Assume the corporate tax rate equals 30%, that the personal tax rate on equity income equals 10%, and that the personal tax rate on interest income equals 20%. Assume also that TaxFlow Inc. has a 20% chance of earning $5 million per year, a 30% chance of earning $10 million per year, a 35% chance of earning $25 million per year, and a 15% chance of earning $50 million per year. What is TaxFlow’s optimal level of interest payments?

Note: You will need to perform calculations to justify your answer. Show your work in case you need partial credit.

Wall Street Journal Questions are on the back of this page.