

Admitted to appear in the High and Constitutional Courts

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Amaanat Group
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Attention: Mr HAK Omar

Dear Sir

**RE: PRELIMINARY GUIDANCE NOTE ON THE SHARIAH COMPLIANCY
OF TURNOVER RENT**

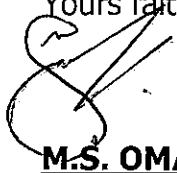
1. A typical turnover rent structure requires the tenant to pay a base fixed rent (usually between 70 – 80% of the open market rent) and a fixed percentage of the tenant's annual turnover, to the extent that such turnover exceeds the base rent.
2. The crucial shariah issue is whether or not the turnover rent is an amount which is certain or capable of ascertainment.
3. The answer is that turnover rent is capable of easy ascertainment, because the agreed turnover clause is clear, unambiguous and does not lead to any dispute between the parties. (*see for example Radd al-Muhtar ala al-Dur al-Mukhtar*)
4. A useful analogy is fixing a floating rental based on a well defined benchmark and/or index, which does not lead to any uncertainty or dispute, in determining the rent.
5. The distinguished contemporary jurist Mufti Taqi Usmani has permitted fixing the rental to a well-defined benchmark. In this regard, please see the extract from his book, "An Introduction to Islamic Finance", which is annexed hereto.



6. Similarly, the eminent well-known, Shariah Council of AAOIFI, headed by Mufti Taqi Usmani, has permitted to the use of a specific index or benchmark, to determine floating rentals. The benchmark must be well defined and must not lead to dispute. *(see article 5/2/3 of Shariah Standard on Ijarah).*
7. A turnover rent clause is, in my view, certain, when compared to determining a rent based on a variable but well-defined index.
8. The turnover rental formula is agreed upfront, not open to any dispute, and the relevant annual turnover is confirmed at the relevant time by the certificate of a qualified, registered auditor.
9. I am not aware of any eminent contemporary shariah expert, who has ruled against a conventional turnover clause.

AND ALLAH KNOWS BEST

Yours faithfully



M.S. OMAR

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NOTE

This guidance note purports to be a very short summary and not a detailed Shariah opinion, having regard to time constraints and work engagements.

An Introduction
To
ISLAMIC FINANCE

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Variable Rentals in Long Term Leases

5. In the long term lease agreements it is mostly not in the benefit of the lessor to fix one amount of rent for the whole period of lease, because the market conditions change from time to time.

In this case the lessor has two options:

(a) He can contract lease with a condition that the rent shall be increased according to a specified proportion (e.g. 5%) after a specified period (like one year).

(b) He can contract lease for a shorter period after which the parties can renew the lease at new terms and by mutual consent, with full liberty to each one of them to refuse the renewal, in which case the lessee is bound to vacate the leased property and return it back to the lessor.

These two options are available to the lessor according to the classical rules of Islamic Fiqh. However, some contemporary scholars have allowed, in long-term leases, to tie up the rental amount with a variable benchmark which is so well-known and well-defined that it does not leave room for any dispute. For example, it is permissible according to them to provide in the lease contract that in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of same amount. Similarly it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. Therefore if there is an increase of 5% in the rate of inflation, it will result in an increase of 5% in the rent as well.

Based on the same principle, some Islamic banks use the rate of interest as a benchmark to determine the rental amounts. They want to earn the same profit

through leasing as is earned by the conventional banks through advancing loans on the basis of interest. Therefore, they want to tie up the rentals with the rate of interest and instead of fixing a definite amount of rental, they calculate the cost of purchasing the lease assets and want to earn through rentals an amount equal to the rate of interest. Therefore, the agreement provides that the rental will be equal to the rate of interest or to the rate of interest plus something. Since the rate of interest is variable, it cannot be determined for the whole lease period. Therefore, these contracts use the interest rate of a particular country (like LIBOR) as a benchmark for determining the periodical increase in the rent.

This arrangement has been criticized on two grounds:

The first objection raised against it is that, by subjecting the rental payments to the rate of interest, the transaction is rendered akin to an interest based financing. This objection can be overcome by saying that, as fully discussed in the case of murabahah, the rate of interest is used as a benchmark only. So far as other requirements of Shari'ah for a valid lease are properly fulfilled, the contract may use any benchmark for determining the amount of rental. The basic difference between an interest - based financing and a valid lease does not lie in the amount to be paid to the financier or the lessor. The basic difference is that in the case of lease, the lessor assumes the full risk of the corpus of the leased asset. If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset loses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot

claim the rent, while in the case of an interest-based financing, the financier is entitled to receive interest, even if the debtor did not at all benefit from the money borrowed. So far as this basic difference is maintained, (i.e. the lessor assumes the risk of the leased asset) the transaction cannot be categorised as an interest-bearing transaction, even though the amount of rent claimed from the lessee is equal to the rate of interest.

It is thus clear that the use of the rate of interest merely as a benchmark does not render the contract invalid as an interest - based transaction. It is, however, advisable at all times to avoid using interest even as a benchmark, so that an Islamic transaction is totally distinguished from an un-Islamic one, having no resemblance of interest whatsoever.

The second objection to this arrangement is that the variations of the rate of interest being unknown, the rental tied up with the rate of interest will imply *Jahalah* and *Gharar* which is not permissible in Shari'ah. It is one of the basic requirements of Shari'ah that the consideration in every contract must be known to the parties when they enter into it. The consideration in a transaction of lease is the rent charged from the lessee, and therefore it must be known to each party right at the beginning of the contract of lease. If we tie up the rental with the future rate of interest, which is unknown, the amount of rent will remain unknown as well. This is the *Jahalah* or *Gharar* which renders the transaction invalid.

Responding to this objection, one may say that the *Jahalah* has been prohibited for two reasons: One reason is that it may lead to dispute between the parties. This reason is not applicable here, because both parties

have agreed with mutual consent upon a well defined benchmark that will serve as a criterion for determining the rent, and whatever amount is determined, based on this benchmark, will be acceptable to both parties. Therefore, there is no question of any dispute between them.

The second reason for the prohibition of *jahalah* is that it renders the parties susceptible to an unforeseen loss. It is possible that the rate of interest, in a particular period, zooms up to an unexpected level in which case the lessee will suffer. It is equally possible that the rate of interest zooms down to an unexpected level, in which case the lessor may suffer. In order to meet the risks involved in such possibilities, it is suggested by some contemporary scholars that the relation between rent and the rate of interest is subjected to a limit or ceiling. For example, it may be provided in the base contract that the rental amount after a given period, will be changed according to the change in the rate of interest, but it will in no case be higher than 15% or lower than 5% of the previous monthly rent. It will mean that if the increase in the rate of interest is more than 15% the rent will be increased only upto 15%. Conversely, if the decrease in the rate of interest is more than 5% the rent will not be decreased to more than 5%.

In our opinion, this is the moderate view which takes care of all the aspects involved in the issue.

Penalty for Late Payment of Rent

In some agreements of financial leases, a penalty is imposed on the lessee in case he delays the payment of rent after the due date. This penalty, if meant to add to the income of the lessor, is not warranted by the Shari'ah. The reason is that the rent after it becomes due, is