



Strategic Business Tax Planning

Second Edition

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JOHN E. KARAYAN
CHARLES W. SWENSON



John Wiley & Sons, Inc.

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Contents

ABOUT THE AUTHORS	v
ACKNOWLEDGMENTS	xiii
INTRODUCTION	xv
PART 1	
<hr/>	
Strategic Tax Planning	1
CHAPTER 1	
A Framework for Understanding Taxes	3
How Are Taxes Important in Decision Making?	5
Types of Taxes	8
Basic Principles of Taxation	30
Sources of Tax Laws	35
Important Principles and Concepts in Tax Law	42
SAVANT Framework	56
CHAPTER 2	
Using the SAVANT Framework to Guide Tax Planning	61
Strategy	63
Anticipation	66
Value-Adding	72
Negotiating	83
Transforming	85
Putting It All Together: SAVANT Concepts Illustrated	87
PART 2	
<hr/>	
Forming the Enterprise	93
CHAPTER 3	
Choosing a Legal Entity: Risk Management, Raising Capital, and Tax Management	95
Strategy	100
Anticipation and Timing Issues	106

Value-Adding	108
Negotiating	110
Transforming	112
Putting It All Together: Applying SAVANT to Entity Choice	116
Specialized Legal Forms	118
CHAPTER 4	
Financing a New Venture	125
Internal Financing	126
External Financing: Debt versus Equity	129
PART 3	
Operating the Firm	153
CHAPTER 5	
New Products: Development, Promotion, and Advertising	155
New Products and Product Improvement	155
SAVANT and Research and Development	175
CHAPTER 6	
Attracting and Motivating Employees and Managers: Company and Employee Tax Planning	179
Executive Compensation	180
Nonexecutive Employee Compensation	182
Perquisites	189
Pension and Profit-Sharing Plans	191
Current and Deferred Compensation	195
Limits on Deductibility on Executive Compensation	195
Stock Options	196
Management Bonus Plans	202
Financial Statement/Finance versus Tax Strategy Trade-Offs	204
Putting It All Together: Applying SAVANT to Executive Compensation	206
CHAPTER 7	
Market Penetration: Operating in Different States	213
General Principles of State and Local Taxation	216
Planning with Income Taxes: Manipulation of Plant, Workforce, and Point-of-Sale Locations	217

Location Choice: Sourcing versus Production Platforms	228
Distribution: Planning for Sales and Use Taxes	230
Lobbying and Tax Abatements	235
Trade-Offs with Local Tax Incentives: Infrastructure, Government Costs/Subsidies, and Other Local Costs	237
Putting It All Together: SAVANT Applied to Market Penetration in Other States	237
CHAPTER 8	
Market Penetration: Company and Employee Tax Planning for Operating in Foreign Countries	241
Some Basics on U.S. Taxation of Overseas Operations	241
Some Basics on Taxation by Countries Other than the United States	244
Tax Treaties	245
Effective Tax Management	247
Putting It All Together: Penetrating Foreign Markets from a SAVANT Perspective	263
CHAPTER 9	
Operations Management	269
Production Design and Process Selection	269
Inventory: Methods of Accounting and Includable Amounts	273
Strategic Capacity Planning: Plant versus People	283
Putting It All Together: Operations Management from a SAVANT Perspective	289
CHAPTER 10	
Financing Ongoing Operations and Tax Planning	293
Operating Earnings	294
Sale of Operating Assets	294
Sale of Investments	296
Short-Term Borrowing	298
Accounts Receivable	299
Decrease in Dividends	300
Stock Dividends	302
Stock Buybacks	303
Using Employee Stock Ownership Plans	305
Receipt of Dividends from Subsidiaries	306
Putting It All Together: Financing Ongoing Operations from a SAVANT Perspective	312

CHAPTER 11**Capital Budgeting 319**

Fixed Asset Acquisition	319
Analysis from a SAVANT Perspective	324
Putting It All Together: SAVANT Concepts Applied to Capital Budgeting	332
Make or Buy Decisions	334
Capital Budgeting and Plant Capacity	338
Risk Considerations	343

CHAPTER 12**Financial Statement Analysis and Proactive Tax Planning 347**

Segmental Analysis	347
Other Tax Aspects in Segmental Analysis	350
Strategic Analysis: Using Competitor's Tax Note and Segmental Data	356

PART 4**Changing Original Form 367****CHAPTER 13****Restructuring 369**

Financial Restructuring	369
Financial Restructuring in the SAVANT Framework	372
Business Restructuring	375
Legal Entity Restructuring	376
Divestitures in the SAVANT Framework	382
Selling Off Parts of the Business	383
Selling a Business to an Outside Entity	384

CHAPTER 14**Mergers and Acquisitions 391**

Some General Tax Rules	393
Tax-Free Mergers and Acquisitions	393
Statutory Mergers and Consolidations	395
Taxable Mergers and Acquisitions	402
Tax Planning and Acquisition Costs	405
Allocating Purchase Price	406
Financial Accounting Trade-Offs	406
Maximizing Tax Benefits	407

Leveraged Buyouts	411
Sources of Merger and Acquisition Finance	412
Defensive Strategies	415
Merger and Acquisition Activity and Scrutiny by Tax Authorities	416
Putting It All Together: Merger and Acquisition from a SAVANT Perspective	417
CHAPTER 15	
Other Topics in Changing Original Form	421
Use of Flow-Through Entities for Divestitures	421
Use of Flow-Through Entities for Acquisitions	425
Liquidations	426
Buying a Subsidiary for Its Assets	432
Fighting Off Takeover Attempts with ESOPs	437
Bankruptcies	439
APPENDIX A Basic Tax Research Skills	441
Steps in the Research Process	441
Sources of the Law	441
Getting Answers to Simple Questions	443
APPENDIX B Present Value Analysis: Lump Sums	445
Annuities	447
Uneven Cash Flows	449
INDEX	451

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John E. Karayan
Charles Swenson

Introduction

This book shows managers the principles of tax management and how to apply them to everyday situations to enhance shareholder value. The book also shows professional advisors how to become more effective consultants and investors how to better analyze financial statements. (It also is used as a text in several leading MBA programs and law schools).

Taxes are important to know but hard to learn. The devil is in the details. But managers and investors do not need to know the details. They just need to be aware of the fundamental principles of taxation and how to apply them when making decisions.

Even this is no simple task. We have tried to do this in two steps. First, over 50 years of hard-earned professional experience have been distilled into an innovative framework that organizes tax principles and their applications. This framework helps nontax specialists see tax-savings opportunities and also helps managers to apply tax principles to make better decisions.

To make it easier to use, this analytic framework is called SAVANT. (A savant is an exceptionally knowledgeable person.) This is an acronym for how tax planning fits into business decisions: through Strategy, Anticipation, Value-Adding, Negotiating, and Transforming.

After explaining and illustrating how SAVANT works, we show how managers can apply this framework to typical business transactions. These applications are illustrated with numerous examples drawn from real life in the marketplace. To make them more usable, the transactions are organized around a venture's typical life cycle.

The *value-adding* and *financial reporting* effects of tax management are emphasized throughout the book. Each chapter provides a general discussion appropriate to managers. Greater detail is presented in sections called Tax Management in Action and Technical Inserts.

APPLYING SAVANT TO MAXIMIZE SHAREHOLDER VALUE

SAVANT is used throughout this book to show nontax specialists how to critically analyze situations to generate tax-savings opportunities. SAVANT works in this way: To add maximum value to each transaction, decision makers need to stay focused on the firm's strategic plan, anticipating tax impacts across time for all parties affected by the transaction. Managers *add value* by considering these impacts when *negotiating* the most advantageous arrangement, thereby *transforming* the tax treatment of items to the most favorable status. Expert managers (and consultants) use these concepts, derived from economic policy and tax law, to maximize shareholder value.

WHY MANAGERS NEED TO KNOW THE PRINCIPLES OF TAX PLANNING

Reducing taxes is beneficial, but why should managers learn the basics of tax planning? It may seem obvious at first glance, especially to the owner-manager or corporate entrepreneur. But this is an important question, which can be answered differently at different times, in different organizations, and for operations in different countries.

Managers need to learn about taxes because optimizing a venture's total tax burden is important to its success, and managers are the main decision makers in an organization. Knowing the fundamentals of taxation and how to apply them allows managers to make better decisions and thus be more effective in their jobs. Managers who are able to identify tax issues can also make more effective use of tax consultants, because these managers can recognize a problem when it arises and advise consultants of the trade-offs involved.

Taxes impact success because operational decisions are generally based on the risk-adjusted net present value of expected *after-tax* cash flows. In addition, federal and local income taxes, payroll (e.g., Social Security), sales (e.g., value-added, goods and services, or gross receipts), and property taxes often add up to one of the largest expense items of an organization. Furthermore, tax payments typically have a high legal priority claim on an organization's cash flow.

That is, not only can taxes be a big expense, but they must also be paid, and paid quickly.

Multinational businesses that are publicly traded in U.S. capital markets can be especially sensitive to tax expense. This is because earnings (which usually have a major impact on stock prices) must be reported on an after-tax basis. Indeed, not only must earnings be reduced by taxes paid in the current year, but earnings must also be reduced by any expected *future* income taxes generated by such earnings. Because senior managers' compensation is often tied to earnings via stock prices (e.g., through stock options), key decision makers in multinational organizations often have a high personal stake in optimizing taxes.

SAVANT BALANCES THE BENEFITS WITH THE COSTS OF TAX PLANNING

All in all, there are many factors that combine to motivate managers of organizations to seek to reduce taxes, provided the cost of doing so is not too high. This is because tax planning requires making changes, and doing so is not cost free, nor are the rewards certain. First, the details of taxation are hideously complex. Second, the cost of complying with tax rules (e.g., preparing tax returns and providing details requested by tax auditors) can be significant. Not only can it be costly to figure out how much to pay but also who to pay and when to pay.

Such costs can be particularly high for cross-border activities, which can involve a multitude of different tax jurisdictions imposing different taxes. In addition, similar taxes are often imposed by different jurisdictions using similar but different basic definitions. This raises the specter of multiple taxation (e.g., the same income effectively being taxed at rates exceeding 100%), although governments typically try to avoid this situation through tax treaties and special adjustments, such as the U.S. foreign tax credit.

Finally, although income and payroll taxes may be the province of headquarters staff, and thus savings may not directly affect a divisional manager's annual performance bonus, other taxes almost always do. This is because these taxes are normally charged to strategic business units and thus reduce their individual bottom lines.

Not every idea that saves taxes is a good one. The SAVANT framework helps managers make better decisions because it balances the benefits of tax planning with the costs of doing so.

GOALS OF TAX PLANNING

Most people think that minimizing taxes should be the goal of tax planning. This is shortsighted, because taxes are only one factor, albeit a major one, in the mix of costs and other factors that generate the amounts most often taxed: profits and wealth. Put simply, one can avoid many taxes by neither earning a living nor owning property, but most people do not aspire to a life of poverty, however tax free it is. Furthermore, strategies that reduce taxes are rarely cost free. If nothing else, when focusing on saving taxes, managers are not focusing on increasing sales, improving product quality, or producing goods and services more efficiently. The SAVANT framework recognizes this by striving toward *optimizing* taxes rather than *minimizing* them. The goal is to balance the benefits against the risks and costs.

Tax strategies are also risky: Changing operations to save taxes (e.g., by operating through multiple corporations) often results in an increase in long-term administrative costs and generates uncertain returns because tax laws can change (and, as the past 20 years have demonstrated in the United States, change can occur dramatically, rapidly, and unpredictably), and tax rules themselves are all too often obscure at best.

In cross-border transactions, the interactions of multiple taxes imposed by different jurisdictions also must be appreciated. Also, tax-savings strategies can be intrusive. Why is it, for example, that profitable businesses in the Los Angeles area, a relatively high-tax location, do not all move to Las Vegas, a very-low-tax location? One reason is that it is costly to move. Another is that nontax factors dominate the decision: Many business owners simply want to live in southern California rather than southern Nevada. Yet another reason is that skilled labor, qualified subcontractors, and competitive suppliers are plentiful in southern California, as are (perhaps more important) customers.

GENERIC TAX-PLANNING STRATEGIES

Thus, even though total elimination of taxes is not a goal, people and organizations often invest significant amounts of time and resources in implementing tax-reducing strategies. The ultimate goal is to reduce taxes while not excessively intruding on the organization's overall operations. SAVANT explicitly recognizes this.

SAVANT also illustrates that tax strategies are usually based on taking advantage of either the time value of money (e.g., paying taxes later) or differences in tax rates (i.e., tax-rate arbitrage). As already noted, tax arbitrage is typically behind artificial transfer pricing schemes, that is, using accounting entries to shift profits to jurisdictions that impose the lowest net taxes (i.e., the lowest tax costs relative to the benefits received by operating in a particular jurisdiction—e.g., free medical care for all people, including a firm's employees).

Tax savings strategies usually fall into one of four types: (1) creation, (2) conversion, (3) timing, and (4) splitting. *Creation* involves plans that take advantage of tax subsidies, such as moving an operation to a jurisdiction that imposes lower taxes. For example, during the past 25 years, many engineering and entertainment firms have fled the city of Los Angeles, which imposes a gross receipts tax, and moved to the relatively tax-free city of Pasadena, which is located just a few miles away.

Conversion entails changing operations so that more tax-favored categories of income or assets are produced. For example, advertising in order to sell inventory results in ordinary income, which is usually taxed immediately and at the highest rates. However, equally successful *image* advertising generates an increase in a firm's goodwill, which is not taxed until the goodwill is sold, if at all, and then would likely be taxed at lower capital gains rates.

Timing involves techniques that move amounts being taxed (also called the tax base) to more favorable tax-accounting periods. A good example is accelerated depreciation, which allows more of an asset's cost to be a tax-deductible expense in early years, thus deferring the payment of taxes until later. Another example is an individual retirement account (IRA).

Splitting techniques entail spreading the tax base among two or more taxpayers to take advantage of differing tax rates. For example,

the top U.S. income tax rate on individuals is 35%, but the standard tax rate on the first \$50,000 of corporate income is only 15%. Incorporating a sole proprietorship generating \$200,000 in profits and paying a \$150,000 salary (provided it is reasonable) to the proprietors is a splitting strategy that saves \$12,500 (i.e., 25% of \$50,000 split off and moved into the corporate tax return) of income taxes each year.

Taxes can also be avoided through fraud, which is fairly widespread throughout the world outside of the United States but relatively small for noncriminal activities within the United States. Those favoring fraud as a strategy generally need not read books like this.

TAXATION: A GLOBAL PERSPECTIVE

For many reasons, people and organizations are increasingly operating in multiple locations and competing in global markets. All of these locations and markets have tax consequences that can be managed through proper planning. For example, a French firm may have two manufacturing facilities—one in Ohio, the other in Singapore. The former sells in all 50 states, the latter in Southeast Asia. Federal income taxes will be due on net taxable income from U.S. operations; Singapore, and perhaps other Asian countries to which sales are made, may also assess income taxes. Property taxes will be due in Singapore, California, and Ohio; use taxes will be due in many of the 50 states.

How can such a complex tax setting be managed? Not easily. But if every important transaction is guided by critical analysis triggered by the SAVANT framework in conjunction with a periodic environmental scanning, then organization-wide, global tax management will occur.

WHY DO YOU NEED THIS BOOK?

In sum, taxes can affect the results of a wide variety of decisions, ranging from those made for organizations in which people toil to very personal decisions, such as marriage. Sometimes tax considerations are paramount. More often they are important but not dominant.

Rather than always trying to minimize taxes, a wise decision maker seeks to optimize tax impacts by balancing expected tax burdens against the costs of reducing them plus the many nontax factors that often are more important in making the best decisions.

Because tax rules are often complex, unclear, and uncertain, even the finest tax experts do not know all of the rules. Instead of trying to help readers learn all of the rules, this book helps managers acquire a critical mass of tax knowledge. Then, using the SAVANT framework, managers can trigger consideration of key tax issues and find and use tax rules to make better decisions in their business, public, and private lives.

PART **1**

Strategic Tax Planning

A Framework for Understanding Taxes

The claim that information would define the future reminded me of the famous party scene in the 1967 movie The Graduate. A businessman buttonholes Benjamin, the college graduate played by Dustin Hoffman, and offers him a single word of unsolicited career advice: “plastics.” I wondered whether, if the scene had been written a few decades later, the businessman’s advice would have been: “One word, Benjamin: ‘information.’”

—Bill Gates, *The Road Ahead*

How much do taxes touch us? Think about what people do every day. Buy a cup of coffee, and some sort of sales tax is almost always in what you pay. Make a telephone call, and most likely there is an excise tax. Earn wages, and a significant portion usually must be withheld for payroll taxes. Make money trading stocks over the Web, and a large percentage of the profits likely will be lost to income taxes.

As this thought experiment suggests, taxes are everywhere, embedded in every transaction. To check this, run a Web search on the word *taxes*. Consider the sheer number of hits generated. Then run the search again on the Web site of a national newspaper (such as www.nytimes.com or www.economist.com). How many articles discuss taxes? Finally, explore one of the gateway Web sites in taxation, such as www.taxsites.com or www.taxworld.org. (As you may already know, a gateway is site that consists primarily of links to other Web sites. Gateways are particularly handy for keeping track of the constant changes in Web addresses and for finding new sites.)

Be sure to look at the Web site for the U.S. Internal Revenue Service (IRS), www.irs.gov. This was one of the first major sites for a governmental agency and is one of the most heavily used. Browse the various publications available there. How many are there? Look for tax calculators, such as www.denvertax.com, and free tax return preparation sites, such as those found at www.taxsites.com/software.html. Finally, take a look at tax policy sites, such as the one devoted to the history of taxation found at www.uic.edu/depts/lib/collections/govdocs/tax/taxhistory.html, or the “Hot Topics in Taxation” page of the University of Michigan’s Office of Tax Policy Research at www.bus.umich.edu/OTPR/whatotpr.htm. A list of similar sites can be found at www.taxsites.com/academia.html.

One reason that taxes seem to be everywhere is that they are a price paid for government. Not the total price: To some extent (and in many ways, both directly and indirectly), governments support themselves by charging users for specific services provided. For example, some local governments charge a monthly fee to owners of residences that are hooked up to municipal sewer systems. However, governments are primarily financed through taxation.

Taxes are charges not directly related to goods or services provided by a government that are imposed on people and organizations located within a government’s legal reach. In many locations, a multitude of governments and their subdivisions—ranging from cities to nations, school districts to metropolitan rapid transit districts—levy a myriad of taxes on a wide variety of activities, such as income taxes on business profits, property taxes on wealth, value-adding taxes on purchases, and payroll taxes on compensation.

Some taxes are periodic. For example, payroll taxes on employees are usually withheld from each paycheck, and income taxes are typically based on one year’s earnings. Other taxes are generated if, and only if, certain transactions occur. For example, sales taxes are usually triggered by the retail sales of goods, and inheritance taxes may arise when title to property is passed to a person’s heirs. (For more information on these and other topics, check Web sites, such as www.taxsites.com. For current details, such tax rate schedules, try the tax authority’s Web site. If U.S. federal taxes are of interest, go to www.irs.gov, click on “Forms and Publications,” click on “Search for a Form or Publications,” and input the term in which you are interested into the search engine.)

The primary purpose of most taxes is to raise revenue to finance governments. But because taxes impose costs on transactions, taxes affect human behavior, and thus can be (and are) used by governments to try to shape society. Indeed, the primary purpose of some taxes—such as excise taxes on the sale of machine guns, tobacco, and pollutants—is to further social engineering goals.

Taxes seem to be everywhere, and are triggered by a bewildering array of activities. Taxes also impose significant costs, which can be reduced by changing one's behavior. Thus, planning for taxes can be important in making good financial decisions.

HOW ARE TAXES IMPORTANT IN DECISION MAKING?

Sometimes taxation, and thus tax planning, is one of the most important factors in decision making. Consider the following scenario. Your best friend, who lives in New York City, e-mails you with the news that she has just inherited a large amount of cash. She asks for your help in investing it in mutual funds, which primarily hold bonds. Look in a financial newspaper or Web site that shows the current earnings of various bond funds. Pick five at random, and calculate their average yield. Now do the same for five that have the words "tax exempt" or "municipal" in their names. (For the uninitiated, this means that these funds invest primarily in bonds issued by U.S. states and local government agencies. Interest paid on such securities typically is exempt from U.S. income tax and can be exempt from state income taxes, as well.) What is the difference in the average yields of the first set of mutual funds and those that are tax exempt? Could a significant part of this difference be accounted for by tax effects?

Tax planning can affect decision making in even the most commonplace of settings. Consider the case of a typical homeowner whose annual property tax payment must be paid before January of the following year. Income tax typically is tax based on net income—that is, taxable revenues less their tax-deductible expenses—for each calendar year. Assume that the property tax is a deductible expense and that the homeowner's marginal tax rate is 28%. (This means that every dollar of additional income results in \$.28 in additional tax. Similarly, every dollar of tax-deductible expense saves \$.28 in taxes.)

If homeowners pay the property tax in December, they will get a tax deduction for the current year. The tax benefit is delayed a year, however, if they wait until January to pay. Thus, simply paying this deductible expense a few days earlier can generate tax savings a year earlier. This simple bit of planning results in tax benefits through *timing*, an important component of strategic tax planning. (For an excellent, albeit conservative, overview of the U.S. income tax on individuals, download the current version of the IRS's Publication 17, *Your Federal Income Tax*, from the IRS Web site at www.irs.gov. Included are the current tax rate schedules, personal and dependency exemption amounts, various thresholds for the phase-out of a variety of tax benefits for higher-income taxpayers, and the amounts for standard deductions. All of these, and many other details, change annually. Many specific amounts are indexed annually for inflation. They also may be changed, for various reasons, by tax legislation. Also included in Publication 17 are good cross references to more detailed publications on other tax topics. These range from Publication 334, *Tax Guide for Small Business*, to Publication 542, *Corporations*.)

Tax planning often represents a significant part of doing business. In some cases, taxes are one of the most important aspects in structuring a transaction. Consider Tax Management in Action 1.1.

This case study illustrates just how important taxes can be in a business transaction. DuPont was able to capture part of Seagram's tax savings by negotiating a lower price for the stock it bought back, and Seagram was able to transform what would have been a taxable transaction (had the DuPont stock been sold on the open market) into a largely tax-free transaction by using the tax law. Moreover, the transaction was motivated by strategic plans of both firms: Seagram, for example, wanted to acquire MCA for strategic business reasons. The decision to sell the stock was motivated by the strategic decision to purchase MCA; only the form—a stock redemption by DuPont of its own shares—was motivated by tax savings. This example shows how good tax planning can *add* significant value to a transaction. Although transactions typically do not have such dramatic tax effects, the example illustrates how a transaction can have an important tax component.

Taxes are only one of the many factors that people and organizations consider when making decisions. In some cases, taxes are a