

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 prerequisites for this course is Corporate Finance (Finance II – 441 or Turbo – 440) and Derivatives I (465). Derivatives I may be taken concurrently. In addition, you should know the material from these courses as we will rely heavily on what you learned in these classes.

Course Readings:

Scholes, Wolfson, Erickson, Maydew, and Shevlin, *Taxes and Business Strategy*, Fourth Edition, 2008, Prentice-Hall, Inc. I will use the authors initials (SWEMS) to refer to the book.

Allen, Brealey and Myers, *Principals of Corporate Finance*, 2008 (or earlier edition)

Course Packet for Finance 447 - Petersen

Western and Southern Enterprise Case

Gulf-Canada Ltd Case

Burlington Northern Railroad Company Case

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
 - The Capital Structure Puzzle, Myers, 1984, Journal of Finance, 575-592¹

Lecture 2: Investment Vehicles and Tax²

- 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, 6 (skim)

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 This is not a tax article, but you read it in Finance II. The issue described will arise several times throughout this course and often in your career. Since this is an issue that many find confusing, I think it worth reviewing. The article describes one way in which capital structure can be relevant. Securities don't always sell for their true value. Thus when calculating the APV of a project, you need to include the mispricing of the security issue in addition to the tax shield and the costs of financial distress. I have posted supplementary exercise on the web for Lecture 0 as a check. These exercises review concepts from Finance II/Turbo which I will need and which 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 (e.g. midterm).

² Since most students have never seen a corporate tax form I have included copies on the web. Knowing how income taxes are calculate is essential to understanding the incentives which are created. The instructions are also on the web. I have included both the corporate income tax (Form 1120) and the alternative minimum tax for corporations (Form 4626).

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
 - Allen, Brealey and Myers, *Principals of Corporate Finance*, Chapter 26³
 - 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 Divestiture

- 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

³ In the eighth edition of Allen, Brealey, and Myers (2008), Chapter 26 is “Leasing.” If you have an earlier edition of the textbook, you will need to figure out to which sections these titles correspond.

Lecture 8: Financial Innovation and Security Design.⁴

- Financial Innovation: Theory
- Security Design: Tax Motivations and Examples
- Treasury Department vs. Wall Street
- Readings
 - Monroe, Crackdown on Creativity, *Institutional Investor*, June, 1997
 - Financial Innovation: The Last 20 Years and the Next, Merton Miller, *Journal of Financial and Quantitative Analysis*, 1986.

⁴ In Finance II, you learned about exotic or compound securities and discussed how these were designed. 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.