ARTICLE IN PRESS

PACFIN-00910; No of Pages 19

Pacific-Basin Finance Journal xxx (2017) xxx–xxx

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

From interest tax shield to dividend tax shield: A corporate financing policy for equitable and sustainable wealth creation

Qamar Uz Zaman [a,*], M. Kabir Hassan [b,*], Waheed Akhter [c], M.A. Meraj [d]

[a] Center of Islamic Finance, Department of Management Sciences, COMSATS Institute of Information Technology, Off G. T. Road, Sahiwal, Pakistan
[b] College of Business Administration, University of New Orleans, 2000 Lakeshore Dr, New Orleans, LA 70148, United States
[c] Department of Management Sciences, COMSATS Institute of Information Technology, 1.5 KM Defence Road, Off Raiwind Road, Lahore, Pakistan
[d] Department of Mathematics, COMSATS Institute of Information Technology, COMSATS Road, Off GT Road, Sahiwal, Pakistan

ARTICLE INFO

Article history:
Received 30 August 2016
Received in revised form 22 December 2016
Accepted 19 January 2017
Available online xxxx

JEL classification:
G32
G35
G38
K34
Z12
H25

Keywords:
Corporate finance
Islamic finance
Interest tax shield
Dividend tax shield
Stability

ABSTRACT

This study critically analyzes debt-incentivized corporate tax and financing policy and provides an Islamic perspective to this important tax deductibility debate. This study advocates that the corporate tax incentive to debt (interest tax shield) be abolished and shifted to equity (dividend tax shield). Later, we use the implications of our proposed taxation policy to reframe the firm financing model and modify M & M's firm valuation model. We use a scenario-based simulation technique and conduct various policy experiments to assess the impact of conventional and proposed tax regimes on levered and zero-levered firms and their values. We find that aligning corporate financing policy with the fundamentals of Islamic finance helps restrain corporate indebtedness and promote profit and loss sharing. According to our proposed model, firms have a reduced cost of financing, tend to be more stable, and are value oriented, especially when they avoid debt to the maximum extent. We further propose that an optimal dividend payout ratio may lead to aggregate equilibrium amongst cost of financing, firm value, and corporate tax contribution to the economy. This study provides new contributions to the discipline of Islamic corporate finance.

1. Introduction

The recent global financial crisis (2007–2008) has forced regulatory bodies to identify and reframe potential policies that may contribute to its recurrence (Agnello et al., 2015; Diaw, 2015; Neuhauser, 2015; Stocker, 2016). The necessary reforms require a mandate if they are to successfully enact global financial stability (Fatemi and Fooladi, 2013; Shahrokhi, 2011). These potential reforms may be implemented at the public or corporate level. At the corporate level, governments are mainly concerned about taxation. Economic and legal experts have identified corporate income tax as a major issue because debt is incentivized over equity financing (Evans, 1987; Warren, 1974). In other words, firms are allowed to deduct interest (interest tax deductibility), but not dividends, from their taxable income. This differential tax treatment has a historical significance because "it was a temporary arrangement to equalize the effect of the World War I excess profit tax" intended to "offset the exclusion of debt from the definition of invested capital in war and excess profit tax" (Warren, 1974; Hutchison, 2015). Later, this ruling was repealed partially,

* Corresponding authors.
E-mail addresses: qamar@ciitsahiwal.edu.pk (Q.U. Zaman), mhassan@uno.edu (M.K. Hassan), drwaheed@ciitlahore.edu.pk (W. Akhter), asad@ciitsahiwal.edu.pk (M.A. Meraj).

http://dx.doi.org/10.1016/j.pacfin.2017.01.003
0927-538X/© 2017 Elsevier B.V. All rights reserved.

retaining interest tax deductibility intact, without any legislative rationale in U.S. law. There is a comprehensive debate on the legal and economic aspects of this issue, yet the full interest deduction is argued to be logically indefensible (Allen, 2012; Bank, 2014; Keightley and Sherlock, 2014). Further, the biased tax treatment is blamed for certain economic inefficiencies, distortions, and instability at the public and corporate levels (Osofsky, 2013).

The implicitly constituted interest tax deductibility has a significant effect on corporate financial theory, specifically financing policy. Firms normally optimize via selection of the cheaper financing source to maximize their value (Modigliani and Miller, 1958). It is believed that interest tax deductibility works as a shield and makes debt financing attractive because employing more debt can help evade taxes, minimize the cost of financing, mitigate agency conflict, provide a positive signal for growth potential, and establish a tradeoff for bankruptcy cost (Harris and Raviv, 1991; Myers and Majluf, 1984; Ross, 1977). This behavior motivates firms to be heavily indebted and prone to instability, i.e. bankruptcy and distress. It is worth noting that higher indebtedness and cheaper debt financing are considered to be triggers of financial crisis (Bhaduri, 2009; Floyd, 2011). According to the IMF, in the post-crisis era higher corporate indebtedness is a vital concern.[1] Therefore, we are now in "a teachable moment" in which "it pays to study how to get it right" (Campa, 2013; Kashyap and Zingales, 2010). In such a situation, there must be a substantial change in the discipline of finance (Gendron and Smith-Lacroix, 2015). Thus, research scholars and policy makers have highlighted the need for a justifiable and economically viable solution (Bryan et al., 2012; Shahrokhi, 2011). The discipline of Islamic finance may potentially lead to such a solution.

The Islamic financial industry has proved to be crisis resilient and stable (Diaw, 2015). It is based on a distinct feature, namely the principle of the impermissibility of interest, or "riba". It also promotes profit and loss sharing (equity participation). In general, the guiding rules of Islamic finance tend to restrict "riba" risk shifting and subsidize risk sharing. This raises the question of whether Islamic finance can help in reframing the debt-equity distinction and corporate financing policy. According to the founding pillars of Islamic finance, the conventional debt-equity distinction is contrary to what it should be. Unlike conventional finance, Islamic financial ideology provides clear guidelines for maintaining the debt-equity distinction. This will potentially convert interest tax deductibility (interest tax shield) to dividend tax deductibility (dividend tax shield). We advocate that the proposed reforms will tend to produce a stable and economically viable solution for corporate financing policy.

The focus of this study is to address the following question: "What is the effect of proposed debt-equity distinctions on firm value?" For this purpose, we propose and derive a firm financing model and provide scenario-based simulated experimentation of the contrary models, consisting of cost of financing and firm value.

This study provides very basic insight into the development of the discipline of corporate Islamic finance. It also provides empirical evidence of the impact of interest-taxability on firm value, demonstrating that interest-taxability may be a viable solution to the circular global financial crisis. Further, this study contributes to the emerging debate on financial stability, which is vital for the overall disciplines of Islamic accounting, finance, and economics.

The remainder of the paper proceeds as follows: the second section presents a review of relevant literature. The third section discusses the methodology of scenario-based simulation through the mathematical estimation of firm value. The fourth section presents the results of the simulation analysis. The last section provides a conclusion as well as policy recommendations.

2. Literature review

This section is divided into five subsections, starting with historical legal scholarship of the debt-equity distinction and its impact on the global financial system. The second section explains debt advocacy theories of capital structure. The third section highlights the significance of debt avoidance and firm behavior in the presence of an alternative tax shield. The fourth section recounts previous attempts to explore the Islamic theory of capital structure, particularly in Islamic countries. The last section explains the Islamic perspective in order to reframe the debt-equity distinction.

2.1. Debt-equity distinction and financial crisis

Consequent to the recent financial crisis, the debate on the long standing issue of the debt tax incentive has received serious attention by policy makers.[2] In this regard, economists and legal experts have explored its consequences, perspectives, and legislative aspects (Bank, 2014; Christensen et al., 2016; Hutchison, 2015; Knoll, 1993; Minsky, 1992; Osofsky, 2013; Pratt, 2006; Stone, 1967; Warren, 1974). In 1918, the temporary arrangement of the full interest tax deduction was instituted to adjust for excess profits and exclude debt from the definition of invested capital during World War I (Warren, 1974; Bank, 2014; Hutchison, 2015). This bill provided a temporary status of tax immunity to debt against equity, later retained without any legislative justification.[3] Economists are of the view that the structural distinction between debt and equity has resulted in frictions, fictions, distortions, social injustice, and extensive arbitrage opportunities (Christensen et al., 2016; Osofsky, 2013; Polito, 2007). This differential treatment motivates the corporate sector to higher indebtedness, exposing it to bankruptcy threats,

[1] See: Global Financial Stability Report (GFSR): Vulnerabilities, Legacies, and Policy Challenges Risks Rotating to Emerging Markets, October 2015: http://www.imf.org/external/pubs/ft/gfsr/2015/02/.

[2] "We need to know whether these incentives cause businesses to become overleveraged in a way that hurts our economy." US Senate Finance Committee Chairman Max Baucus (D-Mont.), March 8, 2011.

[3] See US Revenue Act of 1918, ch. 18, 300–28, 40 Stat. 1057. and H.R. REP. No. 767, 65th Cong., 2d Sess. 12–13 (1918); Revenue Act of 1918, ch. 18, 234(a)(2), 40 Stat. 1077.

Please cite this article as: Zaman, Q.U., et al., From interest tax shield to dividend tax shield: A corporate financing policy for equitable and sustainable wealth creation, Pacific-Basin Finance Journal (2017), http://dx.doi.org/10.1016/j.pacfin.2017.01.003