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ISLAMIC BANKING IN KAZAKHSTAN: CHALLENGES AND OPPORTUNITIES FOR SHARIAH-COMPLIANT PRODUCTS DEVELOPMENT

The development of the Islamic banking sector relies on a dynamic regulatory framework that fosters innovation in product development. In Kazakhstan, despite the introduction of Islamic banking laws and amendments, the sector continues to face significant challenges in achieving parity with conventional banking. While previous research has explored various aspects of Islamic banking, the critical issue of product development remains insufficiently analyzed. This study aims to examine the key obstacles limiting Islamic banks' ability to offer competitive and innovative financing and deposit products, which are essential for meeting market demand and attracting investment, particularly from foreign investors. Additionally, Islamic financing faces tax-related challenges and unforeseen regulatory barriers. Recent court rulings, including decisions by the appellate court in the case of DAMU against Al Hilal Islamic Bank, have heightened risks for the Islamic banking sector in Kazakhstan, making it less attractive to investors, especially given the involvement of a foreign-invested bank. The research employs a qualitative comparative analysis, examining Kazakhstan's banking and taxation regulations in contrast with the laws of neighboring countries, as well as Middle Eastern and South Asian nations. The findings highlight the urgent need for amendments to both banking and tax laws to establish a level playing field for Islamic and conventional banking in Kazakhstan. Based on these findings, practical recommendations are proposed for regulators to enhance the development and competitiveness of the Islamic banking sector in Kazakhstan.

Key words: Islamic Banking, Islamic Finance, Regulation, Legislation, Product Development, Financial Innovation.

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Қазақстандағы ислам банкингі: шариғат талаптарына сай өнімдерді дамытудағы қиындықтар мен мүмкіндіктер

Ислам банкі секторының дамуы өнімдерді әзірлеуде инновацияларды ынталандыратын икемді реттеуші базаға тәуелді. Қазақстанда ислам банкингіне қатысты заңдар мен түзетулер енгізілгеніне қарамастан, бұл сектор дәстүрлі банктермен тең дәрежеде бәсекелесу тұрғысынан әлі де айтарлықтай қиындықтарға тап болуда. Бұрынғы зерттеулер ислам банкингінің әртүрлі аспектілерін қарастырғанымен, өнім әзірлеу мәселесі жеткілікті түрде талданбаған. Бұл зерттеу исламдық банктердің нарықтық сұранысты қанағаттандыру және инвестицияларды, әсіресе шетелдік капиталды тарту үшін маңызды болып табылатын бәсекеге қабілетті және инновациялық қаржылық және депозиттік өнімдерді ұсыну мүмкіндігін шектейтін негізгі кедергілерді зерттеуге бағытталған. Сонымен қатар, исламдық қаржыландыру салықтық және құқықтық реттеуші кедергілермен бетпе-бет келуде. Жақында қабылданған сот шешімі, нақты айтқанда «Даму» қорының Al Hilal Ислам Банкіне қарсы ісі бойынша апелляциялық сот шешімі, Қазақстандағы исламдық банкінг секторы үшін қауіп-қатерлерді арттырып, саланы инвесторлар үшін, әсіресе шетелдік инвестиция қатысатын жобалар үшін тартымсыз етті. Зерттеу әдісі ретінде сапалы салыстырмалы талдау әдісі қолданыла отырып Қазақстанның банктік және салықтық заңнамасы көршілес елдердің, сондай-ақ Таяу Шығыс және Оңтүстік Азия мемлекеттерінің тәжірибелерімен салыстырылды. Зерттеу нәтижелері Қазақстанда исламдық және дәстүрлі банктер үшін тең бәсекелестік жағдайын жасау мақсатында банктік және салық заңнамасына түзетулер енгізу қажеттілігін көрсетеді. Алынған қорытындылар негізінде қаржы нарығын реттеуші органдарға

Қазақстандағы исламдық банкінг секторының дамуы мен бәсекеге қабілеттілігін арттыруға бағытталған нақты ұсыныстар жасалды.

Түйін сөздер: Ислам банкінг, ислам қаржысы, реттеу, заңнама, өнім әзірлеу, қаржылық инновациялар.

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Исламское банковское дело в Казахстане: проблемы и возможности развития для создания шариатских продуктов

Развитие исламского банковского сектора зависит от динамичной нормативно-правовой базы, способствующей инновациям в разработке продуктов. В Казахстане, несмотря на введение законов и поправок в сфере исламского банкинга, сектор продолжает сталкиваться со значительными трудностями в достижении паритета с традиционными банками. В то время как предыдущие исследования затрагивали различные аспекты исламского банкинга, вопрос разработки продуктов остается недостаточно изученным. Данное исследование направлено на выявление основных препятствий, которые сдерживают способность исламских банков разрабатывать конкурентоспособные и инновационные финансовые и депозитные продукты, способные удовлетворить потребности рынка и привлечь инвестиции, включая иностранные. Исламское финансирование сталкивается с налоговыми сложностями и регуляторными барьерами. Недавние судебные решения, включая апелляционный вердикт по делу «Даму» против Исламского Банка Al Hilal, усилили риски для исламского банковского сектора Казахстана, делая его менее привлекательным для инвесторов, особенно с участием иностранного капитала. Исследование основано на качественном сравнительном анализе банковского и налогового законодательства Казахстана в сопоставлении с нормативными актами соседних стран, а также государств Ближнего Востока и Южной Азии. Результаты подчеркивают необходимость срочных поправок в банковские и налоговые законы для обеспечения равных условий для исламского и традиционного банкинга в Казахстане. На основе полученных данных предложены практические рекомендации для регулирующих органов, направленные на развитие и повышение конкурентоспособности исламского банковского сектора в Казахстане.

Ключевые слова: Исламский банкінг, исламские финансы, регулирование, законодательство, разработка продуктов, финансовые инновации

Introduction

Kazakhstan has incorporated Islamic banking into its existing banking by incorporating to existing banking laws. Since the first amendments allowed for Islamic banking operations, the government has enacted three further rounds of changes, aimed at refining the framework to better support Islamic finance and attract greater investment. Recognizing the need to eliminate non-compliance issues with Shariah principles, Kazakhstan also launched the Astana International Financial Center (AIFC, 2024), establishing a distinct set of regulations for Islamic banking and finance. However, due to the lack of active Islamic entities within its framework and several ambiguities in its regulatory alignment with broader Kazakhstani laws, AIFC's role remains outside the scope of my research.

A major hurdle for Islamic finance is product development, where existing law with other related

laws to Islamic banking such Tax law do not fully support the creation of innovative, competitive Islamic banking products. The Islamic banks face difficulties in structuring products that meet both market demands and the Shariah compliance, often limiting their offerings to basic products that are less versatile than those offered in GCC or south Asia countries. This disparity stems in part from a lack of tailored legislative and regulatory infrastructure that would enable Islamic banks to introduce diverse products, from Shariah-compliant investment funds to innovative financing products.

Developing a robust regulatory framework is crucial for overcoming these product development challenges. Such a framework would allow Islamic banks to design and offer competitive financial products, thus creating a more balanced and level playing field alongside conventional banks. In doing so, Islamic banking sector could grow more dynamically, better serving the needs of businesses and investors.

Justification of the Choice of Articles and Goals and Objectives

With over a decade of experience as an Islamic banker in Kazakhstan market as well as in other central Asia markets, I have faced significant challenges in developing innovative Islamic banking products for our operations. These difficulties have encouraged me to study and research this topic, identifying key obstacles and proposing practical solutions to support the growth of Islamic banking in Kazakhstan as well as in the region as the legislations are to some extent same.

Unlike their counterparts in other countries where comprehensive legislation exists for Islamic banks, product developers in Kazakhstan must navigate a complex legal landscape. They must harmonize tax code, civil law, banking law and regulations, Islamic principles as well rules, and any other relevant legal frameworks related to the nature of goods or the specifics of customers of Islamic banks – making product development in such particular situation a very challenging task.

This study aims to highlight some of the key legal barriers, particularly in tax code and banking regulations, while acknowledging that it is not possible to cover all issues and obstacle to create a similar environment in the other countries for new product development. I have also attempted to propose practical solutions to address these issues effectively, contributing to the advancement of Islamic banking in Kazakhstan.

Scientific Research Methodology

This research methodology is centered on an in-depth review of existing banking legislation, specifically focusing on Islamic banking regulations as well as Tax law. Where feasible, the research conducted on a comparative analysis with Islamic banking practices in other countries, such as Tajikistan, Malaysia UAE, and Pakistan, which have well established legal frameworks for Shariah-compliant banking as well mentioned opinion of the Islamic banking expert.

During research the prime source material were used as laws, code, court decision, AAOIFI Shariah standards as well as Quran. From secondary sources the materials which has been used are manuals, articles and books on Sunnah of the Prophet as well as official website of the financial companies. During comparing the study done based on product wise on each mater has been used for the purpose of having solution from other countries on same matter.

Islamic Banking products

Islamic banks in many countries offer almost the same products then what are offering by the Islamic Banks in Kazakhstan market however, for example in GCC, the bank extract much more products and combine multiple product under one below given product. Here is the brief information on some of those products which are offered by the Islamic Banks in other countries.

Deposit Products

Deposits in Islamic banks are segregated into two categories: one is generating profit and second non-generating profit. The generating profit products are based on Wakala and Mudarabah which are risk sharing profit and loss sharing. Under Mudarabah deposit where the capital provider (Rab Al-Mal) is providing money and the Islamic Bank is a fund manager (Mudareb) will manage the fund. It is a partnership which is consisting of cash from the customer of the bank and professional skills from the bank. The parties under Mudarabah have to agree to profit distribution ratios among them. The bank's responsibility is only for negligence, misconduct and nonbinding by the terms of the agreement; hence neither principles nor profit is guaranteed by the bank (The Accounting and Auditing Organization for Islamic Financial Institutions, 2022).

The following earning deposit product is Wakala (agency) where the customer appoints the bank to be its agent in conducting business on behalf of the customer where the customer and the bank agree that the bank invests in profitable project through buying and selling as well as leasing and generates profit up to agreed rate. If the bank reached the agreed rate, any extra amount would be incentive or gift from the depositor to the bank. Similar to Mudarabah, it is also risk sharing or profit and loss sharing between customer and bank. Hence, neither principle nor profit guaranteed by the bank and the bank is responsible only for misconduct, negligence and non-binding by the term of the agreement (Accounting and Auditing Organization for Islamic Financial Institutions, 2022) It is worth to mentioned that Wakala deposit product also used in restricted aspect where the customer will invest in particular project/asset. In ADCB Islamic Bank (formerly Al Hilal Islamic Bank) is using the Restricted Wakala investment where high risky investment project the customer along with Wakala agreement will sign risk acceptance form where customer well aware the consequence of the invested project which choose by its and indicated in the Wakala agreement. Also

the customer will be familiar with novation agreement incase if the financed project will not return the Wakala invested amount the customer will be responsible for further claim toward financed customer.

Non-generating profit deposit product is a current account. It is based on interest-free loan where the bank's obligation is to return the deposit to the customer on demand and according to Shariah, Bank shall not pay any profit to the current account depositors (Accounting and Auditing Organization for Islamic Financial Institutions, 2022).

According AIFC survey on the Kazakhstan market demand on Islamic deposit "Do respondents have a conventional deposit, and would they be interested in Islamic deposit?" The answer of the participate was different where 99% per of the participants expressed interest on Islamic deposits however 15.5% per participants deposited in the conventional bank due lack of alternatives. Also 34% of participants do not have conventional deposit as conventional deposits contradicts to their believes (AIFC, 2024).

Financing Products

Unlike the conventional bank, Islamic banking has numbers of the financing products where risk of each of financing product is different in their risks types and liabilities of the Islamic bank and its customer. I will mention in brief only products which mostly used by Islamic financial companies.

Murabaha: Murabaha is trust sale where the bank has to disclose to the customer all incurred actual cost and expense and profit which it will charge from the customer. The profit can mention in the agreement either in percentage or in lump-sum. The bank must possess the goods/assets before entering into the Murabaha agreement, and upon signing of Murabaha, the bank must transfer the ownership of asset/goods to the customer. After selling of products through Murabaha the customer will pay to the bank on deferment and instalment payment basis (Accounting and Auditing Organization for Islamic Financial Institutions, 2022). The legislation of republic of Kazakhstan on Islamic bank permitted to conduct operation based on Murabaha product under the article 52-9 (Law of the Republic of Kazakhstan on Bank and Banking Activities, 2024) and therefore the existing Islamic banks in the Kazakhstan: ADCB Islamic Bank formerly Al Hilal Islamic Bank, (ADCB Islamic Bank, n.d.) and Alif Islamic Bank (Alif Islamic Bank, n.d.) as well as Islamic leasing company Kazakhstan Ijarah company (Kazakhstan Ijarah company, n.d.) also offer the

product of Murabaha which is main product in the portfolio of their financing product.

Musawamah: is also another type of sell where the bank is not obliged to disclose the details on its incurred expense and its profit to the customer and parties will agree on the price where the customer will pay according to the agreed schedule of the payment. The bank has to own the goods before signing the Musawamah agreement with the customer (Wikipedia, n.d.). The Musawamah product is not used by any bank in Kazakhstan however it is used by Al Hilal Bank in UAE market (Al Hilal Bank, n.d.).

Istisna: is also a type of sale where the bank sells or purchase the goods which do not exist as per agreed specification. The Istisna contract is used for manufacturing and production financing. Under Istisna the Islamic bank may be manufacturer (seller) when it signs an agreement with its customer (purchaser), or Islamic Bank can be a purchaser under a parallel Istisna with another manufacturer or producer (seller) for production and manufacturing of a goods (Accounting and Auditing Organization for Islamic Financial Institutions, 2022). The Istisna product is not offered by any bank as financing product in Kazakhstan however it has been used by Al Hillal Islamic Bank (currently ADCB Islamic Bank) in purchasing of goods which was under production for the purpose further financing through Ijarah (leasing) financing with its customer.

Salam: is another type of sale which is similar to Istisna however it will be used for agricultural products which do not exist and will be sold as per specifications. The bank can sign also parallel Salam (similar to Istisna) where it is the seller and purchaser under different agreement provided, both agreements shall be separated and not linked to each other (Accounting and Auditing Organization for Islamic Financial Institutions, 2022).

The existing banking laws for Islamic bank does not mentioned product by name such Murabaha or Salam and so on however the law mentioned intermediary role of the bank in buying and selling of the goods hence the law cover all above mentioned products. Similarly, the permission for the above transaction also come in Quran in general wording where Quran says:

Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his

Lord and desists may have what is past, and his affair rests with Allah. But whoever returns [to dealing in interest or usury] – those are the companions of the Fire; they will abide eternally therein (Surah Al-Baqara (The Cow), 2: 275) (Saheeh International Translation, 2010).

Leasing: is a sell of usufruct; however, from the Shariah aspect its terms and conditions are different from conventional leasing. Before entering into the lease agreement, the Islamic bank must own the goods/property or its usufruct. During the lease term, the ownership will remain with the Islamic bank, and all risk related to ownership will be bear by the Islamic bank such as risk of total and partial loss of the asset, unless if loss is not due to the fault of the customer. For financial lease types, the bank will transfer the ownership to the customer under separate agreement, once the customer has fulfilled all payment under lease. Islamic bank may use also operating and service lease product for providing renting houses/flat and financing educations for students (Accounting and Auditing Organization for Islamic Financial Institutions, 2022).

The literature available on issues of product development specific to Islamic banking in Kazakhstan is limited. However, Dr. Mahmood Ahmed's article, "Product Development in Islamic Banking: Challenges and Opportunities," (Ahmed, 2015) offers valuable insights. The author begins by questioning the primary challenges and opportunities in product development for Islamic banks, identifying six major challenges and corresponding opportunities.

It is important to note that while the challenges and opportunities outlined by Dr. Ahmed M. are relevant to Kazakhstan Islamic banking markets. One significant challenge specific to Kazakhstan is the intensive reliance on Shariah principles. Islamic banks sometimes compromise on Shariah requirements to meet business demands, especially in the structuring of products. According to Dr. Ahmed M., an opportunity exists for scholars to explore the extensive Islamic legal heritage in Fiqh literature to identify diverse Shariah compliant instruments and principles that could expand product offerings. However, in Kazakhstan, such resources for product development are not readily available due to the lack of a well-established legal infrastructure that would allow scholars to choose between varying levels of Shariah compliance in Islamic financial products.

The second challenge concerns the difference between "Shariah-based" and "Shariah-compliant" finance. According to the author, many Islamic

banks mimic conventional financing models in their products, moving away from ideal Islamic financial practices. Dr. Ahmed M. suggests that Muslim scholars conduct theoretical research within Islamic finance, although he does not provide a clear roadmap for implementing Shariah based Islamic banking products practically. In reality, Shariah compliance often serves as a temporary solution until there is sufficient public education and market demand for Shariah based products. In Kazakhstan, however, the challenge lies even in developing Shariah compliant products, indicating a significant gap in foundational product development.

The third challenge addresses the bank's responsibility to uphold principles of justice, brotherhood, and social welfare within the community. Dr. Ahmed views this responsibility as an opportunity for Islamic banks to prioritize community welfare over profit maximization. In my view, if Islamic banks fulfill their obligations as outlined in Shariah, such as forfeiting non-compliant income to charitable causes and adhering to Zakat payment obligations, they fulfill their responsibilities toward society.

A further challenge is the divergence of opinions among Shariah scholars on Islamic banking products. Dr. Ahmed sees an opportunity to create a standardized approach within the market, which, in my opinion, is critical for the development of new products among Muslim consumers. Countries like the UAE and Malaysia have already introduced regulatory standardization for Islamic banks, with established terms and conditions that ensure consistency and standardization.

The fifth challenge is the predominance of debt-based financing products, such as Murabaha, over asset-based financing options like Mudarabah and Musharakah (partnerships), which poses an economic risk similar to that of conventional financing. Sheikh Muhammad Taqi Usmani, chairman of the Shariah Board of the AAOIFI, also said before about such risk earlier at the Davos Economic Forum in 2010, calling for a restructuring of both the international financial system and Islamic finance (Taqi Usmani, 2010). Unfortunately, the primary product currently available for financing is commodity Murabaha, a debt-based financing option. This reliance on debt-based products may replicate the same level of risk as conventional financing unless Islamic banks are able to introduce more asset-based financing options for their customers.

The final challenge is the limited planning and small budget allocations for research and develop-

ment (R&D) of new products within Islamic banks. Dr. Ahmed M. sees this as an opportunity, as Islamic banks could potentially invest in R&D to foster innovative Islamic banking products, thereby advancing the sector and increasing profitability for participating banks. It is essential for Islamic banks in Kazakhstan to make similar investments in collaboration with local universities to support R&D initiatives and contribute to the development of skilled Islamic banking professionals.

The article “Islamic Banking in Kazakhstan Law” by Maggs (Maggs, 2011) begins with an overview of the history and current state of Islamic banking in Kazakhstan. The primary focus of the article is to explore the regulatory implications of Islamic banking. Maggs examines key principles of Islamic finance, such as the prohibition of interest and the requirement for profit-sharing to involve associated risk. He also raises questions regarding the restriction of certain previously permitted transactions particularly deferred sales without clear justification for these prohibitions. The author highlights that there are no specific directives from the Quran or sayings of the Prophet Muhammad on these issues, even though Allah in Quran explicitly addresses other aspects of permissible financial practices.

“Those who take *riba* (usury or interest) will not stand but as stands the one whom the demon has driven crazy by his touch. That is because they have said: “Sale is but like *ribā*”, while Allah has permitted sale, and prohibited *ribā*. So, whoever receives an advice from his Lord and desists (from indulging in *ribā*), then what has passed is allowed for him, and his matter is up to Allah. As for the ones who revert back, those are the people of Fire. There they will remain forever”, (Surah Al-Baqara (The Cow), 2: 275) (Taqi Usmani, 2022).

In addition, similar to this issue in terms of permissibility transaction in Islamic perspective a Hadith which is narrated by Ibn Mas’ud from Prophet Muhammad following as;

“The Messenger of Allah cursed the one who consumed *Riba*, and the one who charged it, those who witnessed it, and the one who recorded it” (At-Tirmidhi, 892).

Narrated ‘Ubadah bin as-Samit: Allah’s Messenger said: “Gold is to be paid for with gold, silver with silver, wheat with wheat, barley with barley, dates with dates, and salt with salt, same quantity for same quantity and equal for equal, hand to hand (i.e. payment being made on the spot). If these classes differ, sell as you wish as long as payment

is made on the spot.” (Imām Muslim ibn al-Hajjāj al-Naysāburi, 875)

Maggs (Maggs, 2011) further examines scholarly perspectives on the permissibility of certain complex transactions within Islamic banking in Kazakhstan. “To address potential price fluctuations between the bank’s purchase from the supplier and its Murabaha sale to the customer, Maggs suggests appointing the bank as the customer’s agent to promptly execute a Murabaha agreement an approach he notes is permitted under Article 52-11 of the Islamic Banking section in Banking Law.

However, the prevailing interpretation of above article addresses deposit relationships, where the bank acts as an agent to invest the customer’s funds, rather than for executing Murabaha transactions. Furthermore, Maggs’ proposed structure conflicts with the AAOIFI Shariah Standards, which strictly limit cases where the customer can appoint the bank as an agent. These standards do not support the bank acting as the customer’s agent in Murabaha transactions. Maggs references Al Hilal Bank’s in UAE “Walk In – Drive Out” product as an example; however, this product did not rely on an agency structure. Instead, the bank typically retained ownership of the vehicle temporarily before selling it to the customer under a Murabaha arrangement. Notably, Al Hilal Islamic Bank did not offer this product in Kazakhstan.

The author further questions the permissibility of investments in non-Shariah compliant businesses, such as those involving alcohol or pork, highlighting that the decision to engage in such activities falls under the authority of Shariah Board. Based on my experience, Islamic banks make efforts to avoid both direct and indirect involvement in prohibited transactions like alcohol and pork.

The author also suggests that the decision not to introduce an “Islamic window” was influenced by UAE banks seeking to limit competition in the local market. However, to my knowledge, when Kazakhstan’s law was initially passed and approved by parliament, Al Hilal Bank had no intention of investing in Kazakhstan’s financial market. The reasons for not establishing Islamic windows could be Shariah requirements and conditions, which are challenging to implement within a conventional bank structure. Currently, the National Bank has begun reviewing and studying existing laws and the experiences of other countries in this regard.

Regarding the absence of a deposit insurance scheme for Islamic banks, the author attributes this to the high-risk nature of certain investments, sug-

gesting that traditional insurance models would be unsuitable. The primary reason for non-participation is that Kazakhstan's deposit insurance scheme is based on conventional insurance framework which is in conflict with Islamic banking laws and Shariah principles.

The article "Islamic Finance versus Conventional Finance and the Taxation Consequences" by Rabiay D. Lal (Lal, 2013) examines tax treatment adjustments made to create parity between Islamic and conventional finance in South Africa. In 2010, South Africa amended its tax code to promote tax neutrality for specific Islamic finance products, including Mudarabah, diminishing Musharakah, and Murabaha. The author begins with an introduction to Islamic finance principles, highlighting key products and the differences between Islamic and conventional financing.

Lal's analysis is organized by product type, beginning with Mudarabah. In a Mudarabah arrangement, funds must be deposited by the client with the bank, which then invests these funds in Shariah-compliant projects. The client assumes the risk of loss and receives a proportional share of any profit generated. For tax purposes, income received under Mudarabah is treated similarly to conventional interest income, allowing for tax exemptions applicable to conventional banks.

The next product discussed is diminishing Musharakah, where tax law parallels it to conventional debt instruments by treating profit as interest. To qualify for tax exemption, certain conditions must be met: the asset must be acquired from a third-party supplier or client, the client must eventually purchase all the bank's ownership rights, and payments to acquire the bank's share must be made over time. Notably, the law stipulates that ownership can only transfer through purchase, even though AAOIFI's Shariah standards permit Islamic finance companies to transfer ownership through a gift contract. For VAT purposes, diminishing Musharakah is "deemed" equivalent to conventional financing, meaning it is treated as "providing financing" rather than involving an actual sale, purchase, or acquisition of assets. This raises questions about the validity of the underlying sale and purchase contract from a Shariah perspective.

Although the tax law addresses some leasing aspects relevant to diminishing Musharakah, it does not cover operational or service leases. For Murabaha transactions, tax exemption requires that the

asset is purchased by the Islamic financial institution (IFI) from a third party specifically for the customer's benefit, based on the customer's terms. This requirement blurs the line between a genuine sale and a financing arrangement. In principle, the bank should purchase the asset independently, without specifying any beneficial ownership arrangements between the bank and the supplier. Additional conditions for tax exemption include that the customer must take ownership within 30 days, pay a markup over the bank's purchase cost, make payments over a predetermined period, and not exceed the Murabaha amount agreed upon. The law categorizes Murabaha as a debt instrument, treating the bank's profit as equivalent to interest income in conventional financing.

The article also addresses tax implications for Ijarah Sukuk, specifically regarding the taxation of Special Purpose Vehicle (SPV) income and the need to prevent double taxation when assets are transferred to SPV ownership. Although Lal's article provides a good overview, it lacks coverage of other Islamic structured finance products.

In my opinion, introducing tax regulations on a product-by-product basis creates challenges for Islamic banks attempting to develop new products. In contrast, Malaysia and Gulf countries adopt a more streamlined approach, applying tax on Islamic banks' income regardless of the specific product structure, thus enabling greater flexibility and innovation in product development.

The next material reviewed is "Taxation Treatment of Islamic Finance Products in Australia" by Maria Bhatti (Bhatti, 2013). The author begins by introducing the foundational theory of Islamic banking, emphasizing the prohibition of Riba (interest). She then provides a detailed explanation of Murabaha, including its tax implications across different financing contexts: retail, corporate, and interbank. Notably, this article addresses tax treatment for interbank financing using Murabaha, an area that not covered in our previous literature (Bhatti, 2013). It seems Author did not touch tax treatment for other Islamic products such as Ijarah as it is also offered by Islamic financial institutions in Australia like MCCA (MCCA, n.d.).

It is worth mentioning that the approach followed by the countries discussed above is primarily based on product-specific treatment, which often not cover the full range of Islamic finance products or combinations of products typically as usually used in structured Islamic financing.

Result and Discussion

Banking law

The initial Shariah compliant amendments to conventional banking laws were made in 2009. Following this, the government introduced two additional amendments into the law: the first involved incorporating Wakala deposits and commodity Murabaha into legislation to prevent taxation on these products and to establish a level playing field for both Islamic and conventional banking. The second amendment enabled the government to issue Sukuk backed by state assets. Despite these amendments, the issues face by developers of products in Islamic Bank still persist. Islamic banks still face restrictions in creating innovative financial products that meet both market needs and Shariah principles and rules, limiting the sector's competitiveness and growth. Regarding regulations from the National Bank for Islamic banks, no specific regulations currently exist, which poses obstacles to the development of new Islamic banking products. Therefore, this research will focus solely on the Banking Law and tax laws.

Under the Islamic banking part of the banking law of Kazakhstan, the Islamic Financing Principles Board (Shariah Board) has the authority to set additional requirements for the operations of Islamic banks, which are obligatory for these institutions to follow (Law of the Republic of Kazakhstan on Bank and Banking Activities, 2024). The law grants the Shariah Board authority to approve any new Shariah compliant product for the Islamic bank wishes to offer which is unlike Tajikistan where the Shariah Board has not having same level of independence and authority to approve any new product (Shoev, 2024). According Shariah principles, an Islamic model bank, is a trading entity, can engage in various buy-and-sell transactions and types of sales (both spot and deferred). It is also permitted to conduct a range of leasing activities, including financial, operational, service leases, and leases of non-existing asset or forward leasing for specified assets. Additionally, Islamic banks can participate in partnership structures (Musharakah), Mudarabah, and Wakala meanwhile it can offer traditional banking services according to the Shariah principles and rules like letters of guarantee (LGs), letters of credit (LCs), and Shariah compliant treasury products. In essence, an Islamic bank functions as a trading entity while also providing financial services typically available from conventional institutions, yet within the boundaries set by the Shariah.

The Shariah Board has the right to determine and approve new products from above mentioned product or combination of above product under one product; however, for the approved product of the Shariah Board to be effective, corresponding amendments to the tax laws needed. Without such amendments, tax authorities may not recognize the approved products, which may lead to increase in the cost of Islamic financing, creating an uneven playing field compared to conventional banks. Current law lacks a streamlined mechanism for Islamic banks to implement new products without revisiting related regulations. A more efficient approach would allow for broad tax treatment based on the nature of Islamic products, enabling Islamic banks to innovate within a generally approved framework without necessitating legislative changes for each new product. Taxes could then be applied to Islamic banking income without differentiating between types of product profit, a practice already adopted by many countries that permit Islamic banking and for customer of Islamic Bank same treatment of customers of conventional bank where any extra amount above principles amount to treated as interest payment in the conventional bank.

Another challenge for have competitive infrastructure for development of the new product is the restriction on savings deposits for the Islamic Banks within the current Banking Law, which does not allow Islamic banks to provide profit-bearing savings deposits to their customers where the same was proposed by experts in Islamic financing sector (Nagayev, Stambakiyev, 2022). According to the law, conventional savings deposits with its interest in traditional banks must be guaranteed, which requirement of the civil law. In contrast, a Shariah compliant savings deposits, either Mudarabah or Wakala, cannot offer such guarantees for the principles and profit under Islamic principles.

This restriction on profit-bearing savings accounts limits Islamic banks' ability to attract low-cost funding, affecting their competitiveness against conventional banks. Without the ability to offer profit incentives, Islamic banks are at a disadvantage in attracting savings customers, creating an unequal playing field. According to the National Bank of Kazakhstan, total retail deposits in the banking sector, both in national and foreign currencies, reached 20.4 trillion KZT as of December 2023. A survey by the Kazakhstan Deposit Insurance Fund and the Association of Financiers of Kazakhstan found that 95% of bank clients use financial services, including card, deposit, and current accounts, with 66% holding

deposits. This equates to approximately 7,595,500 individuals, out of a population of 11,508,280, holding an average deposit of 2,685,800 KZT (AIFC, 2024).

ADCB Islamic Bank, one of the strongest Islamic banks in Kazakhstan, reported 100 billion KZT in total deposits, covering both current and term accounts by the end of 2023 (ADCB Islamic Bank, 2023). Despite this, Islamic banks hold less than 1% of the deposit market. Interestingly, 99% of survey participants expressed a willingness to switch to Islamic deposit products if available, indicating a significant demand for Shariah compliant options. The inability to provide competitive, profit-bearing savings accounts not only restricts product development for Islamic banks but also prevents them from capitalizing on substantial market interest, underscoring the need for regulatory support to facilitate broader Islamic product offerings.

Taxation

Before examining the specifics of Kazakhstan's tax laws, it's essential to note that the existing tax code was primarily developed for conventional banking, covering all its aspects without regard for the unique nature of Islamic banking which may lead to less profitability of the Islamic banking to the investors or to its customer. During my working experience I experience default of a customer and a significant loss to Al Hilal Islamic Bank due to tax matter. The Islamic banks are involved in the buying and selling of goods and services and have an added religious responsibility to contribute to social development. The current tax code does not align well with these activities. A more suitable approach would be to analyze how the existing tax laws impact Islamic banks and their customers, particularly in situations where income is derived from deferred sales of goods and services, which should ideally receive tax exemptions similar to those available for conventional banking income or in another to neutralize any tax impact either to the bank or the customer for same transaction which may happen in conventional financing. Hence legislative amendments are necessary to extend tax relief to customers of Islamic banks who access financing through any Shariah compliant product.

Sale and Purchase Contracts

The most common product in Islamic banking globally is used the sale and purchase contract. Kazakhstan's tax law began addressing Islamic sale

and purchase products in 2009 with Murabaha contracts, and in 2014, tax code amendments extended to commodity Murabaha product, granting it tax exemption. However, the tax code still lacks comprehensive provisions for various sale and purchase products in Islamic banking, such as LC Murabaha, Murabaha on shares, home appliance and etc.

This existing tax gap has led to legal disputes, notably a case involving DAMU and Al Hilal Islamic Bank (now ADCB Islamic Bank), where Al Hilal Bank incurred substantial financial losses, totaling 2 billion tenge, over a (reverse) commodity Murabaha agreement. In this case, where DAMU financed Al Hilal Islamic Bank (purchaser), and Al Hilal Islamic Bank was expected to make tax-deducted for each installment payments as Tax agent. DAMU argued that the transaction was a sale and purchase, not financing, requiring Al Hilal Islamic Bank to pay the full installment amount without tax deductions. Even due Al Hilal Islamic Bank has received confirmation on compliance of Al Hilal Bank with tax, court decided for DAMU which resulted to a big loss to Al Hilal Islamic Bank. Such ambiguities make Islamic banking sector less attractive to investors and complicate the development of innovative Islamic financial products (Specialized Interdistrict Economic Court of Almaty City, 2024) and Appellation court decision (Almaty City Court, 2024).

The current tax laws on sale and purchase contracts cover Murabaha, particularly for tangible goods like houses, flat, vehicles, and machinery which permit to pay VAT tax once in a year under Article 372 (2.8): "financing of individuals and legal entities by an Islamic bank as a trade intermediary by way of granting a commercial loan on the terms of subsequent sale of goods to a third party (Code of the Republic of Kazakhstan On taxes and other obligatory payments to the budget, 2017). According to this provision, Islamic banks purchasing goods and selling them on installments under Murabaha are exempt from VAT. However, if the purchase home appliance will be subject VAT which difficult for Islamic bank to introduce BPL product. In addition, the law has also gray area which references "granting a commercial loan," which is limited to Murabaha products and does not include other sale-and-purchase products like parallel Salam and parallel Istisna. Consequently, financing agriculture through Salam or production via Istisna may be subject to VAT, posing a financial disadvantage in compare to the conventional financing.

Additionally, to above, the term “goods” in the law restricts VAT exemption to some tangible assets only however If Islamic banks use shares or Sukuk/certificate of Mudarabah or any other Shariah compliance financial instruments as such product exist in UAE market using National Bond’s Sukuk as the subject of Murabaha (National Bond, n.d.), these transactions would be subject to VAT, as the current law does not extend exemption to non-tangible assets.

Lease Contracts

In Islamic banking, buy-and-lease-back arrangements are often used for liquidity financing, where customers needing liquidity sell assets to the bank, which leases them back to the customer. Under this arrangement, the bank holds ownership of the asset, leasing it until the end of the term, when ownership transfers back to the customer.

The tax laws only exempt VAT on leases when the bank purchases the asset from a third party to lease to a corporate customer. However, when the bank buys the asset directly from the customer for financing or liquidity purposes, issues arise. Under Article 228 of the Tax Code, the price difference between the customer’s booked value and the bank’s purchase price may be considered taxable income for the customer, creating an added tax burden. This differs from Malaysia’s tax treatment for buy-and-lease-back products, where tax neutrality principles for Islamic finance prevent such transactions from attracting extra tax liabilities (Ministry of Labor Affairs, 2021). Another tax issue arises with service leases used in financing, such as educational or medical services, where Islamic banks purchase a service from a provider and sell it to the customer on deferred terms for example Dubai Islamic Bank has such product is called “Service Ijarah” (Dubai Islamic Bank, n.d.). In Malaysia and GCC countries, such transactions are VAT-exempt to ensure neutrality with conventional banking products. In contrast, Article 397 of Tax Code exempts financial transactions from VAT but does not include service leases for Islamic banks, leading to additional costs. Ensuring VAT exemption on these transactions, similar to Malaysia’s approach, would create a fairer competitive environment for Islamic banks.

Zakat and Double Taxation on Islamic Banks

Islamic banks are required to pay zakat on their income, as mandated by the Quran and the sayings of the Prophet Muhammad. However, if they are

also subject to corporate tax, this results in double contributions to society, as conventional banks only pay corporate taxes. To avoid this dual obligation, several countries, including Malaysia, Pakistan, Saudi Arabia, and UAE, provide tax relief mechanisms for Islamic banks that pay Zakat.

- Malaysia: Section 44(11A) of the Income Tax Act 1967 (ITA 1967) allows Islamic banks to claim zakat payments as a tax rebate against taxable income, up to either the amount of zakat paid or 2.5% of the bank’s total income, whichever is lower. This policy avoids double taxation, ensuring that zakat fulfills the bank’s social responsibility without added tax burdens (Ministry of Labor Affairs, 2021).

- UAE: Recent corporate tax regulations include provisions where Islamic financial institutions paying zakat to recognized organizations are exempt from double taxation. Although specifics are still being clarified, these updates align UAE’s approach with international practices to ensure that zakat-compliant institutions are not subject to dual tax obligations. Unlike the Pakistan UAE permitted to pay Zakat to licensed charity organization (UAE Federal Tax Authority, 2024).

- Pakistan: Under the Zakat and Ushr Ordinance, 1980, Islamic banks can deduct zakat payments from their taxable income when these payments are made to the government’s zakat fund. This deduction helps Islamic banks fulfill their zakat obligations without facing additional tax liabilities, maintaining tax parity with conventional institutions (Pakistan Federal Board of Revenue, 2001).

According to Kazakhstani Tax code “Article 288. Reduction of taxable income:” the law it will not fully cover the zakat at it has limitation and the purpose of the law to general charity. The laws states: 2) taxpayers, except for taxpayers specified in subparagraph 1) of this paragraph – to the extent of total amount not exceeding 4 percent of taxable income:

- the amount of excess of actually incurred expenses over income (to be) received from the operation of social facilities provided for in Article 239 of this Code;

- the value of property transferred free of charge, the recipient of which is:

- a non-commercial organization;

- an organization carrying out activity in the social sphere;

- charitable assistance given a taxpayer’s decision based on an application from a recipient of assistance.” (Code of the Republic of Kazakhstan On

taxes and other obligatory payments to the budget, 2017)”

The Tax code is limiting the amount of charity payment where it shall not exceed 4 % of taxable income as well as it shall be based on application of recipient of assistance where Zakat amount could be higher and the bank shall take amount and spend according to categories mentioned in Quran and also Islamic bank shall not wait the receipt of the application for assistance where it shall find the deserve person according to Quran categories mentioned and discharge it is responsibilities.

The current tax laws in Kazakhstan fall short of providing comprehensive support for Islamic banking transactions. Amending the tax code to recognize Islamic banking’s unique needs such as VAT exemptions for all Shariah compliant sale and lease contracts and avoiding double taxation such CIT and Zakat payments would create a more equitable regulatory environment. Aligning tax treatment of Islamic banking with international practices could significantly enhance the sector’s appeal to investors and facilitate product innovation in the market.

Conclusion

The development of innovative products is essential for the growth and competitiveness of any business sector, including Islamic banking. The Islamic banking sector is still in its early stages, and to foster its growth as survey of AIFC shows on market demand for the Islamic bank yearly growing, it is crucial that the government and regulatory bodies prioritize creating a competitive and supportive environment. This will not only enhance the appeal of Islamic finance to both local and foreign investors but also encourage sustainable development within the sector. The key points for consideration are as follows:

1. Hybrid and adoptable Regulatory system: As Islamic finance is in its nascent phase in Kazakhstan even after 14 years, the regulatory framework must be structured to accommodate innovative productive development without requiring any legal amendments. Developing a proactive regulatory mechanism that can adapt to new Islamic financial products will enable the sector to develop dynamically. Such a mechanism would streamline the approval process for new Shariah compliant products, allowing the financial sector to innovate effectively while remaining compliant with both Islamic and conventional financial standards.

2. Creating a Level Playing Field: The government should take steps to establish a level playing field between conventional and Islamic finance, ensuring equitable treatment for all Islamic banking products. Disparities in tax treatment, VAT cost implication on some Islamic products, and not regulatory support make Islamic banking products potentially costlier and less attractive to investors, as it happened to AL Hilal Islamic Bank, and customers alike. Introducing tax neutrality principles, similar to those in Malaysia and GCC countries, would help Islamic banks compete fairly with conventional banks, attracting investment and increase customer trust in Shariah compliant products.

3. Tax and Zakat Considerations: The tax treatment of Islamic banking products must account for the unique nature of Islamic financial transactions, such the case in buy-and-lease-back arrangements, subject and nature of Murabaha as well as Salam and Istisna contracts with their parallel contracts. Additionally, the government should consider integrating Zakat as a tax rebate or exemption, as practiced in Malaysia, Pakistan, and Saudi Arabia, to prevent double duties on Islamic banks that pay both Zakat and corporate income taxes. This would not only align with the Shariah obligations but also increase Islamic banks’ appeal to investors seeking socially responsible investments.

4. Encouraging Product Diversity and Market Expansion: Broadening the range of Shariah-compliant products, such as asset-backed financing, agriculture financing via Salam contracts, and project financing with Istisna, will support diverse sectors of the economy of Kazakhstan, including SMEs and large-scale projects from debt financing to asset financing. Ensuring VAT exemptions and regulatory clarity for these products will enable Islamic banks to attract a wider customer base and support economic goals in various sectors.

5. Investment Protection and Legal Clarity: Legal clarity on Islamic financial transactions and dispute resolution mechanisms is essential to protect investors and minimize risks. Ensuring that all Islamic finance transactions, including agency arrangements and commodity Murabaha, are clearly defined in the legal framework would enhance investor confidence, prevent costly legal disputes, and support market stability.

In summary, to advance Islamic banking in Kazakhstan, a supportive and adaptive regulatory framework is essential. By aligning tax treatment,

creating a balanced competitive environment, and facilitating product innovation, Kazakhstan can position itself as a regional hub for Islamic finance, attracting both foreign and domestic investment while meeting the growing demand for Shariah-compliant financial products.

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