

PROPOSED ISLAMIC TAXATION TO AVOID EXCESSIVE DEBT AND FINANCIAL CRISES: CAN ISLAMIC MODEL BE A SOLUTION?

***Abid Izaz¹, Waheed Akhter², Qamar Uz Zaman³.**

¹ PhD Scholar, COMSATS University Islamabad (CUI), Lahore Campus, Punjab, Pakistan.

² Associate Professor, Center of Islamic Finance, CUI, Lahore Campus, Punjab, Pakistan.

³ Associate Professor, COMSATS University Islamabad (CUI) Sahiwal Campus, Punjab, Pakistan.



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ABSTRACT

As, excessive conventional debt, causes financial crisis and financial instability. Many researchers pointed out that we should avoid Riba based financing that is prohibited in Islam. We have proposed to abolish Riba based financing, and promote Sukuk financing. In this study we will compare the performance of conventional debt vs Islamic debt in proposed Islamic taxation policy of leveraged firms. In order to analyze the data, the study has employed simulation tools and designed many experiments to examine how leveraged enterprises perform and how much they are worth in relation to both traditional and proposed tax policies. According to conventional tax policy tax benefit is available to debt and in proposed taxation policy tax benefit will be available to Sukuk. The results demonstrated that, in comparison to traditional debt, Sukuk is more advantageous for the firm's value and cost of capital. It is anticipated to improve the general financial stability of the corporate sector and lessen financial distress and insolvency.

***Corresponding Author's Email:** abidizaz@gmail.com

INTRODUCTION

Conventional debt is a nine-day wonder. You have to pay back through the nose or by breaking the bank. Islamic debt is like a bird in the hand is worth two in the bush.

Debt and equity are two of the most important sources of funding in the corporate world. Both funding sources have different institutional structures and bylaws. A unique regulatory structure and set of rules govern these financial and capital market products, which are fundamentally different in terms of availability (Leland, 1994), market, trading (Harris & Raviv, 1993), rate of return (Fama & French, 2015), taxation (Desai & Dharmapala, 2006), and corporate perspective (Myers, 1984). When choosing between debt and equity, market dynamics and corporate employability are greatly impacted by the primary contrast, which is the tax distinction that permits tax refunds for debt financing returns as opposed to double taxation (Hines, 1999) on equity financing. This tax-based differential in legal fertility is known as the debt-equity distinction; in the corporate financing literature, it is also referred to as the interest tax shield (Zaman, Hassan, & Akhter, 2017) or interest tax subsidy.

The debt-equity divide has historically been contentious because of the law's illogical foundations and legal justifications. Without any legal basis, this regulation was implemented during World War I to combat the financial difficulties brought on by the conflict. The US tax code's permanent feature eventually took the place of this temporary arrangement, and the tax benefit of debt over equity was kept indefinitely without any legislative support. Legal professionals and economists have attempted numerous times

over the years to undo this unfair and contentious tax structure via the legal system, but their efforts have been in vain because of the protracted litigation.

For a number of reasons, the experts are against this unlawful debt-equity unique tax classification. Even though equity financing may be more efficient, this difference tax treatment may misrepresent financing decisions by using debt rather than other sources of funding (Desai and Dharmapala, 2009). Second, compared to the losses in neutral tax treatment, this unequal tax treatment may result in greater losses for the government's revenue (Feld and Heckemeyer, 2011; Dharmapala, Foley, and Forbes, 2011). Thirdly, and maybe more dangerously, it raises debt levels, which may raise the possibility of financial instability (Agnello, Dufrenot, and Sousa, 2015).

Following the massive worldwide financial crises of 2007–2008, a philosophical discussion on financial stability was initiated. The researchers sought to identify the primary drivers of global financial instability. The basic fundamentals of maximising wealth, excessive debt, economic distortions, systematic frictions, and restricted accountability were all the subject of various objections and observations in earlier studies (Beck, Colciago, & Pfajfar 2014). Some research have proposed re-framing the structural abnormalities and financial regulation setup based on the impacted stakeholders and associated results. The global financial system's risk would be reduced and a persistent threat of instability would be avoided with the help of a reframed financial structure (Archer & Karim, 2018). Excessive debt increases the risk of default, especially if a business struggles to make its loan payments. Credit rating downgrades, higher borrowing costs, and limited access to financial markets are some of the negative effects of default (Fan, Titman, & Twite, 2016).

Researchers claim that the Islamic banking industry has proven to be resilient and stable throughout difficult times. Its basis is the idea of "riba," or the impermissibility of interest, which is a special quality. It also promotes equity involvement, which is the division of gains and losses. In general, Islamic financial principles promote risk sharing and restrict "riba" risk shifting. This raises the issue of whether Islamic finance can help redefine business taxation and financing. According to the core tenets of Islamic finance, the conventional interest tax shield is contrary to what it should be. Islamic finance, as opposed to conventional finance, offers clear guidelines for loan repayment. As a result, rental tax

deductibility may shift from interest tax deductibility (interest tax shield) to dividend tax deductibility (dividend tax shield) and, in the case of Sukuk Ijarah, rental tax deductibility (rental tax shield). We think that the proposed adjustments will probably lead to a corporate finance policy that is both profitable and stable.

This study attempts to address the question, "What is the effect of proposed policy on firm value?" To this end, we introduce and build a firm financing model and provide scenario-based simulated tests of the opposite models, namely financing cost and firm value. This report offers very basic information regarding how the field of corporate Islamic financing has developed. It also provides actual evidence of the relationship between interest-taxability and corporate value, indicating that interest-taxability may be a viable solution to the current global financial crisis. Furthermore, this work contributes to the expanding discourse on financial stability, which is critical to Islamic finance, accounting, and economics in general.

LITERATURE REVIEW

Sukuk Advocacy

Modern Conceptual Framework of Sukuk

Sukuk, a sort of Islamic bond issued by the state through any fund (SPV), is the originator of the asset to collect funds or money that the issuing company requires in the market. The word Sukuk is the plural of Sak. These Sukuk issued by the corporation can be classified as either secured or unsecured; asset-backed Sukuk is classified as an unsecured sort of Sukuk, whereas asset-based Sukuk (Sukuk Ijarah) is classified as a secured Sukuk. (Lahsasna, Hassan, & Ahmad, 2018; Radzi & Muhammad, 2019). Additionally, there are other forms of Sukuk, such as Al-Wakalah, Ijarah, Murabaha, Musharakah, and Mudharabah (Afshar, 2013).

Tax Regulation and Legal Framework for Sukuk in Different Countries

Various countries have various Sukuk tax and legal frameworks. Through the SECP in Pakistan, the omnibus bill in Turkey, the tax law in Iran, the Income Tax Exemption Order in Malaysia, and other measures, Sukuk is given a tax-neutral environment. The primary driver of the global increase in Sukuk investments is the fact that many Sukuk-related expenses are tax deductible in the aforementioned nations, just like traditional bonds.

Financial Stability and Islamic Finance

Enhancing capital adequacy decreased the risk of financial crises (Berger, 2019). Researchers studied financial stability, which is the phenomenon where the financial system discourages excessive debt financing, where interest-taking is not permitted, and where extreme risk is avoided or shared rather than shifted (Pagliari et al., 2012). This was made possible by improving the supervisory and regulatory framework.

Because Islamic finance emphasises risk sharing, ethical consideration, and financial system stability, there is an intriguing intersection between Islamic finance and financial stability.

Zaman et al. (2017) looked at tax policy and debt-incentivized financing, and they provided an Islamic perspective on the tax deductibility controversy. According to this analysis, the dividend tax shield should be provided instead of the interest tax shield. Later, they presented a new financing model and reframed the MM firm valuation model, along with a proposed tax policy. The suggested model encourages profit and loss sharing, limits corporate debt, lowers financing costs, is value-oriented, and is more stable when the company steers clear of debt financing as much as possible. Instead of using hazy and speculative financial tools, the study advises financial institutions to deal with transactions involving physical and real assets and concentrate on actual economic activity (Ashfaq, 2016).

Sukuk and Financial Stability

By creating the Sukuk index, Paltrinieri, Dreassi, Miani, and Sclip (2015) compared conventional and Islamic bonds and saw how Islamic bonds correlated with various types of conventional bond assets. The addition of Islamic bonds resulted in a gain in diversification, particularly during financial crises.

Sukuk, Corporate Financing and Capital Structure

Sukuk provides a funding option that complies with Shariah regulations, which prohibit interest payments and receipts and encourage ethical and responsible business practices. Businesses can get long-term funding for their investment projects with Sukuk. In contrast to traditional loans, which frequently have set payback timelines, sukuk can be structured to align with the cash flow generation of the underlying project. Yıldırım, Yıldırım, & Diboglu (2020) state. Because sukuk issuances often have longer maturities than traditional debt, they reduce the risks associated with short-term borrowing and provide firms with long-term funding for capital expenditure projects.

Sukuk vs Firm Performance

Projects or assets that act as collateral are commonly included in sukuk frameworks, offering a certain level of security. Enhancing risk management can be achieved by coordinating Sukuk repayment with the cash flows generated by the underlying assets. Better risk management can reduce default risk and financial hardship, which can increase the value of a corporation (Mohd Noor, N. F. 2024).

Debt Avoidance Vs Firm Performance

The literature suggests that avoiding debt could enhance a company's success. Avoiding debt can improve business success in a number of ways. According to the empirical results, among SMEs with minimal credit risk, the debt ratio has a negative correlation with business performance (Li, Niskanen, & Niskanen, 2019).

Sukuk vs Conventional Bond in Crisis (COVID-19 Pandemic)

Sukuk's unique characteristics, like their underlying asset structure and risk-sharing focus, might have contributed to their strong performance during the economic downturn of the epidemic.

The maritime economic crisis, which has devastated Indonesia's fishing industry since the COVID-19 epidemic, was studied by Maulana & Zahro (2021). Blue Sukuk was proposed as a remedy for this issue. The Indonesian government may be able to enhance marine potential in the long run by issuing blue Sukuk, which may also act as a reserve fund for the fishing industry.

Economic growth and Sukuk market development were found to be closely related over the long term. In contrast to traditional bonds, Sukuk density and volume have a positive impact on growth over time (Yıldırım, Yıldırım, & Diboglu, 2020). According to research by Alam, Aziz, and Iqbal (2020), Sukuk can be used as a capital market tool to achieve national economic development. Researchers found that Sukuk has a wider investor base than other financial securities.

Sukuk, Rental Tax Shield, and Firm Performance

In a tax-neutral setting, Sukuk issuers no longer face any tax disadvantages, which lowers borrowing costs. Researchers claim that this can improve a company's profitability and financial performance. A tax-neutral environment might attract a wider range of investors, including those seeking Sharia-compliant investments. Better pricing for issuers, a reduced cost of capital, and improved business

performance can all be outcomes of increased investor demand (Iqbal and Mirakhor, 2011). A tax-neutral environment for Islamic bonds can encourage the growth of the Sukuk market by providing issuers with additional alternatives for diversification and liquidity. This can boost market efficiency and enhance business success, claim Bhuiyan et al. (2019).

Proposed Reforms

Proposed Tax Reforms to Sukuk (Rental Tax Shield)

The performance of Sukuk (Ijarah) structures may be impacted by the tax-deductible character of rental payments. The following explains how the tax deduction of rental payments can impact Sukuk and business success using a general understanding of Islamic finance:

In certain jurisdictions, rental payments paid to Sukuk investors may be tax deductible. This means that the issuing company can reduce its taxable income and possibly even its total tax burden by deducting the rental payments from its income.

The availability of tax deductions for rental payments can significantly lower the financing expenses of the issuing company, providing the corporation with more money to reinvest or distribute as dividends to shareholders. This tax benefit may encourage investors to consider Sukuk as an investment option. In contrast to traditional debt instruments, where interest payments are proposed to be taxable, Sukuk offers potential tax advantages.

In addition to lowering taxes, rent payments can boost a company's profitability if it issues Sukuk, which could improve its financial performance and increase investor confidence in Sukuk. It's important to remember that local tax laws can affect how Sukuk rental payments are treated specifically tax-wise and whether they are deductible. In addition to tax deductions, other factors that impact the success of the Sukuk include market conditions, creditworthiness, and the capital gain (CG) or loss that will come from underlying assets, which can affect the firm's net income.

Research Framework

In order to transfer the interest tax shield's benefits to a rental tax shield (profit sharing based on Sukuk), it is suggested to provide a rental tax shield model and eliminate the interest tax shield. Second, compare the effects on the company value of the rental tax shield, dividend tax shield, and interest tax shield. To stop

interest-based financing, more taxes should be placed on corporate costs related to debt financing.

In addition to modifying the foundation of the conventional theory of capital structure (Modigliani, Franco, Miller, 1958; Modigliani & Miller, 1963) and its missing impact on debt financing as a result of bankruptcy and financial distress, the proposed debt to Islamic-Debt (Sukuk) distinction has noteworthy propositions for corporate financial theories and practices. Since debt is thought to cause instability and socioeconomic injustice, firms have begun to avoid debt because of its disadvantages, even in the presence of the interest tax shield, which causes economic distress on a global scale (Bessler, Drobetz, Haller, & Meier, 2013).

Following a consideration of the MM theory of capital structure, this paper suggested tax reforms as an Islamic strategy. Below are some hypotheses to gauge our mathematical model. Since our model is based on simulated experiments, statistical hypotheses (null, alternative) are not necessary; similar research have been conducted in the past (Modigliani & Miller, 1958; Zaman et al., 2017).

Sukuk-al-Ijarah structure

Sukuk al-Ijarah are securities of comparable denomination that are linked to an Ijarah contract and represent physical, enduring assets (Kahf, 1997). Assets that produce or are expected to produce cash flow are transferred from the originator or the business in need of finance to a bankruptcy-remote Special Purpose Vehicle (SPV). The SPV then raises funds and issues certificates to investors that are backed by these assets. The SPV serves as a trustee for investors, and these certificates attest to the ownership of the cash-generating assets by investors (Iqbal and Mirakhor, 2011). The original creator then leases the properties. During the lease period, the SPV receives and distributes rental payments—which could be either fixed or variable—for the company's assets to the investors. At the conclusion of the lease period, the company stops paying rent and buys back the asset for the full principal amount (Rafay et al., 2017).

Capital Gain from underlying asset of Sukuk

Since real asset values are rising in Pakistan and businesses must repurchase the underlying asset at principal, it is anticipated that the underlying asset in our scenario would be from the real state, resulting in a capital gain at the conclusion of the term. The estimated value of the Pakistani real estate market in 2025 is \$2.08 trillion USD. Residential real estate,

which is anticipated to generate US\$1.33 trillion in 2025, dominates this market sector. According to Statista.com, it is projected to grow at a compound annual growth rate (CAGR) of 3.75% from 2025 to 2029, reaching a market size of US\$2.41 trillion.

Assumptions for the proposed Islamic model are given below

Proposition 1 – Rental tax shield would be available to firms on Sukuk (Al-Ijarah) but no tax shield will be available on debt

H1: Impact of RTS (Rental Tax Shield) on Firm Value

Proposition 2 – Non-Debt Tax Shield would be available to firms on Sukuk (Al-Ijarah) in case of maintenance of Sukuk asset, as maintenance expenses of the underlying asset is the responsibility of the firm (originator).

H2: Impact of Non-Debt Tax Shield on FV (Firm Value)

Proposition 3 – It is assumed firm will do Sukuk Ijarah on land, its value will increase in long run and firm may benefit from capital gain (Difference of market value and principal amount of the underlying asset)

Proposition 4 – It is assumed firm will incur some costs related to the issuance of Sukuk.

Proposition 5 – Benefits obtained from RTS (Rental Tax Shield), NDTs (Non-Debt Tax Shield) and Capital Gain off-set cost related to the issuance of Sukuk.

H4: RTS, NDTs, and Capital Gain will off-set cost related to the issuance of Sukuk.

H5: Impact RTS, Capital Gain, NDTs, on Firm Value

RESEARCH METHODOLOGY

The current study will use a two-stage approach to test the assumptions. The first is to use the calibrated values and modified MM firm valuation model of (Zaman et al., 2017) in the presence of different tax shields. Secondly, we employ a scenario-based simulation techniques to evaluate the possible difference in the firm's cost and value patterns in non-financial leveraged firms of Pakistan (i.e., firm value, earning per share, and cost of capital).

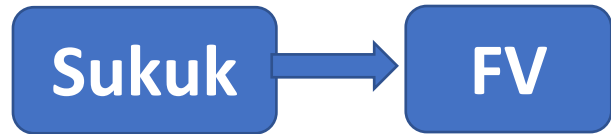
Model

The proposed and modified model focused on the cost and value of the firm. Exogenous factors will not be assumed by it. It is a linear estimation linked to a single period, assuming a “t” point of time, this estimated model employs basic parameters of firm valuation as a net operating income method and builds a firm value mechanism at time t (Zaman et al., 2017).

CONCEPTUAL MODEL OF RTS

Conceptual Model

Rental Tax Shield vs Firm Value



Conceptual Model

Case A: ITS: Model estimation IF Interest tax shield present, Dividend tax shield absent, and Rental tax shield absent (**Interest Tax Shield**)

Case B: RTS: Model estimation IF Dividend tax shield absent, Interest tax shield absent, and Rental tax shield present (**Rental Tax Shield**)

Case C: NTS: Model estimation IF Interest tax shield absent, Dividend tax shield absent, and Rental tax shield absent (**No Tax Shield**)

Model Estimation

Firm value as proposed would be

$$F_v^t = \frac{\hat{Y}^t}{K_0^t} + R_s^t - B_c^t$$

Where

$$F_{vz}^t = \frac{\hat{Y}^t}{K_0^t}$$

K_0 is cost of capital and $\hat{Y}^t$ is earning attributable to stakeholders, R_s is rental tax shield and B_c is bankruptcy cost.

Proposed Net Income Definition

All financing and operating costs, rentals of Sukuk, are regarded as business expenses under the proposed definition of net income. In case of capital gain from Sukuk transaction, will also be added in net income. Interest will be paid after tax as proposed to avoid riba. With this arrangement, rent paid to sukuk are seen as tax deductible and the interest tax subsidy is eliminated. Determining the rental payout is also required in this case.

$$\hat{Y}^t = Y^t + Rent^t + CG^t$$

Dividend on Equity

It is assumed that firm is paying proportion of operating profit (OP) at rate (r) as dividend

$$Div^t = (OP)r^t$$

Rentals on Sukuk

It is assumed that firm is paying proportion of Sukuk underlying asset price (AP) at rate (r) as rent of that Sukuk

$$Rent^t = (AP)r^t$$

As proposed interest will be deducted from operating profit after tax and rentals and dividends will be deducted before tax deduction.

So

EBIT will become EBTI in our proposed model where interest is taxable.

$$EBTI = OP - (OP)r^t - (AP)r^t$$

or

$$EBTI = OP - Rent^t$$

In above equation rental payments are being deducted before interest from operating income before tax and interest.

$$EBI = EBTI - tax$$

The above equation is the application of interest taxability as proposed, tax is being deducted before the deduction of interest.

$$Y^t = EBI - interest$$

In above equation the interest amount is being deducted from income after tax.

$$\hat{Y}^t = Y^t + Rent^t$$

To reach again on earning attributable to stakeholders the rent amount is being added again in the net income.

Cost of Equity

Cost of equity in case of constant dividend payout ratio:

$$k_e^t = \frac{Div^t}{E_m^t}$$

Cost of equity in case of growing dividend payout ratio

$$k_e^t = \frac{Div^t}{E_m^t} + g$$

Cost of equity is equal to dividend divided by equity plus growth in dividend

Cost of Debt

$$k_i^t = I_r^t \text{ Where } PVI_s = 0$$

Cost of debt is equal to interest rate where present value of interest tax shield is zero.

Cost of Sukuk

$$k_s^t = R_r^t (1 - T_r^t)$$

Cost of Sukuk is equal to rental rate multiply by tax subsidy

Cost of Capital

Model 1: Cost of Capital in case of No Tax Shield (NTS)

$$k_0^t = k_i^t \left(\frac{D}{D + E + S} \right) + k_e^t \left(\frac{E}{D + E + S} \right) + k_s^t \left(\frac{S}{D + E + S} \right)$$

Model 2: Cost of Capital in case of Interest Tax Shield (ITS)

$$k_0^t = k_i^t (1 - T_r^t) \left(\frac{D}{D + E + S} \right) + k_e^t \left(\frac{E}{D + E + S} \right) + k_s^t \left(\frac{S}{D + E + S} \right)$$

Model 3: Cost of Capital in case of Rental Tax Shield (RTS)

$$k_0^t = k_i^t \left(\frac{D}{D + E + S} \right) + k_e^t \left(\frac{E}{D + E + S} \right) + k_s^t (1 - T_r^t) \left(\frac{S}{D + E + S} \right)$$

Cost of Sukuk is equal to interest rate plus equity rate plus Sukuk rate multiplied with their proportions. E is debt, E is equity, S is Sukuk, (1-Tr) is tax shield.

Dividend Tax Shield

That is stated as

$$T_E^t = Div^t \cdot T_r^t$$

The net benefit of DTS is stated below:

$$Y_I^t = \frac{I_r^t \cdot B^t \cdot T_r^t}{k_i^t}$$

Rental Tax Shield

That is stated as

$$T_R^t = R_r^t \cdot AV^t \cdot T_r^t$$

The net benefit of RTS is stated below:

$$Y_R^t = \frac{R_r^t \cdot AV^t \cdot T_r^t}{C_s^t}$$

3.3.10 Cost of Distress and Bankruptcy

The traditional method states that the present value of the anticipated interest tax shield (PVI_s) equals the firm's expected cost of bankruptcy (B_c) (Zaman et al., 2017). We can get present value of interest tax shield by multiplying debt amount into tax rate.

i.e PVI_s = B_c = B^tT^t

Firm Value

To establish the consequences of our suggested model, firm value is the proportion of earning attributable to stakeholders plus present value of interest tax shield minus bankruptcy cost.

Model 1: Firm value in case of No Tax Shield (NTS)

$$F_v^t = \frac{\hat{Y}^t}{K_0^t} - B_c^t - F_d^t$$

In above case there is no tax shield available, but in case of leverage bankruptcy cost will decrease the firm value.

Model 2: Firm value in case of Interest Tax Shield (ITS)

$$F_v^t = \frac{\hat{Y}^t}{K_0^t} + PVI_S^t - B_c^t - F_d^t$$

In above case interest tax shield is available, in case of leverage bankruptcy cost may be off-set by the present value of interest tax shield

Model 4: Firm value in case of Rental Tax Shield (RTS)

$$F_v^t = \frac{\hat{Y}^t}{K_0^t} + PVR_S^t - B_c^t - F_d^t$$

In above case rental tax shield is available, in case of leverage the benefit of rental tax shield may be decrease, so it is suggested to be unlevered in case of rental tax shield. Additional benefit in this case is that it is assumed to have a capital gain in operating profit on the basis of increase in real estate prices.

Earnings per Share

$$EPS = \frac{\hat{Y}^t}{Shares}$$

Earnings per share is equal to earnings attributable to shareholder divided by the total number of shares. Share can be calculated by share capital with the share price.

$$Total\ No\ of\ Shares = \frac{Share\ capital}{Share\ Price}$$

The simulation methodology will be used in this study to derive potential policy implications by simulating real-world scenarios. It is typically used to create an artificial environment that can produce pertinent data and information (Haidvogel et al., 2000; Wang, Walter, & Parlange, 2013). Calibrated data of manufacturing companies is used as samples from all Pakistani companies listed on the stock exchange; calibrated values will be utilized based on the actual data, and the anticipated results closely resemble real-world situations. These calibrated values are taken from (Zaman et al., 2017). For the upcoming investigations, the calibration process gives the model baseline measurements that are completely accurate. This procedure is used to assess and achieve the values that serve as a measurement tool's baseline for the right result. Tankov (2003). To determine the data points that contradict the variation specified in the input parameters, this study will employ a different simulation methods.

RESULTS AND DISCUSSIONS

This chapter describes the iterative results of several policy experiments based on the estimated linear

model and calibrated inputs. A Neutral Tax State (NTS), Debt Tax Incentive or Interest Tax Shield (ITS), Rental Tax Incentive or Rental Tax Shield (RTS), are among the various tax treatment options that are intended to be investigated in these experiments. At time t, hypothetical data points are produced for homogenous enterprises with different and sukuk and leverage levels.

Throughout the experiments, a constant rate of interest is assumed in the analysis. Theoretical data points are created for enterprises in order to better understand the implications of interest tax shield and rental tax shields, both separately and in combination. The purpose of the experiments is to assess how various tax regimes might affect a company's cost of capital and total worth. NTS, ITS and RTS, are among the tax states that are tested for leveraged businesses. The outcomes of the suggested model are compared through simulations with benchmark valuation models, including the conventional (ITS) and tax-neutral (NTS) models.

The results are presented and analyzed through data plots, each of which shows simulated firm data points based on variations in input parameters.

Leveraged enterprises' outcomes under various tax regimes, such as tax neutrality (NTS), debt tax incentives (ITS), and rental tax incentives (RTS), are covered in the first section. Every small increase in debt financing or Sukuk financing is handled as a separate starting point in the experiments, which imply an increasing rate of leverage over time. Particularly in the graphical depictions, the term "debt" is used as a stand-in for the "debt ratio" for simplicity's sake.

Comparative Analysis of Firm Value among All Models

In this section comparative analysis will be made to check value of leverage firms on the basis of earning per share, market value of firm and WACC.

Explanation of EPS of (Leveraged Firm) in Different Models with Respect to Changes in Sukuk**4.1.1 Descriptive Table****Table 4**

EARNING PER SHARE -L	Min	Max	Mean	S.D
EPS-NTS-L	0.234 678	2.114 567	0.974 116	0.559 172
EPS-ITS-L	0.235 965	2.188 606	1.001 012	0.580 63
EPS-RTS-L	0.233 024	2.907 837	1.174 591	0.791 008

Fig 1

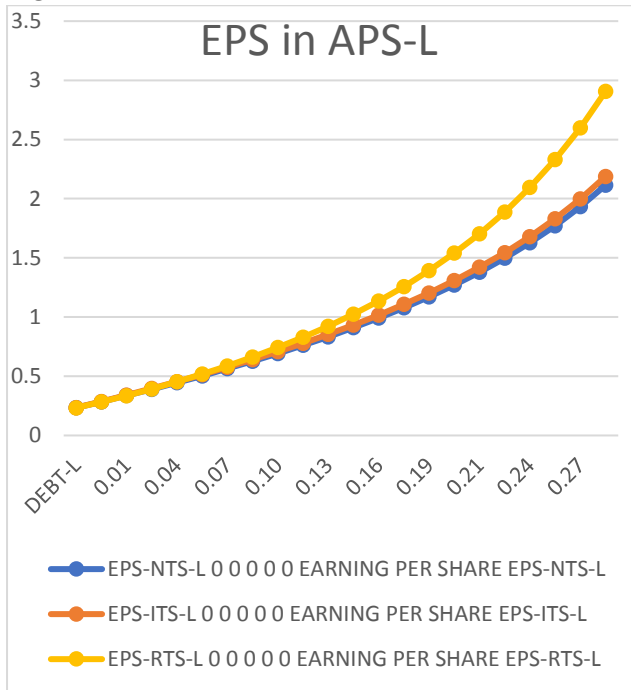


Fig 1

Due to the decreased equity (fewer shares outstanding), all models indicate an increase in EPS as the Sukuk fraction increases. The existence and kind of tax shields determine how much EPS rises: The rise of No Tax Shield (NTS/ITS) is moderate. Maximum increase for Rental Tax Shields (RTS). Because of the synergistic effect of tax shields on both equity and Sukuk, the EPS-(RTS)-L model offers the strongest EPS growth. Through tax reductions, it minimizes the cost of capital while optimizing the benefits of Sukuk. By utilizing tax shields on Sukuk, the EPS-(RTS)-L model maximizes shareholder value. To guarantee sustained growth, the model selection should also take the company's risk profile, market dynamics, and long-term financing plan into account.

Explanation of MVF of (Leveraged Firm) in Different Models with Respect to Changes in Sukuk

4.2.1 Descriptive

Table 5

MARKET VALUE OF FIRM -L	Min	Max	Mean	S.D
MVF.S-NTS-L	2.998347	4.284796	3.58644	0.393779
MVF.S-ITS-L	3.155332	4.275391	3.643484	0.339123
MVF.S-RTS-L	3.20921	4.357671	3.767537	0.36712

Fig 2

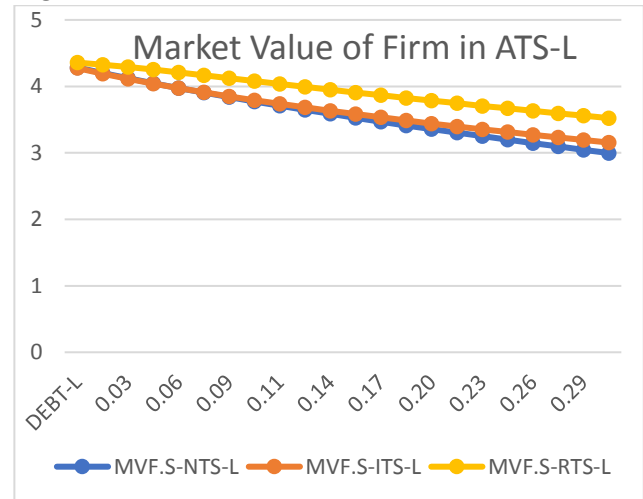


Fig 2

Market Value of Firm-No Tax Shield, or MVF.S-NTS-L: This model assumes that the firm's debt ratio is available and that no tax shield is applied to any charges.

As the percentage of Sukuk rises, the firm's market value falls. At 37% Sukuk, it begins at 4.284796, and at 97% Sukuk, it falls to 2.998347. This fall indicates that the entire firm value declines due to the lack of tax shields, representing a greater cost of capital, while equity declines (and Sukuk increases).

Market Value of Firm-Sukuk Tax Shield, or MVF.S-RTS-L, is a model that offers a tax shelter for Sukuk expenses. At 37% Sukuk, MVF begins at 4.357671 and falls to 3.20921 at 97% Sukuk. In contrast to the NTS and ITS models, the market value of Sukuk is higher due to the tax shield on its cost. However, the tax shield's marginal advantage decreases as the Sukuk share rises.

Market Value of Firm - Sukuk Tax Shield (MVF.S-(RTS)-L): This model includes tax shields for Sukuk. Out of all the models, MVF is the greatest, beginning at 4.357671 and falling to 3.20921. Although firm value is maximized by the rental tax shields, it declines as Sukuk proportions increase because of decreasing returns on leverage.

By contrast Sukuk Proportion's Effect: In every model, as the Sukuk proportion rises, the firm's market value falls. But this decrease is less in case of MVF.S-(RTS)-L, illustrates how funding through Sukuk improves the value of firm.

What Tax Shields Do, No Tax Shield (NTS/ITS): The lack of tax shield advantages causes a significant drop in MVF. Single Tax Shield (RTS): The tax shield on Sukuk is the reason for the greater MVF. MVF is the greatest for Rental Tax Shields (RTS), which get the advantages of tax shields and capital gain for Sukuk.

The reason the MVF.S-(RTS)-L model is the greatest is because it offers the maximum market value for Sukuk at all levels. The rental tax shields increase business value and lower the total cost of capital. Because the MVF.S-(RTS)-L model makes use of Sukuk tax shields, it is the best option for optimizing the firm's market value. The optimal balance for optimizing shareholder wealth is provided by the rental tax shields, even if raising Sukuk proportions may reduce business value.

Explanation of WACC of (Leveraged Firm) in Different Models with Respect to Changes in Sukuk

4.3.1 Descriptive

Table 6

WACC -L	Min	Max	Mean	S.D
WACC - NTS-L	0.047309	0.326796	0.177053	0.086582
WACC- ITS-L	0.047059	0.321296	0.174178	0.084961
WACC- RTS-L	0.046888	0.307295	0.168641	0.080645

Fig 3

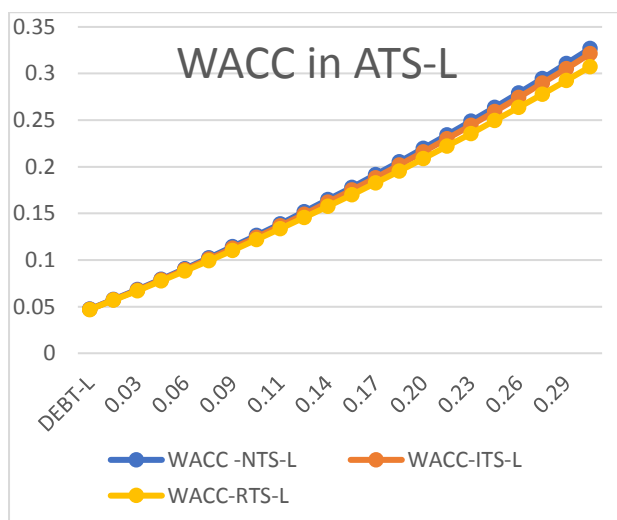


Fig 3

WACC-NTS-L (No Tax Shield): This model makes the assumption that the firm's debt is present and that no tax shield is applied to any costs. As the percentage of Sukuk rises, WACC rises as well. It begins at 0.047309 and increases to 0.326796. Since no tax shield is used, the WACC increases gradually as a result of the rising cost of debt proportions. At higher levels, debt is usually more expensive than Sukuk.

A tax shield on the cost of debt is offered by the WACC-ITS-L (Interest Tax Shield) model. However, the positive effect of the tax shield off-set

with bankruptcy cost. Due to the small benefit from other sources, the behavior is comparable to that of WACC-NTS-L, albeit with somewhat lower values. At 37% Sukuk, WACC is 0.047059, while at 97% Sukuk, it is 0.321296. The rise makes sense given Sukuk's growing price and lack of a significant tax-shield benefit.

Compared to the NTS, ITS, models, the WACC-RTS-L (Sukuk Tax Shield) model applies a tax shield to the cost of Sukuk. The WACC increases more gradually, starting at 0.046888 (at 37% Sukuk) and rising to 0.307295 (at 97% Sukuk). The tax shield on Sukuk reduces the increase in WACC, resulting in lower values than the NTS, ITS model.

Impact of Sukuk Proportion:

The WACC rises in all models as the percentage of Sukuk rises. Different models exhibit different rates of increase; the NTS model exhibits the greatest increase, while the RTS model indicate more moderate increases brought about by tax shields.

No Tax Shield (NTS): Because there are no offsetting tax benefits, WACC increases dramatically. **Interest Tax Shield (ITS):** Because there is tax shield in the capital structure, there is a little decrease in WACC as compared to NTS. Because the Sukuk tax shield lowers the cost of capital as the Sukuk proportion rises, it has a lower WACC, Sukuk tax shields result in the lowest WACC overall for Renal Tax Shields (RTS).

Because it consistently minimizes the WACC across all Sukuk proportions, the WACC-(RTS)-L model is the best. By balancing the expenses of Sukuk, the rental tax shields produce a more effective capital structure.

Because it accounts for the tax shield benefits on Sukuk, the WACC-(RTS)-L model is the best choice for minimizing the weighted average cost of capital. The RTS model offers the firm the most cost-effective structure, even though raising the share of Sukuk can increase the WACC. Because of this, it is the recommended option when making financial decisions.

CONCLUSION

Corporate financing policies can be enhanced with the aid of Islamic finance. We conclude by pointing out that traditional corporate taxation, which favors debt, is a catalyst for less expensive debt financing. This study uses Islamic finance ideology to conceptualize this favor. We discover that the traditional tax preference for debt runs counter to

core Islamic tenets, such as the prohibition of *riba* and the encouragement of profit-and-loss sharing. From the standpoint of Islamic finance, we support the maintenance of this tax benefit in various ways, or it might be granted to equity or other Islamic financial products such as *Sukuk-al-Ijarah*. Sustainability, social fairness, and resource parity would all be facilitated by effectively limiting the detrimental effects of interest (*riba*) and encouraging profit and loss sharing.

We apply the suggested model's consequences to corporate capital structure. NTS is for No Tax Shield environment, ITS is for Interest Tax Shield environment, and RTS is for Rental Tax Shield environment. In this study, we examine these three distinct tax incentive models. There are significant ramifications for business finance behavior from our suggested models (RTS).

The simulated results demonstrate that the presence of rental tax shield increases value of leveraged firms, particularly when firms minimize debt. This is based on research showing that companies that use debt when an RTS is present tend to lose firm value and become more likely to file for bankruptcy. Nonetheless, our suggested model demonstrates a favorable correlation between business market capitalization and the tax deductibility of rentals.

RTS outperforms all other models based on the individual performances of our study models; the cost of bankruptcy and distress is decreased when the rental tax shield is in place. Leveraged-Firms are consistently found to have more stable and constant market values. We contend that agency costs are addressed by the suggested paradigm. We find that avoiding debt and the advantages of the suggested models lead to a fair and long-lasting corporate financing solution. Although our suggested model offers a route to fair and sustainable wealth generation, it may not be at odds with the wealth maximization mindset. We suggest that in order to address the long-standing problem of the financial crisis, discriminatory tax laws should be eliminated and redesigned to promote the general well-being of society.

In short the RTS model with leveraged firms, outperforms the ITS model and NTS model in all key performance indicators, including market value of the firm, WACC, and EPS. As this RTS model outclassed the NTS and ITS model in case of zero leveraged firms in previous study (Izaz et al., 2024) There are other findings and consequences for the future that require further research, such as the

optimization of capital structure to strike a balance of rent levels. Future studies of this kind must also incorporate a few more Islamic financial products and calculate their impact on firm value. Our goal is for this study to act as a springboard for the exploration of other uncharted topics in the literature on corporate finance.

Businesses that want to maximize their value, lower financing costs, and increase shareholder returns should implement a financing strategy of RTS. This approach guarantees optimal utilization of tax shields and diversification of financing sources, which improves financial outcomes. The RTS model outperforms the ITS model in all key performance indicators, including market value of the firm, WACC, and EPS.

Even with leverage, the (RTS)-L Model has the best EPS (earning per share) because tax shields and capital gains on *Sukuk* combine to produce the strongest EPS growth. It maximizes the advantages of leverage while minimizing the cost of capital through tax reductions.

In order to maximize shareholder value, the EPS in the (RTS)-L model is perfect since it makes full use of the capital gain and tax shields offered on *Sukuk*. The company's risk profile, market conditions, and long-term funding strategy should all be considered when choosing a model to ensure steady growth.

The MVF.S-(RTS)-L, Market Value of Firm in RTS model is the best since it provides the highest market value among all *Sukuk* levels. *Sukuk*'s capital gains and rental tax shields raise company value and reduce overall capital costs. The MVF.S-(RTS)-L is the ideal choice for maximizing the firm's market value since it utilizes *Sukuk* tax shields. The rental tax shields offer the best balance for maximizing shareholder wealth.

Because it consistently lowers the weighted average cost of capital (WACC) for all *Sukuk* proportions, the (RTS)-L model has the best WACC. The rental tax shields create a more efficient capital structure by balancing the costs of equity and *Sukuk*.

The weighted average cost of capital, or WACC, in the (RTS)-L model is perfect for minimizing the weighted average cost of capital since it takes into consideration the tax shield and capital gain benefits on *Sukuk*. The RTS model provides the most cost-effective structure for the business. It is therefore the suggested choice when making financial judgments.

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