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Lecture
Taxes and Business Strategy

General hints:

- A pocket calculator is permitted as a tool.
- Prepare both exercises!

Exercise 1: (30 points)

a) What is the difference between a direct foreign tax credit and an indirect (deemed paid) foreign tax credit? **(8 points)**

b) A company is planning to form a foreign subsidiary to undertake a profitable project in a country where the tax rate is 20 %. The company's domestic-tax rate is 40 %.

(1) If the withholding tax rate on dividends paid from the foreign country to the native country is 20 %, how much domestic income will be recognized for each dollar of dividends received by the parent-company? **(10 points)**

(2) Assuming this income is only foreign-source income for the company. What will be the additional tax liability after foreign tax credit for each dollar of dividend received? Suppose the parent company forms a foreign branch, will your solution be the same? **(12 points)**

Exercise 2: (30 points)

a) Calculate the rate of return after taxes for a zero-bond, purchase price 120 $, duration 5 years, interest 45 $. **(8 points)**

Hint: Use the Baldwin method, assume a personal tax rate of 40%.

b) A taxpayer capitalizes a wholly owned corporation with 50,000$. The corporation invests in a project that earns an annual cash flow of 15.000$ and faces a 20% corporate tax rate. The taxpayer faces a personal tax rate of 40% and expects to liquidate the corporation after 5 years. What is the amount of taxes the taxpayer has to pay for the liquidation? **(14 points)**

Hint: Assume that there is no depreciation up to the time of liquidation. The market interest rate for reinvesting is 5% before taxes.

c) Assume a corporate tax rate of 25% and a personal tax rate for dividends of 20%.

(1) If the shareholders want to receive a rate of return net of taxes of 6%. What is the rate of return **before** taxes (cost of capital) the corporation has to earn? **(5 points)**

(2) If Interest payments are completely tax deductible for the corporate tax base. What is the personal tax rate for interest payments which makes the corporation indifferent between debt and equity financing? **(3 points)**