Key to Boeing Quiz: 3/7/12

Quiz: Assume the corporate tax rate equals 30%, that the personal tax rate on equity income equals 25%, and that the personal tax rate on interest income equals 20%. Assume also that Boeing Corp expects to earn an EBIT of $3,000,000 per year for the foreseeable future. Boeing currently has no debt but is considering whether or not to issue $1,000,000 of debt at a 5% interest rate.

a. How would issuing the debt affect the value of Boeing?
b. What annual tax savings would the debt generate for Boeing?
c. What changes in tax rates would give firms a greater incentive to issue debt?

a. $\left(1-\left(\frac{(1-.3)(1-.25)}{1-.2}\right)\right)1{,}000{,}000$

b. .3(1,000,000).05

c. increase corporate tax rate,
increase personal tax rate on equity income,
reduction in tax rate on interest income