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**Abstract**

*Economists and legal experts say, Interest Tax Shield (ITS) available to debt, causes over-indebtedness that ultimately causes financial crisis and financial instability. Many researchers pointed out the necessity to re-frame these subsidizing corporate tax regulations available to debt. We have proposed to abolish (ITS) and introduce, an Islamic corporate tax policy, Rental Tax Shield (RTS) available to Sukuk-al-Ijarah instead of ITS. For data analysis, the study used a simulation technique and drew different experiments to investigate the performance of leveraged and zero-leverage firms and their values with conventional tax policies and proposed tax policies. The findings showed that RTS from Sukuk financing is more beneficial, for a firm's value and cost of capital, as compared to ITS from debt financing. It is expected to mitigate financial distress and bankruptcy and will enhance the overall financial stability of the corporate sector.*

**Keywords:** Excessive Debt, Financial Stability, Interest Tax Shield, Rental Tax Shield, Sukuk

**Authors:**

**Abid Izaz:** (Corresponding Author)

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

Email: [abidizaz@gmail.com](mailto:abidizaz@gmail.com)

**Waheed Akhter:** Center of Islamic Finance, Associate Professor, COMSATS University Islamabad (CUI) Lahore Campus, Punjab, Pakistan.

**Qamar Uz Zaman:** Associate Professor, COMSATS University Islamabad (CUI) Sahiwal Campus, Punjab, Pakistan.

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### Title

## Interest Tax Shield, vs Rental Tax Shield and Financial Crises: A Model for Sustainable Finance

### Abstract

Economists and legal experts say, Interest Tax Shield (ITS) available to debt, causes over-indebtedness that ultimately causes financial crisis and financial instability. Many researchers pointed out the necessity to re-frame these subsidizing corporate tax regulations available to debt. We have proposed to abolish (ITS) and introduce, an Islamic corporate tax policy, Rental Tax Shield (RTS) available to Sukuk-al-Ijarah instead of ITS. For data analysis, the study used a simulation technique and drew different experiments to investigate the performance of leveraged and zero-leverage firms and their values with conventional tax policies and proposed tax policies. The findings showed that RTS from Sukuk financing is more beneficial, for a firm's value and cost of capital, as compared to ITS from debt financing. It is expected to mitigate financial distress and bankruptcy and will enhance the overall financial stability of the corporate sector.

**Keywords:** [Excessive Debt](#), [Financial Stability](#), [Interest Tax Shield](#), [Rental Tax Shield](#), [Sukuk](#)

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### Authors:

**Abid Izaz:** (Corresponding Author)

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

Email: [abidizaz@gmail.com](mailto:abidizaz@gmail.com)

**Waheed Akhter:** Center of Islamic Finance, Associate Professor, COMSATS University Islamabad (CUI) Lahore Campus, Punjab, Pakistan.

**Qamar Uz Zaman:** Associate Professor, COMSATS University Islamabad (CUI) Sahiwal Campus, Punjab, Pakistan.

### 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 major sources of finance in the corporate world. Both sources of funding have different institutional structures and bylaws. These financial and capital market products are governed by a unique regulatory structure and set of rules. These instruments of financing are intrinsically different in terms of availability (Leland, 1977), market, trading





(Harris, & Raviv, 1993), rate of return (Fama, & French, 2014), taxation (Desai, & Dharmapala, 2005), and corporate perspective (Myers, 1984). The prime distinction is related to tax distinction allowing tax rebates for return of debt financing vis-a-vis double taxation (Hines, 1999) on equity financing, significantly affecting the market dynamics and corporate employability of opting between debt and equity. In legal fertility, this tax-based distinction is called the debt-equity distinction, commonly known as interest tax shield (Zaman, Hassan, & Akhter, 2017) or interest tax subsidy in the corporate financing literature.

Historically, the debt-equity distinction has remained controversial due to unjustifiable legal grounds and bases of this law. This law was enforced in World War 1 against the financial troubles caused by the War, without any legal justification. Later on, this temporary arrangement was replaced with the permanent feature of the US tax code, and tax benefit to the debt over equity was permanently retained without any legislative justification. Over time legal experts and economists repeatedly tried to reverse back this differential and controversial tax arrangement in the courts of Law, which remains futile due to delayed proceedings to date.

The experts oppose this illegal debt-equity distinctive tax treatment due to multiple reasons. This differential tax treatment could misrepresent financing decisions by financing debt instead of another source of financing even when equity financing might be more efficient (Desai and Dharmapala, 2009). Secondly, this differential tax treatment could lead to more losses in the revenue of the Government as compared to the losses in neutral tax treatment (Feld and Heckemeyer, 2011; Dharmapala, Foley, and Forbes, 2011). Third and more dangerous is that it leads to a higher level of indebtedness, which might increase the risk of financial instability (Agnello, Dufrenot, and Sousa, 2014).

A philosophical debate was started on financial stability after the giant global financial crises of 2007-2008. The scholars aimed to pinpoint the major causes of global financial instability. In previous research, different criticisms and observations triggered different questions relating to traditional fundamentals of maximizing wealth, over-indebtedness, economic distortions, systematic frictions, and limited liability (Beck, Colciago, & Pfajfar 2014). Depending on the affected stakeholders and related outcomes some studies have suggested re-framing the structural anomalies and financial regulation setup. Re-framing the financial structure

would provide help prevent a continuous threat of instability and decrease the risk of the global financial system (Archer, & Karim, 2017).

The danger of default rises with excessive debt, particularly when a company has trouble repaying its debts. Negative outcomes from default can include credit rating downgrades, increased borrowing costs, and restricted access to financial markets (Fan, Titman, & Twite, 2011).

According to researchers, the Islamic banking sector has demonstrated stability and resilience in times of crisis. Its foundation is the notion of the impermissibility of interest, or "riba," which is a unique characteristic. Additionally, it encourages equity involvement or the sharing of profits and losses. The tenets of Islamic finance generally limit "riba" risk shifting and encourage risk sharing. This begs the question of whether Islamic finance can assist in redefining corporate financing and taxation. The traditional interest tax shield is in opposition to what it ought to be, according to the fundamental principles of Islamic finance. In contrast to traditional finance, Islamic finance has precise rules for debt maintenance. This could change rental tax deductibility from interest tax deductibility (interest tax shield) to dividend tax deductibility (dividend tax shield) and rental tax deductibility (rental tax shield in the case of Sukuk Ijarah). We believe that the suggested changes will likely result in a stable and profitable corporate finance policy.

"What is the effect of the proposed policy on firm value?" is the issue that this study aims to answer. In order to achieve this, we present and construct a firm financing model and offer scenario-based simulated testing of the opposite models, which include firm value and financing cost. Very basic information about the evolution of the field of corporate Islamic financing is provided by this study. Additionally, it offers empirical proof of how interest-taxability affects business value, suggesting that interest-taxability could be a workable remedy for the current global financial crisis. Additionally, this study adds to the growing discussion on financial stability, which is important for Islamic accounting, finance, and economics as a whole.

## Literature Review:

### Sukuk Advocacy:

### Modern Conceptual Framework of Sukuk

The word Sukuk is the plural of Sak, which is a type of Islamic bond issued by the state through any fund (SPV), which is the originator of the asset to collect funds or money that the issuing company needs in the

market. These types of Sukuk issued by the company may be secured or unsecured, asset-based Sukuk (Sukuk Ijarah) is considered a secured Sukuk, and asset-backed Sukuk is considered an unsecured type of Sukuk. (Radzi, & Muhamed, 2019; Lahasna, Hassan, & Ahmad, 2018). And there are different modes of Sukuk like Mudharabah, Musharakah, Murabaha, Ijarah, and Al-Wakalah, etc. (Afshar, 2013).

### **Tax Regulation and Legal Framework for Sukuk in Different Countries**

The legal and tax framework for the Sukuk is different in different countries. Sukuk is being provided with tax neutral environment in Pakistan through SECP, in Turkey by omnibus bill in Iran through tax law, and in Malaysia through Income tax exemption order 2021, etc. In the above countries, different costs related to Sukuk are tax deductible like conventional bonds which is the major reason for the growth in Sukuk investments in the world.

### **Financial Stability and Islamic Finance**

Researchers examined financial stability refers to the phenomenon where the financial system discourages excessive debt financing, where interest-taking is not permissible and extreme risk is avoided or risk is not shifted but shared. Improving the supervisory and regulatory framework was very important to maintain financial stability (Pagliari et al., 2012). Financial stability could be promoted by enhancing capital adequacy which ultimately reduces the risk of financial crises (Berger, 2019).

Islamic finance and financial stability have an interesting overlap, as principles of Islamic finance stress ethical consideration, risk sharing, and stability in the financial system.

Zaman et al., (2017) examined debt-incentivized financing and tax policy and gave an Islamic point of view to this debate on tax deductibility. This study said that the interest tax shield should be abolished and the dividend tax shield should be given. Later they gave proposed policy of taxation and re-framed the MM firm valuation model by framing a new financing model. The proposed model promotes profit and loss sharing, restrains firm indebtedness, reduces the cost of financing, is value-oriented, and is more stable when the firm avoids debt financing to the maximum extent. The study recommends that financial institutions deal with tangible and real asset transactions and focus on real economic activities instead of cloudy and speculative financial instruments (Ashfaq, 2016).

### **Sukuk and Financial Stability**

Paltrinieri, Dreassi, Miani, & Sclip (2015) conducted a comparative study on conventional and Islamic bonds and observed the correlation of Islamic bonds with different kinds of assets of conventional bonds by the construction of the Sukuk index. As a result diversification gain was there after the inclusion of Islamic bonds especially in the days of financial crises.

### **Sukuk, Corporate Financing and Capital Structure**

Sukuk offers a financing choice in accordance with Shariah guidelines, which forbid the payment or receipt of interest and support moral and accountable economic conduct. Sukuk enables firms to obtain long-term finance for their investment initiatives. Sukuk can be designed to coincide with the cash flow generation of the underlying project, unlike a traditional loan, which often has fixed payback schedules. According to Yildirim, Yildirim, & Diboglu, (2020). Sukuk issuances frequently have longer maturities than traditional debt, giving businesses access to long-term financing for capital investment projects and lowering the risks associated with short-term borrowing.

### **Sukuk vs Firm Performance**

Sukuk structures frequently include projects or assets that serve as collateral, providing some degree of protection. Coordinating the repayment of Sukuk with the cash flows produced by the underlying assets helps improve risk management. A rise in business value can result from better risk management because it can lessen financial hardship and default risk (Mohd Noor, N. F. 2024).

### **Debt Avoidance Vs Firm Performance**

On the basis of the literature, debt avoidance may help improve firm performance. Avoiding debt can enhance company performance via a variety of strategies. The empirical findings indicate that the debt ratio is negatively correlated with company performance in SMEs with low credit risk (Li, Niskanen, & Niskanen, 2018).

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

The distinctive qualities of Sukuk, such as their underlying asset structure and risk-sharing orientation, may have had a positive impact on how well they performed in the face of the pandemic's economic hardships.

Maulana & Zahro (2021) examined the maritime economic crisis, Since the COVID-19 pandemic, it has

destroyed the fisheries sector of Indonesia. Blue Sukuk was suggested as a solution to this problem. By issuance of blue Sukuk, it could become a reserve fund in the fisheries sector and it could also be the long-term solution for the government of Indonesia to increase maritime potential.

It was found that Sukuk market development and economic growth have a long-term co-integrated relationship. Over time, Sukuk density and volume influenced growth favorably as compared to conventional bonds (Yıldırım, Yıldırım, & Diboglu, 2020). Alam, Aziz, & Iqbal (2005) investigated and the results showed that Sukuk as an instrument of capital market can be utilized to attain economic development of the country. Instead of other financial instruments, researchers observed that Sukuk has more extensive investors.

### Sukuk, Rental Tax Shield, and Firm Performance

Lower financing costs result from the elimination of any tax disadvantages for Sukuk issuers in a tax-neutral environment. According to researchers, this can enhance the financial performance and profitability of businesses. A more diverse pool of investors, including those looking for Sharia-compliant investments, may be enticed by a tax-neutral environment. Increased investor demand can result in better pricing for issuers, a lower cost of capital, and enhanced business performance (Iqbal and Mirakhor, 2011). The growth of the Sukuk market can be stimulated by a tax-neutral environment for Islamic bonds, giving issuers more options for liquidity and diversification. According to Bhuiyan et al. (2018), this can increase market efficiency and lead to improved company performance.

### Proposed Reforms:

#### Proposed Tax Reforms to Sukuk (Rental Tax Shield)

The tax-deductible nature of rental payments in Sukuk (Ijarah) structures may affect how well Sukuk performs. Using a general understanding of Islamic finance, the following is an explanation of how the tax deductibility of rental payments can affect Sukuk and firms' performance:

Rental payments made to Sukuk investors may be tax deductible in some jurisdictions. This entails that the issuing firm can deduct the rental payments from its income, lowering its taxable income and perhaps even its overall tax burden.

Rent payments that are tax deductible may make Sukuk more appealing to investors. Compared to traditional debt instruments, where interest payments are proposed to be taxable, it offers them possible tax

advantages. Investors may be encouraged to think about Sukuk as an investment choice by this tax benefit.

The availability of tax deductions for rental payments can significantly lower the issuing company's financing expenses. The corporation may have more money to reinvest or provide as dividends to shareholders if tax obligations are lower.

Rent payments are tax deductible, which reduces taxes, and can increase a company's profitability if it issues Sukuk. This could consequently have a favorable effect on their financial performance and could raise investor trust in Sukuk.

It is significant to note that local tax laws can have an impact on how Sukuk rental payments are treated specifically tax-wise and whether they are deductible. Beyond tax deductions, other variables that affect the success of the Sukuk include market circumstances, creditworthiness, and the capital gain (CG) or loss that will come from underlying assets, which can affect the net income of the firm.

### Research Framework

It is proposed to give a rental tax shield model and remove the interest tax shield, it is to shift the benefit of the interest tax shield to a rental tax shield (profit sharing on the basis of Sukuk). Secondly make a comparison between rental tax shield, dividend tax shield, and interest tax shield and their effects on the firm value. Further taxes should be imposed on debt financing (corporate cost), to prevent interest-based financing.

The proposed debt to Islamic debt (Sukuk) distinction has noteworthy propositions for corporate financial theories and practices. Moreover, this proposal intends to modify 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. As it is believed that debt causes instability and leads to socioeconomic injustice, so now firms started avoiding debt because of its disadvantages even in the presence of the interest tax shield it leads to global financial distress (Bessler, Drobetz, Haller, & Meier, 2013)

After a discussion on the MM theory of capital structure, this study proposed an Islamic policy of tax reforms. Some propositions are given below to estimate our mathematical model. Statistical hypotheses (null, alternative) are not required in our model, this is the experimental design on simulated experiments, same studies have been used in the past (Modigliani & Miller, 1958; Zaman et al., 2017).



### Sukuk-al-Ijarah Structure

Securities of similar denominations that are associated with an Ijarah contract and constitute tangible, long-lasting assets are known as Sukuk al-Ijarah (Kahf, 1997). A bankruptcy-remote Special Purpose Vehicle (SPV) receives assets that generate or are anticipated to generate cash flow from the originator, or the entity in need of financing. After that, the SPV raises money and gives investors certificates secured by these assets. According to Iqbal and Mirakhor (2011), the SPV acts as a trustee for investors, and these certificates show that investors own the cash-generating assets. The properties are then leased to the original creator. The SPV collects rental payments for the company's assets during the lease period and disburses them to the investors; these payments may be fixed or variable. The business ceases making rental payments at the end of the lease period and repurchases the asset at the principal amount (Rafay et al., 2017).

### Capital Gain from Underlying Asset of Sukuk

In our case, it is assumed the underlying asset would be from the real state, as real asset value is increasing in Pakistan and companies have to buy back the underlying asset at the principal amount so there will be capital gain at the end of the tenure. In 2025, the Pakistani real estate market is expected to be worth US\$2.08 trillion. This market category is dominated by residential real estate, which is expected to generate US\$1.33 trillion in 2025. It is anticipated to increase at a rate of 3.75% per year (CAGR 2025–2029), reaching a market size of US\$2.41 trillion by 2029 (statista.com).

Assumptions for the proposed Islamic model are given below

Proposition 1 – Non-financial firms (NFF) seeking Sukuk (Al-Ijarah) financing will be entitled to RTS (Rental Tax Shield) instead of ITS (Interest Tax Shield)

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

### Conceptual Model of RTS

Figure 1

Conceptual Model  
Rental Tax Shield vs Firm Value



Proposition 2 – NFF seeking Sukuk (Al-Ijarah) financing will have the additional benefit of NDTS (Non-Debt Tax Shield) as maintenance expenses of the underlying asset are the responsibility of the firm (originator).

H2: Impact of RTS (Rental Tax Shield) on FV (Firm Value)

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

Proposition 3 – 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 and risk faced by the firm

H4: RTS, NDTS, and Capital Gain will off-set cost and risk relating to Sukuk Issuance

H5: Impact RTS, NDTS, on firm value ( $B_c^t, F_d^t, N_E^t, A_{MVR}^t, CG_S^t$  and  $N_S^t$ )

### 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 technique to evaluate the possible difference in the firm's cost and value patterns (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**

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

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

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

**Summary of Models**

**Firm Valuation Model and Variables**

Table 1

Interest Tax Shield	Rental Tax Shield
$F_v^t = \frac{\hat{Y}^t}{K_0^t} + PVI_S^t - B_c^t - F_d^t$ <p>Where for high debt <math>PVI_S^t &lt; (B_c^t + F_d^t)</math>  <math>F_v^t</math> Is firm value  <math>\hat{Y}^t</math> is earnig attributable to shareholders  <math>K_0^t</math> is the cost of capital  <math>I_S^t</math> is an Interest Tax Shield  <math>B^{ut}</math> is bankruptcy cost  <math>F_d^t</math> is financial distress</p>	$V_F^t = \frac{\hat{I}^t}{C_C^t} + PVR_S^t + PVNDT_S^t + CG_{RP}^t - A_{MVR}^t - B_c^t - F_d^t$ <p>Where for high Sukuk <math>PVR_S^t &gt; (A_{MVR}^t + B_c^t + F_d^t)</math>  <math>F_v^t</math> Is firm value  <math>\hat{Y}^t</math> is earnig attributable to shareholders  <math>K_0^t</math> is cost of capital  <math>R_S^t</math> is Rental Tax Shield  <math>NDT_S^t</math> is non debt tax shield  <math>CG_S^t</math> capital gain on repurchase of asset  <math>A_{MVR}^t</math> is asset market value risk</p>

**Interest Tax Shield Model vs Proposed Model (Rental Tax Shield)**

Table 2

Firm Valuation Model and Variables		
Variables	Conventional Modal (Interest Tax Shield)	Proposed Model (Rental Tax Shield)
Firm Value	$F_v^t = \frac{\hat{Y}^t}{K_0^t} + PVI_S^t - B_c^t - F_d^t$	$V_{LF}^t = \frac{\hat{I}^t}{C_C^t} + PVR_S^t + PVNDT_S^t + CG_{RP}^t - A_{MVR}^t - B_c^t - F_d^t$
Net earning	$Y^t = OP^t - I_r^t \cdot B^t - T_r^t \cdot (EBT^t)$	$Y^t = OI^t + CG^t - R^t - T_r^t \cdot (OI^t - R^t)$ <p><math>CG^t = Capital\ gain</math>                      In case of an increase in real land price</p>
Earning-Shareholders	$\hat{Y}^t = Y^t \quad \text{or} \quad \hat{Y}^t = EAIT^t$	$\hat{I}^t = Y^t \quad \text{or} \quad \hat{I}^t = OIART^t$
Cost of Debt/Sukuk (Rentals)	$k_i^t = I_r^t (1 - T_r^t)$	$C_s^t = R_r^t (1 - T_r^t)$
Cost of Equity	$k_e^t = k_e^t = \frac{Div^t}{E_m^t} + g$	$C_e^t = k_e^t = \frac{Div^t}{E_m^t} + g$

Firm Valuation Model and Variables		
Variables	Conventional Modal (Interest Tax Shield)	Proposed Model (Rental Tax Shield)
Cost of Capital	$k_0^t = k_i^t + k_e^t.$	$C_c^t = C_s^t + C_e^t$
Interest/Rental tax shield	$T_I^t = I_r^t \cdot B^t \cdot T_r^t$	$T_R^t = R_r^t AV^t \cdot T_r^t$
The net benefit of Debt Rental tax shield	$Y_I^t = \frac{I_r^t \cdot B^t \cdot T_r^t}{k_i^t}$	$Y_R^t = \frac{R_r^t AV^t \cdot T_r^t}{C_s^t}$
In case of Excessive Debt/Sukuk	$(PVI_S^t) < (B_c^t + F_d^t)$ Interest Tax Shield < Bankruptcy+Financial Distress	$(PVR_S^t + PVNDT_S^t) > (A_{MVR}^t + B_c^t + F_d^t)$ Rental Tax Shield > Asset Market Value Risk+ Cost of issuing new Sukuk

This study will use the methodology of simulation, which pretends to real-world situation to extract conceivable implications of policies. An artificial environment is constructed usually with it, within which relevant data and information can be generated (Haidvogel et al., 2000; Wang, Walter, & Parlange, 2013). Manufacturing firms will be taken as samples from all firms of Pakistan, which are listed on the stock exchange, based on the actual data calibrated values will be used, and the expected output will be closely

related to real-life scenarios (Zaman et al., 2017). The calibration process provides base measures to the model to a complete accuracy for the next experiments. This process is used to evaluate and attain the values as a benchmark of a measurement tool for the correct outcome. (Tankov, 2003). MATLAB is a simulation tool. This study will use this mathematical instrument to calculate the points of data in contradiction to the variation stated in input parameters. (Matlab, 2009).

### Model Parameters

Table 3

Parameters	Symbol	Values
Net operating profit	$OP^t$	1
Total assets	$T_a^t$	7
Corporate income tax rate	$T_r^t$	0.35
Rate of interest	$I_r$	0.08
Total debt	$B^t$	0
The market value of debt	$D^t$	0
Total equity	$E^t$	7
Rate of change (debt/equity)	$B^t / E^t$	0.028
Dividend payout ratio	$r^t$	0.10
Dividend growth rate	$dg^t$	0.02
Rental growth	$rg^t$	0.02
Real state growth rate	$ad^t$	0.037
Capital gain	$CG_r^t$	0.037

### 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), Equity Tax Incentive or Dividend Tax Shield (DTS),

Rental Tax Incentive or Rental Tax Shield (RTS), and a combined Equity and Rental Tax Incentive State (DTS+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 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 dividend 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, DTS, RTS, and DTS+RTS are among the tax states that are tested for both leveraged and non-leveraged (zero-leverage) businesses. The outcomes of the suggested model are compared through simulations with benchmark valuation models, including the conventional (ITS) and tax-neutral (NTS) models.

As a result, the experiments also seek to find the ideal rent value that minimizes the cost of capital while maximizing firm value and tax contributions, which further supports the goals of this dissertation. The results are presented and analyzed through data plots, each of which shows simulated firm data points based on variations in input parameters. The proposed corporate tax treatment links a firm's tax contribution to its earnings level and payout ratio.

Leveraged enterprises' outcomes under various tax regimes, such as tax neutrality (NTS), debt tax incentives (ITS), dividend tax incentives (DTS), rental tax incentives (RTS), and their combination (DTS+RTS), are covered in the first section. Every small increase in debt financing is handled as a separate starting point in the experiments, which implies an increasing rate of leverage over time. Simulations of zero-leveraged enterprises are conducted similarly. 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 the value of firms on the basis of earnings per share, the market value of the firm, and WACC.

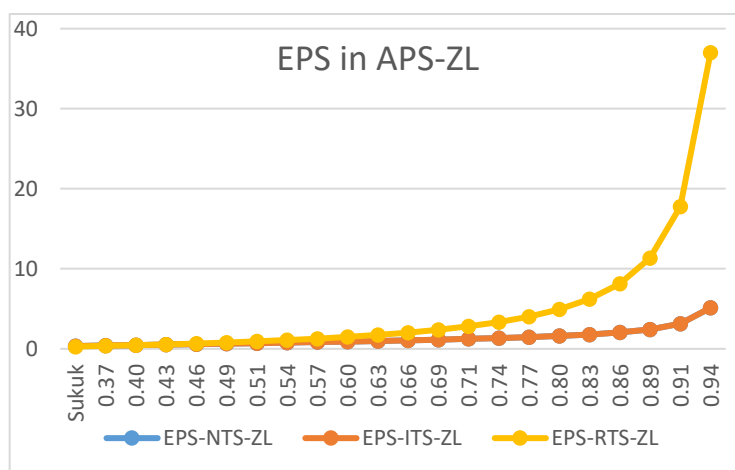
### Explanation of EPS in Different Models with Respect to Changes in Sukuk

Descriptive Table

Table 4

EARNING PER SHARE -ZL	Min	Max	Mean	S.D
EPS-NTS-ZL	0.344574	5.12625	1.347728	1.095528
EPS-ITS-ZL	0.344574	5.12625	1.347728	1.095528
EPS-RTS-ZL	0.278097	37.00125	4.98358	8.31643

Figure 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 Combined Tax Shields (RTS).

Because of the synergistic effect of tax shields on both equity and Sukuk, the EPS-(RTS)-ZL model offers the strongest EPS growth. Through tax reductions, it minimizes the cost of capital while optimizing the benefits of leverage. By utilizing all applicable tax shields on equity and Sukuk, the EPS-(RTS)-ZL 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.

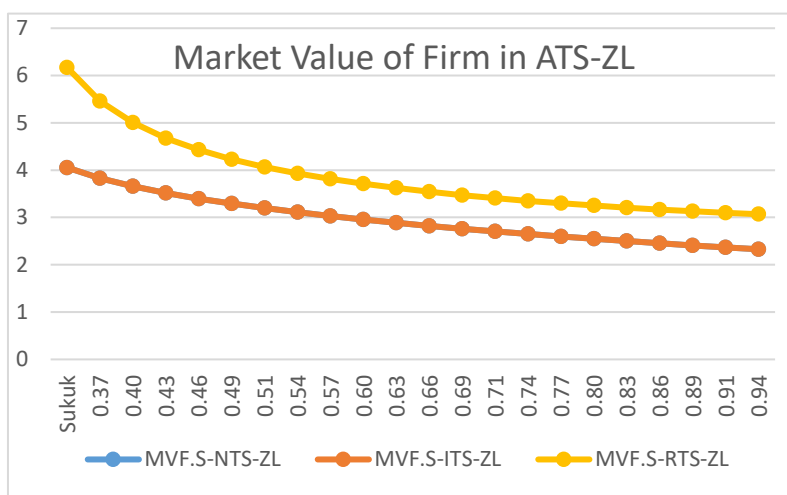
### Explanation of MVF in Different Models with Respect to Changes in Sukuk

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

Figure 2



Market Value of Firm-No Tax Shield, or MVF.S-NTS-ZL: This model assumes that the firm's debt ratio is zero 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 4.0548, and at 97% Sukuk, it falls to 2.3278. 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-ZL, is a model that offers a tax shelter for Sukuk expenses. At 37% Sukuk, MVF begins at 6.1705 and falls to 3.0687 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)-ZL: This model includes tax shields for Sukuk and the cost of equity. Out of all the models, MVF is the greatest, beginning at 6.1705 (at 37% Sukuk) and falling to 3.0687 (at 97% Sukuk). 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. This decrease illustrates how funding through Sukuk loses value as equity is decreased.

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 for Sukuk.

The reason the MVF.S-(RTS)-ZL 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)-ZL model makes use of Sukuk tax shields, it is the best option for optimizing the firm's market value. The optimal balance for maximizing shareholder wealth is provided by the rental tax shields, even if raising Sukuk proportions may reduce business value.



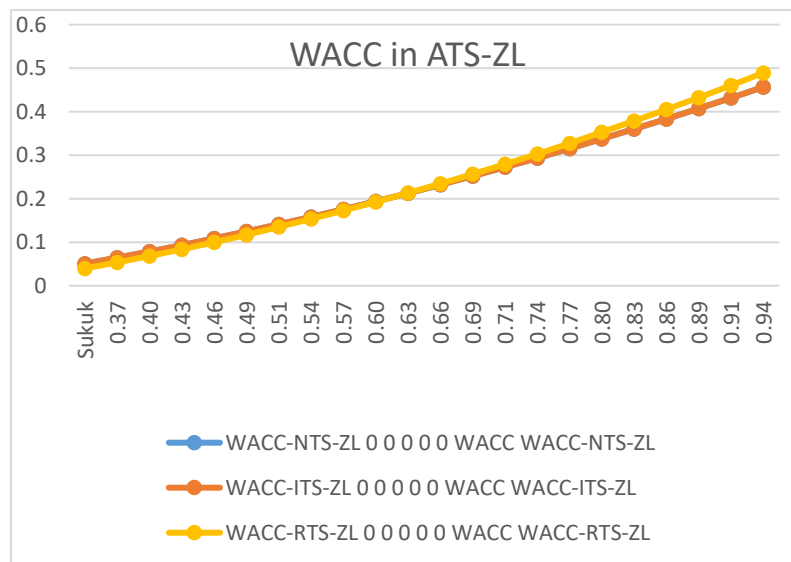
## Explanation of WACC in Different Models with Respect to Changes in Sukuk

Descriptive

Table 6

WACC-ZL	Min	Max	Mean	S.D
WACC-NTS-ZL	0.050746	0.456721	0.233734	0.125973
WACC-ITS-ZL	0.050746	0.456721	0.233734	0.125973
WACC-RTS-ZL	0.039789	0.489264	0.238527	0.139654

Figure 3



WACC-NTS-ZL (No Tax Shield): This model makes the assumption that the firm's debt ratio is zero and that no tax shield is applied to any costs. As the percentage of Sukuk rises, WACC rises as well. At 37% Sukuk, it begins at 0.0473 and increases to 0.3268 at 97% Sukuk. Since no tax shield is used, the WACC increases gradually as a result of the rising cost of greater Sukuk proportions. At higher levels, Sukuk is usually more expensive than equity.

A tax shield on the cost of debt is offered by the WACC-ITS-ZL (Interest Tax Shield) model. However, the tax shield has no effect because the firm's debt ratio is zero. Due to the small benefit from other sources, the behavior is comparable to that of WACC-NTS-ZL, albeit with somewhat lower values. At 37% Sukuk, WACC is 0.0471, while at 97% Sukuk, it is 0.3213. The rise makes sense given Sukuk's growing price and lack of a significant tax-shield benefit.

Compared to the NTS, and ITS, models, the WACC-RTS-ZL (Sukuk Tax Shield) model applies a tax shield to the cost of Sukuk. The WACC increases more gradually, starting at 0.0469 (at 37% Sukuk) and rising to 0.3373 (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 and models 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 no debt 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 Rental Tax Shields (RTS).

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

Because it accounts for the tax shield benefits on Sukuk, the WACC-(RTS)-ZL 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

boost 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, it is for Interest Tax Shield, and RTS is for Rental Tax Shield. 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 a rental tax shield increases firm value, 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. Leverage-averse businesses 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.

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 the market value of the firm, WACC, and EPS.

Because tax shields *Sukuk* work in concert to generate the strongest EPS growth, the (RTS)-ZL Model without leverage has the best EPS (earning per share). Through tax reductions, it minimizes the cost of capital while optimizing the benefits of leverage.

Because it fully utilizes the tax shields available on *Sukuk*, the EPS in the (RTS)-ZL model is ideal for optimizing 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.

Because it offers the highest market value across all *Sukuk* levels, the MVF.S-(RTS)-ZL, Market Value of Firm in RTS model is the best. The rental tax shields increase business value and lower the total cost of capital. Because the MVF.S-(RTS)-ZL makes use of *Sukuk* tax shields, it is the best option for optimizing the firm's market value. The optimal balance for maximizing shareholder wealth is provided by the rental tax shields.

The (RTS)-ZL model's weighted average cost of capital (WACC) is optimal since it continuously reduces the WACC for all *Sukuk* proportions. By balancing the expenses of *Sukuk* and equity, the rental tax shields produce a more effective capital structure.

Because it accounts for the tax shield benefits on both equity and *Sukuk*, the weighted average cost of capital, or WACC, in the (RTS)-ZL model is ideal for minimizing the weighted average cost of capital. The RTS model offers the company the most economical structure. Because of this, it is the recommended option when making financial decisions.

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