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Purifying Islamic equities: the interest tax shield

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Abstract

Purpose – This paper aims to add to the debate regarding the appropriate methodology to purify tainted components from *shari'ah*-compliant equities.

Design/methodology/approach – Based on the *Qur'anical* prohibition against *riba* and an analysis of the purification methodology recommended by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) *shari'ah* Standard 21, this paper highlights the shortcomings in Standard 21 and references the corporate finance literature to argue for the need to also purify the interest tax shield from debt.

Findings – Purification is a pivotal element of the Islamic investment process, yet Standard 21 permits a loose interpretation which causes portfolios to be under-purified. Standard 21 also makes no mention of the interest tax shield from debt even though the benefits are at odds with the principles of social justice in Islam. That there is no mention of the interest tax shield from debt in the (limited) literature on the purification of Islamic equities is puzzling.

Practical implications – This paper has implications for the Islamic funds industry and for devout Muslim investors.

Originality/value – The specific contribution of this paper is the identification of the interest expense tax shield (well-established in the corporate finance literature) as a significant non-compliant *riba*-related component that needs to be considered in the purification process.

Keywords Interest expense tax shield, Islamic funds industry, Purification, *Riba*, *Shari'ah*-compliant investment

Paper type Conceptual paper

1. Introduction

The Islamic funds industry is estimated at 5.5 per cent (Ernst and Young, 2011) of the over $1.0 trillion (Wilson, 2009) global Islamic finance industry, an industry predicted by the Islamic Development Bank to exceed $2.8 trillion by 2015. Although small versus the conventional funds industry, the potential growth from targeting the largely untapped Muslim market (estimated at 23 per cent of the world's population) has garnered significant attention (Hassan and Girard, 2011). However, the nascent Islamic funds industry is already at a crossroads. There are a number of issues which could derail its early promise – chief among these is confusion about how to purify Islamic portfolios to ensure *shari'ah* compliance.

Purification refers to the need to quantify and donate to charity all impure components deemed unacceptable under *shari'ah* principles and teachings (Elgari, 2000). Impure components consist of, *inter alia*, *riba* which in modern Islamic finance has become synonymous with interest-related activity and is unequivocally prohibited in the *Qur'an*. Because nearly every company in the world receives/pays interest on its

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cash/debt balances, the practical effect of an absolute interpretation of the prohibition against *riba* is that the funds industry is, *ipso facto*, off limits for Muslim investors (McMillen, 2011; Moore, 1997). As a result, the *shari'ah* Supervisory Boards (hereafter SSBs) that determine the compliance of any investments have had to make a number of compromises to allow some permissible variation from absolute *shari'ah* principles. While some research has been done relating to the construction and application of Islamic stock screens, there is a paucity of literature about how *haram* elements resulting from permissible variation should be purified[1][2]. Although the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI, 2010) recommends one method to purge impure amounts in *shari'ah* Standard 21 Financial Papers (Shares and Bonds) (hereafter S21), the terminology used throughout is not consistent and, in certain sections, lacks specificity. Also, not all jurists adhere to AAOIFI standards such that there are several methods used in practice (Elfakhani *et al.*, 2005). The result is that, even for those adhering to AAOIFI standards, differing interpretations are possible such that confusion remains and *haram* components go unpurified. To some *shari'ah* scholars, the entire permissibility of an Islamic fund hinges on purification, so this lacuna needs to be addressed (Elgari, 2000).

This paper discusses the unequivocal prohibition against *riba* in the *Qur'an* and the *hadith* and its impact on commercial activity in the Islamic world. It documents how the practice of permissible variation has evolved in the Islamic funds industry to allow a degree of impurity from absolute concepts and analyses some of the various current methodologies suggested for purging the consequent impurities from Islamic portfolios, with a focus on S21. Given what is at stake for the nascent Islamic funds industry, this paper also suggests a comprehensive methodology for the purification of prohibited components which includes the need to also purify the benefits from the interest tax shield from debt – the benefits of which to the firm are well-understood in the corporate finance literature.

2. Islam and commercial activity

Islam is a complete way of life, a lifestyle which constitutes a part of every Muslim's cultural and spiritual identity (Abbasi *et al.*, 1989; DeLorenzo, 2002). Islam aims at striking a balance between individual freedoms (including commercial activities, *Qu'ran* 62:10) while ensuring that such is conducive to the growth and benefit of society at large (Ebrahim, 2003). Indeed, the *Qur'an* and the *Sunnah* (custom and practice) place tremendous stress on justice. All leading jurists therefore, without exception, have held that justice is a central indispensable ingredient of the *maqasid al-shari'ah*, or the goals of Islam (Chapra, 2000). In economics, justice can be interpreted to mean that resources are used in such a manner that, *inter alia*, the equitable distribution of income and wealth and economic stability are realised (Chapra, 2000). Since the emergence of post-independent Muslim states in the 1960s on the global economy, there has been much debate about how commercial activity, and for this paper, the Islamic funds industry, specifically, can be organised to conform to Islamic justice and *shari'ah*. Chapra (2000) contends that these goals cannot be realised without a humanitarian strategy which injects a moral dimension into economics – the prohibition against *riba* is part of this moral dimension.

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3. The prohibition against *riba*

Riba in *shari'ah* technically refers to the premium that must be paid by the borrower to the lender together with the principal amount as a condition for the loan or for an extension of its maturity (Chapra, 1986). *Riba* is prohibited in the *Qur'an* – a popular translation of the *Qur'an* (*Al-Baqarah*) translates key verses pertaining to *riba* [2: 278-279] as:

> 278. O you who have believed, fear Allah and give up what remains [due to you] of interest, if you should be believers.
>
> 279. And if you do not, then be informed of a war [against you] from Allah and His Messenger. But if you repent, you may have your principal – [thus] you do no wrong, nor are you wronged.

Karsten (1982) explains that *riba* is prohibited because it reinforces the tendency for wealth to accumulate in the hands of a few (i.e. works against social justice), and thereby diminishes human beings' concern towards their fellow men. Based on the strict application of the *Qur'anical* prohibition, it is not permitted for compliant Muslims to be involved with *riba* in any way, shape or form – a *hadith* narrated by "Abu Dawud" states that "The Messenger of Allah cursed the one who devours *riba*, the one who pays it, the one who witnesses it, and the one who documents it".

Despite the universal agreement about the unequivocal prohibition against *riba*, it is also broadly agreed that the *Qur'an* does not provide a detailed explanation about what exactly constitutes *riba* (Ahmad and Hassan, 2007). At the time of the revelation of the verses about *riba*, the only type of *riba* known was *riba al-nasi'ah* (pertaining to the application of an exploitative, exorbitant or penal rate of interest). Over time, with the growth of global economic activity and the development of new methods of trade and commerce, this narrow definition of *riba* has been broadened based on *hadith* – The Fiqh Academy of the Organisation of Islamic Conference (OIC) condemned all interest bearing transactions as void (Al-Omar and Abdel-Haq, 1996). The objective served by this broadened definition of *riba* is not only the avoidance of injustice of interest when interest is exploitative or penal but also the avoidance of injustice of interest in all its forms. Any material benefit above the capital sum lent is prohibited such that economic credit is most definitely *riba* (Ahmad and Hassan, 2007).

4. Permissible variation

In the conventional financial sector, financial intermediation is effected through lending and the time value of money is reflected in interest payments such that publicly listed companies operating within this system are inescapably contaminated by either the payment or receipt of interest (and usually both simultaneously). Since *riba* has become synonymous with bank interest, compliant Muslims are concerned whether investing in equities is lawful. Obviously if the absolute *shari'ah* interpretation against *riba* is applied (along with other *shari'ah* based restrictions), the pool of permitted equities would be too small for any reasonable diversification to be possible and investment in equity markets would, to all intents and purposes, be off limits for compliant Muslims (Wilson, 2004)[3].

This fundamental impasse has motivated a compromise by jurists to allow broad-based equity participation within *shari'ah* limits. These compromises are symptomatic of a new impetus in the geo-economics of the Islamic world over the past 20 years referred to as "The Metamorphosis Period" (Haniffa and Hudaib, 2010). For

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example, the AAOIFI was set up in 1991 to prepare accounting, auditing, governance, ethics and *shari'ah* standards for Islamic financial institutions (IFI). Despite the fact that for most IFI these standards are not mandatory, the AAOIFI has been successful in promoting its standards to IFI globally (Kamla, 2009) which contributes to legitimising the financial products that incorporate these standards as Islamic to the Muslim public (El-Gamal, 2006; Kuran, 2004).

The AAOIFI has used a variety of adaptive mechanisms such as *Ijtihad* (reasoning and argumentation), *urf* (local custom) and *darura* (necessity) to, *inter alia*, legitimise innovation and the modernisation of the Islamic finance industry. The result has been a collaboration of interested parties that has laid the foundations for, and instigated the development of, *shari'ah*-compliant products to enable IFI to compete with their traditional Western interest-based counterparts such that the Islamic finance industry has been transformed to compete on the global financial stage. The end result for compliant Muslim investors is that, within *shari'ah* limits and subject to purification, an investment programme has been developed to permit investment in common equity shares, i.e. absolute application has been replaced by permissible variation (Elgari, 2000)[4].

5. Purification in practice

Purification is therefore a crucial element in the Islamic investment process. Indeed, Elgari (2000, p. 2) states that "no part of these programs is on a more solid ground from a *shari'ah* point of view, than that of purification". If permissible variation is the "quid" of the Islamic funds industry, then purification is the "proquo". A problem for the industry is that while there is some research on the construction and application of Islamic stock screens used to deem companies as Islamically acceptable, there is a paucity of literature on the pivotal purification element to explain how forbidden elements of these acceptable companies should be purged[5]. This is because the purification process is difficult and the result is that there is no consensus about what is best purification practice such there are a number of methods used in practice (Elgari, 2000). The most common methods used in practice can be grouped into the "dividend" and the "investment" methods (Ayub, 2000; Elfakhani *et al.*, 2005; Usmani, 2002).

One issue for these methods is whether the amount to be purified is before- or after-tax to the holder of the shares. Obviously, allowing the application of a tax rate on tainted amounts will lower the amount needed to be purified. While after-tax amounts are often used in practice, Clause 3/4/5/5 of Standard 21 stipulates that:

> It is not permitted to utilise the prohibited component in any way whatsoever nor is any legal fiction to be created to do so even if this is through the payment of taxes.

This clause is itself based on the *hadith* narrated by Abu Huraira who said the Prophet said: "Allah […] is pure and accepts only that which is pure". Therefore, per S21, the compliant Muslim investor cannot derive any benefit, including the payment of taxes of any kind, from the prohibited components. This includes permitting the company to pay corporate taxes with the prohibited component in investor's name – prohibited components must be purified *in full*.

Another issue for these methods is whether the amount to be purified is pre- or post-distribution (i.e. dependent on the dividend pay-out ratio). The dividend method focuses on post-distribution amounts requiring that only dividends distributed to

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investors (i.e. dividended income) need to be purified; capital gains, as the argument goes, are a market element not requiring purification. Obviously, this method is problematic for investors in companies which, though deemed *shari'ah* complaint, per the application of Islamic stock screens by SSBs, generate some *riba* gains but do not pay dividends. Finance theory explains how by retaining some or all of the company's earnings, a company is simply reinvesting unpurified elements in the investor's name. This is unacceptable from a *shari'ah* perspective. The investment method focuses on pre-distribution amounts, i.e. on dividendable rather than dividended income. By focusing on the company's ability to generate returns rather than the distribution of those returns, the investment method is (versus the dividend method) more comprehensive. S21 (Clause 3/4/5/4) prescribes a methodology for purifying *haram* amounts as follows:

> The figure […] is arrived at by dividing the total prohibited income of the corporation whose shares are traded by the number of shares of the corporation, thus, the figure specific to each share is obtained. Thereafter the result is multiplied by the number of shares owned by the dealer – individual, institution, fund or another – and the result is what is to be eliminated as an obligation,

and in doing so, favours the investment method over the dividend method (Ayub, 2000). S21 is clear – all prohibited components should be purified when they are generated by the company rather than when they are received by the investor. Diminishing an obligation to purify prohibited components via the application of the payout ratio or the corporate tax rate is not allowed. The clarity on this issue has the additional benefit that personal tax rates on dividends and the additional calculations this causes do not have to be considered in this paper (Graham, 2003)[6]. Therefore, the total *haram* amount to be purified, from the shares owned by an investor of any company j in year t, is calculated as:

$$P_{jt} = [H_{jt} + R_{jt}] * \frac{CSO_{jt}}{TCS_{jt}} \quad (1)$$

where H is the pre-tax *haram* amounts from operations, R is the pre-tax *haram* amounts from *riba*, CSO is the number of common shares owned by the investor and TCS is the total number of common shares outstanding.

Another area of confusion is in the determination of what are the specific *riba* amounts that need to be purified. Insofar as S21 can be viewed as best practice recommendations, this confusion is demonstrated by reference to "prohibited component" in Clauses 3/4/4 and 3/4/5/5 and "total prohibited income" in Clause 3/4/5/4. Because of the unequivocal *Qur'anical* prohibition against *riba*, "prohibited component" implies that *riba* in all its forms (interest expense as well as interest income) needs to be purified. This is in line with the *hadith* narrated by Al-Asqalani, al-Hafiz Ahmad Ibn Hajar, where he says the Prophet says that "every loan that attracts a benefit/advantage is *riba*". "Prohibited income", on the other hand, implies that only *riba* from interest income matters. Some researchers affirm that investment funds ought to have a clear procedure and techniques to sort interest-based income and other sources of contaminated profits (Valpey, 2001). Focusing on interest income alone (as is common in practice) seems an obviously correct step because allowing investors to net interest

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expenses paid from interest income received appears to be directly in opposition to the goal of purging *riba* amounts *in full*. This is based on the logic that anything that causes a reduction in the amount of *haram* components to be purified (i.e. taxes as previously discussed), even if it is itself *riba* (i.e. interest expenses), should be ignored (Elgari, 2000). However, what remains in question, and the specific focus of this paper, is at what point in the purification process should interest expenses be ignored?

6. The interest tax shield

The value of the interest expense tax shield is well-documented in the corporate finance literature. The interest tax shield arises because interest on debt is tax-deductible, such that by taking on debt (i.e. leverage) a company can reduce its tax bill. Chapra (1984, p. 1) extends the definition of *riba* discussed previously, stating that "[*r*]*iba* represents, in the Islamic value system, a prominent source of unjustified advantage". Because the interest tax shield is a way to keep cash flows that would otherwise have been paid as tax, it represents a real gain for investors and is (per Chapra) a *riba* amount that can be estimated for any company, j, in any year, t, as:

$$\textit{Interest expense tax shield} = \tau_{jt} X_{jt} \tag{2}$$

where X is interest expense paid and τ is the marginal corporate tax rate, such that the product of the two is the tax that is saved by company j per dollar of interest expense paid in year t.

Cooper and Nyborg (2006) have shown conclusively the value of the tax shield is a crucial aspect of corporate valuation according to the following equation:

$$V_L = V_U + \sum_{t=1}^{\infty} E(\tau_{jt} X_{jt}) / (1 + K_{jt})^t \tag{3}$$

where V_L is the value of a levered company, V_U is the value of an unlevered company, $E(.)$ is the expectations operator and K is the discount rate appropriate for the tax saving for any company, j, in any year, t[7]. One of the criticisms of estimating the value of tax shields in equation (3) is that, due to the lack of visibility regarding corporate tax rates into the future, there is uncertainty about the appropriate discount rate for those tax shields (Cooper and Nyborg, 2007) and whether interest will continue to be tax deductible in perpetuity (DeMooij, 2011), and so their estimation is not reliable with any degree of certainty. However, all that is required for the purification of any company's equity in the most recently reported year is historical information such that any problems caused by the expectations operator and the appropriate discount rate, K_{jt}, in equation (3) are moot, i.e. the value of the interest tax shield in the most recently reported year can be calculated with relative ease, per equation (2).

From a practical perspective, it is argued that the debt bias induced by the tax deductibility of interest expense has an insipid detrimental impact on the whole society via the erosion of the corporate tax base (DeMooij, 2011). While it is the general view of experts that the debt bias was not a major cause of the financial crisis (Hemmelgarn and Nicodème, 2010; Keen *et al.*, 2010; Lloyd, 2009; Slemrod, 2009), by contributing to the excessive leverage of firms, it might well have deepened the crisis. Chapra (2000) argues that by subjecting dividend payments to taxation while allowing interest payments to

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be treated as a tax deductible expense, the tax system indirectly promoted the use of debt over equity, encouraged the excessive build up in public and private debt and contributed to the volatility of financial markets. Indeed, arising from concerns about the debt bias causing companies to take on too much risk and the subsequent detrimental impact this can have on society in general, a number of countries have imposed thin capitalisation rules which limit the tax deductibility of interest expense.

Another practical criticism of debt bias is that the financial system from which the debt is sourced tends to reinforce the unequal distribution of capital (Bigsten, 1987). The *Qur'an* maintains that wealth should not be concentrated and mobilised in the hands of a few individuals (Kamla, 2009), warning that such wealth mobilisation engenders social imbalances (59:7) (Gambling and Karim, 1991). That is, the Western banking system is not encouraged to deliver competitive funding to any but the largest richest companies such that the interest tax shield can be seen as facilitating, and even encouraging, the unequal distribution of capital, income and wealth and perpetuating injustice.

Obviously, the tax deductibility of interest and the interest expense tax shield were not in existence at the time of the Prophet, and so it is the sources of *shari'ah* other than the *Qur'an* that will determine its permissibility for compliant equities. Iqbal (2008) explains that the principle for determining the permissibility of something is that if it adds to the overall welfare of society and does not contradict any other settled act or issue in the *Qur'an* and the *hadith*, then it should be deemed permissible; otherwise, if either or both of these conditions are not met, it should be declared impermissible. Cooper and Nyborg (2006) have shown that all of the benefit of debt for companies is in the value of the interest tax shield such that not only does debt bias decrease the overall welfare of society directly by eroding the tax base and facilitating the unequal distribution of wealth but the existence of the interest tax shield also indirectly jeopardises the long run welfare of society by encouraging companies to take on too much risk (DeMooij, 2011). In the absence of a settled act or issue in the *Qur'an* or the *hadith* to suggest the contrary, the interest tax shield and the *riba* components generated would appear to be impermissible and requiring purification.

Therefore, it is the contention of this paper that interest expenses should be ignored only after the benefit of the tax shield arising has been accounted for such that the appropriate *riba* amount to be purified is:

$$R_{jt} = I_{jt} + \tau_{jt} X_{jt} \qquad (4)$$

where I is pre-tax interest income received and other variables are as previously defined. By including equation (4), equation (1) can then be modified to show that the total amount to be purified from all *haram* sources generated by the company is given by:

$$P_{jt} = [H_{jt} + I_{jt} + \tau_{jt} X_{jt}] * \frac{CSO_{jt}}{TCS_{jt}}$$

That is, *haram* elements should be purified in full, before tax and include the interest tax shield. This formula can be easily extended from the individual equity to the portfolio level. That is, assuming a compliant Muslim investor has a portfolio of n companies: $C_1, C_2 ... C_n$, then the total amount to be purified from the portfolio is given by:

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$$\sum_{j=1}^{j=n} P_j C_j$$

7. Summary and conclusion

If the Islamic funds industry is to follow through on its early promise and become an accepted permissible practice among Muslim investors, then any suspicion as to its Islamic nature needs to be assuaged. The development of Islamic accounting standards and regulations by the AAOIFI goes some way to meeting these needs, essentially legitimising Islamic finance, banking and the funds industry. However, adherence to AAOIFI standards is not mandatory, and it is argued that the industry departs from the holistic Islamic principle of social justice, leaving a gap between the claims of the industry and what is delivered to compliant Muslim investors (Kamla, 2009). It is important, if not essential then that, balanced as it is precariously between secular goals and sacred intentions, the industry is seen to abstain from what is doubtful in favour of what is clear. That is, insofar, as permissible variation is tolerated at all, maximum effort should be made to purify *all* tainted components (El-Gamal, 2006; Maurer, 2002).

While the recommendations in S21 are a significant contribution in this regard, the lack of agreement among SSBs in practice about the need to purify even seemingly obvious and unequivocally prohibited elements is a concern. It is hardly surprising then that, to the best of this author's knowledge, no consideration has been given to the need to also purify benefits to investors generated by the interest tax shield. Perhaps it has been previously considered and rejected as an overly conservative step too far? If this is the case, then the literature is silent with the exception of Pomeranz (1997, p. 125), who, perhaps knowingly, comments that purification is "more easily done with interest income than interest expense".

At the very least, the need for the interest tax shield to be purified is worthy of consideration according to the words of the Prophet, "that which is lawful is clear, and that which is unlawful likewise, but there are certain doubtful things between the two from which it is well to abstain". If the benefit to investors from the interest tax shield is not immediately obviously forbidden as a benefit from *riba* activity, then it certainly seems to qualify as doubtful. This is a non-trivial point for Muslim investors who want to abide by the guidance of Islam and be convinced that nothing prohibited (*haram*) is made permissible (*halal*). While it can be argued that in certain circumstances the information required to calculate the gains from the interest tax shield (i.e. a breakdown of interest income and interest expense rather than just a net value) might not be available, for most companies this is not the case and for others some basic assumptions can achieve the same goal. That is, if comprehensive purification based on Islamic principles is the aim, then minor impediments should not be used as an excuse, *a priori*, not to achieve that goal. In addition, at a much more fundamental level, it has been shown that the debt bias caused by the tax deductibility of interest expense erodes the tax base, encourages the unequal distribution of capital, income and wealth, encourages risk-taking behaviour and perpetuates injustice in society. In short, it can argued that by failing to meet the moral duty to achieve benefit for all Muslims (Moore, 1997), the interest expense tax shield is also doubtful on the grounds of social justice.

The adoption and amendment of *shari'ah* standards by the AAOIFI is not done lightly. The process is a painstaking, diligent and precise elucidation process to determine if, how, and when concepts should find application (McMillen, 2011). There is

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a constant healthy tension in the process between undue expansion of the concepts and pragmatic implementation so as to advance the development of the Islamic finance industry. This paper attempts to add to the debate on this topic regarding the appropriate steps to comprehensively purify tainted components that arise in *shari'ah*-compliant portfolios as a result of permissible variation, up to and including the interest tax shield. The observations in this paper are inclined to facilitate the legitimacy of the Islamic funds industry in the minds of Muslim investors by engendering conservatism at the margin and leaving no room for loose interpretation or the acceptance of any doubtful components. By adopting the useable model developed in this paper, the gap between Islamically prohibited interest *riba* and practice would be closed to the benefit of *shari'ah*-compliant investment firms and the Muslim investor. The investment firms can focus more on pre-tax *halal* profitable firms, and the Muslim investors will be able to compare the performance of compliant investment firms without fearing that some of the performance is contaminated with prohibited *haram* components that the investor would have to calculate and purify themselves.

Notes

1. In Islamic jurisprudence, *haram* is used to refer to any act that is forbidden and operates as a dichotomy with *halal*, which denotes the permissible.
2. See Derigs and Marzban (2008) for a comprehensive discussion of the application of Islamic stock screens.
3. The difficulty in sourcing suitable Islamically qualified companies is apparent from a study by Al-Baraka Islamic Bank who identified only 560 companies as "compliant" from a potential universe of 19,000 (O'Sullivan, 1996).
4. The specification that the shares be common shares is to exclude preferred shares which are hybrid debt/equity securities which provide a guaranteed return; investing in a company's preferred shares or its bonds is not permitted. Common shares were approved as an instrument for investment by the Council of the Islamic Fiqh Academy in 1993 (Forte and Miglietta, 2007).
5. For a comprehensive analysis on how *shari'ah* limits are used by SSBs to create and apply Islamic stock screens, see Derigs and Marzban (2008).
6. If applied, personal tax rates will lower the amount to be purified further. Nisar (2009) comments that when various methods are used in combination, the purification process often appeared "to be window dressing, whereby […] a small amount of income is purged to solace the conscience of the *shari'ah* compliant investor".
7. This basic relationship also satisfies the approaches used by Modigliani and Miller (1963), Miles and Ezzell (1980, 1985) and Ruback (2002) to the value of the tax shield, although these studies make different underlying assumptions.

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