6’th International Conference on Islamic Banking & Finance

# Why companies prefer debt finance (whether conventional or Islamic) to equity finance.
# What could change this?

This presentation was never delivered as Mohammed Amin made a serious mistake with the time difference.

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# Synopsis

- Disclaimer
- About the speaker
- Debt and equity finance
- Reasons for preferring debt:
  - Fundamental economics
  - Taxation rules
- Conclusions

# Disclaimer

- The speaker has leadership roles and affiliations with many organisations.
- He is speaking in a personal capacity.
- None of his views should be attributed to the organisations he is associated with.

# Mohammed Amin

Mohammed Amin was previously a tax partner in PricewaterhouseCoopers LLP and led their Islamic finance practice in the UK.

He is:

- a chartered accountant
- a chartered tax adviser
- a qualified corporate treasurer

Amin has spoken on Islamic finance in over 20 cities covering every continent except Antarctica. Many of his articles and presentations on Islamic finance can be found in the Islamic finance section of his website:

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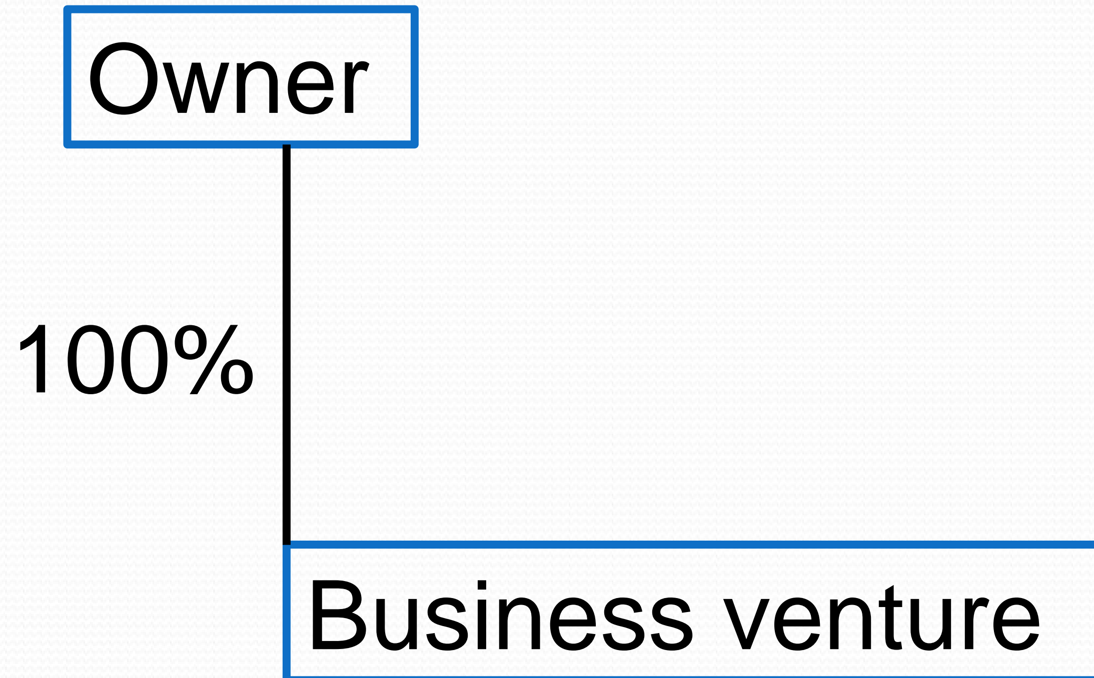
# Debt and equity finance

# Debt finance




External financier

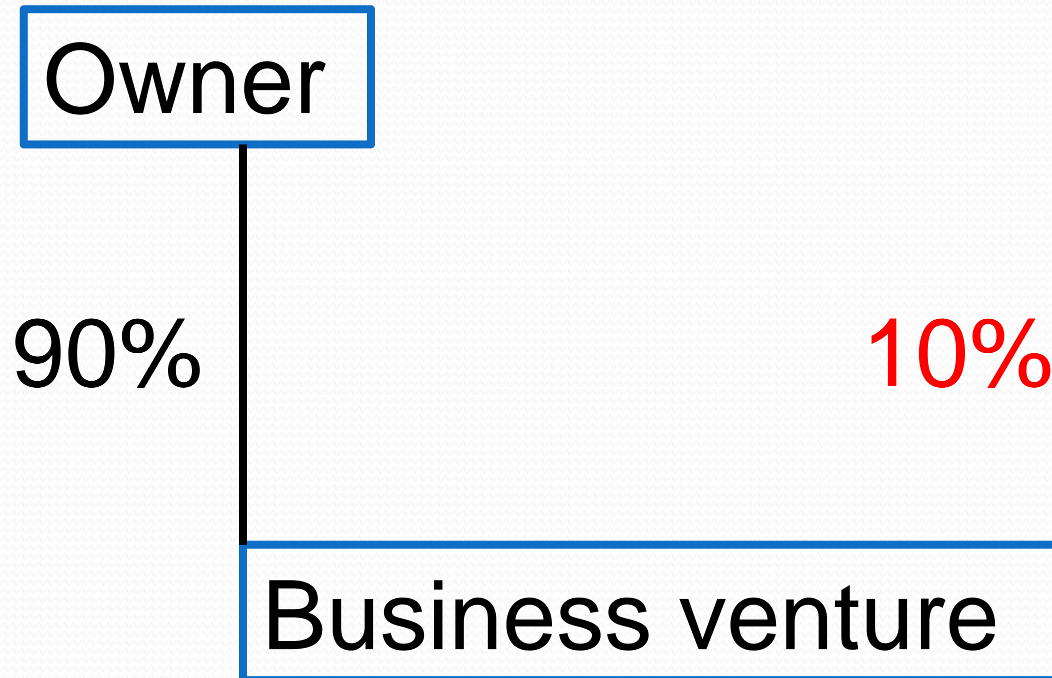
Any form of fixed return contract:

- Interest bearing debt
- Ijarah
- Murabaha
- Wakala with return cap
- Others can be devised

# Characteristics of debt

- Financier takes credit risk of non-payment
- All of owner’s equity cushion’s financier against loss
- Return to financier is fixed
- Financier’s return is typically low, unless venture is exceptionally risky
- Remainder of business returns belong to owner
- Business venture receives tax relief on payments to financier

# Equity finance




External financier

Financier acquires stake in the business (say 10%):

- Financier owns part of the business
- Shares losses, profits, business sale proceeds

# Characteristics of equity

- Owner has reduced ownership share of business
- High risk of loss to financier ➔ financier requires much higher expected return than when providing debt finance
- Typically no tax relief on payments to external financier

# Reasons for preferring debt

# Fundamental economics

- External equity financier requires high expected returns
  - Owners see this as generally expensive
  - Acceptable in high risk new ventures (hence venture capital industry)
  - Owners of stable established companies typically dislike external equity finance

# Taxation

- Debt finance payments (e.g. interest) typically tax deductible
- Equity finance payments (e.g. dividends) typically not tax deductible.
- Makes debt cheaper

# Addressing the tax inequality

- Abolish relief for interest deductions?
  - Many ways to avoid with disguised interest
  - Not recommended
- Introduce tax relief on equity + increase corporation tax rate to ensure no overall loss of tax revenue
  - Several countries have implemented
  - Reduces / eliminates the tax advantage of debt finance over equity finance
  - Reduces business risk due to lower gearing

# Conclusions

Fixed return contracts are preferred for two main reasons.

One is an economic fundamental.

The other can be changed by legislation.