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In this article, Hemel and Polsky analyze proposals by several senators regarding corporate stock buybacks.

In a deeply divided Washington, one of the few issues on which leading lawmakers on both sides of the aisle appear to agree is that corporations should be discouraged from buying back their stock from shareholders. Earlier this month, top-ranking Democratic Sen. Charles E. Schumer of New York, along with Vermont independent Sen. Bernie Sanders,[1] unveiled the outline of a proposal that would bar companies from buying back their shares until they pay all workers at least $15 an hour and offer a suite of healthcare, sick leave, and retirement benefits. On February 12, Florida Republican Sen. Marco Rubio — who has criticized buybacks[2] in the past — announced[3] that he wants to change the tax treatment of buybacks as part of a plan[4] to make U.S. industry more competitive.

When everyone from the self-described Democratic socialist Sanders to the mainstream conservative Rubio sees buybacks as a bugaboo, one might think that there is a real policy problem here, and there is. But it's a different problem than the one that the senators have seized upon. And if the senators solve it, that will likely be by accident.

Buyback Basics

There are two ways a corporation can distribute cash to its investors. The most straightforward way is to a pay a dividend to all shareholders. A second way is to buy back some of its stock from investors. Apart from tax considerations that we'll address later, there is little reason why society should care which option a corporation chooses.

A hypothetical helps to illustrate. Imagine that a company has 100 shares of stock outstanding, with each share trading at $10. Let's say the company has $100 of earnings that it wants to distribute to shareholders. It could either pay a dividend of $1 per share, or it could buy back 10 of its shares for $10 apiece. Either way, $100 moves out of the corporate treasury and into the pockets of (current or former) shareholders.

Why might the corporation want to distribute $100 through a dividend or a buyback? One

[1] Schumer and Sanders, "Schumer and Sanders: Limit Corporate Stock Buybacks," *The New York Times*, Feb. 3, 2019.

[2] Rubio, "America Needs to Restore Dignity of Work," *The Atlantic*, Dec. 13, 2018.

[3] Heaven Taylor-Wynn, "Sen. Rubio Introduces Freedom to Compete Act," WCJB TV20 (Feb. 12, 2019).

[4] Rubio release, "Outlining China's Plan for Global Dominance and Why America Must Respond" (Feb. 12, 2019).

common reason is that the corporation has run out of attractive expansion opportunities, and its executives don't think that they can earn a higher rate of return by investing the $100 in the company's business than shareholders can earn by investing the $100 themselves. Rather than stockpiling cash or pursuing projects that they think will underperform in the market, executives return some of their earnings to shareholders, who can then invest the money in new businesses or in existing companies looking to expand.

What's the Matter With Buybacks?

So far, none of this sounds especially nefarious. Why then do Schumer, Sanders, and Rubio want to restrict or discourage buybacks?

Schumer, Sanders, and Rubio all say that buybacks cause corporations to invest less in their product and their workforce. Schumer and Sanders hope that with their proposed buyback restrictions in place, corporations would choose to plow their earnings into new jobs, equipment, and research and development, or else boost wages and benefits. Rubio believes that changing the tax treatment of buybacks would yield similar results. But those aren't the only ways that corporations could use their cash piles if the buyback route were obstructed or discouraged.

Instead, companies might return cash to shareholders through dividends. Or instead of raising worker pay, they might use the cash to boost executive salaries, upgrade corporate jets, and invest in a CEO's pet projects. More likely, they would use their cash to buy portfolios of other corporations' stocks and bonds. If before they couldn't find expansion opportunities that would allow them to beat the prevailing market rate of return, it's unclear why the Schumer-Sanders or Rubio proposals would alter their investment equations.

Worse yet, restrictions on buybacks could lead to greater concentrations of corporate power. When a company buys back its shares, its market capitalization declines by approximately the amount of the buyback. All else equal, a company that regularly returns cash to shareholders will be smaller than one that retains and reinvests its earnings. Fewer buybacks will likely lead to larger corporations. And increased market capitalization benefits CEOs and other senior managers, who generally can command higher pay when their companies grow in size.[5]

In other words, the greatest risk inherent in the Schumer-Sanders and Rubio proposals is not that they will fail, but that they will succeed. By deterring stock repurchases, the lawmakers' plans may make it even more likely that companies like Amazon and Alphabet will use their cash to acquire rivals and consolidate market share. If companies have no choice but to grow, we'll end up with an economy that's less competitive and more like an oligopoly, in which ever-larger corporations will wield even greater political power.

Death and Taxes

There is, to be sure, one reason why policymakers should be concerned about the recent rise of stock buybacks, which topped $1 trillion for the first time in 2018.[6]

When a company distributes cash through a dividend, all shareholders who hold the company's stock in a taxable account are liable for income tax. The top federal tax rate on dividends paid by domestic corporations is currently 23.8 percent. Foreign investors who own stock in U.S. corporations pay U.S. taxes on dividends as well — at rates ranging from 5 percent to 30 percent, depending on the terms of the tax treaty with the investor's home country.[7]

By contrast, when a company distributes cash in a buyback, only the investors who choose to sell back their shares owe any tax. If they have held their shares for more than a year, they pay tax at the long-term capital gain rate, which tops out at the same 23.8 percent rate that applies to dividends. But there are three wrinkles that make the tax treatment of buybacks much more generous than the tax treatment of dividends.

First, in a buyback, the shareholder pays tax on the difference between the sale price and her basis, which in the normal course of business is

[5] Xavier Gabaix and Augustin Landier, "Why Has CEO Pay Increased So Much?" 123(1) *Q. J. of Econ.* 49-100 (Feb. 2008).

[6] Bob Pisani, "Stock Buybacks Hit a Record $1.1 Trillion, and the Year's Not Over," CNBC, Dec. 18, 2018.

[7] IRS, "Table 1. Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties."

the amount that she paid for the stock. With a dividend, the shareholder pays tax on the full amount of the distribution. Shareholders who receive dividends still will be able to use their basis to reduce their tax liability when they ultimately sell their stock. But because of the time value of money, shareholders are virtually always better off if they can use their basis to offset taxes now rather than later.

Second, when a taxpayer dies, the basis of all her assets is stepped up to the fair market value. Any tax that she might have owed on gains that accrued during her lifetime is wiped away. If her heirs sell her assets then, they will owe zero in capital gains tax.

This means that an investor who holds stock in a corporation until death can avoid shareholder-level tax entirely, provided that the company distributes its earnings via buybacks rather than dividends. For example, CEOs such as Jeff Bezos of Amazon, Warren Buffett of Berkshire Hathaway, Larry Page of Alphabet, and Mark Zuckerberg of Facebook will likely never owe federal income tax on earnings distributions from their companies, because Amazon, Berkshire Hathaway, Alphabet, and Facebook all return cash to shareholders via buybacks rather than dividends. Bezos, Buffett, Page, and Zuckerberg will likely hold onto their stock until they die, at which point their heirs will receive the benefit of stepped-up basis and can sell their shares immediately or in the next round of buybacks. All the while, billions of dollars of gains during the CEOs' lifetimes will escape income tax.

Third, while the United States taxes foreign shareholders on dividends paid by domestic corporations, it doesn't tax foreigners on their capital gains. The ability of U.S. corporations to distribute earnings tax-free to foreigners via buybacks amounts to a huge hole in our system of shareholder-level taxes, especially because the amount of U.S. corporate stock held by foreigners is roughly the same as the amount held in U.S. taxable accounts.[8]

All this means that trillions of dollars of U.S. stock market gains escape federal income taxation. In an era of growing federal deficits and widening wealth inequality, that's a problem.

A Not-So-Simple Fix

The Schumer-Sanders proposal won't fix that problem, however. It would allow corporations that pay their workers $15 an hour and satisfy other criteria to continue to distribute earnings via buybacks, thereby allowing shareholders to minimize federal income taxes. Amazon[9] and Facebook,[10] for example, are likely to meet the minimum-wage requirement — which is commendable, but not a reason that Bezos or Zuckerberg ought to be able to accumulate tens of billions of dollars tax-free.

Rubio's plan comes closer to addressing the problem. While he has not released proposal details, early reporting indicates that Rubio would treat all corporate distributions as dividends — regardless of whether they are denominated as dividends or buybacks.[11] This is similar to an idea that law professor Marvin Chirelstein proposed in a *Yale Law Journal* article 50 years ago.[12] Rubio's report cites Chirelstein's article, which suggests that Rubio might offer a proposal along the same lines.

Chirelstein's idea is as follows: If a company has 100 outstanding shares worth $10 each and it decides to spend $100 on buybacks, each investor — regardless of whether she participated in the buyback — should be taxed as if she had received a $1-per-share dividend (that is, the $100 buyback divided by the 100 shares). The investor's basis in her shares would then be adjusted upward by $1, and any shareholder who actually participates in the buyback would owe capital gains tax on the difference between the sale price and her adjusted basis.

Under Chirelstein's proposal, Bezos would owe tax any time Amazon buys back shares (and ditto for Buffett at Berkshire Hathaway, Page at Alphabet, Zuckerberg at Facebook, and so on).

[8] Steven M. Rosenthal and Lydia S. Austin, "The Dwindling Share of U.S. Corporate Stock," *Tax Notes*, May 16, 2016, p. 923.

[9] Karen Weise, "Amazon to Raise Minimum Wage to $15 for All U.S. Workers," *The New York Times*, Oct. 2, 2018.

[10] Kate Rogers, "Facebook Enters the Minimum Wage Fight," CNBC, May 13, 2015.

[11] Ylan Mui, "GOP Sen Marco Rubio Takes Aim at Stock Buybacks, an Issue Under Attack by Democrats," CNBC, Feb. 12, 2019.

[12] Chirelstein, "Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares," 78 *Yale L. J.* 739 (1969).

For these billionaires to escape federal income tax, their companies wouldn't be able to distribute any earnings during the billionaires' lifetimes. And even then, the billionaires' heirs would owe dividend tax on distributions — whether they come in the form of dividends or buybacks — so the tax advantage of holding stock until death would diminish.

Less wealthy shareholders might bristle at the idea of owing taxes on buybacks in which they haven't actually participated. But if there were no longer a tax advantage to buybacks, corporations would likely shift back to dividends as their preferred method of distributing earnings to shareholders. Overall, we would do a better job of ensuring that billionaires like Bezos and Buffett — as well as foreign investors who hold U.S. corporate shares — pay U.S. tax on their stock-based profits.

Here's the rub though: Chirelstein never said his proposal would cause corporations to reinvest earnings in their business or discourage them from distributing cash to shareholders. And it's not clear that it would. His goal was to put buybacks and dividends on equal footing, not to trap cash inside companies.

Chirelstein did not see anything inherently evil about buybacks — and there's not. But there is an inherent problem in a system that allows billionaires like Bezos, Buffett, Page, and Zuckerberg to largely avoid federal income tax on their massive stock gains. Our flawed tax rules regarding buybacks make that possible and should be fixed. The latest effort to change the tax treatment of buybacks might be motivated by the wrong reason, but it may inadvertently achieve the right result. ■