

Finance 447
Financial Strategy and Tax Planning

Professor Petersen
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Taxes play an important role in both business and personal decisions, but the tax code is extremely complex. Most finance courses mention taxes, but the discussion is often and necessarily brief. This course will not teach you the tax code. Instead this course is intended to fill the gap between an MBA well trained in finance but unfamiliar with taxes and the tax experts that you will rely on in your career (tax lawyers). This course will teach you the structure of tax codes (present, past, and future - U.S. and non-U.S.). I will show you how taxes influence the finance decisions you will be expected to make (investment, capital budgeting, capital structure). You should view this class as an advanced corporate finance course. I will teach you the basic sources of gains from tax planning and then illustrate the general principals with a number of examples and a few cases. Although there are myriad techniques used in practice, there are just a few basic ideas underlying all tax-planning strategies.

You are not expected to have any detailed knowledge of tax law as a prerequisite. I will give you many examples, but you are not expected to memorize any of the details. Instead we will apply the logic of finance to improve your understanding of how taxes and non-tax factors affect financial decisions.

Prerequisites:

The prerequisite for this course is Finance II (441) or Turbo (440).

Course Readings:

Scholes, Wolfson, Erickson, Maydew, and Shevlin, *Taxes and Business Strategy*, 2002, Prentice-Hall, Inc. I will use the authors initials (SWEMS) to refer to the book.
Brealey and Myers, *Principals of Corporate Finance*, 2000 (or earlier edition)
Course Packet for Finance 447 - Petersen
Western and Southern Enterprise Case
Gulf-Canada Ltd Case
Burlington Northern Railroad Company Case

Warning:

There is a risk that the structure and content of this course may change during the course. I reserve the right to add and alter the course materials during the quarter. I understand that this makes organization challenging. You need to keep on top of where we are and what requirements are coming. If you are ever unsure, ASK. The web page contains a course calendar which I will keep up to date. You should check it each week to see what we will cover the next week and what assignments are due.

November 1, 2001

Course Outline

Lecture 1: Sources of Tax Savings and Capital Gains Taxation

- Purpose of the Course
 - Gains from Tax Planning
 - Advanced Corporate Finance
- Purpose of the Tax System
- Mechanics of the Tax Code
 - Differences in Tax Rates
 - Capital Gains Taxation
 - Taxation of Derivatives
- Readings
 - SWEMS, Chapter 2
 - Tax Plan Could Hurt Hedge Play, *WSJ*, 2/11/98
 - Equity Swaps Now Require SEC Filing, *WSJ*, 9/94
 - The Capital Structure Puzzle, Stewart Myers, 1984, *Journal of Finance*, 575-592¹

Lecture 2: Investment Vehicles and Tax Rates

- Different Structures for Holding Assets: When, Who, and How Matters
- Statutory and Effective Tax Rates
 - Effective Marginal Tax Rates
 - Net Operating Losses
 - Alternative Minimum Tax
- Mutual Fund Taxation
- Readings
 - SWEMS, Chapter 3
 - SWEMS, Chapter 5.8.
 - U.S. Corporate Income Tax (Form 1120)
 - Alternative Minimum Tax – Corporations (Form 4626)

¹ This is not a tax article, but you read it in Finance II. The issue described will arise in several times throughout this course. Thus you should be familiar with the argument. The article describes one way in which capital structure can be relevant. Sometimes the securities which a firm sells are mispriced. Thus when you do adjusted present value (APV), in addition to the tax shield and the costs of financial distress, you need to include the mispricing of the security issue. If you remember the argument, you don't need to read it. I have posted supplementary exercise on the web for Lecture 0. These review concepts from Finance II/Turbo which I will need and students don't always remember. You should look at these exercises and work through them if you do not remember. Doing this now will save you later.

Lecture 3: Municipal Bond Market

- Description of the Market
- Implicit versus Explicit Taxes
 - Tax Favored versus Tax Disfavored Asset
 - Tax Clienteles
- Implied Marginal Tax Rates
 - Term Structure of Tax Rates
 - Risk and Return in Tax Rates
- Readings
 - SWEMS, Chapter 5.1-5.7

Lecture 4: Organizational Form and Corporate Taxation

- Taxation of Different Organizational Forms
 - Corporations
 - Pass Through Entities (Partnerships)
 - Double Taxation of Corporate Income
- Real Estate Investment Trusts
 - Partnership Taxation Revisited
 - Stapled REITs
- Dividend Taxation
 - Definition of a Dividend
 - Dividend Received Deduction
- Integration of the Corporate Tax
 - Partnership Taxation in Theory
 - Tax Arbitrage in Practice
- Readings
 - SWEMS, Chapter 4 and 12
 - Abolish the Corporate Income Tax, *WSJ*, March 11, 1998.

Lecture 5: Investment Incentives and Taxes

- Depreciation
- Investment Tax Incentives
- Taxing Old versus New Capital
- Leasing
 - Tax Advantages of Leasing
 - Non Tax Advantages of Leasing
- Readings
 - Brealey and Myers, *Principals of Corporate Finance*, Chapter 25²
 - Brealey and Myers, *Principals of Corporate Finance*, Chapter 19.4
 - Surprise Loophole: Firms Expect Leasing to Save Them Millions Under New Tax Law, *Wall Street Journal*, March 11, 1987

² Chapter 25 is “Leasing” and Chapter 19.5 is “Discounting Safe, Nominal Cash Flows”

Lecture 6: Taxing Business Transactions: Mergers, Acquisitions, and Divestitures

- Taxable Mergers
- Tax Free Mergers
- Divestitures
- Readings
 - SWEMS, Chapter 13, 14, and 16.

Lecture 7: International Taxation

- Mechanics of International Tax.
 - Territorial taxation
 - Worldwide taxation
 - Foreign tax credits
- Repatriation Strategy.
- Readings.
 - SWEMS, Chapter 10 and 11

Lecture 8: Financial Innovation and Security Design.³

- Financial Innovation: Theory
- Security Design: Tax Motivations and Examples
- Treasury Department vs. Wall Street
- Readings
 - Monroe, Crackdown on Creativity, *Institutional Investor*, 6/97.
 - It Looks Like a Stock, but Deducts Like a Bond, *Business Week*, 11/22/93
 - Financial Innovation: The Last 20 Years and the Next, Merton Miller, *Journal of Financial and Quantitative Analysis*, 1986.

³ In Finance II, you learned about exotic or compound securities. Innovation in financial security design is continuing at a rapid pace. We will discuss financial design and innovation in general as well as how tax law is driving innovation – for good or bad.