

**Finance 447**  
**Financial Strategy and Tax Planning**

**Professor Petersen**  
**Winter 2001**

Taxes can 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 and Wolfson, *Taxes and Business Strategy*, 1992, Prentice-Hall Inc  
Brealey and Myers, *Principals of Corporate Finance*, 199?  
Course Packet for Finance 447 - Petersen  
Western and Southern Enterprise Case  
Burlington Northern Railroad Company Case

**Warning:**

The structure and content of this course may be fluid and change in real time. 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, 2000

## 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
  - Scholes and Wolfson, Chapters 1 (skim), 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*, 575-592<sup>1</sup>

### 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
  - Scholes and Wolfson, Chapter 3
  - Scholes and Wolfson, Chapter 6.3.
  - U.S. Corporate Income Tax (Form 1120)
  - Alternative Minimum Tax – Corporations (Form 4626)

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<sup>1</sup>This is not a tax article. However, the issue described will arise in several places 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 have seen this article before and 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
  - Scholes and Wolfson, Chapter 5, except section 5.3

### 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
  - Scholes and Wolfson, Chapter 4
  - Scholes and Wolfson, Chapter 6.2 (skim)
  - 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
  - Scholes and Wolfson, Chapter 5.3
  - Brealey and Myers, *Principals of Corporate Finance*, Chapter 26
  - 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

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

- Taxable Mergers
- Tax Free Mergers
- Divestitures

## Lecture 7: International Taxation

- Mechanics of International Tax.
  - Territorial taxation
  - Worldwide taxation
  - Foreign tax credits
- Repatriation Strategy.
- Readings.
  - Scholes and Wolfson, Chapter 13 and 14.

## Lecture 8: Financial Innovation and Security Design.<sup>2</sup>

- Financial Innovation: Theory
- Security Design: Tax Motivations and Examples
- Treasury Department vs. Wall Street
- Readings
  - Scholes and Wolfson, Chapter 20
  - 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.

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<sup>2</sup> 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.