Raising Revenue from Corporations #LiveAtUrban
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Raising Revenue from Corporations
Share buybacks

Alice Bonaime | Eller College of Management | University of Arizona
Tax Policy Center & UNC Tax Center Virtual Conference
May 16, 2023
What is a share buyback?

- Company
- Shareholders
After a buyback...

- **Cash declines and/or liabilities increase** (depending on how buyback financed).
- **Shareholders’ equity declines** because shares outstanding drop.
- **Theoretically, no change in stock price.**

### (i) Before repurchase
- **Assets** $100
- **Liabilities** $50
- **Shareholders’ equity** $50
- Shares outstanding = 5
  - Price = $10/share

### (ii) After 2 shares repurchased with **cash**
- **Assets** $80
- **Liabilities** $50
- **Shareholders’ equity** $30
- Shares outstanding = 3
  - Price = $10/share

### (iii) After 2 shares repurchased with **debt**
- **Assets** $100
- **Liabilities** $70
- **Shareholders’ equity** $30
- Shares outstanding = 3
  - Price = $10/share
Why do firms buy back stock?

- To return cash to shareholders
- To signal good news to the market
- To combat dilution/boost earnings per share
Payout policy breakdown

Portion of US firms using each form of payout

<table>
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<th>Year</th>
<th>Dividends only</th>
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<th>Both Dividends &amp; Repurchases</th>
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Announced repurchases

Billions of inflation-adjusted US$
Interactive versions of figures can be found at:

https://alicebonaime.com/payout-policy-trends
Raising Revenue from Corporations

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## US Federal Income Tax Treatment of Dividends and Buybacks (pre-IRA)

<table>
<thead>
<tr>
<th>Shareholder Type</th>
<th>Dividends</th>
<th>Buybacks</th>
<th>Advantage</th>
</tr>
</thead>
</table>
| U.S. individuals   | • ≤23.8% rate  
• Delayed basis recovery  
• No non-participation option | • ≤23.8% rate  
• Immediate basis recovery  
• Shareholders can choose not to participate and instead to sell when tax-advantageous | Buybacks      |
| Non-U.S. persons   | • ≤30% withholding tax                                                   | • Generally no U.S. tax                                               | Buybacks      |
| Corporations       | • 10.5% rate (50% dividends received deduction)  
• Delayed basis recovery | • 21% rate  
• Immediate basis recovery | Mixed          |
| Tax-exempts        | • No tax                                                                  | • No tax                                                              | Indifferent   |
What’s the Matter with Buybacks?

1. “Mark Zuckerberg problem”
   • Entrepreneurs can form corporations, generate billions in labor income, return cash to shareholders via buybacks, and pay no shareholder-level tax because they won’t sell shares until they die
   • If they desire liquidity during their lifetimes, they can borrow against their appreciated stock
What’s the Matter with Buybacks?

2. “Panama Papers problem”
   • Foreign investors can stash funds in tax-haven accounts, invest in US stocks, pay no US withholding tax (as long as they receive no dividends), and pay no tax in haven country or home country either
Neutralizing the Tax Advantage of Buybacks

Option 1: Treat buybacks like dividends

- **E.g.**: If corporation with 100 outstanding shares buys back 10 shares for $1/share, remaining shareholders would be taxed as if they received dividend of $0.10/share and would have their basis increased by $0.10/share

  - **Complications**
    1. Shareholders would owe tax even if they hadn’t received cash
    2. Arrangement would be difficult to explain to retail investors
    3. Hard to implement without violating President Biden’s $400k pledge
Neutralizing the Tax Advantage of Buybacks

Option 2: Excise tax

With excise tax on stock buybacks, either:

(1) corporations will pay the excise tax (and US will collect some excise tax $$$ from the Mark Zuckerbergs and Panama Papers account holders); or

(2) corporations will shift from buybacks to dividends (and US will collect $$$ via dividend taxation)

Easy to administer; no problem with $400k pledge
Distributional Implications

- With a 1% excise tax, some publicly traded corporations will continue to return cash to shareholders via buybacks rather than dividends
  - Tax-exempts shoulder some of the burden (whereas they don’t bear the burden of dividend taxation)
- If excise tax rate is high enough that no one buys back shares, then burden of dividend taxation falls on US taxable individuals and foreigners (especially, foreigners in non-treaty jurisdictions)
Scope Limitations

Why only publicly traded corporations?

- Potential to distort choices about going private/going public if privately traded corporations still have ability to make tax-advantaged distributions of cash to shareholders but publicly traded corporations don’t
Scope Limitations

Why not cash acquisitions?

• When corporation is bought out in cash deal, any earnings are (in effect) returned to shareholders (still US tax-free if those shareholders are non-US residents)
Accidental Taxation

• “Accidental taxation”: Application of excise tax to transactions that don’t implicate core concerns that motivated Congress to enact the tax
  • Mandatorily redeemable preferred shares?
  • SPAC liquidations?
• As excise tax rate increases, concerns about “accidental taxation” intensify
• Treasury has broad regulatory authority under § 4501(f) to carve out exceptions for “special classes of stock and preferred stock,” but writing these regs in ways that don’t open up new loopholes is challenging!
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