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Taxing Buybacks

Daniel J. Hemel† **& Gregg D. Polsky**††

A recent rise in the volume of corporate share repurchases has prompted calls for changes to the rules governing stock buybacks. These calls for reform are animated by concerns that buybacks enrich corporate executives at the expense of productive investment. This emerging anti-buyback movement includes prominent politicians as well as academics and Republicans as well as Democrats. The primary focus of buyback critics has been on securities-law changes to deter repurchases, with only passing mention of potential tax-law solutions.

This Article critically examines the policy arguments against buybacks and arrives at a mixed verdict. On the one hand, claims that buybacks reduce corporate investment and inappropriately reward executives turn out to be poorly supported. On the other hand, the Article identifies legitimate tax-related concerns about the rising buyback tide. Buybacks exacerbate two of the U.S. tax system's most severe flaws. The first is the "Mark Zuckerberg problem": the effective nontaxation of firm founders on what is essentially labor income. The second is what we call the "Panama Papers problem": the use of U.S. capital markets by investors in offshore tax havens to generate tax-free returns.

Our search for solutions to the Mark Zuckerberg and Panama Papers problems brings us back to a prescient 1969 article by then-Yale Law School professor Marvin Chirelstein. The main innovation of Chirelstein's article was to explain how buybacks could be taxed the same way as dividends at the shareholder level. Chirelstein's proffered justification for his proposal has obsolesced in the succeeding five decades, but the proposal nonetheless provides a technically elegant framework for addressing two of the modern-day U.S. tax system's major ills.

This Article evaluates Chirelstein's proposal and updates it for the twenty-first century. We outline the mechanics of the proposal, suggest a range of tweaks, and show how adoption of the proposal would substantially improve the U.S. capital-taxation regime. Along the way, we

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illustrate the benefits of incrementalism both in tax policy and tax scholarship. Progress, we argue, often involves reviving the best ideas of yesteryear rather than writing on a blank slate.

Introduction

Stock buybacks announced by U.S. corporations hit an all-time high in 2018, topping $1 trillion for the first time.[1] The pace of share repurchases

1. *See* Matt Egan, *Corporate America Gives out a Record $1 Trillion in Stock Buybacks*, CNN (Dec. 17, 2018, 4:44 PM EST), https://www.cnn.com/2018/12/17/investing/stock-buybacks-trillion-dollars/index.html [https://perma.cc/N369-JKS5].

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slowed slightly in 2019, but buybacks that year remained the single biggest source of demand for U.S. public equity.[2] And although the onset of the COVID-19 crisis put a hold on many stock-repurchase programs,[3] the pause appears to be only temporary.[4] A number of high-profile firms—including Apple,[5] Starbucks,[6] and Warren Buffett's Berkshire Hathaway[7]—have continued buying back their own shares through the pandemic.

While buybacks often raise cheers from investors and analysts, record-breaking share repurchases also have become a cause of consternation among politicians and policymakers who fear that stock buybacks pad the pockets of corporate executives and divert funds from productive investment. Several former candidates for the Democratic Party's 2020

2. *See Share Buybacks to Slide 15% in 2019 and 5% Next Year, Says Goldman*, CHIEF INVESTMENT OFFICER (Dec. 18, 2019), https://www.ai-cio.com/news/share-buybacks-slide-15-2019-5-next-year-says-goldman [https://perma.cc/ZD7K-ZE49].

3. *See* Grace Maral Burnett, *Analysis: S&P 500 Buyback Suspensions, Dividend Cuts Raise Flags*, BLOOMBERG L. (May 22, 2020, 6:29 AM), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-s-p-500-buyback-suspensions-dividend-cuts-raise-flags [https://perma.cc/4LV7-G9P9]. The Coronavirus Aid, Relief, and Economic Security (CARES) Act signed into law in March 2020 provides that firms receiving direct loans and loan guarantees from the U.S. Treasury Department cannot repurchase shares for twelve months after the date that the loan or loan guarantee is no longer outstanding. Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, § 4003(c)(2)(E), 134 Stat. 281, 471 (2020). The repurchase restriction does not apply to firms that received forgivable loans through the $669 billion Payroll Protection Program (PPP). Dozens of public companies received PPP loans; many—though not all—returned their loans under public pressure. *See, e.g.*, Allison Levitsky, *Publicly Traded Tesla Rival Nio Among the Largest PPP Loan Recipients in Silicon Valley, New Data Shows*, SILICON VALLEY BUS. J. (July 8, 2020, 7:19 AM PDT), https://www.bizjournals.com/sanjose/news/2020/07/08/nio-ppp-loan-public-companies-silicon-valley.html [https://perma.cc/CMP4-Q8SP?type=image]; Mark Niquette, *Bailout List Includes Firms with Trump Ties, Major Nonprofits*, WASH. POST (July 7, 2020, 2:27 AM EST), https://www.washingtonpost.com/business/on-small-business/bailout-list-includes-firms-with-trump-ties-major-nonprofits/2020/07/06/66d7ca2a-bf9e-11ea-8908-68a2b9eae9e0_story.html [https://perma.cc/3HH8-PN2X].

4. *See* Grace Maral Burnett, *Analysis: S&P 500 Buyback Suspensions Dropped to Zero in June*, BLOOMBERG L. (July 8, 2020, 4:37 AM), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-s-p-500-buyback-suspensions-dropped-to-zero-in-june [https://perma.cc/Z63Q-QHMJ].

5. *See* Jessica Bursztynsky, *Apple Now Has $192.8 Billion in Cash on Hand, Down from Last Quarter*, CNBC (Apr. 30, 2020, 4:41 PM EST), https://www.cnbc.com/2020/04/30/apple-q2-2020-cash-hoard-heres-how-much-apple-has-on-hand.html [https://perma.cc/B9TQ-4XV3].

6. *See* Daniel B. Kline, *Starbucks Remains Committed to Share Buybacks*, NASDAQ (Mar. 20, 2020, 1:28 PM EST), https://www.nasdaq.com/articles/starbucks-remains-committed-to-share-buybacks-2020-03-20 [https://perma.cc/Q455-DVUB].

7. *See* Wayne Duggan, *Why Warren Buffett May Have Changed His Tune on Berkshire Buybacks*, YAHOO FIN. (July 16, 2020), https://finance.yahoo.com/news/why-warren-buffett-may-changed-180101505.html [https://perma.cc/583Q-CFBF].

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presidential nomination—including Senators Bernie Sanders,[8] Elizabeth Warren,[9] Cory Booker,[10] and Kirsten Gillibrand[11]—put forward or endorsed proposals to restrict corporate share repurchases or to limit the ability of corporate insiders to participate in buybacks. The party's eventual nominee, now-President-elect Joe Biden, called on CEOs to halt buybacks for a year after COVID-19 struck.[12] Robert Jackson, Jr., a Democratic member of the Securities and Exchange Commission (SEC) until 2020, has described trading around the time of buyback announcements as "troubling" and called on the SEC to "reexamine our rules in this area."[13] And antipathy toward buybacks crosses party lines. On the Republican side, Senator Marco Rubio of Florida has called for tax-law changes to end the current "tax code's favoritism" for buybacks over dividends.[14] President Donald Trump, who arguably added fuel to the buyback trend by signing the 2017 tax cuts into law, told reporters in March 2020 that he "never liked stock buybacks" either.[15]

Attention to buybacks from presidents and prominent politicians is a recent phenomenon, but scholars of tax law have been thinking about the problems posed by share repurchases for decades. Last year marked the

8. *See* Chuck Schumer & Bernie Sanders, Opinion, *Schumer and Sanders: Limit Corporate Stock Buybacks*, N.Y. TIMES (Feb. 3, 2019), https://www.nytimes.com/2019/02/03/opinion/chuck-schumer-bernie-sanders.html [https://perma.cc/RJ66-MLCM] ("Our bill will prohibit a corporation from buying back its own stock unless it invests in workers and communities first, including things like paying all workers at least $15 an hour, providing seven days of paid sick leave, and offering decent pensions and more reliable health benefits.").

9. *See* Elizabeth Warren, Opinion, *Companies Shouldn't Be Accountable Only to Shareholders*, WALL ST. J. (Aug. 14, 2018, 7:01 PM ET), https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687 [https://perma.cc/Z6DV-YXKE] (proposing that directors and officers be barred from selling company shares within three years of a buyback).

10. *See* Worker Dividend Act of 2018, S. 2505, 115th Cong. § 2(a) (2d Sess. 2018) (introduced by Senator Booker) (proposing that publicly traded corporation be required to pay a "worker dividend" equal to the lesser of the amount paid by the corporation to repurchase its securities on the open market or 50% of U.S. earnings above $250 million).

11. Senators Gillibrand and Warren were cosponsors of the Reward Work Act, which would have repealed a Securities and Exchange Commission regulatory safe harbor for corporate share repurchases. *See* Reward Work Act, S. 2605, 115th Cong. (2d Sess. 2018).

12. *See* Jacob Pramuk, *Joe Biden Urges 'Every CEO in America' to Commit to No Stock Buybacks for a Year*, CNBC (Mar. 20, 2020, 11:14 AM EST), https://www.cnbc.com/2020/03/20/coronavirus-updates-joe-biden-urges-no-stock-buybacks-for-a-year.html [https://perma.cc/6NG5-NRP2].

13. Robert J. Jackson, Jr., Comm'r, U.S. Sec. & Exch. Comm'n, Speech at the Center for American Progress on Stock Buybacks and Corporate Cashouts (June 11, 2018), https://www.sec.gov/news/speech/speech-jackson-061118 [https://perma.cc/3Z4E-8EQG].

14. Marco Rubio, *America Needs to Restore Dignity of Work*, ATLANTIC (Dec. 13, 2018), https://www.theatlantic.com/ideas/archive/2018/12/help-working-class-voters-us-must-value-work/578032 [https://perma.cc/35PX-LSYK].

15. Steve Holland & Alexandra Alper, *Trump Slams Companies for Using U.S. Tax Credit to Buy Back Stocks*, REUTERS (Mar. 20, 2020, 5:15 PM), https://www.reuters.com/article/us-health-coronavirus-trump-buybacks/trump-slams-companies-for-using-u-s-tax-credit-to-buy-back-stocks-idUSKBN2173HY [https://perma.cc/2QHQ-JALL].

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fiftieth anniversary of the seminal article on buybacks in the tax-law literature: *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, published in the *Yale Law Journal* in 1969 by then-Yale Law School professor Marvin A. Chirelstein.[16] In that article, Chirelstein proposed a new income tax regime for buybacks that aimed to eliminate the buyback tax advantage.[17] In brief: Chirelstein would treat the amount of the buyback as a cash dividend paid out to all shareholders on a pro rata basis, thus triggering dividend tax obligations for all taxpaying shareholders and capital gains or losses for those who choose to cash out their shares.[18] By eliminating the tax advantage of buybacks over dividends, Chirelstein's proposal—which we explain in much more detail below—would render buybacks a less attractive mechanism for returning capital to shareholders.

Subsequent scholarship on the taxation of share repurchases has taken note of Chirelstein's proposal but questioned its political feasibility. Professor Ethan Yale has emphasized the "public relations difficulty" created by the fact that Chirelstein's proposal would require shareholders who do not participate in the buyback to pay a dividend tax.[19] Professor Bret Wells, though sympathetic to Chirelstein's idea, has echoed the public-relations concern.[20] For most of its first half-century of life, Chirelstein's proposal looked like it was destined for the same fate as other tax policy ideas that appeal to wonkish professors and think-tank analysts but appear to be political nonstarters—a category that also might include the taxation of net imputed rent on owner-occupied homes,[21] retrospective capital gains taxation,[22] and the taxation of life insurance "buildup."[23]

The sudden surge in the volume of—and attention to—corporate share repurchases potentially alters the political calculus. As lawmakers and regulators search for policies that can stem the rising buyback tide, Chirelstein's proposal may finally have its moment. Indeed, Senator Rubio included a citation to Chirelstein's article in a recent report—though on

16. Marvin A. Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739 (1969).

17. *Id.* at 751-55.

18. *Id.*

19. Ethan Yale, *Corporate Distributions Tax Reform: Exploring the Alternatives*, 29 VA. TAX REV. 329, 353 (2009).

20. *See* Bret Wells, *Reform of Corporate Distributions in Subchapter C*, 37 VA. TAX REV. 365, 396 (2018) (citing Yale, *supra* note 19, at 353).

21. *See, e.g.*, Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 84 (1990).

22. *See* Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991).

23. Calvin H. Johnson, Andrew Pike & Eric A. Lustig, *Tax on Insurance Buildup*, 112 TAX NOTES 665 (2009).

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page 74 and footnote 287 of a dense 78-page document,[24] it was hardly a Warholian "fifteen minutes of fame." Unlike some of the other anti-buyback proposals, Chirelstein's scheme has the virtue of being intellectually defensible. And it would almost certainly raise revenue—in the ballpark of $70 billion to $80 billion a year in the near term[25]—making it a potentially attractive add-on to future budget bills that strive for revenue neutrality or deficit reduction.

Yet the most persuasive reasons to adopt Chirelstein's proposal have nearly nothing to do with the concerns of current buyback critics. The contention that stock buybacks cannibalize long-term investment is doubtful at best; the claim that buybacks benefit corporate executives at the expense of other shareholders is not well-supported either.[26] Nor is Chirelstein's case for his own proposal particularly persuasive a half-century later. Chirelstein's chief concern was that differential treatment of buybacks "distort[ed] the customary and intended pattern of taxation."[27] By now, though, differential treatment of buybacks and dividends *is* the custom, and it is hard to say that Congress—which has acquiesced to the status quo for decades—"intends" any other result.

There are, however, a number of more powerful arguments in favor of Chirelstein's idea—arguments absent from Chirelstein's original article and largely overlooked in the current buyback debate. One argument relates to the so-called "Mark Zuckerberg problem"[28]: the effective nontaxation of founders of phenomenally successful companies with zero-dividend policies who hold their shares until death and benefit from a step-up in basis.[29] A second pertains to the "Panama Papers problem": the ability of foreign investors who hold stock in tax-haven jurisdictions to avoid U.S. tax—and potentially any tax—on U.S. equity gains. Chirelstein, to be sure, cannot be faulted for failing to consider these points. The rise of zero- and

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24. Marco Rubio, *Made in China 2025 and the Future of American Industry*, U.S. SENATE COMMITTEE ON SMALL BUS. & ENTREPRENEURSHIP 74 n.287 (Feb. 12, 2019), https://www.rubio.senate.gov/public/_cache/files/d1c6db46-1a68-481a-b96e-356c8100f1b7/3EDECA923DB439A8E884C6229A4C6003.02.12.19-final-sbc-project-mic2025-report.pdf [https://perma.cc/BV52-WSQV].

25. For our explanation on the basis for this revenue estimate, see *infra* notes 179-183, 190 and accompanying text. We calculate a $74 billion yield based on revenue gains from foreign shareholders alone.

26. See *infra* Section III.A.

27. Chirelstein, *supra* note 16, at 756.

28. Edward D. Kleinbard, *The Right Tax at the Right Time*, 21 FLA. TAX REV. 208, 299 (2017).

29. We find that the nontaxation of nonredeeming shareholders is especially problematic in the context of corporate founders because their gains are likely best characterized as a form of labor income, which ought to be taxed even under theories of optimal taxation that prescribe a zero rate on capital income. *See, e.g.*, Joseph Bankman & David A. Weisbach, *The Superiority of an Ideal Consumption Tax over an Ideal Income Tax*, 58 STAN. L. REV. 1413 (2006).

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low-dividend stocks largely postdated Chirelstein's article,[30] as did the growth in foreign ownership of U.S. equities.[31] It is either a remarkable coincidence or an extraordinary testament to Chirelstein's clairvoyance that the strongest reasons to adopt his proposal today arise from trends that took off well after he wrote.

In short, while Chirelstein's proposal has much to recommend it, the arguments in its favor are distinct from the arguments that Chirelstein offered and from the anti-buyback arguments that make the proposal politically attractive. More than a half century after its inception, Chirelstein's proposal has finally found both a purpose and a potential set of friends. This Article seeks to explain the modern-day virtues of Chirelstein's proposal as well as its plausible political appeal and possible pitfalls.

Our analysis proceeds in four Parts. Part I introduces the basics of buybacks, explains the difference in the tax treatment of buybacks and dividends, and traces the meteoric rise of buybacks in recent years. Part II presents Chirelstein's proposal and discusses the major challenges that implementation would entail. Part III evaluates the case for taxing buybacks like cash dividends. We find that the arguments for Chirelstein's proposal based on the concerns of current buyback critics are weak, and Chirelstein's own arguments do little to move the dial. However, a number of relatively recent developments in U.S. equity markets give rise to strong tax policy arguments in the proposal's favor. Part IV ends with reflections on Chirelstein's proposal in the context of broader changes to capital taxation and trends in legal scholarship.

I. The Basics of Buybacks

A. Buybacks and Dividends as Alternative Mechanisms for Returning Capital to Shareholders

When a corporation earns profits, it can reinvest those profits or distribute them to its shareholders.[32] If it chooses to distribute the profits, the corporation can redeem (i.e., buy back) outstanding shares, or it can issue cash dividends. If it buys back shares, the number of outstanding shares shrinks, while if it issues cash dividends, the number of outstanding shares remains the same. Nevertheless, as tax lawyers understood well before Chirelstein's 1969 article, the two transactions are "essentially

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30. *See S&P 500 Dividend Yield by Year*, MULTIPL, https://www.multpl.com/s-p-500-dividend-yield/table/by-year [https://perma.cc/B43R-X7QQ].

31. *See Summary of Report on Foreign Portfolio Investment in the United States*, U.S. DEP'T TREASURY (Dec. 31, 1997), https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/shl94sum.aspx [https://perma.cc/9DXR-NCUJ].

32. Note that a corporation need not earn profits in order to engage in buybacks or pay dividends. It could instead finance buybacks or dividends out of cash reserves or borrowed funds.

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equivalent"—or, at least, can be.[33] Two transactions—one denominated a buyback, the other characterized as a cash dividend—can achieve economically identical results both for the corporation and for its shareholders.

To illustrate, consider the following two examples:

Example 1. ChirelsteinCorp issues 100 shares for $1 each. *A* and *B* each buy 50 shares. ChirelsteinCorp then earns $100 in profits, which causes the value of each share to rise from $1 to $2 (assuming that market value equals book value). ChirelsteinCorp thereafter decides to distribute its $100 of earnings to its shareholders. ChirelsteinCorp does so by repurchasing 50 shares. *A* chooses to redeem all 50 of her shares; *B* chooses not to redeem. The total cost of the buyback to ChirelsteinCorp is $100; *A* receives $100 and *B* receives 0; and the value of each ChirelsteinCorp share remains $2. *B* now owns all 50 outstanding shares of ChirelsteinCorp, which is worth $100.

Example 2. ChirelsteinCorp issues 100 shares for $1 each. *A* and *B* each buy 50 shares. ChirelsteinCorp then earns $100 in profits, which causes the value of each share to rise from $1 to $2 (assuming that market value equals book value). ChirelsteinCorp thereafter decides to distribute its $100 of earnings to its shareholders. ChirelsteinCorp does so by issuing a cash dividend of $1 per share, causing the value of each share to fall from $2 back to $1. Afterwards, *B* uses the $50 she has received through the cash dividend to purchase *A*'s 50 shares. *B* now owns all 100 outstanding shares of ChirelsteinCorp, which is worth $100.

Aside from the tax consequences, to which we will turn in a moment, the only practical differences between Example 1 (the buyback) and Example 2 (the cash dividend) are cosmetic. Either way, ChirelsteinCorp distributes $100 to shareholders. Either way, *A* ends up with $100 of cash, and *B* ends up owning all of ChirelsteinCorp, which has total equity of $100. The only difference is that in Example 1, *B* ends up with 50 shares worth $2 each, while in Example 2, *B* ends up with 100 shares worth $1 each. But no one is richer or poorer (pre-tax) in one example than in another, and no one has a larger or smaller stake in ChirelsteinCorp.

33. Chirelstein, *supra* note 16, at 739.

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Table 1. Economic Consequences of Buybacks vs. Dividends

	A	*B*
Example 1		
Initial Holdings	50 shares x $1	50 shares x $1
After Corp Earns $100 Profits	50 shares x $2	50 shares x $2
$100 Buyback	-50 shares x $2	0
Final Holdings	0	50 shares x $2
Example 2		
Initial Holdings	50 shares x $1	50 shares x $1
After Corp Earns $100 Profits	50 shares x $2	50 shares x $2
$100 Dividend	50 shares x $1	50 shares x $1
Holdings Post-Dividend	50 shares x $1	50 shares x $1
Post-Dividend Purchase/Sale	-50 shares x $1	+50 shares x $1
Final Holdings	0	100 shares x $1

Notwithstanding the economic equivalence, though, Example 1 (buyback) leads to very different tax consequences than Example 2 (cash dividends). But before delving into the tax treatment of buybacks and dividends, it is worth pausing to consider the nontax reasons why a firm might choose one method or the other to distribute earnings to shareholders.

First, a company may have genuine nontax reasons for wanting its share price to remain above a certain threshold—for example, because a particular stock exchange will delist a company's shares if they fall below a particular price.[34] But the minimum share price for the New York Stock Exchange and Nasdaq is $1,[35] so this factor cannot explain the buyback decisions of firms whose share prices are comfortably above that floor.

A second nontax reason for corporations to choose buybacks over cash dividends results from the interaction between corporate distributions and employee stock options. To illustrate: imagine that ChirelsteinCorp hires a manager and offers her—as part of her pay package—call options

34. *See, e.g.*, Jonathan Macey, Maureen O'Hara & David Pompilio, *Down and Out in the Stock Market: The Law and Economics of the Delisting Process*, 51 J.L. & ECON. 683, 687-88 (2008).

35. *See* Bob Haring, *The Minimum Stock Price for NYSE*, ZACKS, https://finance.zacks.com/minimum-stock-price-nyse-5116.html [https://perma.cc/JW7A-JA7B]; Tiffany C. Wright, *Nasdaq Delisting Rules*, ZACKS, https://finance.zacks.com/nasdaq-delisting-rules-7450.html [https://perma.cc/S684-43H3].

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on ChirelsteinCorp stock with a strike price of $1.10 per share.[36] If ChirelsteinCorp distributes earnings to shareholders via a buyback, then the share price remains at $2, and the manager's call options are "in the money" (i.e., the share price is higher than the strike price). If ChirelsteinCorp distributes earnings to shareholders via a dividend, then the share price falls back to $1, and the manager's call options are "out of the money." Insofar as managers with stock options have influence over the choice between buybacks and dividends, they will generally prefer buybacks.[37]

Third, corporations may choose buybacks over cash dividends for nontax reasons if managers believe the firm's shares are undervalued.[38] Recall that a buyback is the equivalent of a cash dividend followed by a purchase of shares by nonredeeming shareholders from redeeming shareholders. If managers who own shares in the company believe that the shares are undervalued, and if the managers do not redeem their own shares in the buyback, then the buyback effectively allows the managers to purchase shares at what they believe to be a bargain price.

Finally, corporations may choose buybacks over cash dividends to defend against hostile takeovers. Unlike a cash dividend, a buyback increases the ownership percentage of nonredeeming shareholders. Managers who hold minority interests in a corporation may initiate a buyback—but not redeem any of their own shares—in order to increase their ownership stake and thus reduce the probability that a hostile tender offer will succeed.[39] But again, managers can accomplish the same result by issuing cash dividends and then using their dividends to buy shares, so buybacks are not the only way for managers to increase their percentage holdings.[40]

Many of the nontax reasons for choosing a dividend over a buyback are symmetrical to the above-listed reasons for choosing a buyback over a

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36. A call option is an option that entitles the holder to purchase the underlying asset for the strike price on or before a certain time.

37. *See* Richard A. Lambert, William N. Lanen & David F. Larcker, *Executive Stock Option Plans and Corporate Dividend Policy*, 24 J. FIN. & QUANTITATIVE ANALYSIS 409 (1989). Prior to the enactment of section 409A, a few companies compensated managers with "dividend-protected" stock options that aimed to offset the effect of dividends on option value, but dividend-protected stock options were rare among U.S. firms. *See* Marckus C. Arnold & Robert M. Gillenkirch, *Stock Options and Dividend Protection*, 161 J. INSTITUTIONAL & THEORETICAL ECON. 453, 453-54 (2005). Section 409A, which became effective in 2005, now effectively imposes severe penalties on firms that incorporate dividend-protection provisions in compensatory stock options. *See infra* Section I.C.

38. *See, e.g.*, Theo Vermaelen, *Common Stock Repurchases and Market Signaling: An Empirical Study*, 9 J. FIN. ECON. 139 (1981).

39. *See* Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377, 1393 (1986).

40. Arguably, buybacks solve a collective action problem among managers, who otherwise would have to agree on how many shares each one should purchase on the open market (with potential incentives to freeride). However, a similar collective action problem exists with buybacks if managers are free to redeem shares themselves.

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dividend. First, a company may have nontax reasons for *wanting* its share price to fall. At some point, very high share prices become cumbersome for investors—a case in point being Berkshire Hathaway's Class A shares, which traded at over $320,000 per share as of this writing.[41] Yet, this explanation likely applies to only a few phenomenally successful companies whose share prices rise so much as to become unwieldy.[42] And even in those cases, a company can reduce its share price through a stock split. Second, a company may choose cash dividends over buybacks precisely because the individuals making the distribution decision do *not* want to benefit managers with stock options. Third, a corporation may choose cash dividends over buybacks if managers think that shares are *overvalued*. If other shareholders—but not the managers—are enrolled in "dividend reinvestment plans" (DRIPs) that automatically use dividends to buy new shares, then issuing dividends allows managers to reduce their stake in the corporation.[43]

Several other shareholder-side reasons explain a possible preference for cash dividends over buybacks. First, some mutual funds and other institutional investors are required to maintain a certain percentage of dividend-paying securities in their portfolios.[44] This helps to explain why some companies, such as General Electric, have chosen to pay a dividend of one penny per share rather than eliminating dividends entirely.[45] Concededly, this explanation for cash dividends is incomplete, as it still leaves the question as to why a mutual fund or other institutional investor would commit itself to holding dividend-paying securities—a question to which path dependency may be the only answer.

Second, some trusts and endowments are structured such that the "income" and "principal" are treated differently. For example, an endowment's terms may stipulate that the income—including dividends—can be

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41. *See Berkshire Hathaway Inc BRK.A*, N.Y. STOCK EXCHANGE, https://www.nyse.com/quote/XNYS:BRK.A [https://perma.cc/2TBE-8K3H].

42. *See* Matt Levine, *Who Cares What Apple's Stock Price Is?*, BLOOMBERG OPINION (Apr. 25, 2014, 1:49 PM EST), https://www.bloomberg.com/opinion/articles/2014-04-25/who-cares-what-apple-s-stock-price-is [https://perma.cc/JFQ7-ELGG].

43. Once again, managers can achieve much the same outcome by selling some of their own shares on the open market. An advantage of pursuing this outcome through dividends rather than sales is that companies' insider-trading policies often do not apply to participation or non-participation in a DRIP. *See, e.g.*, BlackRock, Inc., Personal Trading Policy (Apr. 4, 2014), https://www.sec.gov/Archives/edgar/data/1100663/000119312514241353/d745741dex99p2.htm [https://perma.cc/5DVJ-KLBA] (exempting dividend-reinvestment plans from preclearance requirement in Section 5).

44. *See, e.g.*, BlackRock, Inc., BlackRock Equity Dividend Fund: Class K Shares (Summary Prospectus) (Nov. 28, 2018), https://www.sec.gov/Archives/edgar/data/814507/000119312518343088/d647539d497k.htm [https://perma.cc/HX5T-CGET].

45. *See, e.g.*, Michael Sheetz, *GE Makes It Official, Lowers Dividend to a Penny*, CNBC (Dec. 7, 2018), https://www.cnbc.com/2018/12/07/ge-makes-it-official-lowers-dividend-to-a-penny.html [https://perma.cc/3UHU-UE53].

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spent each year, while the principal—including capital appreciation—cannot be. A charitable institution may therefore have an incentive to invest endowment assets in dividend-paying securities in order to generate usable income.[46] Anecdotally, though, we know of very few major institutional investors still subject to restrictions of this sort.

Third, some investors (e.g., retirees living off their savings) may have a preference for liquidity that cash dividends satisfy. But in an era in which major brokerages will conduct commission-free trades,[47] it is relatively easy for these same investors to generate "homemade dividends" by selling their shares when they desire liquidity. Moreover, while companies that distribute earnings through buybacks rather than dividends impose transaction costs on shareholders with a preference for liquidity, companies that distribute earnings through cash dividends rather than buybacks impose transaction costs on shareholders with a preference for reinvesting those dividends.[48] Still, cash dividends potentially allow retail investors to access liquidity without the "regret" that may come from selling shares of a stock whose price then rises—which the behavioral economics literature suggests may be a benefit.[49]

All of this is to say that there are plausible—but, for the most part, not powerful—reasons why some managers and shareholders may prefer buybacks over cash dividends or vice versa. As a general rule, and setting tax considerations aside, managers and shareholders can achieve equivalent pretax economic outcomes through either approach. As the next Section explains, however, tax rules upset the near-equivalence in significant ways.

B. A Primer on the Taxation of Buybacks and Dividends

The taxation of buybacks and dividends is a story of clienteles. By "clienteles," we refer to different groups of taxpayers across whom the tax treatment of buybacks and dividends varies starkly.[50] For some clienteles,

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46. *See, e.g.*, Joel C. Dobris, *Why Trustee Investors Often Prefer Dividends to Capital Gain and Debt Investments to Equity—A Daunting Principal and Income Problem*, 32 REAL PROP. PROB. & TR. J. 255 (1997).

47. *See, e.g.*, *Commissions, Margin Rates, and Fees*, FIDELITY INV., https://www.fidelity.com/trading/commissions-margin-rates [https://perma.cc/HP8N-G6MJ].

48. Some, but not all, companies offer "no-fee" dividend reinvestment plans. *See, e.g.*, *No-Fee DRIPs*, DIRECTINVESTING.COM, https://www.directinvesting.com/search/no_fees_list.cfm [https://perma.cc/W6T3-4NE6]. Note, though, that "no-fee" dividend-reinvestment plans simply shift the transaction costs associated with dividend reinvestment from the shareholder to the corporation.

49. For a regret-aversion theory of cash dividend preferences, see Hersh M. Shefrin & Meir Statman, *Explaining Investor Preference for Cash Dividends*, 13 J. FIN. ECON. 253, 268-71 (1984).

50. *See* Franklin Allen, Antonio E. Bernardo & Ivan Welch, *A Theory of Dividends Based on Tax Clienteles*, 55 J. FIN. 2499 (2000).

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the tax treatment of buybacks is more favorable than the tax treatment of dividends. For others, it is the reverse. Still others are indifferent to the form in which corporations distribute earnings to shareholders. We consider the perspectives of U.S. individuals, foreigners, U.S. corporations, and tax-exempt investors.

1. U.S. Individuals

We start with individual U.S. citizens and residents who hold stock in taxable accounts. These individual taxpayers generally fare better when corporations distribute earnings through buybacks rather than dividends. Under section 302,[51] a buyback is generally treated as the disposition of a capital asset, and only the amount realized over the taxpayer's basis is included in gross income. By contrast, the entire amount of a dividend is included in gross income. Prior to 2003, dividends were treated as ordinary income, which for individuals was taxed at a higher rate than long-term capital gains.[52] Since 2003, income from dividends paid by domestic corporations and certain foreign corporations has been classified as "qualified dividend income," which for individuals has been taxed at the same rate as long-term capital gains.[53] But despite the post-2003 rate equivalence, different rules regarding realization and basis for buybacks and dividends have preserved the tax advantage of the former for U.S. individuals.

To illustrate: consider again Example 1 above, in which ChirelsteinCorp buys back 50 shares from *A* at a price of \$2 per share. The buyback is a realization event for *A*, and *A* has a capital gain equal to the amount realized (\$100) minus her cost basis (\$50), or \$50. If *A* has held her ChirelsteinCorp shares for more than a year, the gain will be taxed at the long-term capital-gain rate, which—for taxpayers in the highest income tax bracket—is currently 20%.[54] The buyback from *A* would not be a realization event for *B*, so *B* would pay no tax on the transaction.

Now consider Example 2, in which ChirelsteinCorp issues a cash dividend of \$1 per share and *B* then uses her cash dividend to buy *A*'s shares. Assuming again that the qualified-dividend provision applies, *A* and *B* would each pay tax at the long-term capital-gain rate on their \$50 of qualified dividend income. If both are in the top bracket, the tax for each one is 20% times \$50, or \$10. If *B* then buys *A*'s shares, *A* would experience a

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51. I.R.C. § 302 (2018).

52. *See* STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 23 (Comm. Print 2005), http://www.jct.gov/s-5-05.pdf [https://perma.cc/5KJX-DBW3]; David Hunkar, *U.S. Dividends and Capital Gains Tax Rate Since 1961*, SEEKING ALPHA (Aug. 7, 2011), https://seekingalpha.com/article/285468-u-s-dividends-and-the-capital-gains-tax-rate-since-1961 [https://perma.cc/3Z3K-AY59].

53. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760-61 (codified as amended at I.R.C. § 1(h) (2018)).

54. I.R.C. § 1(h) (2018).

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realization event—though in this example, the sale price ($1 per share) is equal to *A*'s purchase price, so no capital-gain tax is owed.

In Example 1 (buyback), the total tax paid by *A* is $10. In Example 2 (dividend), the total tax is $20 (i.e., $10 for each one). To be sure, the buyback approach does not necessarily eliminate tax liability—rather, it defers tax liability. In Example 1, *B* is left with 50 shares of ChirelsteinCorp stock, which she purchased for $50 and which are now worth $100. When she sells—assuming the long-term capital-gain rate remains the same—she will owe a tax of $10. In Example 2, *B* is left with 100 shares of ChirelsteinCorp stock and basis of $100, so she will owe no tax at the time of sale unless ChirelsteinCorp's share price rises in the future. Thus, either way (and with caveats soon to follow), *B* will ultimately pay $10 of tax; the difference between the buyback approach and the dividend approach is that with the buyback approach, she pays the $10 later, while with the dividend approach, she pays the $10 now.

Deferring the $10 tax liability is potentially a benefit to *B* if the nominal interest rate is greater than zero (as it generally is). Note that this deferral benefit arises even if *B* redeems some but not all of her shares in the buyback. The reason is that when *B* redeems some of her shares, she pays capital gains tax on the amount realized *minus basis*, while when she receives a dividend, the entire amount of the dividend is included in income. So in Example 1, if *B* had redeemed one share of ChirelsteinCorp stock at a price of $2, she would have paid capital gains tax on $1 (i.e., the amount realized minus her basis of $1 per share), while if she had received a $2 dividend, the entire dividend would have been taxable immediately.

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Table 2. Tax Consequences of Buybacks vs. Dividends

	A	*B*
Example 1		
Initial Holdings	50 shares x $1	50 shares x $1
After Corp Earns $100 Profits	50 shares x $2	50 shares x $2
$100 Buyback	-50 shares x $2	—
Final Holdings	0	50 shares x $2
Taxable Dividends	$0	$0
Tax at 20% rate	$0	$0
Taxable Capital Gains	50 shares x ($2 - $1) = $50	0
Tax at 20% rate	$50 x 20% = $10	$0
Unrealized Capital Gains	$0	50 shares x ($2 - $1) = $50
Example 2		
Initial Holdings	50 shares x $1	50 shares x $1
After Corp Earns $100 Profits	50 shares x $2	50 shares x $2
$100 Dividend	50 shares x $1	50 shares x $1
Holdings Post-Dividend	50 shares x $1	50 shares x $1
Post-Dividend Purchase/Sale	-50 shares x $1	+50 shares x $1
Final Holdings	0	100 shares x $1
Taxable Dividends	$50	$50
Tax at 20% rate	$50 x 20% = $10	$50 x 20% = $10
Taxable Capital Gains	50 shares x ($1 - $1) = $0	0
Tax at 20% rate	$0	$0
Unrealized Capital Gains	$0	100 shares x ($1 - $1) = $0

The benefit of deferral is not, however, the only potential tax benefit of the buyback approach. Most significantly, the step-up in basis at death[55] means that if *B* holds her shares for the rest of her life and bequeaths them to her children or other heirs, she can avoid tax on her $50 capital gain entirely. As we discuss below, this rule, with an assist from the tax law's treatment of buybacks, results in what the late Edward Kleinbard memorably called "the Mark Zuckerberg problem."[56] The problem, in brief, is

55. *See id.* § 1014.
56. Kleinbard, *supra* note 28, at 299.

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that current law allows founders of successful companies to amass and consume tremendous fortunes without paying any tax on those gains. They do this by acquiring stock when their companies are initially formed (often literally for pennies) and then by holding that stock until they die, at which point their heirs can sell their shares without any income tax due to the stepped-up basis rule. In the meantime, the corporation can distribute earnings to the shareholders via buybacks, and the founders will face no tax liability as long as they do not redeem their shares. We discuss the Mark Zuckerberg problem further in Section III.D.

The buyback approach—which allows *B* to avoid immediate taxation of dividends and instead hold stock with unrealized gains—confers benefits on *B* even if she does not hold her stock until death and benefit from the step-up in basis. If *B* ultimately contributes her ChirelsteinCorp shares to charity, she can avoid tax on her capital gain as well. Better yet, if *B* has held her shares for more than a year, she can claim a charitable contribution deduction for the fair market value of those shares, including the untaxed appreciation.[57] Even if *B* does not hold her shares until death or donate them to charity, she can time her sale of ChirelsteinCorp stock for a year in which she is in a lower bracket. And if *B* has capital losses that would otherwise go unused, she can use them to soak up the $50 capital gain. Because capital losses generally can be used to offset capital gains but not dividend income,[58] this is an additional advantage of the buyback approach.

Before leaving behind the tax treatment of individuals, one final point merits mention: section 302 of the Code, which governs the tax treatment of buybacks, provides that a corporation's redemption (i.e., repurchase) of its own shares will be treated as a payment in exchange for stock—and not as a cash dividend—"if the redemption is not essentially equivalent to a dividend."[59] The Supreme Court has held that a redemption is not essentially equivalent to a dividend if it results "in a meaningful reduction of the shareholder's proportionate interest in the corporation."[60] For repurchases by public companies, which are the focus of this Article, the IRS generously has determined that *any* reduction in percentage ownership interest by a non-controlling shareholder qualifies as a meaningful reduction.[61] As a practical matter, this means that repurchases by public

57. *See* I.R.C. § 170(e)(1)(A).

58. *See id.* § 1211(b). For individual taxpayers, net capital losses can offset ordinary income to the extent of $3,000 per year.

59. *Id.* § 302(a)-(b)(1).

60. United States v. Davis, 397 U.S. 301, 313 (1970).

61. Rev. Rul. 76-385, 1976-2 C.B. 92 (ruling that where a redeeming shareholder goes from a .00011118% interest in the corporation to a .0001081% interest, the redemption is not essentially equivalent to a dividend because "the redemption involves a minority shareholder whose relative stock interest . . . is minimal and who exercises no control over the affairs of [the

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corporations will almost always be treated as buybacks giving rise to capital gains (or losses) rather than as dividends.[62]

For nonpublic companies, the legal regime is rather more complicated. Any transaction in which a shareholder redeems (i.e., sells back) all of her stock will automatically be treated as a repurchase.[63] Thus, in Example 1, where *A* sold back all of her shares, the transaction would clearly qualify as a buyback rather than a dividend.[64] Likewise, a transaction is automatically treated as repurchase—and not as a dividend—if a shareholder reduces her voting and total interest by more than one fifth (e.g., from 10% to less than 8%) and ends up with less than 50% of the voting power in the company.[65]

For transactions that do not trigger automatic buyback treatment, the Supreme Court's meaningful-reduction test must be applied. In the context of closely held corporations, the test is a facts-and-circumstance standard. For example, in a 1975 IRS revenue ruling, a reduction of a shareholder's interest from 57% of a corporation's common stock to 50% qualified as a meaningful reduction when there was only one other shareholder because the redeeming shareholder went from having full control of the corporation to being positioned in a deadlock situation. The redemption therefore was treated as a sale and not a dividend.[66] A revenue ruling the following year reached the same result where the redeemed shareholder's interest was reduced from 27% to 22.27%. The IRS reasoned that—in light of the ownership percentages of other shareholders in the same corporation—the transaction meant that the taxpayer would now need the support of two

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corporation, and] as a result of the redemption, [the shareholder] experienced a reduction of its voting rights, its right to participate in current earnings and accumulated surplus, and its right to share in net assets on liquidation").

62. One exception would be where the redeeming shareholder has a sufficiently large post-redemption interest in the public company to allow her to continue to exercise some degree of practical control over the corporation. Another exception would be where the redeeming shareholder sold a smaller percentage of her shares than the percentage reduction of outstanding shares as a result of all of redemptions pursuant to the plan of redemption. For example, if a corporation with 100,000,000 shares outstanding redeems 5,000,000 shares, any shareholder who redeems shares totaling 5% or less of her shares would not qualify. Consider a shareholder who owns 5,000 shares before the redemption and who redeems 250 shares. Her percentage ownership would be unchanged: from 5,000/100,000,000 (0.005%) to 4,750/95,000,000 (0.005%). Accordingly, the redemption would be treated as a dividend, *see* I.R.C. § 302(a), and the basis of the redeemed shares would be shifted over to the shareholder's remaining shares. *See* Treas. Reg. § 1.302-2(c) (2007) (requiring "proper adjustment of the basis of the remaining stock" where the redemption is treated as a dividend).

63. I.R.C. § 302(b)(3).

64. Technically, this qualifies under a safe harbor that provides for sale treatment when there is a complete termination. *See id.* A similar safe harbor applies in the case of substantially disproportionate redemptions, which are determined by mathematical formulas. *See id.* § 302(b)(2).

65. *Id.* § 302(b)(2)(A).

66. Rev. Rul. 75-502, 1975-2 C.B. 111.

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other shareholders in order to constitute a majority (whereas she previously could have done so with only one other).[67]

While U.S. individuals who hold stock in taxable accounts have a tax incentive to prefer buybacks over dividends, those investors account for a relatively small fraction of all U.S. corporation stockholdings. According to a recent estimate by researchers at the Tax Policy Center, only around 25% of outstanding C corporation stock is held directly or indirectly by U.S. households in taxable accounts.[68] Another 40% is held by foreign residents, making it especially important to consider the way that U.S. and foreign tax rules affect those investors' preferences for buybacks versus dividends.[69]

2. Foreigners

For foreign investors—nonresident aliens and foreign corporations—the rules are different, but the result is generally the same: the U.S. federal income-tax treatment of buybacks is more generous than the tax treatment of dividends.[70]

The United States generally does not tax nonresident aliens and foreign corporations on capital gains from the sale of U.S. securities.[71] Thus, for those investors, buybacks are effectively U.S. tax-free. The United States does, however, tax dividends paid by U.S. corporations to nonresident aliens and foreign corporations. For those investors, the standard tax rate on dividends is 30%, and the dividend tax is withheld at the source by the issuing corporation.[72] Tax treaties often reduce this 30% rate to 15% (or 5% where the shareholder owns more than 10% of the issuing

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67. Rev. Rul. 76-364, 1976-2 C.B. 91.

68. Steve Rosenthal & Theo Burke, *Who's Left to Tax? US Taxation of Corporations and Their Shareholders* 1 (Urban-Brookings Tax Policy Ctr., Working Paper, 2020), https://www.law.nyu.edu/sites/default/files/Who's%20Left%20to%20Tax%3F%20US%20Taxation%20of%20Corporations%20and%20Their%20Shareholders-%20Rosenthal%20and%20Burke.pdf [https://perma.cc/877L-J2LA].

69. *See id.*

70. *See* Stanley Veliotis, *Equating U.S. Tax Treatment of Dividends and Capital Gains for Foreign Portfolio Investors*, 56 AM. BUS. L.J. 345 (2019) (noting the buyback advantage and mentioning Chirelstein's article in passing, though not explaining how Chirelstein's proposal would address the buyback advantage).

71. *See* I.R.C. § 865(a) (2018) (providing that personal property sales of foreigners are subject to various exceptions not relevant to stock sales, sourced outside the United States); *id.* § 871 (taxing foreign individuals who are not engaged in a trade or business in the United States only on their United States source of income); *id.* § 881 (same for foreign corporations).

72. See I.R.C. § 871(a)(1)(A) (taxing dividends received by foreign individuals); *id.* § 881(a)(1)(A) (taxing dividends received by foreign corporations); *id.* § 1441 (imposing withholding tax on dividends received by foreign individuals); *id.* § 1442 (imposing withholding tax on dividends received by foreign corporations).

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corporation's shares), but none of the United States' tax treaties provide for the total exemption of dividends.[73]

Often, a foreign investor's home jurisdiction will allow the foreign investor to credit U.S. taxes against her home jurisdiction tax liability. Even so, the home jurisdiction's own tax rules will often reproduce the buyback tax advantage. Although many countries nominally tax capital gains and dividends paid to residents at the same rate, some of the same factors that make buybacks more attractive to U.S. individual shareholders make them more attractive to foreign shareholders as well. Shareholders who do not sell their stock in a buyback can defer or strategically time their ultimate sale, so investors in those countries will have a tax preference for buybacks over dividends.[74]

Current law's treatment of foreign shareholders contributes to what we call "the Panama Papers problem": the ability of high-net-worth individuals from around the world to accumulate significant gains from U.S. equity investments without paying any tax anywhere. They can do this by purchasing shares listed on the New York Stock Exchange and Nasdaq via entities in tax-haven jurisdictions. While the U.S. imposes a withholding tax of up to 30% on dividends, no or little withholding tax is due if investors buy no- or low-dividend-yield stocks that return all or most of their earnings to shareholders via buybacks. As a result, these stocks offer an attractive place for tax dodgers to park their cash. We discuss the Panama Papers problem in Section III.E below.

3. U.S. Corporations

Domestic corporations that hold stock in other domestic corporations constitute a meaningful—though modest—share of the U.S. stockholding base. Intercorporate equity holdings account for about 6% of total U.S. public equity outstanding, according to a Tax Policy Center analysis of Federal Reserve data.[75] For these shareholders, the tax preference for buybacks is potentially reversed. For domestic corporations, dividends and capital gains are both taxed at the ordinary corporate rate, which is currently 21%. However, these corporations also generally receive a dividend-received deduction equal to 50% of the dividend.[76] The upshot is that

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73. *See Table 1. Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties*, INTERNAL REVENUE SERV. (Feb. 2019), https://www.irs.gov/pub/irs-utl/Tax_Treaty_Table_1_2019_Feb.pdf [https://perma.cc/T3L3-WYKB].

74. *See* Marcus Jacob & Martin Jacob, *Taxation, Dividends, and Share Repurchases: Taking Evidence Global*, 48 J. FIN. & QUANTITATIVE ANALYSIS 1241, 1249-1250 & tbl.2 (2013).

75. *See* Rosenthal & Burke, *supra* note 68, at 12 tbl.1.

76. *See* I.R.C. § 243. The deduction is 100% for dividends received by corporations who own 80% or more of the issuing corporation.

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dividends received by corporations are typically taxed at an effective rate of 10.5%—half the rate on capital gains.

The lower effective tax rate on dividends than on capital gains may suggest that domestic corporations that hold shares in other corporations have a straightforward tax incentive to prefer dividends over buybacks. In fact, the incentives facing domestic corporations are more complicated. First, domestic corporations potentially experience a tradeoff between the deferral benefit of buybacks and the benefit of the lower effective rate for dividends.[77] Second, corporations—like individuals—can use capital losses to offset capital gains but not dividends. Thus, a corporation with significant unused capital losses may prefer to receive distributions via buyback rather than cash dividend.[78] Depending on the particular circumstances of the domestic corporation (including the length of time for which it plans to hold shares and the extent of its unused capital losses), the tax benefits of cash dividends may outweigh the benefits of buybacks or vice versa.[79]

4. Tax-Exempt Investors

Finally, note that a significant portion of U.S. corporate stock is held by investors who have no tax preference for buybacks versus cash dividends. According to Tax Policy Center estimates, tax-exempt or tax-indifferent investors—including pension plans, individual retirement accounts (IRAs), governmental and nonprofit institutions, and life insurers—held around 37% of all U.S. corporate equity in 2019.[80] Distributions to pension-plan participants and IRA holders are taxed the same way regardless of whether they are funded from capital gains or cash dividends, so these shareholders are (at least for tax purposes) indifferent between buybacks and dividends. Meanwhile, investment income of nonprofit institutions is

77. Recall that the deferral benefit arises because repurchases allow immediate use of basis to offset proceeds, while dividends do not. This earlier use of basis results in tax deferral. Deferral is less valuable in the context of corporations in part because they do not have the potential for a stepped-up basis at death. Dealers in securities must calculate tax on a mark-to-market basis, effectively eliminating the tax benefit of deferral. *See id.* § 475(a).

78. The problem of unused capital losses is often more acute for corporations than individuals. While individuals may carry forward unused capital losses until they die, corporations may carry back capital losses to the three prior taxable years or carry them forward for only five years. *Compare id.* § 1212(b) (allowing unlimited carrying forward for individuals), *with id.* § 1212(a) (allowing a three-year carryback and five-year carryforward for corporations).

79. For a high-profile example of firms structuring a redemption as a dividend rather than a buyback in order to achieve more favorable tax treatment, see Merle M. Erickson & Shiing-wu Wang, *Exploiting and Sharing Tax Benefits: Seagram and DuPont*, 21 J. AM. TAX ASS'N, no. 2, 1999, at 35. In that case, Seagrams potentially saved $1.5 billion or more by structuring its redemption of DuPont shares as a dividend. *See id.* at 41 tbl.1.

80. *See* Rosenthal & Burke, *supra* note 68, at 14 tbl.4. Rosenthal and Burke's estimates—24% of U.S. equities held by taxable domestic investors, 40% by foreigners, 37% by tax-exempt or tax-indifferent investors—do not add to 100% due to rounding. For these purposes, intercorporate holdings are traced back to their ultimate owners.

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generally taxed very lightly or not at all,[81] and life insurers effectively pay no tax on investment income on their reserves,[82] so these shareholders have few tax-related reasons to prefer buybacks over dividends or vice versa.

All of this serves to illustrate that the conventional wisdom that buybacks are tax-advantaged relative to dividends amounts to an oversimplification. Foreign investors and U.S.-resident taxable individuals will generally prefer buybacks to dividends, but U.S. corporations that hold stock in other companies will not always share that preference, and a large segment of the shareholding population will be indifferent between the two forms of corporate cash distributions. As we discuss in Part III, these various positions will have important implications for buyback tax policy.

Table 3. U.S. Federal Income Tax Treatment of Buybacks and Dividends

Investor Type	Buybacks	Dividends
U.S. individuals (taxable accounts)	—Top rate on long-term capital gain = 23.8% —Deferral advantage (early basis recovery) —Capital losses can be used to offset —Avoid tax entirely through stepped-up basis, charitable contributions	—Top rate on qualified dividends = 23.8% —No immediate basis recovery —Capital losses cannot be used to offset
Foreign investors	—No U.S. tax (possibly home-country tax consequences)	—U.S. withholding tax at rate of ≤ 30%
U.S. corporations	—Rate = 21% —Deferral advantage (early basis recovery) —Capital losses can be used to offset	—Rate = 10.5% —No immediate basis recovery
Pension plans, retirement accounts, nonprofit organizations, life insurers	—Indifferent	

81. Private foundations pay a tax of 1 to 2% on net investment income. *See* I.R.C. § 4940 (2018). Starting in 2018, private colleges and universities with endowment assets of $500,000 per student or more are taxed at a rate equal to 1.4% of net investment income. *See id.* § 4968. Private foundations and wealthy colleges and universities have a slight tax incentive to prefer buybacks over dividends because of the deferral advantage.

82. *See* I.R.C. §§ 805(a), 807(b).

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C. The Fall of Dividends and the Rise of Buybacks

Around the time that Chirelstein wrote his landmark article, cash dividends still were the dominant form of corporate distribution in the United States. Gross buybacks by U.S. corporations remained less than 10% of aggregate cash distributions until 1979, rising to approximately 12% by 1980, 29% by 1990, and 53% by 2000.[83] By the third quarter of 2019, approximately 61% of cash distributions by S&P 500 firms came in the form of buybacks (with the remainder in dividends).[84] Commentators now routinely refer to this recent period as a "buyback boom."[85]

What explains the rise of buybacks relative to cash dividends? At least three factors potentially contributed to the trend.

First, in November 1982, the Securities and Exchange Commission (SEC) promulgated Rule 10b-18 under the Exchange Act of 1934, which provides issuers with a limited safe harbor from liability for market manipulation when they buy back their shares.[86] Importantly, the Rule 10b-18 safe harbor applies to liability "*solely* by reason of the manner, timing, price, and volume" of repurchases;[87] it does not affect liability for insider trading when the corporation possesses material, nonpublic information concerning the value of its securities.[88] Still, the SEC rule is widely credited with reducing regulatory uncertainty surrounding buybacks,[89] and it appears to be associated with a sharp rise in buybacks as a percentage of corporate cash distributions over the course of the 1980s.

Second, starting in the 1980s, stock option grants became an increasingly large component of compensation for executives and other employees. Whereas stock-option grants constituted only around 14% of direct compensation for CEOs at the largest publicly traded U.S. companies in

83. Gustavo Grullon & Roni Michaely, *Dividends, Share Repurchases, and the Substitution Hypothesis*, 57 J. FIN. 1649, 1655 tbl.1 (2002) (dividing the "REPO" column by the sum of the "REPO" + "DIV" columns).

84. Edward Yardeni, Joe Abbott & Mali Quintana, *Corporate Finance Briefing: S&P 500 Buybacks & Dividends*, YADENI RES., INC. 9 fig.11 (Feb. 14, 2020), https://www.yardeni.com/pub/bbdivepsyield.pdf [https://perma.cc/9FTY-KNNZ].

85. *See, e.g.*, Andrew Barry, *Why the Buyback Boom Is Bullish for Investors*, BARRON'S (May 12, 2018), https://www.barrons.com/articles/why-the-buyback-boom-is-bullish-for-investors-1526089472.

86. *See* 17 C.F.R. 240.10b-18 (2005).

87. *Id.* n.1.

88. Div. Trading & Mkts., *Answers to Frequently Asked Questions Concerning Rule 10b-18 ("Safe Harbor" for Issuer Repurchases)*, U.S. SEC. & EXCHANGE COMMISSION (Dec. 2, 2016), https://www.sec.gov/divisions/marketreg/r10b18faq0504.htm [https://perma.cc/A8S8-YTLT].

89. On the history of Rule 10b-18, see Douglas O. Cook, Laurie Krigman & J. Chris Leach, *An Analysis of SEC Guidelines for Executing Open Market Repurchases*, 76 J. BUS. 289, 292-93 (2003).

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1980, that figure had risen to 48% by 1994.[90] Several factors account for this phenomenon. Pressure from potential acquirers during the hostile takeover boom of the 1980s encouraged corporations to adopt compensation arrangements that linked executive pay to share price.[91] Academic researchers who advocated for equity-based compensation in the 1980s and early 1990s also arguably played a role.[92] Then in 1993, Congress added section 162(m) to the Internal Revenue Code, which limited the ability of corporations to claim deductions for compensation to senior executives in excess of $1 million unless those pay packages were performance-based.[93] Stock options were one type of performance-based compensation to which corporations turned so that they could pay their top executives more than $1 million and still deduct the full cost.[94] The December 2017 tax law ended the exception for performance-based pay.[95]

To be sure, these developments do not explain why stock options, as opposed to alternative forms of incentive-based pay, became predominant. The preference for stock options in particular was likely largely a function of financial accounting standards. A 1972 accounting rule instructed corporations not to treat compensatory stock-option grants as expenses unless the strike price was lower than the company's share price at the time.[96] The effect of that rule was that corporations could compensate executives and employees in valuable stock options that did not immediately reduce the firms' reported profitability. The Financial Accounting Standards Board

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90. *See* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid like Bureaucrats?*, 113 Q.J. ECON. 653, 661 tbl.IIa (1998).

91. *See* Amanda Bennett, *A Great Leap Forward for Executive Pay: Stock Options Propelled Gains by CEOs in '88*, WALL. ST. J. (Apr. 24, 1989), https://search.proquest.com/docview/135406875 [https://perma.cc/724D-LH4Z].

92. *See* Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got Here, What Are the Problems, and How to Fix Them* 35 (Harvard Bus. Sch. Negotiation, Orgs. & Mkts Unit, Working Paper No. 44, 2004), https://ssrn.com/abstract=561305 [https://perma.cc/X6BM-T6Y3] (citing Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, but How*, HARV. BUS. REV., May-June 1990, at 138; Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top Management Incentives*, 98 J. POL. ECON. 225 (1990)).

93. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13211, 107 Stat. 312, 435, 470-71 (codified as amended at I.R.C. § 162(m) (2018)).

94. *See, e.g.*, Austan Goolsbee, *What Happens When You Tax the Rich? Evidence from Executive Compensation*, 108 J. POL. ECON. 352, 368 (2000).

95. Pub. L. No. 115-97, § 13601(a), 131 Stat. 2054, 2155-56 (2017) (amending I.R.C. § 162(m)).

96. *See* Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 54 (2003).

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changed that rule in 2004, with the change taking effect in 2006.[97] Since then, stock-option grants to top executives have declined significantly.[98]

The rise of stock-option grants between the early 1980s and the mid-2000s helps to explain the increase in buybacks over that period. This is because stock-option grants generally are not "dividend-protected." Recall that in Example 2 above, the decision to distribute earnings to shareholders through cash dividends rather than buybacks reduces the corporation's share price. When a company's share price declines, so too does the value of employees' stock options. Managers who hold stock options thus have an incentive to favor buybacks over cash dividends. Cross-firm comparisons provide some support for the view that option-based compensation contributed to the buyback rise.[99]

In theory, corporations could grant "dividend-protected" stock options to executives and other employees. While there are several ways to achieve dividend protection, one method commonly used in the over-the-counter options market (and therefore known as "over-the-counter dividend protection") is to reduce the strike price of a call option by the amount of the dividend paid.[100] However, U.S. tax rules have made over-the-counter dividend protection extremely unattractive for U.S. corporations compensating executives and other employees in option form. Compensatory stock options are subject to section 409A of the Internal Revenue Code if the exercise price could under any circumstances be reduced below the fair market value of the stock on the day that the option was granted.[101] The consequences of section 409A's application are severe and include acceleration of taxable income before exercise and a 20% excise tax.[102] Likewise, prior to the December 2017 tax law, the exemption from section 162(m) for performance-based pay did not apply to stock options if the exercise price could be reduced below fair market value as of the grant date.[103] A fair market value exercise price with dividend protection

97. Press Release, Fin. Accounting Standards Bd., FASB Issues Final Statement on Accounting for Share-Based Payment (Dec. 16, 2004), https://www.fasb.org/news/nr121604_ebc.shtml [https://perma.cc/5QN3-LJLR].

98. *See* Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, *in* 2A HANDBOOK OF THE ECONOMICS OF FINANCE 211, 224 fig.2 (George M. Constantinides, Milton Harris & René M. Stulz eds., 2013).

99. *See* Christine Jolls, *Stock Repurchases and Incentive Compensation* (Nat'l Bureau of Econ. Research, Working Paper No. 6467, 1998), https://www.nber.org/papers/w6467 [https://perma.cc/6SJN-QBCX].

100. This turns out to provide imperfect dividend protection for call-option holders. For a discussion, see Robert Geske, Richard Roll & Kuldeep Shastri, *Over-the-Counter Option Market Dividend Protection and "Biases" in the Black-Scholes Model: A Note*, 38 J. FIN. 1271 (1983).

101. *See* Treas. Reg. § 1.409A-1(b)(5)(A)(1) (2007).

102. *See* I.R.C. § 409A (2018).

103. *See* Treas. Reg. § 1.162-27(e)(2)(vi)(A) (2015). The regulation does allow for the payment of a "dividend equivalent" to the optionholder but only if the dividend equivalent payment is not contingent on the exercise of the option. The over-the-counter dividend protection,

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would not qualify for the exemption. Recall that one of the reasons for paying executives in stock options so that compensation over $1 million could be deductible to the corporation. Using dividend-protected stock options would have defeated this objective.

While the rise of stock-option-based compensation may help to explain the increasing frequency of buybacks from the 1980s until the mid-2000s, stock options cannot account for the more recent uptick in buyback activity over the last several years. That is because the buyback boom over the past decade has come at a time when fewer firms are granting stock options to executives and other employees, and stock options are coming to constitute a smaller share of executive and employee pay.[104] Stock awards, which in most cases do come with dividend protection, have supplanted stock options as the primary form of performance-based pay at publicly traded corporations.[105] While stock options accounted for 60% of the compensation paid to top executives in a sample of S&P companies in 2000, they accounted for only 17% of senior-executive pay in 2013.[106] Meanwhile, non-option-based stock compensation rose from 10% to 42%.[107] One observer has gone so far as to argue that stock options were "on the verge of extinction" by 2013.[108] So while stock options may have played a role in the initial shift from cash dividends to buybacks, they do not appear to account for the continuation and acceleration of that trend.

A third factor contributing to the rise of share repurchases—in addition to the Rule 10b-18 safe harbor and the shift toward stock options—is the dramatic decline in transaction costs of buying and selling stocks. The average commission per share traded on the New York Stock Exchange fell from approximately $0.25 in 1980 to well below $0.05 by the early 2000s.[109] This trend is attributable both to technological advances and to an increase in price competition among brokers following the SEC's 1975

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which reduces the exercise price, only benefits the holder in the event of exercise, so the protection would disqualify the options as performance-based under section 162.

104. *See* Emily Chasan, *Last Gasp for Stock Options?*, WALL ST. J. (Aug. 27, 2013), https://www.proquest.com/docview/1941733546 [https://perma.cc/W9QC-QASA].

105. *See* Kristina Minnick & Leonard Rosenthal, *Stealth Compensation: Do CEOs Increase Their Pay by Influencing Dividend Policy?*, 25 J. CORP. FIN. 435 (2014); *CEO and Executive Compensation Practices*, CONF. BOARD 17 (2019), https://conference-board.org/pdfdownload.cfm?masterProductID=20236 [https://perma.cc/5GJP-AWL8].

106. David I. Walker, *The Way We Pay Now: Understanding and Evaluating Performance-Based Executive Pay*, 1 J.L. FIN. & ACCT. 395, 396 (2016).

107. *Id.*

108. Chasan, *supra* note 104.

109. Sam Ro, *Average Commission per Share vs. Trading Volume*, BUS. INSIDER (Apr. 21, 2015, 7:04 PM), https://www.businessinsider.com/average-commission-per-share-on-nyse-vs-volume-2015-4 [https://perma.cc/MG8L-SQ39]; *see also* Michael A. Goldstein, Paul Irvine, Eugene Kandel & Zvi Wiener, *Brokerage Commissions and Institutional Trading Patterns*, 22 REV. FIN. STUD. 5175, 5179 fig.1 (2009) (showing the decline in institutional investor average cents-per-share commission from 1977 to 2004, dropping from above twelve cents per share to little over four cents per share).

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abolition of fixed-rate brokerage commissions.[110] The decline in transaction costs makes it easier for investors to generate "homemade dividends" by selling shares when they desire liquidity. The availability of homemade dividends, in turn, makes cash dividends less attractive. Note, though, that the same development allows shareholders who do not desire liquidity to reinvest dividends at lower cost—thus reducing the *disadvantage* of dividends for some shareholders. The increasing popularity of dividend-reinvestment plans—which allow a corporation's shareholders to purchase additional shares with dividends directly from the company without commission—has done the same.[111] Thus, the causal relationship between the decline in transaction costs and the rise in buybacks is not crystal clear.

Interestingly, the rise in buybacks relative to cash dividends does *not* appear to be a function of changes in tax rules that make buybacks more attractive. If anything, the tax advantage of buybacks relative to dividends is smaller today than it once was. From 1954 until 1986 and again from 1990 to 2003,[112] dividends were taxed at a higher rate than long-term capital gains, thus adding a rate advantage to the deferral advantage of buybacks. Moreover, the tax advantage of deferral increases with the nominal interest rate, which is lower today than at most points in the past half-century.[113] Finally, the advent and expansion of IRAs and similar tax-preferred savings vehicles have created newer and larger opportunities for Americans to hold corporate stock in accounts that neutralize the tax disadvantage of dividends.[114]

The December 2017 tax law does appear to have contributed to the recent buyback boom, but not because it increased the tax advantage of buybacks relative to dividends (it did not). Rather, the December 2017 law allowed U.S. corporations to repatriate earnings from offshore subsidiaries at no incremental tax cost, freeing up funds for corporate distributions of all sorts.[115] This development may—as will be discussed in Part III—

110. *See, e.g.*, Vartanig G. Vartan, *Market Place: Those Discount Stockbrokers*, N.Y. TIMES (Jan. 19, 1984), https://www.nytimes.com/1984/01/19/business/market-placevartanig-g-vartan-those-discount-stockbrokers.html [https://perma.cc/A33V-LM42].

111. *See The DRIP Answer Report*, DRIP INVESTOR, https://www.dripinvestor.com/drip_answer_report.asp [https://perma.cc/MR7F-Y3YS] (noting that more than 1,100 companies have dividend-reinvestment plans).

112. On the history of dividend taxation, see JAMES G. GRAVELLE & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R43418, THE TAXATION OF DIVIDENDS: BACKGROUND AND OVERVIEW 17-19 app. A (2014). On the history of capital gains taxation, see *Historical Capital Gains and Taxes*, TAX POL'Y CTR. (May 4, 2017), https://www.taxpolicycenter.org/statistics/historical-capital-gains-and-taxes [https://perma.cc/KYV6-9FJX].

113. *Interest Rates, Discount Rate for United States*, FED. RES. BANK ST. LOUIS (Aug. 24, 2020), https://fred.stlouisfed.org/series/INTDSRUSM193N [https://perma.cc/ALB6-WPK7].

114. *See* Rosenthal & Burke, supra note 68, at 14 (estimating that 37% of U.S. company stock is held in tax-exempt or tax-preferred accounts).

115. *See* Anne Marie Knott, *Why the Tax Cuts and Jobs Act (TCJA) Led to Buybacks Rather Than Investment*, FORBES (Feb. 21, 2019),

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provide a new impetus for changes to the Internal Revenue Code that level the playing field between buybacks and cash dividends, but the buyback advantage has long been embedded in U.S. tax law.

II. Chirelstein's Proposal

Given that the buyback boom of the 1980s was still more than a decade off, Professor Chirelstein's proposal in 1969 to level the tax playing field between buybacks and cash dividends was arguably an idea before its time. Chirelstein's interest in the topic was likely piqued by a buyback boomlet in the early to mid-1960s—his first footnote notes that corporations listed on the New York Stock Exchange paid out more than $1.3 billion to repurchase shares in 1963.[116] But to put that figure in perspective, companies listed on the New York Stock Exchange paid out approximately $13 billion in cash dividends that same year,[117] so even during the buyback boomlet, repurchases constituted less than tenth of corporate cash distributions by New York-listed firms.

While the buyback boomlet of the 1960s was little more than a blip by the standards of later years, Chirelstein nonetheless perceived the differential tax treatment of buybacks and cash dividends to be a tax policy problem. To address this problem, Chirelstein suggested that all cash distributions by publicly traded corporations be treated like cash dividends. Chirelstein's basic insight was that every buyback can be redescribed as—and taxed as—a cash dividend followed by a sale of shares from redeeming shareholders to nonredeeming shareholders.

In this part, we introduce Chirelstein's proposal through a series of illustrations. We then discuss a number of complications and implementation challenges. We conclude the Part by examining Chirelstein's justifications for his approach.

A. The Basics

Chirelstein's proposal is perhaps easiest to understand by way of example. Recall again Examples 1 and 2 above, which we reprint here for easy reference:

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https://www.forbes.com/sites/annemarieknott/2019/02/21/why-the-tax-cuts-and-jobs-act-tcja-led-to-buybacks-rather-than-investment [https://perma.cc/JV38-GAVC].

116. *See* Chirelstein, *supra* note 16, at 739 n.1.

117. Peter L. Elkovich, *1963 Trading Volume Highest in History of Stock Exchange*, N.Y. TIMES (Jan. 1, 1964), https://www.nytimes.com/1964/01/01/archives/1963-trading-volume-highest-in-history-of-stock-exchange.html [https://perma.cc/X74E-BXGZ] (noting the NYSE's market capitalization of $405 billion at the end of 1963); *Dividend Yield of Common Stocks on the New York Stock Exchange, Composite Index for United States*, FED. RES. BANK ST. LOUIS (Aug. 20, 2012), https://fred.stlouisfed.org/series/M1346BUSM156NNBR [https://perma.cc/LN8A-BHSJ] (showing an aggregate dividend yield of 3.13% for NYSE companies in December 1963).

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Example 1. ChirelsteinCorp issues 100 shares for $1 each. *A* and *B* each buy 50 shares. ChirelsteinCorp then earns $100 in profits, which causes the value of each share to rise from $1 to $2 (assuming that market value equals book value). ChirelsteinCorp thereafter decides to distribute its $100 of earnings to its shareholders. ChirelsteinCorp does so by repurchasing 50 shares. *A* chooses to redeem all 50 of her shares; *B* chooses not to redeem. The total cost of the buyback to ChirelsteinCorp is $100; *A* receives $100 and *B* receives zero; and the value of each ChirelsteinCorp share remains $2. *B* now owns all 50 outstanding shares of ChirelsteinCorp, which is worth $100.

Example 2. ChirelsteinCorp issues 100 shares for $1 each. *A* and *B* each buy 50 shares. ChirelsteinCorp then earns $100 in profits, which causes the value of each share to rise from $1 to $2 (assuming that market value equals book value). ChirelsteinCorp thereafter decides to distribute its $100 of earnings to its shareholders. ChirelsteinCorp does so by issuing a cash dividend of $1 per share, causing the value of each share to fall from $2 back to $1. Afterwards, *B* uses the $50 she has received through the cash dividend to purchase *A*'s 50 shares. *B* now owns all 100 outstanding shares of ChirelsteinCorp, which is worth $100.

Chirelstein would treat Example 1 the same as Example 2. That is, he would treat Example 1 as if the corporation had paid a cash dividend of $1 per share, causing the value of each share to decline by $1, and then the nonredeeming shareholder had purchased the redeeming shareholder's stake. *A* and *B* would each have $50 of dividend income, on which they would owe tax. *A* would owe no capital gains tax because the sale price ($1 per share) is equal to her basis. *B* would now have basis of $100, reflecting the amount that she paid for her own shares plus the amount that she is deemed to have paid to *A* for *A*'s shares.

Table 4. Tax Consequences of Buybacks vs. Dividends—Status Quo vs. Chirelstein Proposal

	A	***B***
Example 1		
Initial Holdings	50 shares x $1	50 shares x $1
After Corp Earns $100 Profits	50 shares x $2	50 shares x $2
$100 Buyback	-50 shares x $2	—
Final Holdings	0	50 shares x $2
Status Quo		
Taxable Dividends	$0	$0
Taxable Capital Gains	50 shares x ($2 - $1) = $50	0
Unrealized Capital Gains	$0	50 shares x ($2 - $1) = $50

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Chirelstein Proposal		
Taxable Dividends	$50	$50
Taxable Capital Gains	50 shares x ($1 - $1) = $0	—
Unrealized Capital Gains	$0	100 shares x ($1 - $1) = $0
Example 2		
Initial Holdings	50 shares x $1	50 shares x $1
After Corp Earns $100 Profits	50 shares x $2	50 shares x $2
$100 Dividend	50 shares x $1	50 shares x $1
Holdings Post-Dividend	50 shares x $1	50 shares x $1
Post-Dividend Purchase/Sale	-50 shares x $1	+50 shares x $1
Final Holdings	0	100 shares x $1
Taxable Dividends	$50	$50
Taxable Capital Gains	50 shares x ($1 - $1) = $0	—
Unrealized Capital Gains	$0	100 shares x ($1 - $1) = $0

Two more examples may reinforce the point:

> **Example 3.** ChirelsteinCorp has 100 shares of stock outstanding, with five investors (*A*, *B*, *C*, *D*, and *E*) each owning 20 shares. The value of each share is $0.80, and each shareholder's basis is zero. ChirelsteinCorp then earns $20, causing the value of each share to rise to $1. ChirelsteinCorp uses its $20 of earnings to repurchase shares. Only *A* elects to participate in the buyback, and she chooses to redeem all of her shares at $1 per share.

Under current law, the transaction would be treated as the disposition of a capital asset by *A*, with *A* paying capital gains tax on $20, which is the difference between her amount realized ($20) and her basis ($0). Under Chirelstein's proposal, the transaction would be broken down into two steps. At step one, the corporation would pay a cash dividend of $0.20 per share to *A*, *B*, *C*, *D*, and *E*. Assuming that each shareholder holds her shares in a taxable account, each would owe a tax at the dividend rate on $4 (i.e., $0.20 per share times 20 shares), and the value of each share would decline by $0.20. At step two, *A* would be treated as if she had sold all of her shares for $0.80 per share. She would thus owe capital gains tax on $16 (i.e., the sale price of $0.80 per share minus her basis of $0.00 per share, multiplied by 20 shares). *B*, *C*, *D*, and *E* would each acquire five new shares of ChirelsteinCorp stock from *A* with a basis of $0.80 per share. The result

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is that each of these shareholders end up with a total of $4 basis in their shares (up from $0). Thus, under Chirelstein's proposal, *A* ends ups with $4 of dividend income and $16 of capital gain, in contrast with $20 of capital gain under current law. Each of *B*, *C*, *D*, and *E* ends up with $4 of dividend income and a $4 basis increase, while under current law they would experience no immediate tax consequences or basis adjustment.

> **Example 4.** ChirelsteinCorp has 100 shares of stock outstanding, with five investors (*A*, *B*, *C*, *D*, and *E*) each owning 20 shares. The value of each share is $0.90, and all shares have a basis of zero. ChirelsteinCorp then earns $10, causing the value of each share to rise to $1. ChirelsteinCorp uses its $10 of earnings to repurchase shares. Only *A* elects to participate in the buyback, and she chooses to redeem 10 of her shares at $1 per share.

Again, current law would treat the transaction as the disposition of a capital asset by *A*, with *A* paying capital gains tax on $10, which is the amount realized ($10) minus her zero basis. Chirelstein would separate the transaction into (i) the payment of a cash dividend of $0.10 per share to all shareholders, which causes the value of each share to decline by $0.10, followed by (ii) the sale by *A* of 10 shares at a price of $0.90 per share. All five shareholders would recognize dividend income of $0.10 per share ($2 total). *A* would owe capital gains tax on $9, which is equal to a sale price of $0.90 per share minus basis of zero multiplied by 10 shares. She would now hold 10 shares with a value of $0.90 per share and a basis of zero, for an unrealized gain of $9 going forward. *B*, *C*, *D*, and *E* would each acquire 2.5 new shares from *A* with a basis of $0.90 per share, or $2.25 in total. Each would now hold 22.5 shares with a value of $0.90 per share ($20.25 total) and a basis of $0.90 in 2.25 of those shares ($2.25 total). Each would thus have a total unrealized gain of $18 going forward.

Two aspects of this redescription are somewhat inelegant. First, the redescribed transaction leaves the corporation with a different number of outstanding shares than it actually has. Thus, we have redescribed the transaction in Example 4 as if *B*, *C*, *D*, and *E* had each purchased 2.25 shares from *A*, when in fact, *A*'s shares were redeemed and cancelled. Second, in the redescribed transaction, the corporation has a different share price than it actually has. Thus, in Example 4, the redescription imagines that the corporation's share price falls from $1 per share to $0.90, when in fact, the corporation's shares would continue to trade for $1.

The easiest way to smooth over this inelegance is to adjust the basis of all shares by the amount of the imputed dividend, and otherwise to respect real-world share cancellations and price changes. Though Chirelstein does not explicitly adopt this approach, his analysis appears to assume it.[118]

118. *See* Chirelstein, *supra* note 16, at 752-53 (explaining, in an example, that the nonredeemers' aggregate basis would simply be increased by the deemed dividend).

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Thus, in Example 4, after taxing each shareholder on an imputed dividend of $0.10 per share, we would adjust each shareholder's basis upward by $0.10. The redeeming shareholder (*A*) would have a capital gain of $1 per share minus her new basis of $0.10 per share, multiplied by 10, for a total of $9. Shares that are redeemed and cancelled could be treated as such, so *A* would now hold 10 shares and *B*, *C*, *D*, and *E* would each hold 20. Each shareholder would have a basis of $0.10 per share going forward. *A* would thus have an unrealized gain going forward of $9 (i.e., a share price of $1 per share minus a basis of $0.10 per share, multiplied by 10 shares). *B*, *C*, *D*, and *E* each would have an unrealized gain of $18 going forward (i.e., a share price of $1 per share minus a basis of $0.10 per share, multiplied by 20 shares).[119]

A more technical accounting of the recharacterized transaction (i.e., distributions of cash to all shareholders followed by purchases of redeemed shares) would give the newly acquired shares of *B*, *C*, *D*, and *E* a fair market value basis, while their old shares' basis would be unaffected. Broadly speaking, the basis-adjustment approach we recommend is consistent with this more precise accounting of the transaction because each shareholder's overall stock basis is the same regardless.[120]

In general, the basis-adjustment approach will put nonredeeming shareholders at a (sometimes slight) disadvantage relative to a scenario in which the corporation actually pays a dividend and some shareholders use the dividend to acquire stock from others. To illustrate, recall again Example 3:

> **Example 3.** ChirelsteinCorp has 100 shares of stock outstanding, with five investors (*A*, *B*, *C*, *D*, and *E*) each owning 20 shares. The value of each share is $0.80, and each shareholder's basis is zero. ChirelsteinCorp then earns $20, causing the value of each share to rise to $1. ChirelsteinCorp uses its $20 of earnings to repurchase shares. Only *A* elects to participate in the buyback, and she chooses to redeem all of her shares at $1 per share.

If the corporation had simply distributed a dividend of $0.20 per share and *B*, *C*, *D*, and *E* each had used their dividend to purchase five shares of stock from *A*, the value of each share would be $0.80, the nonredeeming shareholders would each hold 25 shares (their original 20 plus the 5 purchased from *A*), and each would have a fair market value basis in the shares bought from *A*. If one of the nonredeeming shareholders (say, *B*) then chose to liquidate $4 of her holdings, she could choose to sell the five shares with fair market value basis and pay a capital gains tax of zero. She would

119. The effect is that of a reverse stock split. In Example 4, there would be a 4:5 stock split. Reverse stock splits are tax-free, and the basis of the canceled shares are added to the basis of the remaining shares. *See* I.R.C. § 305 (2018).

120. *See* Yale, supra note 19, at 352-53 (noting this distinction).

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then have $16 of unrealized gains going forward ($0.80 per share multiplied by 20 shares).

If the corporation bought back *A*'s shares, then the basis-adjustment approach would respect the fact that *B*, *C*, *D*, and *E* actually own only 20 shares with a value of $1 per share, and it would adjust the basis of each share from zero to $0.20. If *B* then chose to liquidate $4 of her holdings, she would sell four shares and pay capital gains tax on $3.20 (an amount realized of $1 per share minus a basis of $0.20 per share, multiplied by 4 shares), and she would have $12.80 of unrealized gains going forward ($0.80 per share multiplied by 16 remaining shares). She would have lost the ability to cherry-pick among shares so as to defer capital gains tax.[121]

**Table 5. Tax Consequences of Buybacks—
Status Quo vs. Precise Accounting vs. Basis Adjustment**

	A	***B***	***C***	***D***	***E***
Example 3					
Initial Holdings	20 shares x $0.80	20 shares x $0.80	20 shares x $0.80	20 shares x $0.80	20 shares x $0.80
After Corp Earns $20 Profits	20 shares x $1.00	20 shares x $1.00	20 shares x $1.00	20 shares x $1.00	20 shares x $1.00
$20 Buy-back	-20 shares x $1.00	—	—	—	—
Final Holdings	0	20 shares x $1.00	20 shares x $1.00	20 shares x $1.00	20 shares x $1.00
Status Quo					
Taxable Dividends	$0	$0	$0	$0	$0
Taxable Capital Gains	20 shares x ($1 - $0) = $20	$0	$0	$0	$0
Unrealized Capital Gains	$0	$20	$20	$20	$20

121. In other cases, the basis-adjustment approach could benefit nonredeemers. For example, in the case of an actual dividend reinvestment, the holding period for the newly purchased shares would begin upon purchase, meaning that if those shares were sold for a gain within a year, the gain would be characterized as a short-term capital gain (and taxed at ordinary rates). Under the basis-adjustment approach, by contrast, the shareholder could sell within a year of the redemption and potentially claim a long-term capital gain (taxed at preferential rates).

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Precise Accounting					
Taxable Dividends	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4
Taxable Capital Gains	20 shares x (\$0.80 - \$0) = \$16	\$0	\$0	\$0	\$0
Unrealized Capital Gains	\$0	20 shares x (\$0.80 - \$0) + 5 shares x (\$0.80 - \$0.80) = \$16	20 shares x (\$0.80 - \$0) + 5 shares x (\$0.80 - \$0.80) = \$16	20 shares x (\$0.80 - \$0) + 5 shares x (\$0.80 - \$0.80) = \$16	20 shares x (\$0.80 - \$0) + 5 shares x (\$0.80 - \$0.80) = \$16
Basis-Adjustment Approach					
Taxable Dividends	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4	20 shares x \$0.20 = \$4
Taxable Capital Gains	20 shares x (\$1 - \$0.20) = \$16	\$0	\$0	\$0	\$0
Unrealized Capital Gains	\$0	20 shares x (\$1.00 - \$0.20) = \$16	20 shares x (\$1.00 - \$0.20) = \$16	20 shares x (\$1.00 - \$0.20) = \$16	20 shares x (\$1.00 - \$0.20) = \$16

Table 6. Tax Consequences of Buybacks—
Status Quo vs. Precise Accounting vs. Basis Adjustment

	A	***B***	***C***	***D***	***E***
Example 4					
Initial Holdings	20 shares x \$0.90	20 shares x \$0.90	20 shares x \$0.90	20 shares x \$0.90	20 shares x \$0.90
After Corp Earns \$10 Profits	20 shares x \$1.00	20 shares x \$1.00	20 shares x \$1.00	20 shares x \$1.00	20 shares x \$1.00
\$10 Buy-back	-20 shares x \$1.00	—	—	—	—
Final Holdings	0	20 shares x \$1.00	20 shares x \$1.00	20 shares x \$1.00	20 shares x \$1.00

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Status Quo					
Taxable Dividends	$0	$0	$0	$0	$0
Taxable Capital Gains	20 shares x ($1 - $0) = $20	$0	$0	$0	$0
Unrealized Capital Gains	$0	$20	$20	$20	$20
Precise Accounting					
Taxable Dividends	20 shares x $0.10 = $2	20 shares x $0.10 = $2	20 shares x $0.10 = $2	20 shares x $0.10 = $2	20 shares x $0.10 = $2
Taxable Capital Gains	20 shares x ($0.90 - $0) = $18	$0	$0	$0	$0
Unrealized Capital Gains	$0	20 shares x ($0.90 - $0) + 2.5 shares x ($0.90 - $0.90) = $18	20 shares x ($0.90 - $0) + 2.5 shares x ($0.90 - $0.90) = $18	20 shares x ($0.90 - $0) + 2.5 shares x ($0.90 - $0.90) = $18	20 shares x ($0.90 - $0) + 2.5 shares x ($0.90 - $0.90) = $18
Basis-Adjustment Approach					
Taxable Dividends	20 shares x $0.10 = $2	20 shares x $0.10 = $2	20 shares x $0.10 = $2	20 shares x $0.10 = $2	20 shares x $0.10 = $2
Taxable Capital Gains	20 shares x ($0.90 - $0) = $18	$0	$0	$0	$0
Unrealized Capital Gains	$0	20 shares x ($1.00 - $0.10) = $18	20 shares x ($1.00 - $0.10) = $18	20 shares x ($1.00 - $0.10) = $18	20 shares x ($1.00 - $0.10) = $18

Chirelstein suggested that his proposal should apply to public companies but not to closely held private firms. He thought that the "basic legislative aim" of the Code provisions governing buybacks and dividends was "to bear lightly on withdrawals" from "closely-held or family-owned corporations"—and in his view, that aim should be respected.[122] Chirelstein was writing well before the advent of the limited liability company (LLC)

122. Chirelstein, *supra* note 16, at 750.

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and the significant liberalization of the S corporation limitations, so many closely held businesses were then organized as C corporations. Now, however, the overwhelming majority of closely held businesses are organized as pass-throughs.[123] Likewise, Chirelstein was writing before the private-equity boom of the late twentieth century made it relatively easy for public companies to raise capital from other sources and remove their shares from stock exchanges—and well before "unicorn" start-ups such as Uber and Airbnb achieved multibillion-dollar valuations before going to public equity markets.

In the current climate, we think that a public/nonpublic distinction would be unwise, as it could encourage public companies seeking to go private or private companies staying private to achieve a more favorable tax regime. And due to the popularity of flow-through structures for closely held businesses, concerns about taxing withdrawals from those businesses are vastly mitigated. We will therefore proceed on the assumption that Chirelstein's proposal would apply to all corporations under subchapter C, whether or not their shares are publicly traded.

As will soon be apparent, we believe that Chirelstein's proposal—with the above-mentioned modifications—represents an ingenious solution to a difficult and important tax policy problem. Yet Chirelstein's explanation of his proposal is vulnerable to criticism on two fronts. First, Chirelstein never addresses the administrative, compliance, and political challenges that his proposal would entail. Second, while Chirelstein argues at some length that buybacks and cash dividends are economically equivalent, he

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123. Some closely held organizations are still formed as C corporations. Some professional associations are organized as C corporations and "zero out" all of their income through compensation paid to the owner-employees. These organizations will be unaffected by the proposal because they do not have earnings and profits and do not make distributions. In addition, start-ups that seek venture-capital financing are often formed as C corporations. *See generally* Gregg D. Polsky, *Explaining the Choice-of-Entity Decisions by Silicon Valley Start-Ups*, 70 HASTINGS L.J. 409 (2019) (discussing how lawyers commonly recommend C-corporation structures to their start-up clients). These start-ups typically generate large losses while they are private. The vast majority fail, while the successful ones often go public or are acquired by a public company within their first decade. *See id.* at 428. Occasionally, a successful start-up will linger as a private company for more than a decade. The proposal will generally not affect start-ups because they do not earn profits and, if they do, they reinvest those profits. If and when they start earning and distributing profits, they often will be a public company (or a subsidiary of one).

Closely held businesses organized as C corporations before the advent of the LLC will, in some cases, retain the C corporation form because tax rules make conversions of profitable C corporations to LLCs quite costly. *See id.* at 414 (noting that tax reclassifications of C corporations to LLCs and other tax partnerships are often financially infeasible because they require deemed or actual liquidations of the C corporation, which triggers immediate double taxation). One possibility would be to implement a grandfather rule that would exempt C corporations formed prior to 1998 (when the check-the-box regulations were finalized) if they have 100 or fewer shareholders (the threshold for S corporation status today). Note, though, that shareholders of closely held corporations generally have influence over firm payout policies, and so if buybacks generate liquidity problems for those shareholders, they can have their corporations distribute cash through dividends instead.

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never explains why the appropriate tax policy response to this economic equivalence is to tax buybacks the same way that we currently tax cash dividends (rather than taxing cash dividends the same way we currently tax buybacks).

B. Implementation Challenges

One challenge in implementing Chirelstein's proposal involves the application of taxes on cash dividends to nonredeeming shareholders who—in reality—received no cash. This is sometimes called the "phantom income" problem.[124] Recall that under Chirelstein's proposal, nonredeeming shareholders are deemed to have received cash dividends and then to have reinvested those dividends in the corporation. So what if the nonredeeming shareholders do not have the cash to pay the tax they now owe?

As noted above, although Chirelstein limited his proposal to public companies, applying his proposal to public companies but not to other C corporations backed by private equity would create strong incentives for firms to leave public markets. Nevertheless, the primary impact of our proposal will be on public companies. For public-company shareholders, there generally will not be substantial liquidity issues for U.S. shareholders because they can easily sell or borrow against their shares to pay the tax. Selling a small percentage of public-company shares to approximate the cash flow of dividends is already a popular investment strategy. If necessary, these so-called "homemade dividends" can be used to pay the tax.

On the other hand, the liquidity issue is trickier in the context of foreign investors—nonresident aliens and foreign corporations—who are subject to a tax of up to 30% on dividends paid by U.S. corporations. Under current law, the federal government collects this tax by requiring domestic corporations to withhold dividend payments to foreign investors at the source and then to remit those amounts to the IRS.[125] But how would withholding work when no cash dividend is actually paid? And if those foreign investors have no other assets in the United States, then how can the United States collect the tax that is due on imputed dividends?

One possibility is that U.S. corporations might respond to the Chirelstein proposal by switching entirely from buybacks to cash dividends. After all, while the taxation of shareholders who lack the liquidity to pay the tax poses a headache for the IRS, it is a headache for those shareholders as well. If some shareholders want to dispose of their interests and others want to increase their ownership percentage, then they can transact among

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124. Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case for a Dividend Deduction*, 65 TAX L. 3, 8 (2011).

125. *See* I.R.C. § 1441 (2018) (requiring withholding at the source by U.S. persons with respect to dividends and other fixed and determinable income items paid to non-U.S. persons).

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each other rather than directly with the corporation. As noted above, corporations potentially would have an incentive to pay dividends, which shareholders who want to remain invested in the corporation could use to buy stock from shareholders who want to liquidate—thereby allowing the remaining shareholders to take a fair market value basis in some of their shares.[126]

Another possibility is that corporations—either by their own volition or by legal mandate—could pay a cash dividend of at least $0.43 for every $1 they expend on buybacks. The reason why we choose $0.43 (or rather, .3/0.7, which rounds up to 0.43) is that the highest U.S. tax rate on dividends paid by domestic corporations is the 30% tax on dividends paid to nonresident aliens and foreign corporations in jurisdictions that have not entered into a tax treaty modifying the default rate. If a corporation pays a cash dividend of $0.43 for every $1 it spends on buybacks, then a nonredeeming shareholder will owe tax on $1.43. Applying a 30% rate to $1.43 results in a tax liability of $0.43 (or, without rounding, $0.429). By withholding the entire cash dividend from foreign investors in nontreaty jurisdictions,[127] U.S. corporations can ensure that withholding obligations are satisfied.[128]

To illustrate, consider again Example 3. The corporation chooses to distribute its $20 of earnings ($0.20 per share). Imagine that instead of returning all of that cash through dividends or all via buybacks, the corporation pays a cash dividend of $0.06 per share ($6 total, or 30 percent of $20) and buys back shares worth $14. Again, *A* elects to participate in the buyback, and she redeems 14 shares at a price of $1 per share. Under Chirelstein's proposal, *A*, *B*, *C*, *D*, and *E* each would report as income the $0.06 per share cash dividend and the $0.14 per share imputed dividend, or $0.20 per share in total. If one of the nonredeeming shareholders is a nonresident alien or foreign corporation in a nontreaty jurisdiction, she will owe tax of 30% times $0.20 per share, or $0.06 per share, which is equal to the amount

126. As mentioned above, many corporations already have dividend reinvestment plans (DRIPs) in effect, and one might think that, if the proposal were enacted, these might be used to adjust ownership percentages. *See supra* notes 43, 48, 111 and accompanying text. The shares issued through these plans are often treasury shares, which are acquired by companies through buybacks, though corporations could also issue new shares to satisfy DRIP demand.

127. Because all shareholders of the same class must be treated alike, the 43-cent cash dividend would have to be paid on all shares, not just those owned by foreign shareholders. While a foreign shareholder's 43-cent dividend would be subject to withholding (and the 30% rate would be entirely withheld), for other shareholders, the dividend would be paid in full to the shareholder. In essence, the 43-cent cash dividend solution would result in the corporation distributing no more than 57% of its annual distributions to a class of stock in the form of redemptions.

128. Another, less intrusive, approach would be to allow the company to sell a portion of a nonredeeming foreign shareholder's shares to satisfy the withholding tax obligation. This approach would effectively mandate the participation of foreigners in a buyback to the extent necessary to pay the withholding tax. The foreigner could then, if it wished, purchase shares on the open market to restore its ownership percentage back to the status quo prior to the mandated sale. A significant practical problem with this approach is that it would treat foreigner shareholders and domestic shareholders disparately, which could violate existing tax-treaty rules.

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of the cash dividend. The U.S. corporation can satisfy its withholding obligations by remitting all of the foreign investor's cash dividends to the IRS.

Our own view is that a legal requirement that corporations pay $0.43 in cash dividends for every $1 of share buybacks would fully neutralize the phantom income objection to Chirelstein's proposal. More precisely, the requirement would be that the ratio of cash dividends to buybacks be equal to $t/(1 - t)$, where t represents the highest applicable tax rate on dividends. While such a requirement would constrain corporations in their choice of form for cash distributions, the constraint seems minor given that every economic outcome that can be achieved through buybacks also can be attained through a mix of buybacks and cash dividends.

A more heavy-handed approach would be to outlaw buybacks entirely, thereby requiring that nonliquidating corporate distributions always be accomplished through cash dividends. This would eliminate all liquidity concerns and would be straightforward to administer. It is also consistent with Chirelstein's fundamental insight that, leaving aside tax consequences, buybacks and dividends are economically equivalent. Nevertheless, outlawing buybacks could have profound repercussions in other contexts. For example, while option compensation is losing popularity, it still exists, and section 409A effectively forecloses dividend protection. Absent amendment to section 409A, outlawing buybacks would make option-based compensation much less attractive because the value of a manager's options would decline every time the corporation distributes cash to shareholders. For critics of stock option-based compensation, this outcome may be a feature rather than a bug.[129] It is, however, an outcome that Congress should consider directly rather than generating as an accidental byproduct of a tax policy change.

A second—and similarly soluble—challenge in implementing Chirelstein's proposal relates to basis tracking.[130] In the normal course, a

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129. *See, e.g.*, Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 60 (2003).

130. This concern (and the related concern of requiring shareholders to report imputed dividends) formed the basis for William Andrews's recommendation that, in lieu of the Chirelstein proposal, Congress should impose a corporate excise tax on redemptions. *See* AM. LAW INST., FEDERAL INCOME TAX PROJECT SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS 472-73 (1982). The corporate excise-tax rate would equal the average effective shareholder-level tax rate on corporate dividends. Andrews acknowledged that the Chirelstein approach would yield a more exact equivalence between dividends and buybacks. *Id.* at 472. Andrews's excise tax would undertax (relative to a dividend baseline) repurchases by firms whose continuing shareholders were in high brackets and would over-tax (relative to the dividend baseline) repurchases by firms whose continuing shareholders were predominantly tax-exempt or low-bracket taxpayers. *Id.* at 473. Andrews nevertheless preferred the excise tax primarily for its relative simplicity. *Id.* However, as explained in the text, brokers are now required to report stock basis amounts to their clients and to the IRS thereby dramatically easing the compliance burdens noted by Andrews. *See infra* note 133 and accompanying text.

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shareholder's adjusted basis in stock is simply the purchase price plus the cost of purchase (e.g., brokerage commissions).[131] Under our basis-adjustment version of Chirelstein's proposal, a shareholder would take an upward basis adjustment equal to the amount of any imputed cash dividend. The reason for the basis adjustment is to reflect the fact (or perhaps more accurately, the fiction) that the shareholder has received the cash dividend and reinvested that amount in the corporation. So when a taxpayer ultimately sells her shares (assuming no step-up in basis along the way), she will have to know not only how much she paid for the shares (plus commissions), but also how much she has recognized as imputed dividend income since then.[132]

This additional element in the basis calculus will complicate tax compliance marginally. We do not expect, however, that the compliance burden will be any more than marginal. Existing law requires tracking of stock splits, spinoffs, and mergers. Brokers have been required to track and report their customers' basis in equities since 2011.[133] Several automated basis tracking programs allow brokers to comply with these reporting

In a similar vein, George Yin in 1990 proposed a corporate distributions tax, which would be paid by the corporation whenever it made distributions, regardless of the form of the distribution. *See* George K. Yin, *A Different Approach to the Taxation of Corporate Distributions: Theory and Implementation of a Uniform Corporate-Level Distributions Tax*, 78 GEO. L.J. 1837 (1990). Yin's approach would represent a more sweeping reform measure than either the Andrews or the Chirelstein proposals because Yin would tax all distributions the same regardless of the tax status of the shareholder. Andrews would continue to take into account shareholder tax status for dividend distributions (but not for repurchases), while Chirelstein would continue to take into account shareholder tax status for both dividends and repurchases. Chirelstein's more nuanced treatment of dividends and repurchases is more significant now than at the time of the Andrews and Yin proposals due to the recent growth of tax-exempt ownership of public-company stock, which is now estimated to total more than 40% of market capitalization. *See supra* note 80 and accompanying text.

To be clear, our argument here is not that Chirelstein's approach is "better" than Andrews's or Yin's on the basis of first principles. Andrews's approach would effectively eliminate the benefit of shareholder-level income-tax exemptions with respect to repurchases from the perspective of pension plans, IRAs, and nonprofit-institution shareholders. Yin's approach would effectively eliminate the benefit of shareholder-level income-tax exemptions with respect to repurchases *and dividends* from those shareholders' perspective. Yin, *supra*, at 1871-77. Whether that is an advantage or disadvantage depends, ultimately, on one's view of the desirability of tax exemption for pension plans, IRAs, and nonprofit institutions. A feature of Chirelstein's approach is that it addresses the buyback problem without upending the entire corporate and shareholder-level income tax system. See *infra* Section IV.C.

131. *See, e.g.*, *Frequently Asked Questions: Stocks (Options, Splits, Traders)*, INTERNAL REVENUE SERV. (July 15, 2020), https://www.irs.gov/faqs/capital-gains-losses-and-sale-of-home/stocks-options-splits-traders/stocks-options-splits-traders-1 [https://perma.cc/D8XS-6AGM].

132. Basis tracking would be more complicated if, instead of adjusting basis in all shares by the amount of the imputed dividend, nonredeeming shareholders were treated as if they had bought a block of stock from redeeming shareholders and taken a fair market value basis in those new shares.

133. *See* Jonathan Horn, *The Brave New World of Cost Basis Reporting*, J. ACCT. (Sept. 1, 2013), https://www.journalofaccountancy.com/issues/2013/sep/20137345.html [https://perma.cc/WY2A-6JQC].

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requirements at modest cost.[134] Updating these basis-tracking solutions to include imputed dividends would not require a significant technological leap.

A final hurdle to Chirelstein's proposal is political. As Ethan Yale writes, "Any proponent of Chirelstein's proposal would have to conquer the public relations difficulty that nonredeemed shareholders would be taxed even when they chose not to sell, 'merely' because of the actions of others."[135] This public-relations difficulty would be mitigated somewhat by the fact that only about a quarter of U.S. households own stock directly.[136] Individuals who hold stock in tax-preferred retirement plans or accounts such as 401(k)s and IRAs would be unaffected because those vehicles are exempt from any tax on dividend income.[137] Even so, the taxation of "phantom" income has long been thought to operate as an insuperable obstacle to proposals such as Chirelstein's that separate taxation from realization.[138]

Our suggestion that corporations be required to pay $0.43 in dividends for every $1 of buybacks would eliminate the phantom income problem entirely (given current tax rates). As tax rates change, the minimum dividend-to-buyback ratio could change too. This modification—along with the groundswell of antipathy toward buybacks—may give Chirelstein's proposal the political traction today that it lacked 50 years ago. While it is too soon to say how long the current anti-buyback moment will last, it is not impossible to think that it will last long enough to see through changes to the buyback tax regime.

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134. *See* Carolyn T. Geer, *New Tax Reporting Rules*, WALL ST. J. (Jan. 5, 2011), https://www.wsj.com/articles/SB10001424052748703727804576017984041795712 [https://perma.cc/R9JV-8Q4A].

135. Yale, *supra* note 19, at 353. Yale noted that the same result occurs in economically identical cases where some shareholders receive a cash dividend and others a stock dividend. *See id.* In such a situation, all shareholders would receive a taxable dividend. *See* I.R.C. § 305(b)(2) (2018). While this is true, it is doubtful whether this technical point will have any political salience with either voters or policymakers.

136. *See* Steven M. Rosenthal & Lydia S. Austin, *The Dwindling Taxable Share of U.S. Corporate Stock*, 151 TAX NOTES 923, 926 (2016).

137. *See* I.R.C. § 501(a) (exempting qualified retirement accounts from taxation).

138. *See, e.g.*, Clarissa Potter, *Mark-to-Market Taxation as the Way to Save the Income Tax—A Former Administrator's View*, 33 VAL. U. L. REV. 879, 901 (1999) (arguing that individuals and politicians would exhibit "antipathy" toward "any rule that taxes income before it is realized"). On the other hand, Congress already has provided for taxation on "phantom" income in a very similar situation. Section 305(c) authorizes Treasury regulations that would apply to changes in conversion ratios, changes in redemption prices, differences between redemption prices and issue prices, redemptions which are (under current law) recharacterized as distributions, and other similar transactions. I.R.C. § 305(c) (2018). Treasury Regulation 1.305-7, promulgated pursuant to this authority, imposes tax on shareholders whose proportionate interest in the corporation is increased as a result of these transactions. Treas. Reg. § 1.305-7 (1995). Like the nonredeemers under the Chirelstein approach, these shareholders are taxed on such an increase even though they are mere bystanders to the transaction and receive no cash or other property in the transaction. We thank Lawrence Zelenak for pointing out the section 305(c) analogy.

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C. Justification

Perhaps the most serious shortcoming in Chirelstein's explanation of his own proposal is the lack of a normative foundation for his prescription. Chirelstein convincingly showed that "share repurchasing and ordinary dividend payments are largely interchangeable from an economic standpoint."[139] He did not demonstrate, however, why the differential tax treatment of buybacks and dividends is a policy problem, beyond the fact that it arguably offends an aesthetic interest in seeing like transactions taxed alike. If the consequence of differential taxation is that corporations choose to distribute cash through buybacks rather than cash dividends, then the efficiency loss is small precisely because the two forms are essentially equivalent.

Arguably, the differential taxation of buybacks and dividends violates the principle of horizontal equity (i.e., the idea that similarly situated individuals should pay the same amount in tax) because two otherwise identical taxpayers will owe different amounts based on the cash distribution policies of the corporations in which they own shares.[140] But even this proposition is doubtful, because the tax efficiency of a corporation's cash-distribution policy may affect its share price. For example, if Berkshire Hathaway distributes cash via buybacks while Coca-Cola pays cash dividends, then tax-sensitive investors will—all else equal—be willing to pay a premium for Berkshire Hathaway shares. If so, then the tax advantage of buybacks vis-à-vis cash dividends does not represent a windfall for Berkshire Hathaway shareholders relative to their Coca-Cola-owning peers, as the Berkshire Hathaway shareholders have effectively paid for the tax benefit through a higher purchase price.

Insofar as the tax efficiency of a corporation's cash-distribution policy is incorporated into its share price, then the cost of equity capital may be lower for corporations that can credibly commit to buybacks than for corporations that cannot. This potentially could result in a misallocation of equity capital across enterprises whose only distinguishing features are their tax attributes—though we are skeptical that this misallocation is economically significant. The misallocation would arise if there are some firms that are especially inclined to distribute earnings through cash dividends rather than buybacks, and therefore cannot access equity capital on the same terms as repurchasing firms. But in light of the economic equivalence between buybacks and cash dividends, it is difficult to see why such a preference for cash dividends would arise.

139. Chirelstein, *supra* note 16, at 741.

140. Even if the differential treatment of buybacks and dividends can be characterized as a violation of horizontal equity, it is not clear that we should care. For doubts about the normative relevance of horizontal equity, see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989).

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One further possibility is that the differential tax treatment of buybacks and dividends may lead firms to adopt suboptimal compensation arrangements so as to signal that their cash distributions will be tax efficient. The idea would be as follows: Tax-sensitive shareholders (other than domestic corporations) prefer that firms distribute earnings through buybacks rather than cash dividends, but they cannot know for sure whether firms will do so. Firms may therefore choose to compensate their managers in dividend-unprotected stock options so as to demonstrate to potential investors that distributions will be in buyback form. After all, if managers hold dividend-unprotected stock options, then they have a strong incentive to favor buybacks over cash dividends.[141] Dividend-unprotected stock options may not, however, be the way those firms would choose to compensate their managers in the absence of tax considerations. The upshot is that firms may adopt economically inefficient compensation arrangements as a way to commit to tax-efficient earnings distributions.

While such a distortion is theoretically possible, we again are doubtful of its magnitude. First, we are aware of no corporate-law rule that would prohibit a company from inserting a provision into its charter or bylaws that requires it to distribute earnings via buybacks rather than cash dividends. Thus, if a firm wants to make a credible commitment to a zero-dividend approach, it should be able to do so without adopting an inefficient compensation scheme. Second, if a firm wants to commit to a zero-dividend approach but prefers to compensate managers in restricted stock rather than stock options, it can simply use dividend-unprotected restricted stock units (i.e., restricted stock units that do not entitle the holder to receive dividends until the stock has vested). Thus, no firm is ever "forced" to compensate managers in stock options rather than stock because of a desire to signal a commitment to buybacks. The decline in the use of compensatory stock options further suggests that the tax treatment of buybacks is not significantly skewing pay packages toward options.

Last but not least, even if the differential treatment of buybacks and cash dividends is inherently problematic, it is unclear why the solution is to tax buybacks like cash dividends rather than vice versa. We can achieve parity in the taxation of buybacks and cash dividends by treating every buyback like a cash dividend followed by a basis adjustment, but we can just as easily achieve parity by treating every cash dividend like a buyback. To illustrate: consider again Examples 1 and 2. In Example 1, ChirelsteinCorp buys back 50 shares from shareholder *A* for $2 per share; in Example 2, ChirelsteinCorp pays a dividend of $1 per share to each of its two investors (who hold 50 shares apiece), and shareholder *B* uses her dividend to

141. *Cf.* Jeffrey R. Brown, Nellie Liang & Scott Weisbenner, *Executive Financial Incentives and Payout Policy: Firm Responses to 2003 Dividend Tax Cut*, 62 J. FIN. 1935, 1935 (2007) (finding that executives with greater stock awards tended to increase dividends in response to the 2003 dividend tax-rate cut, while executives with greater options did not).

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buy A out. We said that the tax treatment of the buyback (Example 1) is generally more favorable than the tax treatment of the cash dividend (Example 2) because in the buyback scenario, shareholder A pays a tax on the buyback proceeds minus basis ($50 total), while in the cash dividend scenario, each shareholder pays tax on the full amount of the dividend ($50 per shareholder). But if the tax treatment of buybacks is not set in stone, neither is the tax treatment of cash dividends. We could, for example, treat the shareholders in Example 2 as if they had sold half their shares for $50 per share, thus allowing them to utilize basis ($1 per share) to offset tax on the capital gain. More generally, a cash dividend of d paid by a corporation with a price per share of p could be taxed as if the shareholder had sold a fraction (d/p) of her interest, thus allowing the shareholder to utilize the same fraction (d/p) of her adjusted basis.

Ethan Yale has developed this approach in greater detail, referring to it as the "'exchange equivalent distributions' (EED) tax."[142] The EED tax would treat all corporate distributions—whether in the form of pro rata dividends or stock redemptions—as stock sales.[143] The deemed seller, in the case of dividends, would be allowed to recover the proportional amount of her stock basis in these sales, just as the redeeming shareholder does in a redemption. However, in contrast with the Chirelstein proposal, nonredeemers would not face any tax consequences under the EED approach.

Both the EED tax and the Chirelstein proposal would come close to putting dividends and repurchases on equal tax footing, the former by allowing equivalent stock basis recovery and the latter by denying any such recovery. However, for reasons that we explain in the next Part, we believe that Chirelstein's proposal is preferable to the EED tax on efficiency and equity grounds—specifically because we think that nonredeeming shareholders *should* pay tax. The EED tax underscores, though, that the case for Chirelstein's proposal cannot rest on the fact that it generates greater parity in the taxation of buybacks and cash dividends. After all, Yale's EED tax does that too—and without the potential problem of phantom income. That Chirelstein failed to consider this alternative mechanism for achieving parity between buybacks and cash dividends is, we think, a surprising omission but ultimately not a fatal flaw.

III. The Case for Taxing Buybacks Like Dividends

This Part evaluates the case for taxing buybacks like cash dividends. First, we address what we think is a red herring: the argument that buybacks should be taxed like cash dividends so as to discourage buybacks for

142. Yale, *supra* note 19, at 336.
143. *See id.* at 337.

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nontax reasons. We then move on to consider several more substantial arguments for taxing buybacks like cash dividends.

A. The Buyback Backlash

The dramatic increase in buybacks in recent years has sparked something of a "buyback backlash,"[144] with academics, politicians, and even some prominent financial professionals joining the chorus of criticism.[145] The crux of the critique is two-fold: first, that buybacks divert capital from productive investment; and second, that buybacks benefit executives at the expense of other stakeholders.[146] We address each point in turn.

1. Buybacks and Productive Investment

It is hard to see why buybacks—any more than economically equivalent cash dividends—divert capital from productive investment. Setting tax considerations aside, corporate managers who seek to maximize shareholder value will distribute rather than reinvest earnings when the corporation has no available investment opportunities for which the expected rate of return exceeds the opportunity cost of capital. Put differently, managers will distribute rather than reinvest earnings when shareholders can do better investing that money for themselves than the corporation can do investing on their behalf. Cash distributions—whether in the form of buybacks or dividends—are a sign that managers believe there are better investment opportunities outside the corporation than within.

It is, of course, possible that managers will systematically err in deciding when to distribute earnings and when to reinvest. But it is not obvious that such errors will be in the direction of excessive distributions. Managers themselves benefit from an increase in their firm's market capitalization. The CEO of a $2 billion market-cap company is likely to command a higher salary than the CEO of a $1 billion market-cap company.[147] Managers may therefore have an incentive to retain earnings—thereby increasing the book value and likely the market value of their firm's equity—even when the decision that would maximize shareholder value would be to distribute cash via buyback or dividend.

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144. *See, e.g.*, Dan McCrum, *The Buyback Backlash, GE as Exhibit A*, FIN. TIMES: ALPHAVILLE (Feb. 19, 2018), https://ftalphaville.ft.com/2018/02/19/1519031430000/The-buyback-backlash--GE-as-exhibit-A [https://perma.cc/3DWS-PNGW].

145. *See* Akin Oyedele, *Here Is the Letter the World's Largest Investor, BlackRock CEO Larry Fink, Just Sent to CEOs Everywhere*, BUS. INSIDER (Jan. 24, 2017, 8:10 AM), https://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-ceos-2017-1 [https://perma.cc/38AS-2GKJ].

146. *See, e.g.*, William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV., Sept.-Oct. 2014, at 46, https://hbr.org/2014/09/profits-without-prosperity [https://perma.cc/7YUS-4E8T].

147. *See* Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49 (2008).

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Even if one believes that corporations are too quick to distribute rather than reinvest earnings, that belief does not necessarily translate into an argument against the current tax law status quo. Somewhat counterintuitively, the current tax treatment of buybacks may cause corporations to retain rather than distribute earnings. The reason for this—discussed at greater length in Section III.B—is that under current law, shareholders may want corporations to delay distributions so that they (and their heirs) can take advantage of the step-up in basis at death. Chirelstein's proposal would reduce the incentive to delay nonliquidating distributions until death because the tax on distributions, which would be treated as dividends, does not depend upon basis. If the policy objective is to discourage cash distributions (and we consider that to be a questionable goal), then taxing buybacks like dividends is not necessarily the right path.

Finally, we should note that the evidence in support of the claim that buybacks are cannibalizing productive investment is quite weak. Cash returned to shareholders via buybacks does not vanish; shareholders can reinvest that cash in other enterprises. And while cash is flowing out of corporations through buybacks, it is flowing back into corporations through new equity issuances. According to calculations by Jesse Fried and Charles Wang, net shareholder payouts of S&P 500 firms—buybacks plus dividends minus new equity issuances—total to approximately 50% of net income during the 2007 to 2016 period (and 41% of "R&D-adjusted net income," i.e., net income with research and development expenses added back in).[148] That is, on an S&P 500-wide basis, $0.50 to $0.59 of every $1 of profits earned by corporations remain within the company. Meanwhile, cash as a percentage of total assets of S&P 500 nonfinancial firms at the end of the third quarter of 2019 was 10%, down from highs above 12% before the December 2017 tax law but well above the historical average of 7%.[149] Corporations—at least before the COVID-19 crisis struck—were awash in cash. All of this makes it very difficult to argue that buybacks were at the same time depriving companies of the liquidity they needed to pursue new projects.

2. Buybacks and Executive Compensation

The claim that buybacks benefit executives at the expense of other corporate stakeholders is potentially—though limitedly—true if the alternative to a buyback is a cash dividend and executives hold dividend-

148. Jesse M. Fried & Charles C.Y. Wang, *Are Buybacks Really Shortchanging Investment?*, HARV. BUS. REV., Mar.-Apr. 2018, at 88, 88, https://hbr.org/2018/03/are-buybacks-really-shortchanging-investment [https://perma.cc/QBE7-G4GK].

149. John Authers, *Authers' Newsletter: Following the Money Leads to a Grim Outlook*, BLOOMBERG (Oct. 21, 2019, 12:01 AM EST), https://www.bloomberg.com/news/newsletters/2019-10-21/authers-newsletter-corporate-cash-trends-defy-incentives [https://perma.cc/8HFK-49NZ].

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unprotected stock options. An equally valid way to frame the same point is that the choice to distribute earnings via buybacks rather than cash dividends shields executives from a hit to their compensation that is unrelated to firm performance. Thus, while executives with compensatory stock options are generally better off when a company buys back shares rather than paying dividends, it is difficult to describe this benefit to executives as in any way illegitimate.

Beyond the stock option context, executives are sometimes said to benefit from buybacks if their compensation is explicitly tied to earnings per share (EPS). Outspoken buyback critic William Lazonick writes that buybacks "automatically increase earnings per share (EPS) by decreasing the number of shares outstanding."[150] This claim is puzzling. Buybacks affect both the numerator and denominator of a company's earnings-per-share calculation, and it is far from automatic that the overall effect on EPS will be positive.

To illustrate: imagine a corporation with $90 of noncash assets, $10 of cash, no liabilities, and 100 shares outstanding. If market value equals book value, the value of each share will be $1. Assume that the $90 of noncash assets generate income of $4.50, reflecting a rate of return of 5%. The corporation can use its $10 of cash to invest in new projects, repurchase shares, or pay a dividend. If the corporation reinvests the $10 of cash in a project that yields a 5% return (i.e., $0.50), then its earnings for the year will be $5 (i.e., $4.50 plus $0.50) and its EPS will be $0.05. If the investment yields a return of more than 5%, then EPS will be higher than $0.05. If the yield is lower, then EPS will be lower.

What if the corporation uses the $10 of cash to buy back 10 shares of stock at the beginning of the year? Now earnings for the year will be $4.50, but the number of outstanding shares will be 90. EPS will thus be $0.05. Note that $0.05 is the same EPS as if the firm had reinvested the $10 of cash at a 5% rate of return. Only if the firm is earning less than a 5% return on its marginal investment will buying back shares raise EPS. If the firm would have earned more than a 5% return on its marginal investment, buying back shares will have lowered EPS. There is no alchemy here. Returning cash to shareholders when that cash otherwise would be earning a below-market return boosts profitability. Returning cash to shareholders when that cash otherwise would be earning an above-market return reduces profitability.

Finally, if the corporation uses the $10 of cash to pay a dividend of $0.10 per share at the beginning of the year, then its earnings for the year will be $4.50 and its EPS will be $0.045. In this respect, the corporation can

150. William Lazonick, *The Curse of Stock Buybacks*, AM. PROSPECT (June 25, 2018), https://prospect.org/article/curse-stock-buybacks-0 [https://perma.cc/88DB-DRRK].

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"inflate" its EPS by distributing cash to shareholders via buybacks rather than dividends. But again, it is hard to characterize this aspect of buybacks as illegitimate. It is equally valid to say that dividends artificially "deflate" EPS and that buybacks are a way of returning cash to shareholders that is EPS-neutral.[151]

One might think that corporations could manipulate EPS by buying back shares at the end of a reporting period. Thus, they would be able to invest cash (and earn positive returns) over the course of the period and then could use that cash to buy back shares and reduce the EPS denominator at the very end. Fortunately, the Financial Accounting Standards Board understands this problem and has crafted a definition of EPS that addresses it. FASB requires firms following generally accepted accounting principles (GAAP) to report EPS on the basis of the weighted-average number of shares outstanding for the period.[152] Thus, if the corporation bought back 10 shares on the last day of the year, its EPS denominator (in a non-leap year) would be (364 days x 100 shares + 1 day x 90 shares)/365 days, or 99.97. There is no obvious EPS benefit to buying back shares at the beginning of a period because then the company loses any yield that it would have earned on the cash used to finance the buyback, and no obvious EPS benefit to buying back stock at the tail end because then the effect on the weighted average number of shares is negligible.[153]

So, while it is true that buybacks almost always increase EPS relative to dividends, they do not necessarily increase EPS relative to reinvestment. Buybacks increase EPS relative to reinvestment if the opportunity cost of the buyback is less than the company's earnings yield (i.e., earnings per share divided by price). If the company in the example above could have earned greater than a 5% return by reinvesting the $10 itself, then the

151. To elaborate: if executives are focused on EPS and dividends are the only available means of distributing cash to shareholders, then there is a risk that executives will make inefficient investments in order to prop up EPS. In the in-text example, EPS will be higher if the firm reinvests the $10 of cash in *any* project yielding a positive return, even if the positive return is less than the opportunity cost of capital. In other words, EPS targets encourage executives to make inefficient corporate finance decisions *unless* buybacks are an available option.

152. *Statement of Financial Accounting Standards No. 128: Earnings per Share*, FIN. ACCT. STANDARDS BOARD FAS128-2, FAS128-4, FAS128-20 (1997), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220129071&acceptedDisclaimer=true [https://perma.cc/48UJ-3S74].

153. There is, to be sure, no law against using non-GAAP measures of EPS to calculate executive compensation, so long as the details of those measures are disclosed to shareholders. *See* 17 C.F.R. § 229.402(b) instruction no. 5 (2019) (requiring disclosure). We are not aware of firms that compensate executives based on unweighted EPS metrics. But even if firms chose to do so, that would be a weak argument for regulating buybacks. Firms likewise could—conceivably—compensate executives based on share price with no adjustment for reverse stock splits (e.g., two-for-one reverse splits that mechanically cause share price to double). That would be a silly way to pay an executive, but it would not be obviously illegal. If it called for any regulatory action, the solution would seem to lie in better regulation of executive compensation rather than restrictions on reverse stock splits (or, analogously, buybacks).

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buyback effectively reduced EPS. Tying an executive's compensation to EPS encourages buybacks only if the company lacks internal investment opportunities that will generate returns exceeding the company's earnings yield.[154]

Indeed, buybacks may ultimately have a negative effect on top executives' personal interests (relative to reinvestment). First, while buybacks do not mechanically reduce a company's EPS, buybacks—like dividends—do mechanically reduce the company's market capitalization (i.e., the price of its shares multiplied by the number of outstanding shares). As noted above, CEO compensation tends to increase in tandem with market capitalization, so in buying back shares, CEOs potentially shrink their own salaries.[155] Second, buybacks—like dividends—reduce free cash flow. Substantial free cash flow potentially allows managers to pursue pet projects, purchase plush corporate jets, redecorate their own offices ornately, and so on.[156] Distributing cash to shareholders thus may come at the expense of executive perquisites.

Just as the effect of buybacks on executive pay is ambiguous, the effect of buybacks on workers' wages is similarly unclear. While buyback critics often allege that share repurchases hurt workers,[157] none of these arguments explain why buybacks are any worse than dividends in this regard, and the alternative to buybacks and dividends—retention of earnings—may be even worse. A corporation that retains earnings rather than distributing cash to shareholders can use those retained earnings to expand horizontally or vertically, swallowing up rivals and other enterprises in related industries. The resulting concentration of pricing power raises the risks of labor-market monopsony and product-market monopoly, potentially allowing employers to depress wages or sellers to inflate prices.[158]

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154. EPS-based performance-pay targets potentially induce managers to engage in buybacks that increase risk. Imagine, for example, that a company has $90 of noncash assets that generate earnings of $4.50, $10 of cash, and 100 outstanding shares with a value of $1 per share. EPS will be $4.50 if the cash remains idle. Say that the board sets an EPS target of $5 and offers a large bonus to the CEO that is contingent upon meeting that target. By using the cash to buy back 10 shares, the CEO can hit her $5 EPS target. In doing so, she increases the riskiness of investments in the corporation: one share now represents $1 of (risky) noncash assets rather than $0.90 of (risky) noncash assets and $0.10 of (riskless) cash.

This does not necessarily mean that EPS-based performance-pay targets are ill-conceived. Managers are often thought to be excessively risk-averse in the absence of compensation arrangements that align managerial incentives with shareholder interests. *See, e.g.*, Yakov Amihud & Baruch Lev, *Risk Reduction as a Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981). EPS-based performance-pay targets are one way to encourage managers to take on more risk. Stock options are another way.

155. *See supra* note 147 and accompanying text.

156. *See, e.g.*, *Merrill Lynch CEO Thain Spent $1.22 Million on Office*, CNBC (Jan. 22, 2009, 11:38 AM EST), https://www.cnbc.com/id/28793892 [https://perma.cc/6LPY-DD3J].

157. *See, e.g.*, Schumer & Sanders, *supra* note 8.

158. On labor-market monopsony, see generally Ioana Marinescu & Eric A. Posner, *A Proposal to Enhance Antitrust Protection Against Labor Market Monopsony* (Roosevelt Inst.,

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None of this is to suggest that buybacks are always and everywhere unproblematic from a policy perspective. For example, Jesse Fried has argued that managers may initiate buybacks in order to capitalize on private information indicating that their company's shares are undervalued.[159] Although the managers might in theory buy company stock for their own accounts, they would expose themselves to insider trading liability if they did. Instead, they might initiate buybacks and retain their own shares, thereby increasing their percentage stake in the corporation. While the Securities and Exchange Commission maintains that insider-trading laws apply to corporate-share repurchases, Fried argues that lax disclosure requirements surrounding buybacks make "insider trading via the corporation" difficult to detect.[160]

Fried does not suggest that all or even most buybacks result from managers' efforts to capitalize on private information indicating undervaluation.[161] To the extent that weak disclosure rules surrounding buybacks allow executives to profit from "insider trading via the corporation," the logical policy prescription would be—as Fried recommends—to bolster disclosure requirements.[162] Changing the tax treatment of buybacks in order to address the potential for corporate insider trading would be a remarkably roundabout policy response.[163] Note also that buybacks are not unique in their vulnerability to insider trading. Executives also can reduce their stake in the companies they run by issuing new equity (i.e., selling

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Working Paper, 2018), http://rooseveltinstitute.org/proposal-enhance-antitrust-protection-against-labor-market-monopsony [https://perma.cc/S76G-L23F], which describes the U.S. labor-market monopsony and proposing legislation to strengthen stakeholders' ability to bring antitrust suits against monopsonies.

159. *See* Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801 (2014).

160. *Id.* at 813-14.

161. *Id.* at 819-20.

162. *Id.* at 834-35.

163. The same could be said of the mirror-image concern that managers initiate buybacks not because they want to increase their ownership of their companies but because they want to partially liquidate their positions. *See* Jesse M. Fried, *Open Market Repurchases: Signaling or Managerial Opportunism*, 2 THEORETICAL INQUIRIES L. 865, 885-91 (2001); Jackson, *supra* note 13. This theory posits that managers rely on buybacks for price and liquidity support when they are selling their own shares. Jackson cites the fact that insider sales increase five-fold in the eight days following a buyback announcement as evidence that executives "use [buybacks] as an opportunity to pocket some cash at the expense of the shareholders they have a duty to protect, the workers they employ, or the communities they serve." Jackson, *supra* note 13.

The implications of insider sales after a buyback announcement are not so clear, however. Recall that buybacks add risk to the portfolios of nonredeeming shareholders. In effect, the nonredeemers now hold less in cash and more in noncash assets. We would therefore expect insiders who had optimized the cash/noncash allocation of their portfolios before a buyback to sell shares in a buyback in order to maintain the same allocation as before. The fact that insiders sell shares after a buyback announcement is not necessarily an indication of any foul play.

In any event, if insider sales after a buyback announcement are a policy problem, the logical response would be to alter the rules regarding post-buyback insider trading, not to change the tax treatment of buybacks. Indeed, redeeming shareholders are the ones *least* affected by the tax laws' current favoritism for buybacks over dividends because redeeming shareholders *do* pay tax.

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new shares). Thus, new equity issuances—the polar opposite of buybacks—also allow executives to profit from insider trading via the corporation when executives have negative rather than positive inside information about firm prospects.

B. The Tax Treatment of Buybacks and the Distribution Decision

Even if one is unpersuaded by our arguments in the previous Section, a general antipathy toward corporate cash distributions would be a weak reason to support Chirelstein's proposal. This is because Chirelstein's proposal will not necessarily discourage—and might well accelerate—corporate distributions of cash.

To understand why, a primer on the "new view" of dividend taxation is potentially helpful. One key insight of the new view is that a constant tax rate on corporate cash distributions to shareholders does not affect the timing of distributions. All that matters is the relative after-tax rate of return on investments inside and outside the corporation. To illustrate: imagine that a corporation has $100 of retained earnings and that the tax rate on distributions is 20%. The corporation can earn an after-tax return of 5% by investing the $100 in new projects, and shareholders can earn an after-tax return of 5% by investing themselves. Under these circumstances, shareholders should be indifferent as to whether the corporation distributes cash now or in the future. If the corporation distributes cash now, then the $100 distribution will be subject to a 20% tax, leaving $80 for shareholders to invest. If shareholders invest $80 at a 5% after-tax rate of return, they will end up with $84 next year. If instead the corporation reinvests the $100 at a 5% after-tax rate of return, the investment will grow to $105 next year. If the corporation distributes $105 to shareholders then, the distribution will be subject to a 20% (i.e., $21) tax, and shareholders will end up with $84. Either way, shareholders end up in the same position ($84). The same general logic would hold if the tax rate on distributions were any other figure from 0 to 100%. Assuming that the after-tax rate of return is the same inside the corporation and outside, the shareholder ultimately ends up in the same position regardless of whether the corporation distributes earnings today or later on.

According to the new view,[164] shareholders should prefer for the corporation to retain rather than distribute earnings if the corporation's after-tax rate of return is higher than the shareholder's after-tax rate of return. That might be the case if the corporation has access to investment opportunities unavailable to its shareholders individually, or if corporations and

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164. *See, e.g.*, MERVYN KING, PUBLIC POLICY AND THE CORPORATION (1977); Alan J. Auerbach, *Wealth Maximization and the Cost of Capital*, 93 Q.J. ECON. 433 (1979); David Bradford, *The Incidence and Allocation Effects of a Tax on Corporate Distributions*, 15 J. PUB. ECON. 1 (1981).

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individuals have access to the same investment opportunities but the income tax rate on corporations is lower than the rate on individuals. The latter condition exists today with respect to investments by U.S. corporations and high-bracket individuals in dividend-yielding and interest-generating assets: the corporate income tax rate is 21% (effectively half that with respect to dividends eligible for the dividends received reduction), while the top rate on individuals is 23.8% for long-term capital gains and qualified dividends and 40.8% for short-term capital gains, as well as ordinary dividends and other ordinary income. By contrast, shareholders should prefer for the corporation to distribute rather than retain earnings if the corporation's after-tax rate of return is lower than the shareholder's after-tax rate of return. That condition plausibly exists today for pension plans, tax-exempt institutions, and individuals investing through tax-preferred retirement accounts—all of whom face a tax rate of zero on investment income. It also potentially exists for taxable individuals investing in stocks with low or zero-dividend yields who plan to hold their investments until death. The effective tax rate on capital gains for those individuals is 0%, while for corporations it is (as noted above) 21% percent.

An important caveat to the propositions in the previous paragraphs is that taxes on distributions may distort timing if the tax rate is variable. Imagine, for example, that the tax rate on corporate cash distributions is 20% this year but will be zero next year, and shareholders can invest at a 5% after-tax rate of return. If the corporation distributes $100 today, then—as illustrated above—the shareholders end up with $84 next year. If the corporation retains the $100 and reinvests it at any after-tax rate of return higher than negative 16%, then shareholders will end up with more than $84 next year. The expectation that the tax rate on distributions will decline next year potentially leads the corporation to retain earnings even when doing so is quite inefficient from a non-tax perspective.

Under certain circumstances, the current tax law's treatment of buybacks interacts with other features of the code to create an expectation of declining tax rates on distributions. Imagine a corporation with a single shareholder who is a taxable U.S. resident individual. Assume that the individual's basis in her shares is low relative to fair market value, so distributions in the form of dividends or buybacks both would generate substantial tax liabilities. However, if the individual holds her shares until death, then her heirs' basis will be stepped up to fair market value and the corporation can buy back shares without triggering any capital gains-tax liability. The shareholder may therefore want the corporation to delay distributions even if investment opportunities inside the corporation are significantly less attractive than investment opportunities outside. Chirelstein's

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proposal would potentially (though only partially[165]) offset this incentive for delay, because the single shareholder's heirs would be taxed on distributions even if they occurred after basis step-up.[166]

To be clear: It is not our claim that Chirelstein's proposal necessarily will accelerate distributions of corporate cash; the effects could go in either direction.[167] If corporations currently are retaining earnings and delaying distributions until pivotal shareholders can benefit from stepped-up basis, then Chirelstein's proposal would potentially accelerate distributions—the opposite of what buyback critics appear to want. But Chirelstein's proposal also might cause corporations to delay distributions—either because they expect the Chirelstein regime to be temporary and want to wait it out, or because Chirelstein's proposal would turn corporations into more attractive vehicles for holding stock relative to individual taxable accounts. We thus cannot rule out the possibility that Chirelstein's proposal will achieve what buyback critics apparently want (i.e., a drop in distributions), though we cannot guarantee that outcome either.

C. Buybacks and the Lock-In Problem

Chirelstein's proposal would go some way toward addressing the familiar problem of capital gains lock-in, though we do not think this is the most powerful argument in the proposal's favor. In this Section, we first explain the lock-in problem and then consider the ways in which Chirelstein's proposal would mitigate it but not eliminate it.

An example serves to illustrate the lock-in phenomenon: Imagine that one share of stock in Company *P* and one share of stock in Company *Q* are both worth $1. An investor holds 100 shares of stock in Company *P* with basis of $0.50 per share. The investor expects that Company *P*'s stock will increase by 9.5% ($0.095) next year and that Company *Q*'s stock will increase by 10% ($0.10). Assume a tax rate of 20% on capital gains.

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165. We discuss the interaction between stepped-up basis and Chirelstein's proposal at greater length in Section III.D. *See infra* Section III.D.

166. The single-shareholder example is of course not an accurate description of the ownership structure of most publicly traded U.S. companies. Those companies will generally have a broad range of shareholders, some of whom are tax-exempt institutions or non-U.S. residents. It may be possible under current law for the corporation to buy back shares primarily or exclusively from tax-exempts and foreigners, thereby avoiding any tax on distributions even before the death of a founder and the resulting step-up in basis.

167. One way in which Chirelstein's proposal might delay distributions is by making corporations into more attractive investment vehicles. Recall that under current law, corporations can claim a 50% dividends-received deduction that reduces their effective tax rate on dividend income to 10.5% (half the statutory rate of 21%). By treating all distributions as dividends rather than capital gains, Chirelstein's proposal would make corporations more attractive vehicles for holding equity investments (as corporations generally enjoy a tax advantage relative to individuals with respect to dividends but not necessarily with respect to capital gains). This could cause corporations to retain more cash but to reinvest their earnings in other companies' stock rather than in organic growth.

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Setting tax considerations aside, it is clear that the investor should sell her 100 shares of Company *P* and buy 100 shares of Company *Q*, since 100 shares of *Q* will be worth $110 while 100 shares of *P* will be worth only $109.50. Tax changes the calculus. If the investor sells her stock in *P* today, she will owe capital gains tax of $10 (i.e., the amount realized of $100 minus her basis of $50, multiplied by 20%). She will therefore be able to afford only 90 shares of stock in *Q*. Those shares will increase in value to $99 a year from now; if she sells those shares then, she will owe an additional capital gains tax of $1.80; and she will be left with $97.20. By contrast, if the investor holds onto her stock in *P* for another year and sells it then, her amount realized will be $109.50; she will pay tax of $11.90; and she will be left with $97.60. Because of tax considerations, the investor has an incentive to hold on to Company *P*'s stock. She is "locked in" to the lower-performing asset.

Table 7. Illustration of Lock-In Effect

	Hold *P* (no tax)	Sell *P*/Buy *Q* (no tax)	Hold *P* (20% tax)	Sell *P*/Buy *Q* (20% tax)
Value at 1/1	$100	$100	$100	$90
Value at 12/31	$109.50	$110	$109.50	$99
Sales proceeds	$109.50	$110	$109.50	$99
Stock basis	$50	$100	$50	$90
Gain	$59.50	$10	$59.50	$9
Tax due	N/A	N/A	$11.90	$1.80
After-tax cash	$109.50	$110	$97.60	$97.20

The step-up in basis at death makes the lock-in problem worse in some ways and better in others. Imagine that our hypothetical investor believes that she has only twelve more months to live. She can either hold on to her stock in Company *P*, in which case her heirs will be able to sell the stock tax-free upon her death, or she can reallocate from *P* to *Q*, in which case her heirs would be able to sell the stock in *Q* tax-free upon her death. Now the incentive to hold on to Company *P*'s stock is even stronger. The investor would prefer to leave her heirs 100 shares of stock in *P* with a value of $109.50 rather than 90 shares of stock in *Q* with a value of $99. Indeed, the investor would have an incentive to hold on to her shares of stock in *P* even if she expected that the share price of *P* would *decline* (though by no more than 1%) during the remainder of her life. Note, though, that stepped-up basis can also reduce lock-in because after a person's death, her heirs can rebalance inherited portfolios without worrying about tax on unrealized gains.

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The welfare costs of lock-in are two-fold. First, lock-in may lead to the misallocation of capital. That is, lock-in may deter investors from reallocating capital away from another lower-performing company and toward a new, more efficient company or an existing company raising new capital for promising projects. Second, lock-in may discourage investors from diversifying their portfolios and may lead them to bear excessive idiosyncratic risks. Imagine, for instance, that Investor *J* holds 100 shares of stock in Company *P* (worth $1 per share) and Investor *K* holds 100 shares of stock in Company *Q* (worth $1 per share), and that neither investor has any special knowledge as to the trajectory of either company's stock price. *J* and *K* would both be better off if *J* traded 50 shares of *P* stock to *K* for 50 shares of stock in *Q*, because each would thereby diversify their portfolios and reduce their exposure to idiosyncratic risk. But if the investors' basis in their respective shares is low, they may be deterred by lock-in from trading their shares. The upshot is that lock-in can stand in the way of what would be—absent tax considerations—Pareto-efficient asset reallocations.

Lock-in arises from the difference between the fair market value of an asset and a shareholder's basis in that asset: the larger the (positive) difference, the larger the lock-in effect. Chirelstein's proposal mitigates the lock-in problem by taxing all shareholders on their pro rata portion of corporate distributions and adjusting basis upwards when that happens. This is a virtue of Chirelstein's approach. Yet importantly, Chirelstein's proposal does not eliminate lock-in—for two reasons. First, many companies will continue to retain at least some earnings under Chirelstein's regime (e.g., because they believe they can earn a higher after-tax rate of return by reinvesting earnings inside the corporation than their shareholders can earn outside). Earnings retention generally pushes fair market value above basis. Second, fair market value will far exceed basis for shareholders in many firms not because of earnings retention, but because of earnings expectations. An early investor in Facebook, for example, would still experience lock-in under Chirelstein's proposal—just to a slightly lesser extent.[168] In short, we consider lock-in mitigation to be a benefit of Chirelstein's proposal but not an overwhelming argument for its adoption.[169]

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168. Facebook's authorized share repurchases since 2017 totaled $33 billion as of this writing. *See* Patrick Thomas, *Facebook Expands Share Buybacks*, WALL ST. J. (Dec. 7, 2018, 6:25 PM EST), https://www.wsj.com/articles/facebook-expands-share-buybacks-1544225152 [https://perma.cc/U6RN-8HDF]. Under Chirelstein's proposal, a shareholder who bought Facebook stock for $38 per share at its initial public offering in May 2012 would have a basis of about $49 (i.e., $33 billion divided by roughly 3 billion shares equals $11 per share plus $38). Facebook was trading at slightly more than $254 per share as of this writing. *See Facebook, Inc.*, YAHOO FIN. (Sept. 25, 2020, 4:00 PM EST), https://finance.yahoo.com/quote/FB [https://perma.cc/NDA6-SQQ9].

169. The EED proposal to neutralize the direct tax consequences between redemptions and dividends, previously discussed, *see supra* notes 142-143 and accompanying text, would

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D. Buybacks and the Mark Zuckerberg Problem

One of the most significant benefits of Chirelstein's proposal is that it would reduce the Mark Zuckerberg problem noted earlier. Current law allows founders of successful companies to amass tremendous fortunes without paying any income tax on those gains by acquiring founder's stock and then holding that stock until they die. Because of the stepped-up basis rule, the founder's heirs can then sell the shares without any income tax due.[170] During the founder's life, the corporation can distribute earnings to shareholders via buybacks, and the founders will face no tax liability as long as they do not redeem their shares. When she desires liquidity, the founder can borrow against her stockholdings and extend the terms of those loans indefinitely. Zuckerberg, for example, should not face too much trouble in finding a financial institution that will lend him all he could need for his lifetime consumption secured by his $60 billion of Facebook stock. Moreover, the loan plus accrued interest will be a liability of the founder's estate, meaning that it will reduce estate tax when the founder dies. As Edward J. McCaffery writes, "the wealthy . . . can literally live a tax-free life using Buy/Borrow/Die."[171]

The ability of founders to avoid tax through "Buy/Borrow/Die" is problematic from virtually any normative perspective. Founder income largely represents a return to entrepreneurial labor, not a return to capital investment. In the Facebook case, for example, Zuckerberg's own capital contributions to the company were trivial. While some commentators have argued that the optimal tax on capital income is zero (and, indeed, a long literature in public finance theory supports that conclusion[172]), nearly everyone agrees that labor income should be taxed. Although "Buy/Borrow/Die" is arguably the product of a number of individually defensible policy choices, the ultimate outcome is exceedingly difficult to justify.

The most straightforward way to address "Buy/Borrow/Die" is to repeal section 1014, the code provision that allows for stepped-up basis at death.[173] We agree with that prescription, and Chirelstein did too.[174] However, stepped-up basis has been repealed twice before and replaced with

exacerbate rather than ameliorate the lock-in effect because it would reduce rather than increase stock basis whenever earnings are distributed. *See* Yale, *supra* note 19, at 361.

170. *See* I.R.C. § 1014 (2018).

171. Edward J. McCaffery, *Taxing Wealth Seriously*, 70 TAX L. REV. 305, 321 (2017).

172. *See* Bankman & Weisbach, *supra* note 29.

173. *See* Richard Schmalbeck, Jay A. Soled & Kathleen DeLaney Thomas, *Advocating a Carryover Tax Basis Regime*, 93 NOTRE DAME L. REV. 109, 110-11 (2017); Jay A. Soled, Richard A. Schmalbeck & James Alm, *Reassessing the Costs of the Stepped-Up Basis Rule*, 162 TAX NOTES 769, 774 (2019).

174. MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION: A GUIDE TO THE LEADING CASES AND CONCEPTS 62 (7th ed. 1994) ("No convincing rationale for the death-basis rule has ever been offered . . . .").

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carryover basis, and in both cases, Congress "repealed the repeal."[175] Mounting concerns about widening wealth inequality might cause stepped-up basis repeal to "stick" this time, but if the past is prologue, then repeal of section 1014 will not solve the Mark Zuckerberg problem provided that Zuckerberg outlives the repeal. Moreover, since most of the revenues from stepped-up basis repeal would be far in the future, the ten-year revenue estimate for replacing stepped-up basis with carryover basis is relatively low (about $105 billion over a decade, according to the Congressional Budget Office).[176] Chirelstein's proposal, by contrast, would begin to raise revenue from high-net-worth founders such as Zuckerberg as soon as their companies begin distributing cash.[177] Whether or not revenue falls within the 10-year window has no obvious policy significance, but it does have political significance due to Congress's inordinate emphasis on 10-year revenue projections.

None of this is to suggest that Chirelstein's proposal is a substitute for stepped-up basis repeal—rather, the two policies are complementary. Moreover, leaving stepped-up basis in place while implementing the Chirelstein regime could detract from the efficacy of Chirelstein's proposal. To illustrate: imagine that a founder who acquired stock for $0 dies when shares are worth $100. Upon the founder's death, her heirs' basis is stepped up to $100. If the corporation then initiated a buyback that resulted in an imputed dividend of $10 per share, the heirs would be taxed on the distribution but would now have basis of $110 per share. If the heirs redeemed their shares in the buyback or sold their stock immediately thereafter, they would have a capital loss of $10 per share. If the heirs had net long-term capital gains that could soak up the capital loss, then the overall tax impact of the buyback would be neutral: the heirs would pay tax on an imputed dividend of $10 (versus zero under current law) but would recapture that tax when they deduct their capital loss. If the heirs had net short-term capital gains but not net long-term capital gains in their basket, then they would actually win from Chirelstein's proposal, since the tax on the imputed dividend (23.8% x $10 per share = $2.38, assuming that they are in the top bracket) would be less than the value of the capital loss (40.8% x $10 per share = $4.08).

175. McCaffery, *supra* note 171, at 320 (discussing the fate of stepped-up basis repeal provisions in 1980 and 2001 legislation).

176. *See Options for Reducing the Deficit: 2019 to 2028*, CONG. BUDGET OFF. 219 (Dec. 2018), https://www.cbo.gov/system/files/2019-06/54667-budgetoptions-2.pdf [https://perma.cc/8L9N-7LHL].

177. The EED proposal to neutralize the direct tax consequences between dividends and redemptions would not have this salutary effect because the EED tax would have no impact on nonredeemers. *See supra* notes 142-143 and accompanying text. Thus, as under current law, the Zuckerbergs of the world can simply choose to not redeem and avoid the EED tax, whereas under the Chirelstein proposal they would be taxed whenever the corporation buys back stock from any shareholders.

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Table 8. Illustration of Interaction Between Chirelstein Proposal and Stepped-Up Basis Rule

	Current law	Chirelstein Proposal
Value of shares	$100	$100
Redemption effect	N/A	$10 dividend
Redemption tax	$0	$2.38
Basis after redemption	$100	$110
Sales proceeds	$100	$100
Loss on sale	$0	($10)
Tax benefit of loss if offsets net long-term capital gain	$0	$2.38
Tax benefit of loss if offsets net short-term capital gain	$0	$4.08
Net tax consequence if offsets net long-term capital gain	$0	$0
Net tax consequence if offsets net short-term capital gain	$0	$1.70 tax reduction

Nevertheless, in practice we expect that Chirelstein's proposal still would raise significant revenue from founders and their heirs even if the stepped-up basis rule is retained or resurrected. Under current law, a founder's heirs can replicate the results of "Buy/Borrow/Die" through "Inherit/Borrow/Die": they avoid realizing any gains during their lifetimes, borrow against appreciated stock for liquidity, and repay loans only after death and basis step-up. If capital gains taxes are essentially irrelevant to heirs, then the fact that Chirelstein's proposal reduces capital gains taxes on heirs (but not below zero[178]) is essentially irrelevant too. In sum, Chirelstein's proposal is likely to mitigate the Mark Zuckerberg problem even if stepped-up basis remains, and if stepped-up basis is repealed permanently, Chirelstein's proposal still would serve the salutary purpose of alleviating (though not eliminating) lock-in.

E. Buybacks and the Panama Papers Problem

Chirelstein's proposal further serves to address what we previously termed "the Panama Papers problem." Because current law exempts capital gains, but not dividends, realized by foreign holders of U.S. stock, high-net-worth individuals from around the world can accumulate significant gains from U.S. equity investments without paying any tax anywhere. They do this by purchasing publicly traded U.S. stocks that pay zero or low

178. Recall that capital losses can offset only capital gains and up to $3,000 of ordinary income. *See* I.R.C. § 1211(b) (2018). Losses are in this sense "nonrefundable": a capital loss can be carried forward indefinitely, but without taxable income to offset, it is essentially worthless.

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dividends through entities in tax haven jurisdictions. As a result, zero- or low-dividend-yield U.S. stocks offer an attractive place for tax dodgers to park their cash.

The magnitude of the Panama Papers problem is staggering. Economist Gabriel Zucman has estimated that individuals and firms in tax havens held 9% of all U.S.-listed equities as of 2013.[179] If that percentage holds today over a total of $40.6 trillion in U.S. equity issuances, it would mean that more than $3.65 trillion in U.S. equities lie in the hands of tax haven investors.[180] One can argue with Zucman's figures at the margins (for example, his definition of tax havens is certainly contestable[181]), but it is difficult to disbelieve the fact that a significant slice of U.S. equities are held by investors in very low-tax jurisdictions—often out of sight of authorities in investors' home countries. When U.S.-listed corporations distribute cash to shareholders via buybacks, they effectively allow tax haven investors to earn returns tax-free.

Chirelstein's proposal would close this opportunity by extending the withholding tax to all cash distributions—dividends as well as buybacks. High-net-worth individuals still might (and indeed, likely would) use offshore entities to avoid home country tax authorities, but they would have to pay U.S. tax if they wanted to park their hidden wealth in U.S. equities.[182] The near-term revenue gain would be substantial: assuming a 30% withholding rate, a 2.5% buyback rate,[183] and $3.65 trillion of tax haven equity investments, the revenue gain from tax haven investors alone would be in the range of $27 billion per year. Again, there is no indication that Chirelstein—writing before the rise of tax-haven investing—anticipated this benefit. This is one more way in which Chirelstein's proposal has found a new justification in its later life.

Importantly, our estimate of revenue gains from tax-haven investors assumes that implementation of Chirelstein's proposal does not affect the share of U.S. equities held in tax havens. It is possible that tax-haven investors, faced with higher effective tax rates under Chirelstein's proposal,

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179. Gabriel Zucman, *Taxing Across Borders: Tracking Personal Wealth and Corporate Profits*, 28 J. ECON. PERSP. 121, 137 (2014).

180. *See* Rosenthal & Burke, *supra* note 68, at 14 (reporting U.S. equity issuances of $40.581 trillion in 2019).

181. *See, e.g.*, Conor Clarke, *What Are Tax Havens and Why Are They Bad?*, 95 TEX. L. REV. 59, 67-68 (2016) (reviewing GABRIEL ZUCMAN, THE HIDDEN WEALTH OF NATIONS: THE SCOURGE OF TAX HAVENS (2015)).

182. On the role of onshore financial centers such as the United States in facilitating offshore tax evasion, see Daniel Hemel, *What's the Matter with Luxembourg?*, NEW RAMBLER REV. (Jan. 13, 2016), https://newramblerreview.com/book-reviews/economics/what-s-the-matter-with-luxembourg [https://perma.cc/DM22-YVGZ], which reviews ZUCMAN, *supra* note 181.

183. *See* Edward Yardeni, Joe Abbott & Mali Quintana, *Corporate Finance Briefing: S&P 500 Buybacks & Dividends*, YADENI RES., INC. 9 fig.10 (Nov. 6, 2020), https://www.yardeni.com/pub/bbdivepsyield.pdf [https://perma.cc/K2LK-E8XV].

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would reallocate their portfolios toward other markets. In that case, our back-of-the-envelope estimate of revenue raised from tax-haven investors would be an overestimate. This caveat, though, comes with two qualifications of its own. First, we know very little about the price elasticity of demand for U.S. equities among tax-haven investors. It may be that the relative safety and strong performance of U.S. equities over time induces tax-haven investors to retain U.S. stocks even when the tax advantages decline. Second, U.S. stocks constitute more than half of the global equity market.[184] Investors interested in diversification therefore may decide to retain U.S. equities notwithstanding tax disadvantages because diversification benefits outweigh tax costs.

Chirelstein's proposal—unlike several other changes to capital taxation such as the repeal of stepped-up basis or a move to a mark-to-market system—also would raise revenue from foreign investors in non-tax-haven jurisdictions in the near term.[185] Tax treaties generally allow the United States to tax foreign residents on dividends from U.S. corporations but not on capital gains from the sale of U.S. companies' stock.[186] "Dividends" are defined to include income that is taxed like a dividend when received by a U.S. resident.[187] By treating buybacks as dividends with respect to U.S. residents, the United States would likely gain the right to treat buybacks as dividends with respect to foreign resident shareholders (and to tax them accordingly). By contrast, the United States almost certainly would not be able—under existing tax treaties—to extend mark-to-market treatment to foreign shareholders or to tax foreigners on capital gains at death.[188]

The application of Chirelstein's proposal to foreign investors in non-tax-haven jurisdictions is normatively more complicated than its application to tax-haven holdings. In many cases, the investors themselves would be unaffected by the change because their home-country government would give them a dollar-for-dollar credit equal to the tax that they paid to

184. *See* Brian J. Scott, Kimberly Stockton & Scott J. Donaldson, *Global Equity Investing: The Benefits of Diversification and Sizing Your Allocation*, VANGUARD RES. 2 (Feb. 2019), https://www.vanguard.com/pdf/ISGGEB.pdf [https://perma.cc/22XV-2ZTB] (estimating that U.S. equities accounted for 55.1% of the global equity market in 2018).

185. The Andrews corporate excise tax and Yin corporate distribution tax proposals discussed above, *see supra* note 130, would have this feature too. Both proposals would effectively impose a U.S. tax on stock repurchases even when those repurchases were from foreign shareholders.

186. *See* United States Model Income Tax Convention of November 15, 2006, 1 Tax Treaties (CCH) ¶ 209.10, art. 10(1) (2020) (allowing the taxation of foreign residents on dividends); *id.* art. 13(6) (limiting the taxation of foreign residents on capital gains).

187. *See id.* art. 10(5) (defining "dividends" to include any "income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident").

188. *See id.* art. 13(6).

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the United States.[189] The near-term revenue gain to the United States would be substantial though: based on data suggesting that approximately 40% of U.S. equities are held by foreigners, subtracting out the 9% in tax havens, assuming a 15% withholding rate, and again projecting a buyback rate of 2.5% over a total of $40.6 trillion in U.S. equity issuances, we estimate a revenue gain of approximately $47 billon per year.[190] The net effect would be a redistribution of wealth from the home country government to the U.S. government rather than a change in the total amount of tax that the investor pays. Whether the United States should be in the business of siphoning off revenue from its overseas trading partners is a question that we bracket for the time being.[191] If this outcome is objectionable, the United States can—at least in theory—neutralize it through government-to-government transfers. The efficacy of a strategy aimed at shifting revenue from foreign governments to the United States also is open to question: foreign governments ultimately may respond by adopting versions of Chirelstein's proposal themselves, thereby raising revenue from U.S. residents who hold foreign equities. The more easily defensible claim, we think, is that the United States ought to ensure that high-net-worth individuals who hide wealth in tax haven jurisdictions should pay some tax on their U.S. equity gains. Chirelstein's proposal—while not designed to increase the effective tax rate on tax-haven holders of U.S. stock—would likely have that salubrious effect.[192]

IV. Beyond Buybacks

Our analysis so far has evaluated Chirelstein's proposal as a piecemeal reform of the federal income-tax system that leaves other elements in place. Chirelstein's proposal provides a partial solution to the Mark Zuckerberg problem (the effective nontaxation of the labor income of firm

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189. *See Guide to Going Global: Tax—Full Handbook*, DLA PIPER 249 (Sept. 28, 2020), https://www.dlapiperintelligence.com/goingglobal/tax/handbook.pdf [https://perma.cc/LLU3-N5JE].

190. The 15% withholding rate is based on tax treaties. The overall estimate of a $74 billion per year revenue effect ($27 billion from foreigners in tax haven jurisdictions plus $47 billion from foreigners in non-tax-haven jurisdictions), *see supra* note 25 and accompanying text, assumes (very conservatively) that gains from mitigating the Mark Zuckerberg problem offset losses from the reduced rate on dividends received by C corporations in buybacks.

191. On the role of national interest in U.S. tax policy, see Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policy*, 54 TAX L. REV. 261 (2001), which discusses the interplay between geopolitical developments and international income taxation.

192. The EED proposal to neutralize the direct tax consequences between dividends and redemptions, *see supra* notes 142-143 and accompanying text, would not have this effect because under that proposal, (i) redeemers are still treated as recognizing capital gains, and (ii) nonredeemers are unaffected. In fact, the EED proposal could, depending on the technical details of its implementation, exacerbate the Panama Papers problem because it might treat all transactions that are dividends under current law as constructive sales yielding capital gains, which are exempt from U.S. tax when recognized by foreigners.

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founders) and a partial solution to the Panama Papers problem (the use of U.S. equity markets by tax-haven investors to generate tax-free returns). No one would argue, though, that Chirelstein's proposal fixes all of the federal income-tax system's flaws—or even all of the flaws in the status quo treatment of equity returns. In this Part, we consider potential interactions between Chirelstein's proposal and more sweeping reforms. We conclude by reflecting on the limits and merits of incrementalism in tax policy and tax law scholarship.

A. Buybacks and Rate Equalization

One oft-discussed reform to capital taxation is rate equalization: an end to the preferential rate for long-term capital gains and qualified dividends. All of the leading 2020 Democratic presidential candidates—including Joe Biden, Bernie Sanders, Pete Buttigieg, Elizabeth Warren, Amy Klobuchar, and Mike Bloomberg—said they would tax capital gains and dividends at the same rate as ordinary income, at least for the highest income households.[193] Chirelstein's proposal would be complementary—and indeed, integral—to such a shift.

Proposals to tax qualified dividends and long-term capital gains at the same rate as ordinary income have obvious appeal in an era of wide wealth inequality. In 2016, according to IRS data, long-term capital gains and qualified dividends taxed at preferential rates accounted for 3% of all income reported by taxpayers in the bottom 95% of the income distribution, rising to 71% for taxpayers in the top 0.001% of the income distribution.[194] Ordinary investors tend to hold all or most of their stock in tax-preferred accounts, such as IRAs and 401(k)s, and therefore would be largely unaffected by a capital gains increase. Increasing the capital gains rate therefore seems like a well-targeted tax increase on the well-to-do, and the current capital gains rate preference of 17% appears to be awfully ripe for the picking.

This analysis, however, neglects to consider behavioral responses by taxpayers to a significant increase in the capital gains rate. As noted above,

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193. *See, e.g.*, Brian Faler, *Bloomberg Targets the Rich with His Tax Plan, but More Gently than Some of His Rivals*, POLITICO (Feb. 1, 2020, 12:30 PM EST), https://www.politico.com/news/2020/02/01/michael-bloomberg-tax-plan-110105 [https://perma.cc/XY86-]; *Capital Gains Taxes*, POLITICO (Feb. 26, 2020), https://www.politico.com/2020-election/candidates-views-on-the-issues/tax-reform/capital-gains-taxes [https://perma.cc/GC5J-V8RF] (outlining the 2020 Democratic Party presidential candidates' positions on capital gains taxes).

194. *See* Lily Batchelder & David Kamin, *Taxing the Rich: Issues and Options* 4 tbl.1 (Sept. 18, 2019), https://ssrn.com/abstract=3452274 [https://perma.cc/JP8P-49TD] (working paper). For taxpayers in the 96th through 99th percentiles, long-term capital gains and qualified dividends accounted for 9% of reported income; for taxpayers in the top percentile but outside the top tenth of a percentile, 17%; and for taxpayers in the top tenth of a percentile but outside the top 0.001% of the income distribution, 39%. *Id.*

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capital gains are currently imposed only upon a realization event, such as a sale. In addition, capital losses recognized on the sale of depreciated assets can be used to offset capital gains recognized on the sale of appreciated assets. This means that selective realizations can be used to avoid paying current capital gains tax. Stepped-up basis at death exacerbates this problem, but even if that were eliminated, taxpayers could substantially reduce the effective tax rate on equity returns by delaying realization and deferring tax.[195]

Raising the tax rate on long-term capital gains and qualified dividends without changing other features of federal income-tax law would thus have relatively muted revenue effects. The Penn Wharton Budget Model predicts that the revenue-maximizing tax rate on capital gains under current law is approximately 33%; rate increases beyond that threshold would not raise additional revenue and ultimately would reduce revenue.[196] The revenue-maximizing rate would be higher—approximately 42%, according to the Penn Wharton Budget Model's estimates—if stepped-up basis at death were eliminated and death were treated as a realization event.[197] Notably, though, the 42% figure is still below the top tax rate on capital gains proposed by the leading 2020 Democratic contenders.[198] Chirelstein's proposal would likely push that revenue-maximizing rate higher than 42%, as investors could no longer avoid tax during their lifetimes by purchasing stock in companies that return earnings to shareholders via buybacks rather than dividends. And the harder it is to avoid a tax, the higher the revenue-maximizing rate.

B. Buybacks and an End to Realization

A more substantial reform to capital taxation than simply increasing the statutory rate would be to end the realization requirement altogether. One such proposal is for mark-to-market taxation: for assets that taxpayers

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195. To illustrate: imagine that the return on equity capital is 10% per year and the tax rate is 40%. After 10 years, an investment of $100 would be worth $259.37, and if realized, would produce a tax liability of 40% x ($259.37-$100) = $63.75, resulting in $195.62 after taxes. That is the equivalent of a 6.94% after-tax return, substantially above the 6% return that would be produced by applying the 40% tax to the 10% pre-tax return each year.

196. *See* John Ricco, *The Revenue-Maximizing Capital Gains Tax Rate: With and Without Stepped-up Basis at Death*, PENN WHARTON BUDGET MODEL (Dec. 4, 2019), https://budgetmodel.wharton.upenn.edu/issues/2019/12/4/the-revenue-maximizing-capital-gains-tax-rate-with-and-without-stepped-up-basis-at-death [https://perma.cc/5EM7-SEB3].

197. *Id.*

198. The top capital gains rate (including a net-investment income tax) would be at least 43.4% under plans proposed by Pete Buttigieg and Joe Biden, at least 55.8% under Sanders's plan, and 58.2% under Warren's proposal. *See* Erin Arvedlund, *Democratic Candidates' Proposed Wealth, Income Taxes: Who Has the Lowest and Highest Tax Plan?*, PHILA. INQUIRER (Feb. 3, 2020), https://www.inquirer.com/business/2020-election-trump-warren-sanders-biden-capital-gains-taxes-wealth-tax-20200203.html [https://perma.cc/L8TE-RWKB].

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hold year-to-year, taxpayers would owe tax each year on any increase in value from January 1 to December 31.[199] Results similar to mark-to-market taxation could be achieved by delaying the assessment of tax until realization but imposing a surcharge designed to negate any tax benefit from deferral—a proposal known as "retrospective capital gains taxation."[200] In a mark-to-market world, domestic taxable investors would be essentially indifferent between buybacks and dividends, because any year-to-year increase in a stock's value would be taxed in full. Thus, for purposes of domestic taxation, Chirelstein's proposal and mark-to-market taxation are substitutes rather than complements.

As noted above, though, the analysis changes significantly once foreign investors enter the picture. Because tax treaties generally allow the United States to tax U.S.-source dividends but bar the United States from taxing foreign investors on capital gains (while following home-country definitions of dividends and capital gains),[201] mark-to-market taxation of capital gains would raise little revenue from non-U.S. investors. Reclassifying buybacks as dividends, by contrast, would bring foreign shareholders of zero-dividend U.S. corporations within reach of the U.S. tax system. Once again, this outcome raises difficult normative questions,[202] but it is far from duplicative of mark-to-market taxation.

C. Buybacks and Tax Incrementalism

Chirelstein's proposal would still leave gaps in the United States's capital taxation regime. Founders of firms that retain earnings rather than distributing cash to shareholders via buybacks or dividends still could avoid taxation on what is essentially labor income for their whole lives. Tax haven investors would be subject to U.S. tax whenever firms in which they own equity repurchase shares, but they still could earn tax-free returns on investments in U.S. corporate debt.[203] Other well-acknowledged flaws in the U.S. system of capital taxation—such as the nontaxation of life insurance buildup[204]—would linger as well.

The Chirelstein proposal is thus an incremental reform rather than a structural overhaul. Our endorsement of the Chirelstein proposal should not be understood to imply that reform *ought* to proceed incrementally.

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199. For an overview of mark-to-market income taxation, see Daniel Hemel, *Taxing Wealth in an Uncertain World*, 72 NAT'L TAX J. 755, 757-58 (2019).

200. *Id.* at 758-59 (defining retrospective capital gains tax and differentiating it from an annual wealth tax and mark-to-market income tax). The idea of a retrospective capital gains tax emerged from the work of economist Alan Auerbach, who also coined the term. *See* Auerbach, *supra* note 22.

201. *See supra* notes 185-188 and accompanying text.

202. *See supra* note 191 and accompanying text.

203. *See* I.R.C. § 871(h) (2018) (portfolio interest exemption).

204. *See* Johnson, Pike & Lustig, *supra* note 23, at 665.

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At the same time, there is a danger in thinking exclusively in terms of structural overhaul: it may leave us unprepared to identify and capitalize upon windows for incremental improvements. In an era of often-divided government, opportunities for incremental reform are likely to be relatively more frequent (though still absolutely rare) than opportunities for vast structural change to the tax system. Chirelstein's buyback proposal—because of its bipartisan appeal—may exert a special attraction. Focusing intently—though not exclusively—on incremental reforms such as Chirelstein's buyback proposal can put us in a better position to seize the day when chances for smaller-scope changes present themselves.

There is another respect in which our endorsement of the Chirelstein's proposal is incrementalist. This Article innovates upon Chirelstein's 50-year-old framework rather than charting an entirely new course for the taxation of buybacks. Our innovations are, we believe, real improvements on the original. We think, for example, that our proposed basis-adjustment method and our 43-cents-on-the-dollar rule would make Chirelstein's proposal more straightforward from an administrative and compliance perspective. And—most importantly—the connections we draw between Chirelstein's proposal and the Mark Zuckerberg and Panama Papers problems give normative force to a proposal that was previously long on elegance and short on justification. All the while, we recognize—and emphasize—that we are standing on the shoulders of a giant.

Incrementalism of this variety has a different sort of value. The fascination with novelty and the fear of preemption in tax-law academia encourage authors to seek out new ideas where old ideas might suit well or better. Chirelstein's proposal is, we have argued, an ingenious idea that arrived before its time. The intellectual hypothesis motivating our Article is that often (though certainly not always) the best ideas were already thought, and that much progress can be made by plumbing tax law scholarship's past. The proof of this proposition is ultimately in the pudding, and Chirelstein's proposal is—we think—one data point in its favor.

Conclusion

Marvin Chirelstein's half-century-old proposal to tax buybacks as dividends has garnered relatively little attention from tax law academics despite the irrefutable economic similarity between the two transactions and the technical elegance of Chirelstein's solution. Nevertheless, after passing its fiftieth anniversary, the proposal is due for a new life—though for different reasons than those cited by Chirelstein. While parity for parity's sake is not an altogether convincing argument, the Chirelstein proposal would mitigate fundamental problems that currently plague the federal income system. Given the explosive growth of buybacks and the bipartisan antipathy towards them, the Chirelstein proposal also has the virtue of being politically realistic in an era when partisan polarization potentially puts

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more sweeping reforms out of reach. Chirelstein's proposal was an idea ahead of its time. More than fifty years later, time has finally caught up.

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