Quiz: 3/19/12

Quiz: Assume the corporate tax rate is 30%, the personal tax rate on interest income is 25% and the personal tax rate on equity income is 20%. Determine the optimal capital structure for Android Corporation if the firm has a 45% chance of having an annual EBIT of $1,000,000 and a 55% of having an annual EBIT of $3,000,000. What is Android’s optimal level of interest payments?

Note: You will need to do enough calculations to show that your answer is optimal.

Note: Bonus WSJ Questions on back of page

$$T^* = 1 - \frac{(1 - 0.55)(1.3)}{1 - 0.25} = 0.1093$$

$$T^* = 1 - \frac{(1 - 0.0)(1 - 0.2)}{1 - 0.25} = -0.067$$

$$T^* = \frac{0.2 - 0.25}{1 - 0.25} =$$

+6 (=) Optimal interest = 3 million