Chapters 8 and 9: Compensation Planning

Forms of compensation

	Taxed to employees	*Taxed to Employers*
Non-taxable fringe benefits	no	immediate deduction

Non-taxable fringe benefits include employer paid life and health insurance, really good coffee, free soda, employer sponsored parties, really good office location, space, furniture, etc. A critical issue for employers is do employees get a big enough bang out of these "benefits" to forgo salary. For a given dollar of expenditure, the employee gets to keep the entire $1 worth if it's non-taxable and only ($1 $(1-t_p)$) if it's taxable. Obviously, as employee tax rates increase fringe benefits look better.

Pensions	deferred, ordinary income when received	immediate deduction

Recall pensions are identified as savings vehicles 6. The employer get to take a deduction when contributing to the plan and the employee is not taxed until he or she withdraws the money (perhaps well into the future). Pensions get "better" if current employer tax rates are higher than anticipated future rates (a measure of the government's subsidy) and if current employee tax rates are higher than anticipated future rates (better to pay taxes when the rates are low).

Incentive stock options (ISO)	deferred, capital gains when stock sold	no deduction

ISOs grant employees the right to purchase shares at a specified strike price. Important conditions for ISO treatment include: 1. Mandatory 1 year holding period after exercise, 2. Mandatory holding period of 2 years after date of grant, 3. Limit of $100,000 in stock value per-employee per-year. Since firms don't get a tax deduction, ISOs are going to look better to firms with low tax rates (e.g., start-ups) and they're going to look better the longer the anticipated holding period (e.g., if you hold until death you get to avoid all income taxation). It is important to note that most firms that grant ISOs never report compensation expense associated with them for financial reporting purposes.

Deferred compensation	deferred, ordinary income when receive	deferred deduction

Basically, the employer and employee enter into a plan prior to service that specifies that a portion of compensation will be deferred. Unlike pensions, deferred compensation gets "better" if current employer tax rates are lower than anticipated future rates. As with pensions, deferred compensation is more attractive if anticipated future rates are less than current rates.

Non-qualified Stock Options	deferred, ordinary income when options exercised capital gains on subsequent appreciation	deferred deduction

These are the big boys of stock options. Basically, the same kind of deal as ISOs without the ISO limits (i.e., they grant employees the right to purchase shares at a specified strike price). The big difference is in how the taxes play out. Firms with high tax rates can take advantage of a deduction equal to the difference between the strike price and the market price at exercise. (Note: exercising employees have to declare ordinary income at this point—to avoid tax they've got to give away the shares.) It is important to note that most firms that grant NQOs never report compensation expense associated with them for financial reporting purposes.

Stock Appreciation Rights	deferred, ordinary when exercised	deferred deduction

Stock appreciation rights are like stock options, in that they enable the employee to receive the increase in stock value from some specified level. When the compensation is paid to employees, its tax deductible to the employer and taxable to the employee. With SARs, however, the employee does not buy the underlying stock. Rather, the employee is given the cash equivalent. It is important to note that firms that grant SARs have to record compensation expense each period equal to the increase in the value of the claim of the SAR holders for financial reporting purposes. It is generally suspected that this makes SARs far less desirable than ISOs and NQOs.

Interest free demand loans	deferred, ordinary income when received equal to each periods interest savings	deferred deduction

Here's how it works. Your employer gives you an interest free demand loan of $1,000. Each year you must declare income equal to the interest expense that would have been earned on the outstanding balance of the loan at a specified federal rate. The employer gets a deduction in the same amount. The trick is that the loan is a demand loan, which means your employer can say "pay-up" at any point in time.

Interest free term loans	immediately, ordinary income Equal to present value of interest savings	immediate deduction

Here's how it works. Your employer gives you an interest free 3-year term loan of $1,000. The federal rate is 10%. At the point the loan is granted, you must declare income equal to the present value of interest expense that is being forgiven you in the future. Since the loan is a term loan vs. a demand loan, your employer can't call the loan due.

Cash salary	immediately, ordinary income	immediate deduction

The beauty of cash salary is that it gives you cash—and you need cash to buy stuff. Also, if you have cash, you don't need to borrow cash.

Cash bonus	immediately, ordinary income	immediate deduction

Bonuses can be quite flexible in nature. However, compensation in excess of $1,000,000 that is not tied to a structured performance plan is subject to disallowance as a deduction at the corporate level (Section 162(m)).

Which form of compensation is best?

In general it depends on what the employee values / wants / needs. For example, an employee may value non-taxable fringe benefits highly. Say an employee really wants a great ergonomically sophisticated (though not medically required) chair. The cost of the chair to the employee is $2,000. However, the employer can get the same chair for $2,000 (1-t) or $1,300 for a firm with a tax rate of .35. The $700 difference in the cost of the chair can be viewed as "tax savings" that the employee and employer can share.

As an aside, if you're self-employed and you're outfitting your office, you might be able to get the same chair for as little as $2,000(1-t) or $1,208 for a taxpayer with a marginal rate of 39.6%. (I'm assuming you can invoke Section 179, which allows for the immediate write-off of up to $17,500 otherwise depreciable assets in 2001.)

Specific Comparisons of Alternative forms of Compensation

Salary vs. Deferred Compensation

Current Compensation:

Cost of $1 current salary to employer:

$\$1(1-t_{co})$

where t_{co} = is equal to the current corporate tax rate

Deferred Compensation

Assume that the employer can invest money not paid out as after-tax current compensation, $\$1(1-t_{co})$, and earn an after-tax rate, r_{cn}, for n periods. The amount available to pay the employee at the end of n periods will equal:

$\$1(1-t_{co})\ (1+ r_{cn})^n$

Now, let's say D is the actual amount of deferred compensation the employer has to pay the employee at the end of n periods to make the employee indifferent to a $1 of current compensation. The after tax cost of D to the employer is $D(1-t_{cn})$, where t_{cn} is the employers tax rate in period n.

Decision rule

If $D(1-t_{cn}) < \$1(1-t_{co})\ (1+ r_{cn})^n$

then deferred compensation preferred

What's the intuition of this rule?

Setting equal and Rearranging:

$D = \$1(1+ r_{cn})^n \quad (1-t_{co}) / (1-t_{cn})$

where D is the maximum a corporation would be willing to pay an employee in future deferred compensation vs. current compensation

True or False: If corporate rates are constant over time, employers can offer employees their after tax rate of return on deferred compensation?

True or False: All else equal, if future corporate tax rates are likely to be higher than current tax rates deferred compensation preferred. Why?

Problem: What is the profile of the employee who wants current compensation? What is the profile of the employee who wants deferred compensation?

How do we find D, the amount that we have to pay employees after n periods to make them indifferent between current and deferred compensation?

Note the following:

Benefit of \$1 of salary to employee: $\$1(1-t_{po})$

After-tax accumulation at the end of period n: $\$1(1-t_{po})\ (1+ r_{pn})^n$

Decision rule

If $D(1-t_{pn}) > \$1(1-t_{po})\ (1+ r_{pn})^n$

then deferred compensation preferred

What's the intuition of this rule?

Using what we've derived thus far and chugging the algebra, employees will prefer current compensation to deferred compensation whenever the following is true:

$$\frac{(1-t_{po})}{(1-t_{pn})} \frac{(1+r_{pn})^n}{(1+r_{cn})^n} > \frac{(1-t_{co})}{(1-t_{cn})}$$

LHS numerator	=	after tax return from current salary
LHS denominator	=	after tax return from deferred compensation
RHS numerator	=	after tax cost of $1 of current compensation
RHS denominator	=	after tax cost of $1 of deferred compensation

What's the intuition of this rule?

Salary vs. Defined Contribution Pension Compensation (e.g., 401(k))

Recognize that since contributions to a pension fund are tax deductible to the employer, the employer is indifferent to paying employees currently or making pension contributions.

From the employee's standpoint, all money invested in pension plans on their behalf accumulates returns tax free until withdrawn. At that point the employee has to pay tax at ordinary rates. Thus the future value of $1 contributed to a pension plan is:

$\$1(1+R_{pen})^n (1-t_{pn})$

where

R_{pen} = pretax return on assets held in the pension fund
n = number of periods funds are held in pension fund
t_{pn} = employee's tax rate when funds are withdrawn from the fund

The future value of $1 of current compensation:

$\$1(1-t_{po}) (1+r_{pn})^n$

where

t_{po} = employee's current tax rate on ordinary income
r_{pn} = annualized after tax rate of return available to the employee
n = number of periods funds are held in pension fund

When is pension compensation preferred?

Whenever $\$1(1+R_{pen})^n (1-t_{pn}) > \$1(1-t_{po}) (1+r_{pn})^n$

Problem: Who prefers pension compensation? Why? Who prefers to be paid currently in cash? Why?

Defined Contribution Pension Compensation vs. Deferred Compensation

Recall that a corporation can give an employee deferred compensation equal to D in n periods that will leave the employee indifferent to alternative current compensation of $1:

$$D = \$1\,(1-t_{co})\,(1+r_{cn})^{n} \,/\, (1-t_{cn})$$

Which has an after-tax value to the employee of:

$$\$1\,(1-t_{co})\,(1+r_{cn})^{n} \,/\, (1-t_{cn}) \qquad (1-t_{pn})$$

where

r_{cn} = annual after tax return to the corporation
n = number of periods
t_{co} = current corporate tax rate
t_{cn} = future corporate tax rate
t_{pn} = the employee's tax rate in n periods

Also, recall the corporation can make a tax-deductible contribution to a pension plan that will grow into the following after tax amount after n periods:

$$\$1(1+R_{pen})^{n}\,(1-t_{pn})$$

where

R_{pen} = pretax return on assets held in the pension fund
n = number of periods
t_{pn} = employee's tax rate when funds are withdrawn from the fund

So employees will prefer deferred compensation to pensions when

$\$1\ (1-t_{co})\ (1+ r_{cn})^n\ /\ (1-t_{cn}) \quad (1- t_{pn}) \quad > \quad \$1(1+R_{pen})^n\ (1-t_{pn})$

Rearranging:

$(1-t_{co}) / (1-t_{cn}) \quad > \quad (1+R_{pen})^n\ /\ (1+ r_{cn})^n$

True or False: The preference for deferred compensation increases with the corporation's after-tax rate of return. Why?

True or False: The higher the current corporate tax rate the lower the preference for pension compensation? Why?

True or False: Pension compensation is less risky to the employee than deferred compensation? Why?

Problem: What is the profile of the employee who wants pension compensation? What is the profile of the employee who wants deferred compensation?

Post-Retirement Compensation

There are two primary forms of post-retirement compensation:

1. Pension Plan compensation
2. Insurance coverage

Contributions to qualified pension plan trust funds are tax-deductible while contributions to trusts set up to service retiree's post-employment insurance coverage are not tax deductible.

Question: Assuming that a firm wants to compensate its employees in part by promising to cover its employees post retirement medical coverage how should the firm accomplish this objective?

Alternative Stock Based Compensation Plans: ISOs vs. NQOs

ISOs	* no tax deduction for the employer * taxable to employees when sold at capital gains tax rate
NQOs	* tax deduction for the employer when exercised by employee * taxable to employees at ordinary rates when exercised. * additional tax to employee at capital gains rates when sold

To make an employee indifferent between ISOs and NQOs, the employer will have to compensate the employee for the present value of the additional tax the employee is going to have to pay on NQOs.

ISO taxation	NQO taxation
$(P_e-P_g)t_{cg} + (P_s-P_e)t_{cg}$	$(P_e-P_g)t_p + (P_s-P_e)t_{cg}$

where

P_g	=	Grant price
P_e	=	Exercise price
P_s	=	Price at which employee sells stock
t_{cg}	=	capital gains tax rate
t_p	=	tax rate on ordinary income

The additional tax the employee will have to pay if he receives NQOs rather than ISOs is equal to:

Additional Tax = $(P_e-P_g)\ (t_p - t_{cg*})$

What it boils down to is this:

With both ISOs and NQOs the employee is going to have to pay tax at capital gains rates on the appreciation between the date of exercise and the ultimate sale of the stock.

With NQOs, the employee is going to pay tax at ordinary tax rates on the appreciation between the date of grant and the date of exercise.

With ISOs, the employee is going to pay tax at capital gains rates on that same appreciation and, moreover, will get to defer that tax payment for n periods, where n equals the number of periods between exercise and ultimate sale.

> What this means is that the relevant t_{cg*} is t_{cg} discounted to present value, i.e., $t_{cg}/(1+r)^{n,}$ where n equals the number of periods between exercise of the option and sale of the stock.

To make the employee whole, the employer has to give the employee the additional tax that will be due because the option is a NQO versus an ISO. Since any additional compensation will be taxable, the employer has to gross up the additional payment by taxes that will be due: (Note: this amount is tax deductible to the employer.)

$(P_e-P_g)\ (t_p - t_{cg*})$ / $(1- t_p)$

So when will employers prefer NQOs to ISOs?

Tax benefit to corporation at exercise	$(P_e-P_g)t_c$	[1]
Less after tax additional payment to employee	$(P_e-P_g)\ (t_p - t_{cg*}) / (1- t_p)\ (1- t_c)$	[2]

If [1] – [2] is greater than zero employers will prefer NQOs to ISOs.

Simplifying the equation ([1] – [2] > 0) you get:

$t_c \quad > \quad (t_p - t_{cg*}) / (1- t_{cg*})$

What's it all mean?

1. The higher the corporate tax rate, t_c, the more attractive NQOs. Recall that firms with NOLs (oftentimes start-ups) have relatively low tax rates and thus are more likely to prefer to issue ISOs rather than NQOs.

2. The higher the incremental tax to the employee, $(t_p - t_{cg*}) / (1- t_{cg*})$, the less attractive NQOs will be. If ordinary income tax rates and capital gains tax rates are the same and the employee flips the stock as soon as the options are exercised, there will be no incremental tax. As capital gains rates decline relative to ordinary rates and as the expected holding period for the stock (n used to calculate t_{cg*}) increases, ISOs begin to look better and better.

When should an employee exercise a NQO? (most have a termination date)

Factors to consider:

1. Need cash to live large
2. Expectations regarding future of value of stock, future ordinary tax rates, and future capital gains tax rates

Basic choice:

1. Exercise now and pay tax currently at ordinary tax rates and later at capital gains tax rates OR
2. Exercise later and pay tax at ordinary tax rates

Tax implications of choice 1 Tax implications of choice 2

$(P_e-P_g)t_p + (P_s-P_e)t_{cg*}$ = $(P_e-P_g)t_{p*}$

which is equal to

$(P_e-P_g)t_p + (P_s-P_e)t_{cg*}$ = $(P_e-P_g)t_{p*} + (P_s-P_e)t_{p*}$

(Note: * indicates the present value of tax rate, i.e., t_{cg*} and t_{p*} are t_{cg} and t_p discounted for the n periods between the exercise of the stock option and the ultimate sale of the optioned security, i.e., $t_{cg}/(1+r)^n$)

So when is choice 1 going to be preferred?

When you expect significant price appreciation in the future. You exercise the option, take the ordinary tax rate hit but get the clock started on lower capital gains tax rates.

If you're not confident in the stock you don't want to do this. Specifically, if you exercise, pay tax at ordinary rates and the stock price falls, you've got a capital loss on your hands that you can't use to offset ordinary income (above a $3,000 annual limit). While the capital loss is available to offset capital gains, these are taxed at preferred rates so the benefit is limited.

Why don't you see more SAR plans?

Stock appreciation plans can generate the same returns to employees as NQOs $(P_e-P_g)t_p$ without all the messy stock purchase and sale business—but you don't see them all that often.

The problem with SARs is that, to the extent that the "option" goes in the money, they generate expenses that must be reported for financial reporting purposes.

Chapters 10 and 11: Multinational Tax Planning:

In an economic environment where major companies operate businesses around the world (and where many U.S. multinationals draw significant amounts of their income) you've got to have a grip on multinational tax planning.

How is income earned across national borders taxed in a home country?

There are two basic approaches to taxing income earned outside a home country:

1. Territorial Taxation
2. Worldwide Taxation

Countries that operate territorial tax systems do not tax foreign source income (e.g., Canada, France, Australia).

Countries that operate worldwide tax systems tax all income without regard to where it is earned (e.g., U.S., Japan, U.K.)

Several things to note at the outset:

1. Income from foreign-based subsidiaries is not taxable until it is repatriated as a dividend or deemed dividend (e.g., if a foreign subsidiary lends a domestic parent money, the amount of the loan might be characterized as a dividend for tax purposes).
2. The second level of tax that is paid upon repatriation is similar to the "double tax" takes place when a corporation earns income, pays a tax, and then, after a period of time equal to n, distributes a dividend based on that income to a shareholder and the shareholder pays tax. The return to the shareholder is equal $[1+R(1-t_c)]^n (1-t_p)$, where R is the pretax rate of return, t_c is the corporate tax rate and t_p is the shareholder tax rate. In the multinational setting, t_c is the rate of tax imposed by the foreign country and t_p is the tax upon repatriation. Note: the second level of tax to which the income of a firm based in a worldwide taxation country is subject may put that firm at a competitive disadvantage relative to a firm operating out of a territorial tax country.

3. When foreign subsidiaries repatriate dividends, a credit against U.S. taxes is allowed for foreign taxed paid on the dividend (This is called the Foreign Tax Credit).
4. Foreign branches of U.S. companies cannot defer U.S. taxation. However, they can readily make use of operating losses to offset U.S. taxable income. This is something that foreign subsidiaries can't do.
5. U.S. based firms can create Foreign Sales Corporations (FSCs) through which to funnel foreign sales. 15% of income earned by FSCs is tax exempt in the U.S. Groups like the WTO view FSCs as abusive tax subsidies.
6. It is likely that significant implicit taxes exist that drive down the pretax rates of return that can be earned on investments in countries that offer significant tax concessions to attract business (e.g., Ireland, Singapore).
7. Some foreign income (Subpart F income) is taxable in the U.S. when earned. Subpart F income is generated from passive investments in things like bonds and stocks. Subpart F income earned by a Controlled Foreign Corporation (CFC) (a corporation that's more than 50% owned by U.S. taxpayers, where a U.S. taxpayer is a shareholder that owns more than a 10% interest). A CFC's Subpart F income is deemed distributed as dividends as earned, unless some *de minimus* rules are met. Note that, unlike pretax returns to active income from conducting a business that are likely significantly influenced by implicit taxes, the pretax rates you can earn overseas on Subpart F income (even in a tax haven country) approximate those you can earn in the U.S. Put another way, the implicit tax on Subpart F income is not too big.
8. Word of caution—pun coming—there's a world of complexity in the taxation of multinational operations. Every country has its own set of rules for determining taxable income and for taxing distributions outside its borders. Differences in the definition of taxable income can make it possible for a single expense to be deductible in two jurisdictions (double-dipping). Tax treaties play large and can affect the route dividends follow since they affect the amount of tax withheld (e.g., firms actively attempt to move money across countries to minimize withholding taxes—they "treaty shop.")

Calculation of the Foreign Tax Credit Limit (FTC) (note that the FTC limit is computed for 8 separate income baskets)

The maximum allowable foreign tax credit is defined as:

$$FTC = \frac{\text{Pretax foreign source income}}{\text{Pretax worldwide income}} * \text{U.S. Tax on Worldwide Inc.}$$

The FTC that can be used in any given year is equal to the lessor of the FTC as calculated above or the actual amount of foreign taxes paid or deemed paid. Any FTC not used in one year can be carried back 2 years and forward 5 years.

Generally, foreign source income is equal to the sum of Subpart F income, foreign income earned by branches of U.S. companies, 25% of FSC income, and income earned and repatriated by foreign subsidiaries.

Foreign source income associated with a repatriation from a foreign subsidiary is equal to the following:

$$D_f \; / \; (1-t_f)\,(1-t_w).$$

where:

D_f = the foreign dividend
t_f = the foreign income tax rate
t_w = the withholding tax collected by the foreign country when dividends are paid to overseas shareholders

With respect to the calculation of FTC, note that the higher foreign source income, the higher the allowable credit. The level of foreign source income is affected by the allocation of revenues and costs within a controlled group of corporations (this is done using “transfer prices”) and by specific income sourcing rules. With respect to transfer prices, the guiding principle is that they should be set to approximate an arms length transaction.

Problem: A U.S. based multinational company operates two foreign subsidiaries. Relevant information follows:

	After-tax Earnings and Profits	Dividend Paid	Withhold. Tax	Foreign Income Tax Rate
Sub 1	$100	$20	$2	20%
Sub 2	$200	$40	$6	30%

U.S. income tax rate equals 35%

1. Assume the company only operates Sub 1. How much tax will be due upon repatriation?
2. Assume the company only operates Sub 2. How much tax will be due upon repatriation?
3. Assume the company operates both Sub 1 and Sub 2. How much tax will be due upon repatriation?
4. Assume the company operates both Sub 1 and Sub 2. What is this company's foreign tax credit position—specifically does the firm have excess foreign tax credits or will it have to pay U.S. taxes upon repatriation (assume that all foreign source income and taxes can be pooled in generating the FTC)?
5. Does this company have an incentive to generate additional income in a high or low tax rate country (relative to the U.S.)? How might that income be generated?

When should a company repatriate earnings?

At first blush it may appear that, since repatriation can trigger an additional tax (say for U.S. firms operating in countries that have lower than 35%), postponing repatriation for as long as possible makes sense.

But, it doesn't, necessarily.

Consider the following:

A U.S. based multinational company operates one foreign subsidiary. The subsidiary has accumulated after-tax earnings and profits of $100. The subsidiary faces a tax rate of 20% on all income earned. By treaty, there are no withholding taxes on dividends to the U.S. parent. The parent can earn 15.0% pretax in the U.S. and 11.25% pretax in the foreign country. Assume the U.S. tax rate is 40%

1. Is the parent better off by postponing repatriation of accumulated earnings and profits for 1 year?
2. Would the parent be better off postponing repatriation of accumulated earnings and profits for 1 year if the foreign pretax rate were greater than 11.25%? less that 11.25%?
3. Assume that the parent could invest the foreign subsidiary's accumulated earnings and profits in investments that generate Subpart F income (e.g., stocks and bonds) and that these investments return 15% per year, exactly what the firm would earn on similar investments in the U.S.. Should the firm make these investments overseas or at home? For the sake of concreteness, calculate the difference between repatriating immediately and investing at home to earn 15% pretax each year for 5 years and investing abroad, generating Subpart F income and repatriating at the end of 5 years.

Chapter 12: Corporate Formation, Capital Structure, and Liquidation

A bunch of bullets

- Unless otherwise specified, we're talking about C corporations. Most entities that you think of as "corporations" are, in fact, C corporations.

- One of the central tenets of corporate taxation is that corporate profits should be taxed and distributions to corporate owners should also be taxed. This is "double taxation."

- The determination of taxable income actually starts with income for financial reporting purposes. Important temporary differences in accounting methods used for tax and financial reporting purposes include the accelerated write-off of depreciable assets, use of the cash basis accounting for warranty obligations, the use of actual write-offs of A/R vs. estimated write-offs. Permanent differences include exemptions relating to municipal securities, the write-off of goodwill for financial reporting but not tax purposes, and the expensing of non-qualified stock options for tax purposes but not for book purposes.

- Corporate Formation is generally a nontaxable event. Specifically, investors contribute property to the corporation in return for which they get shares of stock that represent ownership claims. Absent Section 351, this exchange would give rise to taxable income equal to the difference between the basis of the property in the hands of the investor and the fair market value of the property.

- To avoid corporate formation being treated as a taxable event, three conditions which are noted below have to be met. As a practical matter, it's not terribly difficult to meet these conditions. Perhaps the most interesting is the first. There, it is important to make sure that the product of "service" type work gets characterized as property. Insuring that this happens appropriately is a job for lawyers.

    1. investors must contribute property, not services
    2. investors must receive stock
    3. investors must collectively control 80% of the firm

- In a nontaxable corporate formation, the corporation inherits the investor's basis in property (so-called "carryover basis"). That is, property contributed is not "stepped up" to market value.

- Investors take a basis in stock equal to their basis in contributed property (so-called "substituted basis").

- Basis is used for the determination of gain or loss. It is also used to determine amounts of write-offs in the case of depreciable or amortizable assets. Consider the following: an asset qualifying under Section 1231 is purchased for $100,000 and depreciated $40,000. The acquisition price is the asset's basis, the basis less accumulated depreciation, $60,000 is referred to as adjusted basis. If the asset were sold for $120,000, the total gain of $60,000 would be parsed into two pieces. $40,000 related to the "recapture" of depreciation would be ordinary income. The remaining $20,000 would be a capital gain. The accounting analogue to basis and adjusted basis is "cost" and "book value."

- If investors receive boot (think cash or some other asset—anything but the stock of the newly formed corporation), they have to recognize taxable income equal to the lessor of the realized gain on the transaction or the boot received. The investor's basis, in turn, will equal the basis of contributed property plus any realized gain (you can think of this as a step up in basis "paid for" by recognizing the gain for tax purposes) less any boot received (think of this as the portion of the asset contributed that you've "sold"). Example: an investor contributes property with a basis of $100,000 and a fair market value of $200,000 and gets in return shares of common stock and $110,000 in cash. What's the realized gain? What's the boot? What will the investor report as income? What will the investor's basis in the stock be?

- If one company holds more than 50% of the equity of another company, consolidated financial statements have to be prepared for financial reporting purposes. If one company holds more than 80% of the equity of another company it can consolidate for tax purposes. Advantages of consolidation include the opportunity to offset one firm's income against another's losses.

- Some fairly strong empirical evidence indicates that firms with high marginal tax rates are more likely to use debt than firms with low marginal tax rates.

  Why does this make sense?

- Trust-preferred stock is reported in the mezzanine section of the Balance Sheet (between liabilities and equity). "Dividends" are deducted from income for both tax and financial reporting purposes. In essence, trust-preferred stock looks an awful lot like debt. What is, to me, somewhat remarkable is that it counts towards Tier 1 capital for banks (i.e., banks can meet their capital requirements by issuing a security that generates tax deductible interest vs. non tax deducible dividends.

  Will trust-preferred stock be a favored form of financing for firms with high or low tax rates?

- Earnings and Profits (E&P) is the tax analogue to Retained Earnings.

- Corporate distributions can be treated as:

  1. Dividends (provided there is sufficient E&P)
  2. Returns of capital (if there is not sufficient E&P out of which to pay dividends), or
  3. Capital gains (implies that distributions have eliminated E&P and that the shareholder's basis in the stock has been reduced to zero through returns of capital)

- Constructive dividends occur when distributions are made to shareholders without formal declaration of dividends. You see this when firms try to distribute corporate profits to owners in a tax deductible manner (e.g., excessive compensation, excessive perks). This is especially likely in closely held corporations.

- Property dividends occur when property is distributed to shareholders. Gains must be recognized at the corporate level on distributed property (so that the corporate tax is not avoided).

- Share repurchases trigger capital gains and losses for shareholders.

- Proportional share repurchases would be treated as dividends (here the idea would be to prevent shareholder's from avoiding ordinary tax treatment on dividends versus capital gains treatment—and that on only the portion of the distribution that exceeded the shareholder's basis.

- Corporate liquidation entails the sale of all of a corporation's assets, payment of all liabilities and distribution of proceeds to shareholders. Any gains or losses on sale of assets or settlement of liabilities would be taxable at the corporate level. Shareholders would have to recognize capital gains or losses equal to the difference between the liquidating dividend and their basis in the stock.

- When a parent corporation liquidates a subsidiary it is typically structured as a non-taxable event under Section 332.