Capital Structure Theory With Corporate Taxes Included in the Analysis

Modigliani and Miller's (MM) 1963 paper titled "Corporate Income Taxes and the Cost of Capital" (American Economic Review, June 1963) revisited the capital structure topic, by relaxing the simplifying assumption of no taxes.

MM present a theoretical analysis which shows that capital structure does matter, if the tax deductibility of interest is considered. They find that when firms finance with debt, they reduce their taxable income, due to the interest tax deduction. MM's 1963 results show that the optimal capital structure is close to 100% debt financing, since the larger the tax deduction for interest expense, the lower the amount of cash flows paid to the government as taxes.

Value of the unlevered firm: $V_U = NI/r_O$.