CONTENTS

Preface xv
About the Authors xviii

CHAPTER 1 Introduction to Tax Strategy 1
1.1 Why Do Tax Rules Influence Investment Decisions? 2
1.2 Structure and Themes of the Book 2
   A Planning Approach 3
   Taxing Authority as Investment Partner 3
   The Importance of a Contractual Perspective 5
   Implicit Taxes and Tax Clienteles 6
   Tax Planning as a Tax-Favored Activity 6
   Why Study Tax Planning? 7
1.3 Topics Covered in This Book 8
1.4 Intended Audience for This Book 10
Summary of Key Points 13
Appendix 1.1 Overview of Calculation of Income Tax Liability 14
Discussion Questions 15
Exercises 16
Tax-Planning Problems 17
References 18

CHAPTER 2 Tax Law Fundamentals 19
2.1 Types of Tax Planning 21
   Converting Income from One Type to Another 21
   Shifting Income from One Pocket to Another 22
   Shifting Income from One Time Period to Another 23
2.2 Restrictions on Taxpayer Behavior 25
   Examples of Broad Restrictions on Taxpayer Behavior in the U.S. Constructive-Receipt
   Doctrine 25
   Substance-over-Form and Business-Purpose Doctrines 25
   Related-Party versus Arms-Length Contracts 27
   Assignment-of-Income Doctrine 28
2.3 The Legislative Process and Sources of Tax Information 29
   Primary and Secondary Authorities 29
   The Legislative Process 29
   Regulations and Revenue Rulings That Result from the Passage of a Tax Act 31
CHAPTER 3 Returns on Alternative Savings Vehicles 67

3.1 Intertemporally Constant Tax Rates 68
   Review of Compound Interest 70
   Investments in Savings Vehicles I and II 70
   Hybrid Savings Vehicles 73
   Differences in After-Tax Accumulations in Savings Vehicles I
      and II as a Function of Pretax Rates of Return 73
   Investments in Savings Vehicle III 73
   Comparison of Savings Vehicles II and III 74
   Investments in Savings Vehicle IV 75
   Investments in Savings Vehicle V 76
   Investments in Savings Vehicle VI 77
   Dominance Relations and Empirical Anomalies 77

3.2 Changes in Tax Rates over Time 78

3.3 More on Pension Plans 79
   Traditional Deductible IRAs 80
   Roth IRAs 80
   Nondeductible IRAs 81
   Comparison of the Deductible and Roth IRAs: New Contributions 81
   Comparison of the Deductible and Roth IRAs: The Rollover Decision 84

Summary of Key Points 85
Discussion Questions 86
Exercises 87
Tax-Planning Problems 88
Reference and Additional Readings 90

CHAPTER 4 Choosing the Optimal Organizational Form 91

4.1 Organizational Forms for Producing Goods and Services 93
   After-Tax Returns to Pass-Through and Non-Pass-Through Forms of
      Organization 95
   The Choice of Partnership or Corporate Form in Special Cases:
      Assuming Zero Dividends 97

4.2 Changing Preferences for Organizational Forms Induced
   by Tax-Rule Changes 98
   The Required Before-Tax Rates of Return on Corporate and Partnership
      Activities 98
Contents

The Required Rate of Return on Stocks in the Presence of Dividends 100
The Effective Annualized Tax Rate on Shares: \( t_s \) 102
Required Before-Tax Rate of Return: Corporations Versus Partnerships: \( R^*_c \) 102
Post-1997 Taxpayer Relief Act (1997–2000) 106
Further Analysis of the 2003 Tax Act 107
Cross-Sectional Variation in Corporate, Personal, and the Shareholder-Level Tax Rates 109
Net Operating Losses and the Corporate Tax Rate 109
Further Complications in Determining the Shareholder-Level Tax Rate, \( t_s \) 110
Progressive Personal Income Tax Rates, \( t_p \) and \( t_{cg} \) 112

4.3 Other Organizational Forms Used to Organize Production Activities 112
Hybrid Corporate Forms 112
Other Noncorporate Organizational Forms 115

4.4 Nontax Advantages of Operating in Corporate Form 117
Summary of Key Points 118
Appendix 4.1 Dividend Imputation in the Corporate Form 120
Appendix 4.2 Other Investment Vehicles 123
Discussion Questions 124
Exercises 125
Tax-Planning Problems 126
References and Additional Readings 128

CHAPTER 5 Implicit Taxes and Clienteles, Arbitrage, Restrictions, and Frictions 130

5.1 Tax-Favored Status and Implicit Taxes 132
5.2 The Implicit Tax Rate, the Explicit Tax Rate, and the Total Tax Rate 137
Computing the Implicit Tax 137
Total Tax Rates in a Competitive Market 138
5.3 The Importance of Adjusting for Risk Differences 139
5.4 Clienteles 142
Evidence on the Existence of Implicit Taxes and Clienteles 143
5.5 Implicit Taxes and Corporate Tax Burdens 145
5.6 Tax Arbitrage 147
5.7 Organizational-Form Arbitrage 148
   Immediate Tax Rebates When Taxable Income Is Negative 148
   No Tax Rebates on Negative Taxable Income 149
   Restrictions on Organizational-Form Arbitrage 150
   Full Taxation with Deferral and Organizational-Form Arbitrage 151
   The Effects of Frictions on Organizational-Form Arbitrage 151
   Bankruptcy Rules and Organizational-Form Arbitrage 153
   Buying and Selling Implicitly Taxed Assets to Effect Organizational-Form Arbitrage 154

5.8 Clientele-Based Arbitrage 155
   Clientele-Based Arbitrage with Investments in Tax-Favored Assets
     Other Than Tax-Exempt Bonds 157
   Market Equilibrium with Tax-Exempt Entities 157

Summary of Key Points 158

Appendix 5.1 Adjusting for Risk Using the Capital Asset Pricing Model 161

Discussion Questions 161
Exercises 162
Tax-Planning Problems 164
References and Additional Readings 166

CHAPTER 6 Nontax Costs of Tax Planning 170

6.1 Symmetric Uncertainty, Progressive Tax Rates, and Risk Taking 172
   R&D and O&G Activities 174
   Progressive Tax Rates and Hedging 176

6.2 Tax Planning in the Presence of Risk-Sharing and Hidden-Action Considerations 176
   Contracting in Capital Markets 177
   Contracting in Labor Markets 179
   Conflicts Between Risk Sharing and Tax Minimization 180
   Conflicts Between Incentive Contracting and Tax Minimization 180

6.3 Tax Planning in the Presence of Hidden-Information Considerations 181

6.4 Tax Planning and Organizational Design 183

6.5 Conflicts Between Financial Reporting and Tax Planning 185
   Income Shifting Across Time 186
   LIFO/FIFO Studies 187
   LIFO Adoption 187
   LIFO Liquidation 187
   LIFO Abandonment 188
   Regulatory Costs 188
   Asset Purchases, Sales, and Divestitures 189
   Dollar Estimates of Firms' Willingness to Forgo Tax Savings 190
   Political Cost Impediments to Tax Planning 191
   Other Book-Tax Conformity Costs 192
   Other Informational Cost Impediments to Tax Planning 193
CHAPTER 7  The Importance of Marginal Tax Rates and Dynamic Tax-Planning Considerations  202

7.1 Marginal Tax Rate: Definitional Issues  204
   Evidence on NOLs for U.S. Corporations  207
   Estimating Corporate Marginal Tax Rates  208
   Foreign, State, and Local Corporate Taxes  210
   Individual Taxpayers' Marginal Tax Rate  211
   Average and Effective Tax Rates  211
   Problems with Effective Tax Rates  212

7.2 Tax Planning for Low Marginal-Tax-Rate Firms  213

7.3 Adaptability of the Tax Plan  215
   Transaction Costs and Tax Clienteles  216
   Adaptability in Investment and Financing Decisions  217

7.4 Reversibility of Tax Plans  217

7.5 Ability to Insure Against Adverse Changes in Tax Status  219

7.6 Tax Planning When a Taxpayer’s Marginal Tax Rate Is Strategy Dependent  223

Summary of Key Points  224

Appendix 7.1 Medical Savings Plans and Dynamic Tax Planning  226

Discussion Questions  226

Exercises  227

Tax-Planning Problems  229

References and Additional Readings  230

CHAPTER 8  Compensation Planning  233

8.1 Salary versus Deferred Compensation  233
   Employer and Employee Tax Rates Both Expected to Fall  236

8.2 Salary versus Fringe Benefits  237
   Analysis for Taxable Employer  239
   Analysis for Tax-Exempt Employer  239

8.3 Cash Bonus Plans  240

8.4 Stock-Based Compensation Components  240
   Restricted Stock  240
   Employee Tax Rates Expected to Rise  244
   Employee Stock Options and Stock Appreciation Rights  245
Contents

Tax Issues Relating to Incentive Stock Options and Nonqualified Stock Options 247
NQOs versus ISOs 249
Evidence on the Role of Taxes in the Choice of ISOs 252
Disqualifying Dispositions of ISOs 252
The Role of Taxes in the NQO Exercise Decision 254
Backdating Exercise Dates 257
Tax Rates Are Expected to Increase 258
Financial Accounting and Tax Comparison of Restricted Stock, Stock Appreciation Rights, and Stock Options 259
Other Differences Between Restricted Stock and ESOs 262
Compensation in Venture-Capital-Backed Start-Ups 263
Other Influences of Taxes on Compensation Structure 263
Concluding Remarks 264

Summary of Key Points 264
Appendix 8.1 Accounting for the Tax Benefits of Employee Stock Options 267
Appendix 8.2 Backdating Stock Option Grants 278
Appendix 8.3 Incentive Stock Options and Alternative Minimum Tax Complications 282
Discussion Questions 285
Exercises 287
Tax-Planning Problems 290
References and Additional Readings 292

CHAPTER 9 Pension and Retirement Planning 294

9.1 Types of Pension Plans 295
9.2 A Comparison of Salary and Pension Compensation 298
  Rates of Return on Investments In and Out of Pension Accounts 299
  Antidiscrimination Rules 300
9.3 Deferred Compensation versus Pension 301
9.4 The Stocks-versus-Bonds Puzzle 302
9.5 Does It Pay to Maintain an Overfunded Pension Plan? 306
  Advantages and Disadvantages 306
  Empirical Evidence on Determinants of Defined Benefit Plan Pension Funding 309
9.6 Funding Postemployment Health Care Benefits 310
  The Sweetened Pension Benefit Approach 311
  The Pay-as-You-Go Approach 312
  Other Factors Relevant to the Funding Decision 313
9.7 Employee Stock Ownership Programs 314
Summary of Key Points 316
Appendix 9.1 Excise Tax Complications 319
Discussion Questions 320
CHAPTER 10  Multinational Tax Planning: Introduction and Investment Decisions  325

10.1 Overview of Multinational Taxation  326
   Avoiding Worldwide Taxation  328
   Operating as a Branch, Partnership, or a Foreign Subsidiary  329
   Foreign Tax Credits  331
   Subpart F Income and Controlled Foreign Corporations (CFCs)  335
   Inversion Transactions  337

10.2 How Taxes Affect the Location and Structure of Investments  339
   Large Implicit Taxes and Foreign Investment Incentives  343

10.3 The Decision to Repatriate or Reinvest  345
   Subpart F Income and Controlled Foreign Corporations  347
   A Tax Holiday for Repatriations  348
   Investment and Repatriation Policy When the Foreign Tax Rate Exceeds the Domestic Tax Rate  348

Summary of Key Points  349
Discussion Questions  350
Exercises  350
Tax-Planning Problems  351
References and Additional Readings  356

CHAPTER 11  Multinational Tax Planning: Foreign Tax Credit Limitations and Income Shifting  358

11.1 Foreign Tax Credit Limitations and Incentives  358
   Example of Excess FTC Limitation  359
   Example of Excess FTC Credit  361
   Example of FTC with Multiple Subsidiaries  363
   Country-by-Country FTC Limitations  364
   Separate Basket Limitations  364
   FTC Limitations and the Capital Structure of Foreign Subsidiaries  365

11.2 Shifting Income Across Jurisdictions  366
   Transfer Pricing  366
   Source of Income Rules  367

11.3 Attempts to Encourage Exports and/or Domestic Production  368

11.4 U.S. Tax Treatment of Foreign Investors  369
Summary of Key Points  370
Discussion Questions  371
Exercises  371
Tax-Planning Problems  372
References and Additional Readings  374
CHAPTER 12 Corporations: Formation, Operation, Capital Structure, and Liquidation 376

12.1 Corporate Formation 377
12.2 Taxation of Corporate Operations 379
   Book-Tax Differences: Taxable Income versus GAAP Income 380
   Net Operating Losses 381
   Gains and Losses and Tax Basis 381
   Capital Gains and Losses 381
   Section 1231 Assets 382
   Dividends Received Deduction 382
   Consolidated Tax Returns 382
12.3 Possible Tax Benefits of Leverage in Firms' Capital Structures 383
   Theory of the Tax Benefits of Leverage 383
   Empirical Work on the Tax Benefits of Leverage 385
12.4 Debt-Equity Hybrids 386
   Traditional Preferred Stock 386
   Trust Preferred Stock 387
   Zero-Coupon Bonds 390
12.5 Taxation of Distributions and Share Repurchases 392
   The Concept of Earnings and Profits 393
   Special Kinds of Distributions 395
   Taxation of Share Repurchases 396
12.6 Tax Planning Using the Tax Rules for Distributions and Share Repurchases 397
12.7 Taxation of Liquidations 398
   Parent-Subsidiary Liquidations 398

Summary of Key Points 399
Discussion Questions / 400
Exercises 400
References and Additional Readings 402

CHAPTER 13 Introduction to Mergers, Acquisitions, and Divestitures 404

13.1 Overview of Issues 405
   Reasons for Mergers, Acquisitions, and Divestitures 405
   Types of Mergers, Acquisitions, and Divestitures 406
13.2 Major Tax Issues Associated with Mergers, Acquisitions, and Divestitures 407
   Shareholder Tax Liabilities 407
   Effect on Tax Attributes 408
   Target Corporate-Level Tax Effect of the Merger, Acquisition, or Divestiture 409
   Change in the Tax Basis of the Target or Divested Subsidiary Assets 409
   Effect of Leverage on Mergers and Acquisitions 410
13.3 Nontax Issues in Mergers, Acquisitions, and Divestitures 411
13.4 Five Basic Methods to Acquire a Freestanding C Corporation 412
13.5 Four Methods to Divest a Subsidiary or Line of Business 413
13.6 Tax Deductibility of Goodwill and Other Intangible Assets Under Section 197 414
Summary of Key Points 418
Discussion Questions 419
References and Additional Readings 419

CHAPTER 14 Taxable Acquisitions of Freestanding C Corporations 421

14.1 Tax Consequences of Alternative Forms of Corporate Acquisitions 422
Case 1: Taxable Asset Acquisition without a Complete Liquidation of the Target 423
Case 2: Sale of the Target Firm's Assets Followed by a Liquidation 426
Case 3: Purchase of the Target's Stock Followed by a Section 338 Election 427
Case 4: Purchase of the Target's Stock without a Section 338 Election 430
14.2 Comparison of Taxable Acquisition Structures 431
Analysis of Acquiring Firm Indifference Price 436
14.3 Practical Issues Associated with Structuring and Pricing an Acquisition 438
Estimating the Net Tax Basis of a Target's Assets 438
Summary of Key Points 443
Discussion Questions 444
Tax-Planning Problems 445
References and Additional Readings 446

CHAPTER 15 Taxable Acquisitions of S Corporations 447

15.1 Tax Consequences of Taxable S Corporation Acquisition Structures 448
Case 1: Taxable Asset Acquisition 450
Case 2: Taxable Stock Acquisition with a Section 338(h)(10) Election 453
Case 3: Taxable Stock Acquisition without a Section 338(h)(10) Election 455
Which Structure Is Optimal in the Sale of an S Corporation? 456
Advanced Analysis: S Corporation Acquisition 458
15.2 Comparison of the Sale of Similar S and C Corporations 462
Tax Consequences for T1 and T2 Shareholders in a Taxable Stock Sale 464
Tax Consequences for a Corporation 464
Indifference Point for T1's Shareholders (C Corporation) with an Asset Sale Structure 464
Indifference Price for T2's Shareholders (S Corporation) with an Asset Sale Structure 464
Will the Acquirer Pay T1's (C Corporation) Indifference Price in a Taxable Asset Sale? 465
CHAPTER 17  Tax Planning for Divestitures  510

17.1  Subsidiary Sales  511
    Tax-Free Subsidiary Sales  511
    Taxable Subsidiary Sales  513
    Comparison of Taxable Acquisition Structures  518
    Additional Complexities: Subsidiary Sale  524
    Difference Between Subsidiary Sales and Sales of Freestanding C Corporations  526
    Valuation Effects  527

17.2  Tax-Free Divestiture Methods  527
    Equity Carve-Outs  527
    Tax-Free Spin-Offs  529
    Other Variants of the Spin-Off: Split-Ups, Split-Offs, and Tracking Stock  533
    Factors That Influence Divestiture Method Choice  534

17.3  Advanced Divestiture Techniques  534
    Tax-Free Subsidiary Sale Under Section 351 Followed by Secured Borrowing  534
    Derivative-Based Divestiture Techniques  537

Summary of Key Points  538
Discussion Questions  538
Tax-Planning Problems  539
References and Additional Readings  542

CHAPTER 18  Estate and Gift Tax Planning  543

18.1  Fundamentals of Estate and Gift Taxation  546
    Specifics of the Gift Tax  547
    Specifics of the Estate Tax  548
    Generation-Skipping Transfer Tax  550

18.2  Estate- and Gift-Planning Strategies  550
    Making Full Use of the Annual Gift Tax Exclusion  551
    Gifting in Excess of the Annual Exclusion  551
    Using Each Spouse's Unified Credit and Lower Brackets  552
    Using the Marriage Deduction to Defer Estate Taxation  552
    Keeping Life Insurance Out of the Gross Estate  553
    Family Limited Partnerships  554
    Transfers of Knowledge, Information, and Services  555
    Charitable Remainder Trusts and Grantor Retained Trusts  555

18.3  Monetizing Appreciated Assets without Triggering Taxation:
    A Case Study  556
    Taxation of Short Sales  557
    The Strategy  557
    Congress Takes Action  558
    Avoiding the Constructive Sale Rules  559
Contents

18.4 The Tax Subsidy to Charitable Giving 560

18.5 A Model of the Trade-Offs Between Gifting Now versus by Bequest 561

The Trade-Offs Between Gifting and Losing the Step-Up in Basis on Bequests 562

Summary of Key Points 564

Discussion Questions 565

Exercises 565

Tax-Planning Problems 565

References and Additional Readings 567

Glossary 568

Index 585