

Why is tax minimization different from efficient tax planning? essay sample

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Effective tax planning involves considering the role of taxes when implementing the decision rule of maximizing after-tax returns. Tax-minimization does not aim to maximize after-tax returns, so it may be undesirable. Tax minimization can introduce significant costs along nontax dimensions. Tax minimization may not consider risks and costs, so may not catch the some profitable chances. But, effective tax planning always consider the risks, costs, benefits, and other stuff to make a good decision in order to maximize after-tax returns.

Taxpayer A purchased \$100, 000 of corporate bonds yielding 12. 5% per annum; the interest income from these bonds is taxed at a rate of 28%.

Taxpayer B purchased \$100, 000 of municipal bonds yielding 9% per annum.

The interest from these bonds is tax exempt. The bonds have similar maturities and risk. What is the after-tax rate of return earned by each taxpayer? Is taxpayer B paying taxes in any sense here? a. Who are the taxes being paid to?

b. What is the implied tax rate?

After-tax rate of return earned by Taxpayer A= $12.5\% \times (1 - 28\%) = 9\%$ After-

tax rate of return earned by Taxpayer B= $1 \times 9\% = 9\%$

Taxpayer B is paying taxes here in some sense, which is the implicit tax.

Municipal bonds are tax-exempt investment, so the interest rate of municipal bonds is weight less than the corporate bonds ($9\% < 12.5\%$). When we think of implicit tax, actually, the tax consideration is in the rate. As showed in the calculation, the after-tax rate of return earned by Taxpayer B is the same

with after-tax rate of return earned by Taxpayer A. Taxpayer B actually pay the implicit tax, which is the reduced yield.

Taxpayer A is paying taxes to federal government, and taxpayer B is paying the implicit taxes to the local government who issuing the municipal bonds.