

# PRINCIPLES OF Finance



SCOTT BESLEY 6E EUGENE F. BRIGHAM

## Chapter 6

### Business Organizations and the Tax Environment

Besley & Brigham

# Chapter 6 – Learning Objectives

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- ✓ Describe the different forms of business organization, and give the advantages and disadvantages of each.
- ✓ Discuss the goal(s) that firms should pursue and whether firms always pursue appropriate goals.
- ✓ Discuss the role of ethics in successful businesses.
- ✓ Explain why it is important for a business to have a clear corporate governance policy.
- ✓ Explain how foreign firms differ from U.S. firms.
- ✓ Explain why it is important to consider taxes when making financial decisions.

# Alternative Forms of Business Organization

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✓ **Proprietorship** - unincorporated business owned by **one individual**

✓ Advantages

- ✓ Easy and inexpensive to form
- ✓ Subject to few government regulations
- ✓ **Taxed like an individual**

# Alternative Forms of Business Organization

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## ✓ Proprietorship

### ✓ Disadvantages

- ✓ Proprietor has **unlimited *personal liability*** for business debts
- ✓ Life of proprietorship is limited to time the creator owns it
- ✓ **Transferring ownership can be difficult**
- ✓ **Difficult for proprietorship to obtain large sums of capital (funds)**

# Alternative Forms of Business Organization

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✓ **Partnership** - unincorporated business owned by **two or more persons**

✓ Advantages

- ✓ Easy and inexpensive to form
- ✓ Subject to few government regulations
- ✓ **Taxed like an individual**

# Alternative Forms of Business Organization

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## ✓ Partnership

### ✓ Disadvantages

- ✓ Partners have **unlimited personal liability** for business debts
- ✓ Life of partnership is limited to time the same group of partners owns it
- ✓ **Transferring ownership can be difficult**
- ✓ **Difficult for partnership to obtain large sums of capital** (funds); but better than for a proprietorship

# Alternative Forms of Business Organization

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- ✓ **Corporation** - legal entity created by a state
  - ✓ Advantages
    - ✓ Separate and distinct from its owners
    - ✓ Unlimited life
    - ✓ Easy transferability of ownership; stock represents ownership
    - ✓ **Limited liability**
    - ✓ Easier for corporations than for proprietorships and partnerships **to raise money in the financial markets; can issue stocks and bonds**

# Alternative Forms of Business Organization

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- ✓ **Corporation** - legal entity created by a state
  - ✓ **Disadvantages**
    - ✓ **Setting up and filing state and federal reports is complex**
      - ✓ Corporate charter is filed with the state providing information about the company and directors
      - ✓ Bylaws are for internal management and operating procedures
    - ✓ Earnings are subject to **double taxation**

# Alternative Forms of Business Organization

## – Hybrid Businesses

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- ✓ Limited liability partnership (LLP)
  - ✓ A partnership form of business that provides for **limited liability** for some partners
  - ✓ At least one partner must be a general partner who **is personally responsible for all of the firm's liabilities**

# Alternative Forms of Business Organization

## – Hybrid Businesses

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- ✓ Limited liability company (LLC)
  - ✓ Provides for limited liability for owners
  - ✓ Taxed like a partnership
  - ✓ Flexible ownership structure

# Alternative Forms of Business Organization

## – Hybrid Businesses

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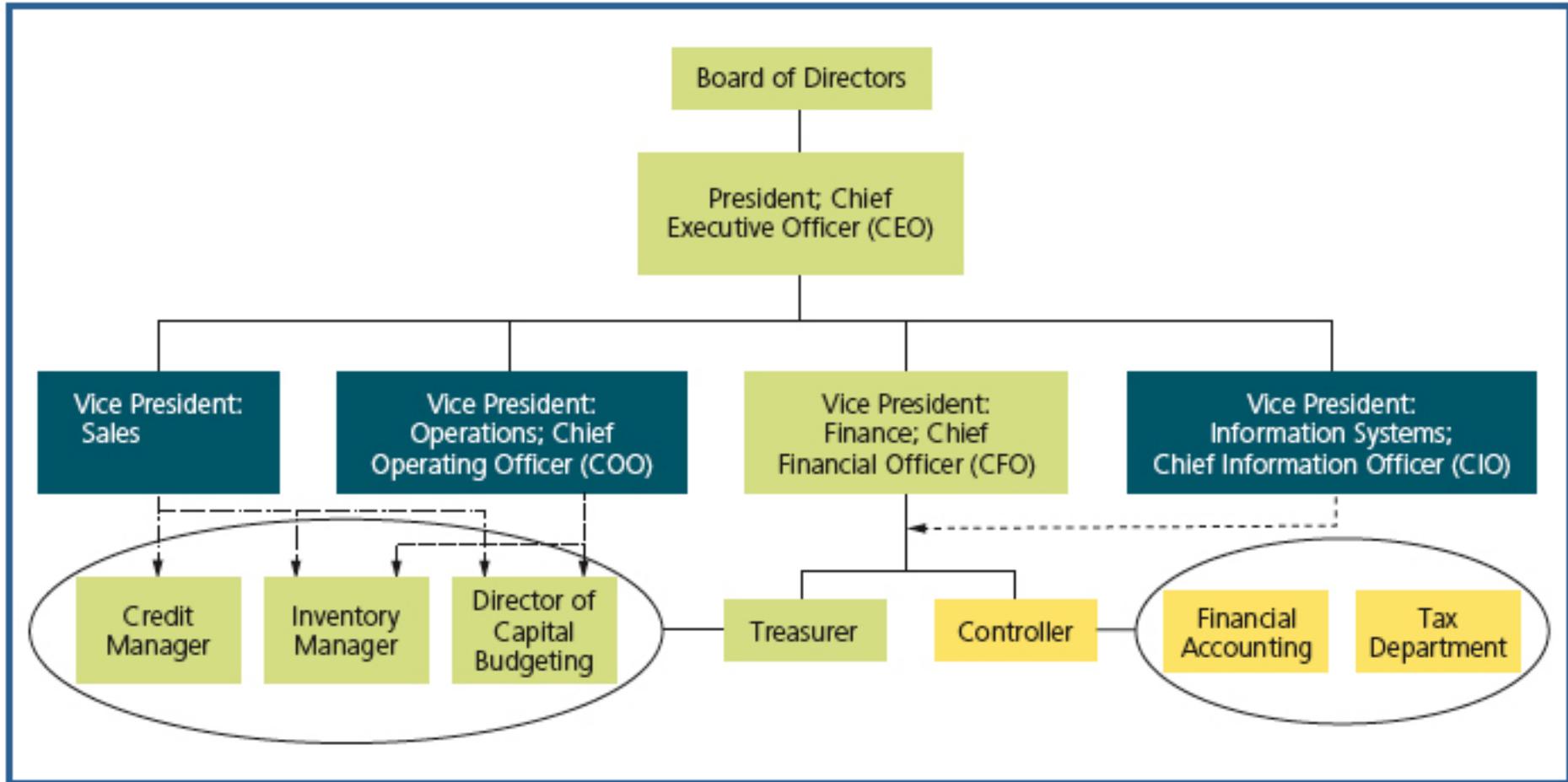
- ✓ S Corporation
  - ✓ 100 or fewer stockholders
  - ✓ Only one kind of stock
  - ✓ Can choose to be taxed like a partnership

# Why Organize as a Corporation?

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- ✓ Value of the business will be maximized:
  - ✓ **Limited liability** reduces risks borne by investors
  - ✓ Corporations can **attract funds more easily** than unincorporated businesses
  - ✓ **Corporate ownership can be transferred more easily** than unincorporated businesses

# Finance in the Organizational Structure of the Firm



# The Goals of the Corporation

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- ✓ **Stockholder wealth maximization**
  - ✓ Considers the risk and timing associated with expected cash flows **to maximize the price of the firm's common stock**

# The Goals of the Corporation

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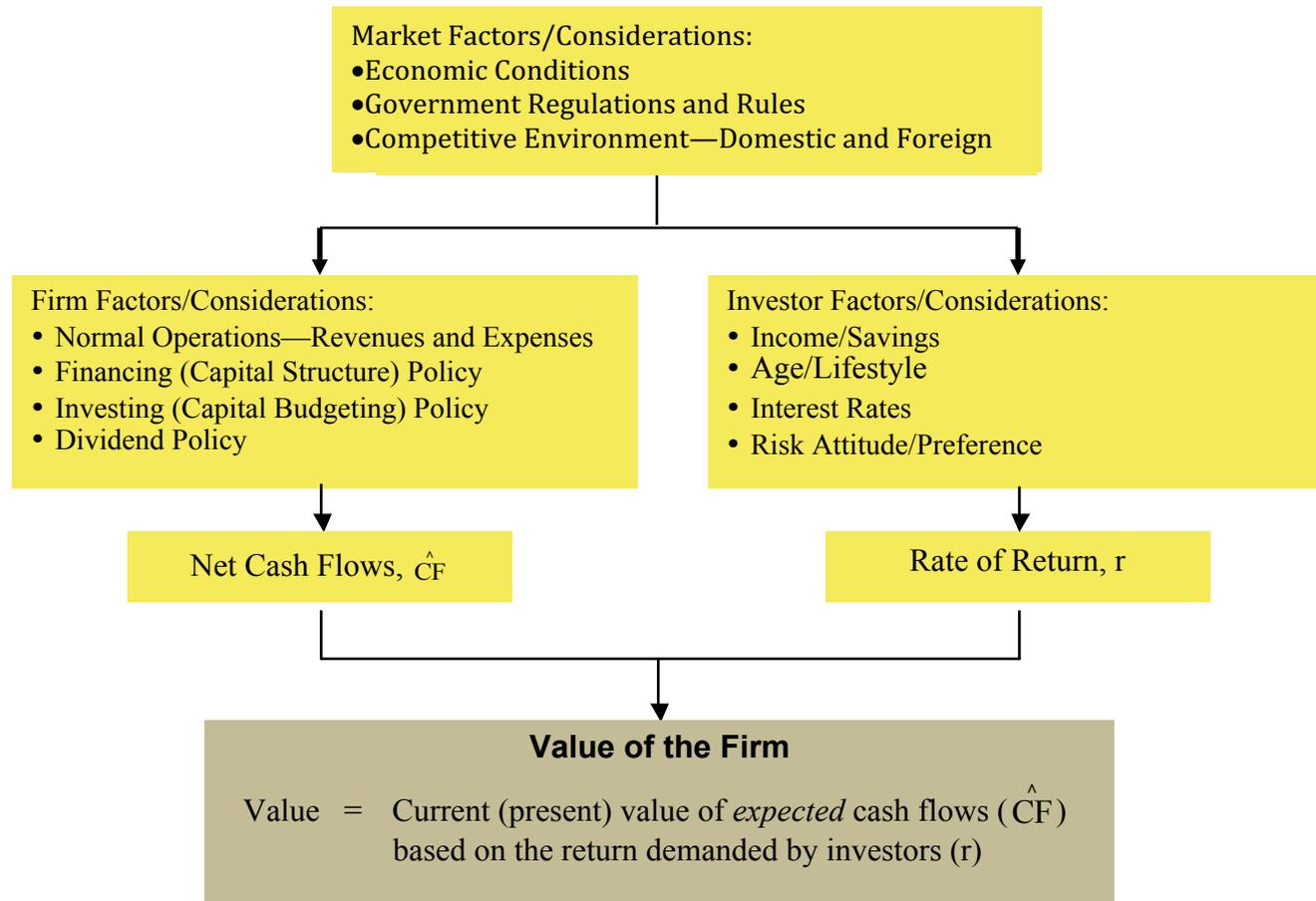
- ✓ Stockholder wealth maximization
- ✓ Managerial incentives to maximize shareholder wealth
- ✓ **Social responsibility**
- ✓ Stock price maximization and social welfare

# Managerial Actions to Maximize Shareholder Wealth

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- ✓ Profit Maximization
  - ✓ Will profit maximization also result in stock price maximization?
  - ✓ **Not necessarily, because profit maximization does not always consider:**
    - ✓ Timing of earnings/cash flows
    - ✓ Risk of cash flows

# Value of the Firm



# Agency Relationships

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- ✓ Owner/principal hires an agent and delegates decision-making authority to that agent to act on behalf of the principal
- ✓ Problem exists when there are conflicts of interest between stockholders and
  - ✓ Managers
  - ✓ Creditors

# Stockholders versus Managers

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- ✓ Managerial compensation
  - ✓ Performance shares
  - ✓ Executive stock options
- ✓ Shareholder intervention
- ✓ **The threat of hostile takeover**
  - ✓ Due to underpriced stock
    - ✓ Caused by poor management

# Stockholders versus Creditors

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- ✓ Creditors lend at rates based on:
  - ✓ **Riskiness** of the firm's existing assets
  - ✓ **Expectations** concerning the riskiness of future asset additions
  - ✓ The firm's existing **mix of financing** (capital structure)
  - ✓ Expectations concerning future capital structure changes (amount of debt)
- ✓ Stakeholders must be treated fairly

# Business Ethics

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- ✓ **Company's attitude** and conduct toward its stakeholders (employees, customers, stockholders...)
- ✓ Ethical behavior requires **fair and honest** treatment toward all parties

# Business Ethics

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- ✓ Sarbanes-Oxley Act, 2002
  - ✓ Corporation must:
    1. Have a committee of outside directors to oversee audits
    2. Hire an external auditor
    3. Provide information about procedures used to construct financial statements

# Business Ethics

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- ✓ A firm with good ethics
  - ✓ Avoids fines and legal expenses
  - ✓ Builds public trust
  - ✓ Attracts business from customers who appreciate and support the firm's policies
  - ✓ Attracts and keeps employees of the highest caliber
  - ✓ Supports the economic viability of the communities in which it operates

# Corporate Governance

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- ✓ The “set of rules” that a firm follows when conducting business
- ✓ Should provide stakeholders with an understanding of :
  - ✓ How executives run the business
  - ✓ Who is accountable for important decisions

# Forms of Businesses in Other Countries

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- ✓ Most foreign companies are more “closed,” meaning they have fewer owners, than similar-sized U.S. companies

# Forms of Businesses in Other Countries

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- ✓ Companies in other countries might be called
  - ✓ Public limited company (PLC)
  - ✓ Aktiengesellschaft (AG)
  - ✓ Sociedad Anónima (SA)
  - ✓ Industrial groups
    - ✓ Keiretsu
    - ✓ Chaebol

# Multinational Corporations

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- ✓ Operate in more than one country
  - ✓ To seek **new markets**
  - ✓ To seek raw materials
  - ✓ To seek new technology
  - ✓ To seek **production efficiency**
  - ✓ To avoid political and regulatory hurdles

# Multinational versus Domestic Managerial Finance

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- ✓ Different currency denominations
- ✓ Economic and legal ramifications
- ✓ Language differences
- ✓ Cultural differences
- ✓ Role of governments
- ✓ Political risk

# The Federal Income Tax System

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- ✓ U.S. Federal Tax Code includes two sections:
  - ✓ Section applicable to individuals
  - ✓ Section applicable to corporations

# Individual Income Taxes

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- ✓ **Progressive tax:** higher tax on higher incomes
- ✓ **Taxable income** is gross income minus exemptions and allowable deductions
- ✓ **Marginal tax rate** is the tax on the last unit of income
- ✓ **Average tax rate** is taxes paid divided by taxable income

# Individual Tax Rates 2014

## Single Taxpayer

Taxable Income Bracket	Base Tax Amount	Plus This Percentage of the Amount Over	Average Tax Rate at the Top of the Bracket
\$ 1 – \$9,075	\$ 0.00	+ 10.0% \$ 0	10.0%
9,076 – 36,900	907.50	+ 15.0 9,075	13.8
<b>36,901 – 89,350</b>	5,081.25	+ <b>25.0</b> 36,900	20.4
89,351 – 186,350	18,193.75	+ 28.0 89,350	24.3
186,351 – 405,100	45,353.75	+ 33.0 186,350	29.0
405,101 – 406,750	117,541.25	+ 35.0 405,100	29.0
406,751 –	118,118.75	+ 39.6 406,750	39.6

## Married Taxpayer

Taxable Income Bracket	Base Tax Amount	Plus This Percentage of the Amount Over	Average Tax Rate at the Top of the Bracket
\$ 1 – \$18,150	\$ 0.00	+ 10.0% \$ 0	10.0%
18,151 – 73,800	1,815.00	+ 15.0 18,150	13.8
73,801 – 148,850	10,162.50	+ 25.0 73,800	19.4
148,851 – 226,850	28,925.00	+ 28.0 148,850	22.4
226,851 – 405,100	50,765.00	+ 33.0 226,850	27.1
405,101 – 457,600	109,587.50	+ 35.0 405,100	28.0
457,601 –	127,962.50	+ 39.6 457,600	39.6

# Taxes on Interest Income

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- ✓ **Interest income** received by individuals from investments is **added to other income and taxed**
- ✓ Interest on most state and local government bonds (**municipals**) is **not subject to federal income taxes**

# Comparing Yields Tax-free and Taxable

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Equivalent pre-tax yield on a taxable investment =  $\frac{\text{Yield on tax-free investment}}{1 - \text{Marginal tax rate}}$

A taxpayer in the 25% marginal tax bracket who could buy a municipal bond that yields 6% would have to receive a before-tax yield of 8% on a corporate or U.S. Treasury bond to receive the same after-tax yield.

$$= \frac{6\%}{1 - 0.25} = 8\%$$

# Individual Income Taxes

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- ✓ Interest paid by individuals is generally **not deductible**, with the **exception of mortgage interest**
- ✓ **Taxes on dividend income** were **lowered** in 2003 to mitigate double taxation
- ✓ **Capital gains versus ordinary income**
  - ✓ Profit from sale of capital asset
  - ✓ Benefits of long-term capital gains
- ✓ **Business versus personal expenses**

# Corporate Income Taxes

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- ✓ Interest and dividend income received by a corporation
  - ✓ 70% of dividends received by another corporation is excluded from taxable income
- ✓ Interest and dividends paid by a corporation
  - ✓ Interest paid is a tax-deductible expense
  - ✓ Dividends paid are not tax-deductible

# Corporate Income Taxes

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- ✓ Corporate capital gains
  - ✓ Currently taxed at same rate
- ✓ Corporate **loss carryback and carryover**
  - ✓ Losses can be carried back two years and carried over to the next 20 years
- ✓ Depreciation
  - ✓ Expensing the price of a long-term asset over time

# Corporate Income Taxes

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- ✓ S Corporation
  - ✓ **Small corporation** that elects to be **taxed as a proprietorship or partnership** yet retains limited liability and other benefits of incorporating
  - ✓ Fewer than 100 shareholders

# Corporate Tax Rates 2014

## *Single Taxpayer*

<b>Taxable Income Bracket</b>	<b>Base Tax Amount</b>	<b>Plus This Percentage of the Amount Over</b>		<b>Average Tax Rate at the Top of the Bracket</b>
\$ 1 – \$ 50,000	\$ 0	+	15.0% \$ 0	15.0%
50,001 – 75,000	7,500	+	25.0 50,000	18.3
75,001 – 100,000	13,750	+	34.0 75,000	22.3
100,001 – 335,000	22,250	+	39.0 100,000	34.0
335,001 – 10,000,000	113,900	+	34.0 335,000	34.0
10,000,001 – 15,000,000	3,400,000	+	35.0 10,000,000	34.3
15,000,001 – 18,333,333	5,150,000	+	38.0 15,000,000	35.0
18,333,334 –	6,416,667	+	35.0 18,333,333	35.0

# Corporate Tax Rates for Selected Countries 2000 & 2014

	<u>Tax Rates</u>			<u>Tax Rates</u>	
	2000	2014		2000	2014
<b><i>I. Developed Markets</i></b>			<b><i>II. Emerging Markets</i></b>		
Australia	36.0	30.0%	Brazil	33.0	34.0%
Canada	44.6	33.0	Chile	15.0	17.0
France	40.0	33.3	China	33.0	25.0
Germany	52.3	29.4	India	35.0	34.0
Italy	41.5	31.4	Indonesia	30.0	28.0
Japan	48.0	40.7	Korea	30.8	24.2
Netherlands	35.0	25.5	Malaysia	28.0	25.0
Switzerland	25.1	21.2	Mexico	35.0	28.0
United Kingdom	31.0	28.0	Philippines	33.0	30.0
<b>United States</b>	<b>40.0</b>	<b>40.0</b>	Thailand	30.0	30.0

# Chapter Principles

## Key Business Organizations / Tax Environment Concepts

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- ✓ What are the different forms of business organization and what are the advantages and disadvantages of each?
  - ✓ Proprietorship & Partnership
    - ✓ Easy to start, but unlimited personal liability
  - ✓ Corporation
    - ✓ Difficult to start, but limited liability
- ✓ What goal(s) should firms pursue?
  - ✓ Maximize stockholders' wealth

# Chapter Principles

## Key Business Organizations / Tax Environment Concepts

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- ✓ What is the role of ethics in successful businesses?
  - ✓ Established codes of conduct help “ethical” firms prosper whereas “unethical” firms do not
- ✓ Why is it important for a business to have a clear corporate governance policy?
  - ✓ Rules for managers help stakeholders have a clear understanding of how executives run the business and who is accountable for important decisions

# Chapter Principles

## Key Business Organizations / Tax Environment Concepts

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- ✓ How do foreign firms differ from U.S. firms?
  - ✓ Foreign firms have more concentrated ownership
  - ✓ Managerial finance factors that distinguish domestic firms from multinational firms
    - ✓ Different currency, economic and legal ramifications, languages, cultural differences, role of governments, political risk
- ✓ Why is it important to consider taxes when making financial decisions?
  - ✓ Because taxes must be paid in cash the effects of taxes on cash flows must be considered