Session 7 - Nontax costs

- One important non-tax cost we have already seen is the implicit tax on tax-favored assets
- We now focus on other types of non-tax costs:
  - Organizational form costs
  - Risk
  - Administrative costs
  - Agency (incentive) costs
  - Financial reporting costs
  - Transaction costs

Organizational form costs

- Suppose you want to use a partnership to reduce tax costs. What types of non-tax costs will you face?
  - The Boston Celtics Limited Partnership (BCLP) faced this decision in 1997 when Congress changed tax law in 1987 to tax "publicly traded partnerships" as corporations. The provision was "grandfathered" so that it did not apply to existing publicly traded partnerships for 10 years
  - BCLP was operated as a publicly traded limited partnership

Alternatives considered by BCLP

- Maintain BCLP's tax status as a partnership by paying the "toll tax" imposed under the tax law. The tax would be a federal tax at a rate of 3.5% of gross income from the active conduct of trades or businesses in taxable years beginning after December 31, 1997.
  - Benefit—still have partnership tax treatment
  - Cost—the toll tax
- Allow BCLP to be taxed as a corporation
  - Benefit—don't have to do anything
  - Cost—future earnings subject to double taxation
- Become a corporation
  - Celtics, Inc., the general partner, would have to give up control of the team
  - Subject to double tax

Alternatives considered by BCLP

- Delisting the partnership units so they were no longer publicly traded
  - Benefit - still have partnership tax treatment
  - Cost - investment units become much less liquid
- Selling the team and liquidating the partnership
  - Benefits:
    - avoid corporate tax treatment
    - value of sale may be greater than value as going concern
  - Cost - give up potential future appreciation in the value of the team

What did BCLP actually do?

- Ownership structure
  - BCLP unit holders own a 99% limited partnership interest in BCLP
  - BCLP owns a 99% limited partnership in "Celtics Limited Partnership" (CLP)
  - CLP owns the team
- Proposed transaction
  - Form 2 new entities—BCLP II and Castle Creek (both limited partnerships)
    - BCLP II will remain publicly traded on NYSE and BSE
    - Castle Creek units are not traded on any securities market
  - Each unit holder of BCLP may elect to receive *either*:
    - $1 cash plus a $20 face amount 6% subordinated debenture for each BCLP unit, or
    - one Castle Creek unit for each 100 BCLP units owned

After the transaction

- BCLP was reorganized with unit holders given the choice of owning shares in the publicly traded partnership or the non-traded partnership
  - If partnership tax benefits greater than non-tax costs, choose Castle Creek, if non-tax costs greater, choose BCLP II
- How has BCLP II tried to minimize corporate tax effects?
  - Cash distribution prior to reorganization
  - Distribution of debentures
  - Interest payments to unit holders deductible
  - Principal repayment not a dividend

Risk

- Taxes can both increase and decrease risk of investments
- Consider the following investment of $1,000,000 with no taxes
  - PV of payoff = $2,000,000 with probability of 50%
    = $0 with probability of 50%
  - Expected payoff is $1,000,000
  - Range of payoffs is 0 to 2,000,000

Risk - symmetric taxation

- Consider the same investment with 35% tax rate and symmetric treatment of gains and losses
  - After-tax payoff = \$1,650,000 with probability of 50%
    = \$350,000 with probability of 50%
  - Expected payoff is still \$1,000,000
  - Range of distribution of payoffs is \$350,000 to \$1,650,000
- Taxes have reduced the risk associated with the investment while keeping the expected payoff the same

Risk - asymmetric taxation

- Now consider asymmetric tax treatment of gains and losses
  - Gains taxed at 35%, Losses non-deductible
  - After-tax payoff = $1,650,000 with probability of 50%
    = $0 with probability of 50%
  - Expected payoff is now $825,000
  - Range of distribution of payoffs is $0 to $1,650,000
- Government has reduced the expected payoff and increased the risk relative to the symmetric tax treatment

Other effects on risk

- Income is imposed on *realized* gains and losses, however, economic income reflects changes in the values of assets (changes in the values of assets is called "economic depreciation")
- If most stock price changes, for example, reflect changes in the values of assets and liabilities, while the corporate income tax is only levied on realized taxable income, most of the investment risk may not be reduced by income taxes

Diversification risk

- Assume you want to minimize your diversifiable risk by having a well diversified portfolio
  - Some of your investments increase in value while others decrease in value
- Because you don't want to incur a capital gains tax you don't sell the appreciated assets.
  - This is known as the "lock in" effect of capital gains taxation.
  - The more your assets have appreciated, the larger tax you will have to pay when you sell, so the less likely you are to sell
- In terms of your portfolio allocations, you become "over invested" in the appreciated securities, taking on more risk because of taxes. You may be better off paying the taxes and diversifying.

Administrative costs

- Legal, accounting, and data processing fees may be substantial
- Multiple entities with multiple tax returns
- Use of multistate or multinational entities increases these costs
- Keeping track of each partner's share of taxable income, basis, etc, on a daily basis
- Compliance costs in aggregate, 1995

  $42 billion in 1995 for individuals (@$15/hr) + $8 billion in fees

  Corporate $20 billion

  IRS $7.6 billion (0.6% of revenue)

  Total cost: ~10¢/ $1

Agency (incentive) costs

- Example: Use of a limited partnership
  - General partner makes all decisions
  - General partner cannot be removed without 60% vote of limited partners
  - General partner has right to convert general partnership interest into limited partnership interests
  - Effectively impossible for limited partners to remove general partner
  - Managers of the partnership's activities are employees of the General Partner
    - Incentives of managers aligned with GP, not LP

Example: Drilling oil wells

- LP owns leases on unproven reserves
- GP owns leases on adjacent properties
- LP agreement allocates 100% of drilling costs to limited partners
  - This provides tax deductions to limited partners
- GP decides where to drill
- What are GPs incentives?
  - GP has incentive to "prove" GPs reserves by drilling adjacent to GP's properties
  - If oil is found, GP's properties become more valuable
  - If no oil is found, costs of drilling are charged to limited partne

Example: Apache Petroleum LP incorporation

- After 1987 tax law change Apache Petroleum LP converted into a regular corporation, Key Production Company, Inc.
  - One reason cited was administrative costs exceeded tax benefits
  - However, all operating and managerial functions of Key were performed by Apache Corporation, the former GP of Apache Petroleum LP
- In 1992 Key's board of directors decided to establish an independent management team
- Apache Corporation dissolved the underlying operating partnership and the two entities (Key and Apache) split

Effect compared to the Celtics

- Both organizations faced loss of partnership tax treatment
  - Apache converted from partnership to corporation
  - Boston Celtics retained partnership form but was taxed as corporation
- Why? Possibly for non-tax reasons
  - LP form allows GP to control basketball operations
  - As Apache found, corporation form allows board of directors to appoint independent managers

Financial reporting costs

- There are many times when managers must incur
  - tax costs to achieve financial reporting objectives, or
  - financial reporting costs to achieve tax objectives
- Examples
  - Use of preferred stock to avoid balance sheet liability
    - Tax cost = no deduction for dividend payments
  - LIFO
    - Tax benefit is gained by reporting lower income

Another example - Leases

- Want operating lease treatment for financial reporting to keep lease liability off of balance sheet
- Want capital lease treatment for tax purposes
  - PV of tax benefits of rapid depreciation and interest on lease liability is greater than PV of tax benefits from rent expense
- One solution developed by leasing companies is a "Synthetic Lease" - treated as an operating lease under FASB rules but treated as a capital lease under IRS rules

More on synthetic leases

- Lease terms have to be designed very carefully
- Public interest groups have criticized the IRS for not cracking down on synthetic leases.
  - IRS argues it is a financial reporting issue. In other words, the leases are properly considered as capital leases but "loopholes" in FASB lease classification rules allow them to be treated as operating leases on financial statements
  - FASB counters by arguing if they change the capital lease standards leasing companies will simply change the terms of their leases so that they still don't meet the new rules
- Illustrates how difficult it is to use objective rules.

Another example - Earnings management

- You want to increase the reported earnings of your company
- One solution is to sell appreciated assets
  - You get to report a gain on your income statement
  - Tax cost is you have to pay tax on the gain
- Example of how to "have your cake and eat it too" - Coca Cola Company

“Issuances of stock by equity investors”

- When one of our equity investees issues additional shares to third parties, our percentage ownership interest in the investee decreases. In the event the issuance price per share is more or less than our average carrying amount per share, we recognize a noncash gain or loss on the issuance. This noncash gain or loss, net of any deferred taxes, is generally recognized in our net income in the period the change of ownership interest occurs.
- In September 1998, CCEAG, our bottler in Germany, issued new shares valued at approximately $275 million to effect a merger with Nordwest Getranke GmbH & Co. KG, another German bottler. Approximately 7.5 million shares were issued, resulting in a one-time noncash pretax gain for our Company of approximately $27 million. We provided deferred taxes of approximately $10 million on this gain. This issuance reduced our ownership in CCEAG from approximately 45 percent to approximately 40 percent.

The general idea:

- You own shares of a subsidiary accounted for under the equity method
- Alternative 1: You sell some of the subsidiary's shares that you own
  - Financial reporting result: gain
  - Tax result: gain (pay tax)
- Alternative 2: You have the subsidiary sell its own shares
  - Financial reporting result: gain
  - Tax result: no gain, no tax (a corporation doesn't recognize a tax gain from selling its own stock)

Transaction costs

- To maximize tax benefits we should sell any stock that has gone down in value every day. Why don't we do this?

- Three reasons (at least):
  - Transaction costs.
  - "Wash sale rules."
  - Psychological reasons.

- The tax benefit has to exceed:
  - The transaction costs
  - Other non-tax costs (like investment bank fees)
  - The risk that the IRS will later challenge the transaction

Ex-dividend day returns

- A corporation declares a dividend to be paid to "holders of record" on a particular day
  - Shares purchased BEFORE this day (called "cum dividend") receive the dividend
  - Shares purchased ON OR AFTER this day do NOT receive the dividend
- How should the price of a share of stock change when it begins trading ex dividend?
  - Absent taxes, it should drop by the amount of the dividend

Ex-dividend day returns

- What actually happens when a share of stock begins trading ex dividend?
  - The price drops LESS than the amount of the dividend
  - This means that if you buy cum dividend and sell ex dividend you will:
    - Get to keep the dividend (assume it is $1)
    - Have a capital loss that is less than $1
    - You have made money (on a pre-tax basis anyway)
  - However, what if the dividend you receive is taxed more heavily than a capital gain?
    - On an after-tax basis you are indifferent
    - This is the traditional explanation for why prices drop by less than the amount of the dividend on the ex dividend day

Consider tax arbitrage opportunities

- Suppose you are a stock broker (called a "short-term trader" in tax language)
  - Dividend income is ordinary income to you
  - Gains and losses from selling stock is also ORDINARY income to you (This is because you are in the business of buying and selling stock)
  - Therefore, dividends and capital losses have the same tax effect for you
- You could engage in tax arbitrage by buying cum dividend and selling ex dividend
- Why doesn't this arbitrage activity drive up the cum dividend price and drive down the ex dividend price so that the change in price equals the dividend?
- You have to pay a transaction cost for each round trip. The very small arbitrage profits may not be enough to offset the transaction costs.