REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

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Date: MAR 30 2022

REVENUE MEMORANDUM CIRCULAR NO. 35-2022

Subject: Tax Treatment of Murabahah (Profit Disclosed Sale) and Tawarruq (Commodity Murabahah) as Islamic Banking Arrangements Pursuant to the Tax Neutrality Provision of Republic Act (RA) No. 11439 (An Act Providing for the Regulation and Organization of Islamic Banks) and as Implemented by Revenue Regulations No. 17-2020.

To: All Banks, Including Islamic Banks (IBs) and Islamic Banking Unit (IBU) of Conventional Banks, Non-Bank Financial Intermediaries Performing Quasi-Banking Functions, Non-Bank Financial Intermediaries, Internal Revenue Officers/Employees and Others Concerned

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Section 1. Background

In line with Section 14 of RA No. 11439 providing that the Government shall endeavor to achieve neutral tax treatment between Islamic banking transactions and equivalent conventional banking transactions within the provisions of the National Internal Revenue Code (Tax Code) of 1997, as amended, the Bureau issued Revenue Regulations (RR) No. 17-2020 dated June 22, 2020.

Among the most common Islamic banking arrangements identified in RR No. 17-2020 are Murabahah (Profit Dislosed Sale) and Tawarruq (Commodity Murabahah). This Circular, therefore, is being issued to provide their tax treatment pursuant to the tax neutrality provision of Section 14 of RA No. 11439, as implemented by RR No. 17-2020 for the guidance and observance of all concerned.

Section 2. Guidelines

Gains or profits derived from Islamic banking arrangements, in lieu of interest income under the conventional banking transactions, as referred hereunder are subject to tax. As provided under Section 4.3 of RR No. 17-2020, any reference to interest shall apply to gains or profits received and expenses incurred in Islamic banking arrangements, in lieu of interest income and/or expenses under the conventional banking transactions.

A. Murabahah Financing (Profit-Disclosed Sale)

A.1 Definition

This refers to an arrangement where the IB/IBU buys a specified asset and subsequently sells that asset to a client at cost plus an agreed profit margin. Payment of the price may be on a deferred lump sum or installment basis.

Murabahah is referred to as *murabahah to the purchase orderer* when a promise to purchase is integrated in the structure.

Receivables arising from *murabahah* financing shall be measured upon initial recognition at fair value plus direct transaction costs, and subsequently measured at amortized cost using the effective profit method.

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A.2 Analysis

The economic substance of a *murabahah* financing is equivalent to a conventional mortgage loan.

In conventional mortgage loan, the property is purchased by the borrower using the loan proceeds. The ownership is transferred to the borrower who repays the amount plus interest pursuant to the loan agreement. The loan is secured by the property. Under Islamic finance arrangement, the IB/IBU purchases the property and subsequently sells the same to the client at a cost plus an agreed profit margin.

Illustration: **Real Property Finance**

The customer approaches an IB/IBU to finance the purchase of a property from a vendor. A purchase instruction with an undertaking to purchase the property is executed by the customer. If the IB/IBU approves the financing, an Asset Purchase Agreement will be executed where the IB/IBU purchases the property from the vendor for a purchase price of ₱1,000,000.00, for instance. The ownership of the property is transferred to the IB/IBU.

The IB/IBU then sells the property to the customer on deferred terms at the purchase price of ₱1,000,000.00 plus a profit component of say, ₱200,000.00, which may be secured by a mortgage in favor of the IB/IBU. The ownership of the property is transferred to the customer.

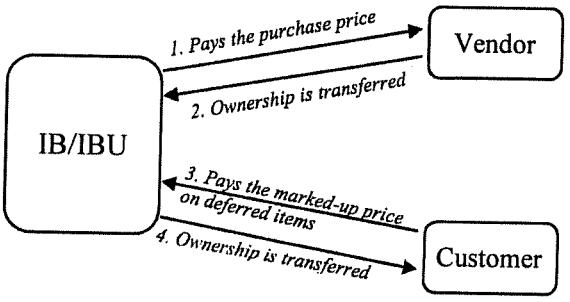


Figure 1. Structure diagram of Murabahah Financing

Tax Neutrality:

	Conventional Mortgage Financing	**Islamic Finance Arrangement**
Bank/ IB/IBU	Interest income derived from mortgage financing shall be subject to regular income tax and gross receipts tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.	Gains or profits derived from Islamic finance arrangement shall be subject to regular income tax and gross receipts tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.: *Provided,* That the ***effective profit method*** shall be used in calculating the amortized cost of the subject financial instruments measured at amortized cost and of allocating

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		the income or expense over the relevant period.
Borrower/ Client/ Customer	Interest payments made by the borrower shall not be subject to withholding tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.	Gains or profits payments made by the customer shall not be subject to withholding tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.
	Mortgage instruments executed shall be subject to DST.	Equivalent Islamic finance instruments executed shall be subject to DST (which shall be computed on the basis of the equivalent amount actually loaned or given at the time of execution of the mortgage, pledge or deed of trust under the conventional mortgage transaction).
	Transfer of real property from the seller to the borrower/buyer shall be subject to Capital Gains Tax (CGT) if the land was held as capital asset or Creditable Withholding Tax (CWT) and Value-Added Tax (VAT) if the land was held as ordinary asset. Additionally, said transfer of real property shall be subject to Documentary Stamp Tax (DST).	Transfer of real property from the vendor to the IB/IBU shall be subject to Capital Gains Tax (CGT) if the land was held as capital asset or Creditable Withholding Tax (CWT) and Value-Added Tax (VAT), if applicable, if the land was held as ordinary asset. Additionally, said transfer of real property shall be subject to Documentary Stamp Tax (DST): **Provided, however**, that transfer of real property from the IB/IBU to the customer/buyer shall be exempt from CGT, CWT, VAT and DST pursuant to Section 4.4 and 4.5 of Revenue Regulations No. 17-2020.

The illustrated structure diagram above may be used for an IB's/IBU's customer to finance the purchase of other assets, for example, cars or industrial machinery. A similar tax treatment applies except that the relevant indirect tax will normally be VAT.

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Illustration: **Car Finance**

A customer requests the IB/IBU to buy a certain car and promises to purchase it from the IB/IBU for an agreed price. IB/IBU purchases the car from the vendor and thereafter offers to sell the same car to the customer for immediate delivery at a deferred payment basis. The customer accepts the offer, concluding the murabahah sale. Customer pays the price (cost + profit) in installments on the payment dates agreed upon by the parties.

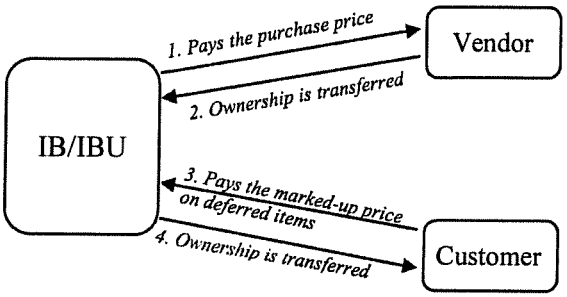


Figure 2. Structure diagram of Murabahah Financing

Tax Neutrality:

	Conventional Mortgage Financing	**Islamic Finance Arrangement**
Bank/ IB/IBU	Interest income derived from mortgage financing shall be subject to regular income tax and gross receipts tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.	Gains or profits derived from Islamic finance arrangement shall be subject to regular income tax and gross receipts tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent. *Provided, That* the ***effective profit method*** shall be used in calculating the amortized cost of the subject financial instruments measured at amortized cost and of allocating the income or expense over the relevant period.
Borrower/ Client/ Customer	Interest payments made by the borrower shall not be subject to withholding tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.	Gains or profits payments made by the client shall not be subject to withholding tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.
	Mortgage instruments executed shall be subject to DST.	Equivalent Islamic finance instruments executed shall be subject to DST (which shall be computed on the basis of the equivalent amount actually loaned or given at the time of execution of the mortgage, pledge or deed of trust under the conventional mortgage transaction).

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	The sale of car to the borrower shall be subject to VAT.	The sale of car by the vendor to the IB/IBU shall be subject to VAT which shall be reimbursed by the customer.

B. Tawarruq (Commodity Murabahah) Financing

B.1 Definition

This refers to a cash generating facility involving the purchase by the customer from the IB or IBU of a commodity at a deferred price determined through mark-up sale, and then selling the same commodity to a third party at spot and at a lower price in order to obtain cash. The accounting treatment for murabahah financing similarly applies to Tawarruq.

B.2 Analysis

The economic substance of a *Tawarruq* financing is equivalent to a conventional cash line facility.

Cash line facility is in general, used to provide for a customer's working capital requirements, or provide for personal consumption, or purchase of assets. It is provided in two ways, namely overdraft facility and revolving credit.

Overdraft is a general cash line facility which is granted to certain agreed limit. The customer can utilize the facility anytime once it is disbursed but cannot exceed the limit prescribed. There is no specific timeline of settlement. Due to its flexibility, the bank usually grants it to selected customers with good credit worthiness.

Illustration:

A customer applies cash line facility product (based on tawarruq) to the bank. The bank will buy the commodity through Broker A and sells it the same commodity to the customer at the bank's selling price (cost + profit) on deferred payment term under murabahah contract.

The customer then appoints the IB/IBU as agent to sell the same commodity at its spot price to Broker B. The bank then credits the cash sales proceeds into the customer's account. Finally, the customer pays to the bank (cost + profit) based on their agreed deferred payment schedule.

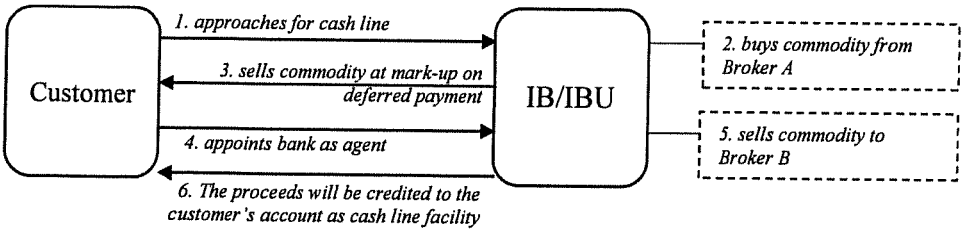


Figure 3. Structure diagram of Tawarruq Financing

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Tax Neutrality:

	Conventional Loan Transaction	**Islamic Finance Arrangement**
Bank/ IB/IBU	Interest income derived from fixed term interest bearing loan transactions shall be subject to regular income tax and gross receipts tax.	Gains or profits derived from Islamic finance arrangement shall be subject to regular income tax and gross receipts tax. *Provided, That* the ***effective profit method*** shall be used in allocating the income or expense over the relevant period.
Borrower/ Customer	Interest payments made by the borrower shall not be subject to withholding tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.	Gains or profits payments made by the customer shall not be subject to withholding tax. However, the withholding tax herein shall apply whenever the payor is classified as top withholding agent.
	Loan instruments executed shall be subject to DST.	Equivalent Islamic finance instruments executed shall be subject to DST (which shall be computed on the basis of the equivalent amount actually loaned or given at the time of execution of the loan instruments under the conventional loan transaction)
		Supply of commodity and services under a *tawarruq* or commodity *murabahah* financing are ignored for tax purposes pursuant to Sections 4.4 and 4.5 of RR No. 17-2020.

C. Reverse Tawarruq

C.1 Analysis

Commodity Murabaha financing may also be used for by an IB/IBU to replicate a term deposit product/facility. The same tax treatment applies.

Islamic banks prefer commodity murabahah over other commonly structured deposit products because it sets forth the profit to be earned during the specified period of the deposit. This structure and mechanism is also known today in the Islamic financial market as reverse tawarruq.

Below is an illustration of a basic structure of *tawarruq* or commodity *murabahah* in a deposit mobilization structure.

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Illustration:

A customer/depositor/investor who has money and is looking for avenues to place the fund and earn return, would first buy a commodity using the bank as his agent and then sell it to the Islamic bank on a deferred basis.

Effectively, the customer/depositor/investor has made a placement that resembles a fixed-income deposit since he will now be receiving a fixed return, i.e., the mark-up charged in the selling price of the commodity.

The Islamic bank would subsequently sell the commodity to another broker, get the cash and invest.

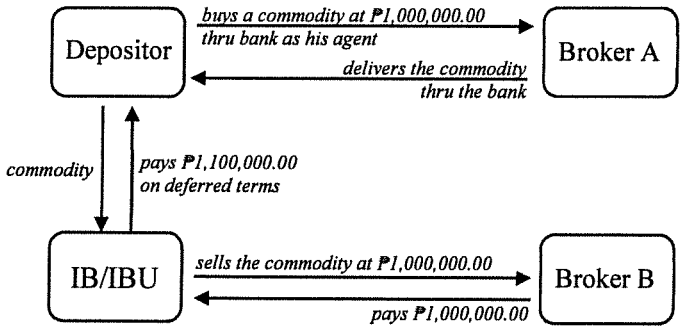


Figure 4. Structure diagram of Reverse Tawarruq Financing

Tax Neutrality:

	Conventional Deposit Products	**Islamic Finance Arrangement**
Bank/ IB/IBU	Interest income, commissions and discounts derived from lending activities shall be subject to regular income tax and gross receipts tax.	Gains or profits derived from Islamic finance arrangement shall be subject to regular income tax and gross receipts tax: Provided, That the ***effective profit method*** shall be used in allocating the income or expense over the relevant period.
Depositor/ Customer	Interest from any peso bank deposit and yield or any monetary benefit from deposit substitute and from trust funds and similar arrangements derived from sources within the Philippines shall be subject to final withholding tax. However, the withholding tax herein shall not apply whenever the maturities of instruments from	Gains or profits derived from Islamic deposit products under the concept of Islamic finance arrangement shall be subject to final withholding tax. However, the withholding tax herein shall not apply whenever the maturities of instruments from which such gain or profit are derived exceed five (5) years.

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	which such income are derived exceed five (5) years.	Supply of commodity and services under a *tawarruq* or commodity *murabahah* financing are ignored for tax purposes pursuant to Section 4 of RR No. 17-2020.

All internal revenue officers and other concerned are enjoined to give this Circular as wide a publicity as possible.

CAESAR R. DULAY
Commissioner of Internal Revenue

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