Key to Chevron Quiz: 3/7/12

Quiz: Assume the corporate tax rate equals 40%, that the personal tax rate on equity income equals 30%, and that the personal tax rate on interest income equals 15%. Assume also that Chevron Corp expects to earn an EBIT of $30,000,000 per year for the foreseeable future. Chevron currently has no debt but is considering whether or not to issue $10,000,000 of debt at a 4% interest rate.
a. How would issuing the debt affect the value of Chevron?
b. What annual tax savings would the debt generate for Chevron?
c. What changes in tax rates would give firms less of an incentive to issue debt?

a. $\left(1 - \left(\frac{(1-.4)(1-.3)}{1-.15}\right)\right)10{,}000{,}000$

b. .4(10,000,000).04

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