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EQUALIZING THE TAX TREATMENT OF STOCK BUYBACKS AND DIVIDENDS

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Equalizing the Tax Treatment of Stock Buybacks and Dividends

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— DRAFT —

Summary: This policy brief highlights flaws in the current federal tax treatment of stock buybacks and proposes to address those flaws by equalizing the tax treatment of buybacks and dividends. (We explore the proposal in greater detail in Hemel & Polsky, Taxing Buybacks, 38 Yale J. on Reg. 246 (2021), https://ssrn.com/abstract=3764112.) Stock buybacks allow foreign shareholders to avoid U.S. withholding tax on corporate cash distributions. Stock buybacks also allow U.S. taxable investors to reduce or eliminate shareholder-level tax on corporate cash distributions through a combination of deferral, loss harvesting, and stepped-up basis at death. Our proposal—based on an idea first suggested by Marvin Chirelstein a half century ago—would plug these gaps in the tax base by treating stock buybacks as imputed dividends. We explain the mechanics of the proposal and the principal design choices facing policymakers. We also estimate—conservatively—that the proposal would raise more than $500 billion over the 10-year budget window.

The Problem: In recent years, share buybacks have supplanted dividends as the preferred means through which large U.S. corporations distribute cash to shareholders.¹ This shift from dividends to buybacks creates four significant problems for the federal tax system:

1. Dividends paid to non-U.S. shareholders—who own approximately 40 percent of U.S. equities—are subject to U.S. tax, which is withheld at the source.² By contrast, non-U.S. shareholders generally pay no U.S. tax when they sell shares back to a U.S. corporation. Shareholders investing via offshore tax havens—who hold an estimated 9 percent of U.S. equities³—often pay no tax on corporate cash distributions in the United States or in their home countries when distributions take buyback form.
2. When corporations distribute cash to U.S. shareholders in the form of dividends, a tax rate of up to 23.8 percent on qualified dividends applies to the entire amount. When corporations distribute cash to U.S. shareholders in the form of buybacks, a tax rate of up to 23.8 percent on long-term capital gains applies to the repurchase amount minus the

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shareholder’s basis. Holders of dividend-paying stock still recover basis upon ultimate sale, but the accelerated-basis-recovery feature of buybacks gives rise to a tax timing advantage for U.S. shareholders and a corresponding loss to the federal government.

3. Dividends—even when eligible for the qualified-dividend rate—still constitute ordinary income that cannot be offset by capital losses beyond a $3000 annual limit. Meanwhile, capital gains can be offset by capital losses without limit. U.S. shareholders can therefore engage in loss harvesting (i.e., selling stock and other securities with built-in losses) to generate capital losses that offset capital gains realized from buybacks. By contrast, the tax burden of dividends cannot be reduced significantly by loss harvesting.

4. U.S. shareholders of dividend-paying stock will pay taxes on corporate cash distributions even if they hold their shares until death. By contrast, if a corporation makes all of its cash distributions via buybacks, U.S. shareholders can hold their stock until death and avoid all taxes on gains via stepped-up basis. The combination of deferral, loss harvesting, and stepped-up basis allows taxpayers to achieve very low or even negative lifetime tax rates on stock market gains provided they invest in corporations that return cash to shareholders via buybacks rather than dividends.

Five of the seven largest U.S. corporations by market capitalization (Amazon, Alphabet, Facebook, Tesla, and Berkshire Hathaway) do not pay any dividend. All of their cash distributions take the form of buybacks. As a result, non-U.S. investors in these corporations—as well as U.S. shareholders who hold their stock until death (or who engage in loss-harvesting)—can avoid U.S. taxation of shareholder-level gains entirely. The founders of those companies also will escape virtually any income taxation on their multibillion-dollar fortunes as long as they hold their shares until death.

The Proposal: The differential tax treatment of buybacks and dividends has been acknowledged in the tax law literature for decades. In 1969, Yale law professor Marvin Chirelstein proposed a method to equalize the tax treatment of buybacks and dividends. Under the Chirelstein method, when a corporation repurchases its own shares, the amount of repurchase proceeds would be treated as an imputed dividend to all shareholders regardless of whether they participated in the buyback. Each shareholder would recognize dividend income in proportion to her ownership interest in the corporation (as measured immediately prior to the buyback). The shareholder’s basis in corporation’s stock would then be adjusted upward by the amount of the imputed dividend. Brokers would be responsible for tracking basis adjustments, as already is the case for basis adjustments that occur as a result of stock splits and tax-free reorganizations.

To illustrate, imagine that a corporation has 1 billion shares of stock outstanding, with each share representing a 1/1 billionth ownership interest. The corporation buys back $2 billion of its own shares. Each shareholder would recognize dividend income of $2 per share, and each shareholder’s basis would be adjusted upwards by $2. Imputed dividends would be eligible for

qualified dividend treatment under section 1(h)(11) provided that the other requirements of that provision are satisfied. The redeeming shareholders would then be treated as selling their stock (with its increased basis) for the amount of redemption proceeds they receive.

The change would have important implications for federal taxation of non-U.S. investors in U.S. corporations. The tax on dividends paid to nonresidents (section 871) and foreign corporations (section 881) would apply to imputed dividends arising from buybacks. U.S. corporations would be obligated to withhold tax on imputed dividends under section 1441 and section 1442. To ensure that corporations can continue to meet their withholding obligations, corporations that repurchase shares would be required to pay a cash dividend sufficient to satisfy the corporation’s withholding liability. The current top tax rate on dividends for withholding purposes is 30 percent (though shareholders in countries that have signed tax treaties with the United States are typically eligible for a lower rate). Corporations that repurchase shares thus would be required to pay at least 30 cents in cash dividends for every $1 in cash plus imputed dividends (i.e., 30 cents in cash dividends for every 70 cents in buybacks).

For example, if a U.S. corporation with 1 billion shares outstanding wanted to make a $2 billion cash distribution to shareholders, the corporation would have to pay (at minimum) $600 million of that $2 billion in the form of cash dividends. The transaction would give rise to imputed dividend income of $1.40 per share along with a cash dividend of $0.60 per share (assuming the corporation paid the minimum cash dividend). For non-U.S. shareholders subject to the top 30 percent withholding rate, the corporation would withhold the entire cash dividend. For U.S. shareholders subject to the top federal tax rate of 23.8 percent on qualified dividends, the federal tax would be $0.476 per share, which could be fully paid out of the cash dividend component (with cash to spare).

In practice, the proposal would likely cause more corporate cash distributions to take the form of dividends, because the tax advantage of buybacks—which is a major incentive for corporations to choose that form—would disappear. That said, the proposal would not lead to significant additional compliance costs even if corporations continue to choose buybacks. Broker basis tracking would alleviate the recordkeeping burden for shareholders, and the requirement that corporations pay cash dividends sufficient to meet withholding obligations would ensure that imputed-dividend recipients would have the liquidity to satisfy their tax liabilities.

Treatment of Individuals Earning Less Than $400,000. There are at least four ways that the proposal could apply to individuals earning less than $400,000, in light of President Biden’s campaign promise not to raise tax rates on taxpayers below that threshold:

5 Old and new versions of the U.S. Model Income Tax Convention allow the United States to tax dividends paid by U.S. corporations to treaty-jurisdiction residents. The definition of “dividends” under the convention includes “income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payor is a resident.”
Since the proposal does not change the tax rate on qualified dividends but simply shifts the composition of corporate cash distributions, the proposal arguably does not count as a tax increase on individuals earning less than $400,000. Applying the proposal to all shareholders would be the most straightforward approach administratively and would raise the most revenue. Note also that individuals earning less than $400,000 would typically own all or the vast majority of their stock in qualified accounts (e.g., 401(k) plans, IRAs, health savings accounts, 529 plans, etc.); the proposal would have no effect whatsoever on stock held in these accounts.

Another approach would be to allow the small minority of individuals earning less than $400,000 who own stock in taxable accounts to elect out of the taxation of imputed dividends. Electing taxpayers then would not be eligible for the corresponding basis adjustments, and would either need to track basis themselves or inform their brokers of their election out.

In lieu of an election-out option, the proposal could be applied to U.S. individuals earning less than $400,000 but be coupled with a reduction in the tax rate on qualified dividends for those taxpayers. Because of the substantial amount of revenue raised by the application of the proposal to non-U.S. shareholders and to high-income U.S. taxpayers, the proposal still would be revenue-positive even if paired with a qualified dividend rate reduction for taxpayers with incomes under $400,000.

As an alternative to the rate-reduction option, the proposal could treat dividend income as long-term capital gains for individuals earning less than $400,000. This would allow those individuals to offset any dividend income (whether actual or imputed through the Chirelstein recast) with capital losses.

**Revenue Estimate:** There are four channels through which the proposal would raise revenue:

- **Non-U.S. shareholders.** The largest component of the revenue gain would come from withholding on imputed dividends to non-U.S. shareholders, who currently pay no tax on corporate cash distributions in buyback form. (Some of these shareholders would be eligible for foreign tax credits in their home countries for amounts withheld in the United States.)

- **Ending the tax timing advantage of buybacks.** Under the proposal, U.S. shareholders would recognize an imputed dividend and corresponding basis adjustment when corporations buy back shares. For shareholders who ultimately sell their stock before a basis step-up, the proposal would not affect the total amount of taxable income in nominal terms, but it would accelerate tax payments (a result that would be reflected in present-value revenue estimates).

- **Reducing loss harvesting.** The proposal would negate the strategy of harvesting built-in losses to offset gains upon corporate cash distributions. The reduction in loss harvesting would accelerate tax payments (a revenue increase for the federal government in present value terms) and raise revenue in nominal terms if losses otherwise would go unused.

- **Interaction with stepped-up basis.** Absent a change to the existing stepped-up basis rules, the proposal would raise significant revenue from U.S. shareholders of non-
dividend-paying stock who hold shares until death. This revenue gain would overlap with the gain from stepped-up basis reform, so a precise revenue estimate will depend upon the details of the stepped-up basis proposal pursued by the Biden-Harris administration and Congress.

The proposal would potentially generate at least three behavioral responses:

- **Shift to dividends.** Without the buyback tax advantage, U.S. corporations would make more of their cash distributions in dividend form. This change would not affect the revenue estimate, though, because buybacks and dividends are taxed the same under the proposal. Shareholders of dividend-paying firms who want to increase their percentage interest in the corporation can choose to participate in the issuer’s dividend reinvestment programs (DRIPs) or use the dividends to buy shares on the market.

- **Changes in corporate distribution policy.** Under the “new view” of dividend taxation, a constant tax on dividends and other distributions does not—as a general matter—affect the decision to retain or distribute corporate earnings. Under that theory, a stable tax on cash dividends and imputed dividends would not increase earnings retention. If the proposal is implemented on a temporary basis, however, corporations may shift from buybacks to earnings retention, thus reducing the revenue estimate.

- **Changes in foreign ownership of U.S. equities.** Over time, the proposal may lead non-U.S. shareholders to shift from U.S. equities to fixed-income and non-U.S. equity investments. This shift would be gradual, though, and would be potentially mitigated by the ability of non-U.S. shareholders to claim foreign tax credits in their home countries for amounts withheld under the proposal.

To generate a revenue estimate, we make the following (conservative) assumptions

- On the foreign shareholder side, U.S.-source imputed dividends under the proposal will be subject to the same average effective withholding tax rate as U.S.-source cash dividends under current law (16.8 percent).

- For U.S. resident individuals, the proposal will apply only to taxpayers with adjusted gross income above $500,000. Those taxpayers will be subject to a 23.8 percent marginal rate (inclusive of the net investment income tax), and 50 percent of shareholder-level capital gains over the next decade will not be realized within the 10-year window under current law. (Note that the $500,000 threshold is higher than the $400,000 threshold that President Biden has set. The higher threshold contributes to the conservatism of our revenue estimate.)

- Buybacks—as well as corporate cash distributions that would have taken the form of buybacks under current law but shift to dividends because of the proposal—will equal 2

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percent of market capitalization over the 2022-2031 period. (The actual S&P 500 buyback yield topped 2 percent over every trailing-12-month period from mid-2010 through mid-2020. Our 2 percent assumption further contributes to the conservatism of our estimate.)

Based on these assumptions as well as available market data and the IRS Statistics of Income, we estimate that the proposal will raise $524 billion from 2022 to 2031. For a full explanation of our revenue estimate, see bit.ly/buybackrevenues.

**Conclusion:** Beyond the revenue gains, the proposal would have three other important benefits:

- **Effect on tax havens.** The proposal would bolster the international tax architecture by limiting the ability of tax haven investors to avoid any taxation of shareholder-level gain on U.S. equities.
- **Progressivity.** The proposal would help to ensure that the very richest Americans, who hold large amounts of non-dividend-paying stock, still pay some income tax on shareholder-level gains.
- **Efficiency.** Current law distorts corporate decisions regarding the form of cash distributions. By removing the tax incentive for buybacks, the proposal would eliminate that distortion.

In sum, equalizing the tax treatment of buybacks and dividends represents a rare opportunity to significantly expand the tax base while also advancing other important tax policy objectives.⁸

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