies is significantly reduced, saving time and the cost of accounting services.

Blockchain could disrupt tax management and taxpayers could expect the process of paying tax to become easier and less time-consuming, with transparency in how tax funds are disbursed. Blockchain is not a magic bullet to all the woes of inefficiency; it is a tool to improve efficiency and the public perception of the Zakat system. ☺

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