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An Excise Tax on Stock Repurchases and Tax Advantages of Buybacks over Dividends

The Build Back Better Act (H.R. 5376), as reported by the Committee on the Budget, includes a provision to impose a 1% excise tax on stock repurchases by publicly traded corporations. Stock repurchases are another way to distribute income to shareholders and, compared to dividends, have favorable tax treatment. This provision is included in the version of the bill, now called the Inflation Reduction Act of 2022, that was passed by the Senate on August 7, 2022.

What Is a Stock Repurchase?

A stock repurchase or buy-back occurs when a firm buys its own shares. This repurchase can be made by a tender offer to shareholders, who can then indicate how many shares they wish to sell and at what price, or, more commonly, shares can be purchased on the open market.

Stock repurchases have been increasing compared to dividends. (See CRS Legal Sidebar LSB10266, *Stock Buybacks: Background and Reform Proposals*, by Jay B. Sykes.) Historically, dividends were the major form of distributing income and share repurchases were rare. Repurchases began to be more common in the mid-1990s, and by the early 2000s, dividends and repurchases were similar in magnitude. By 2004, annual share repurchases had typically begun to exceed dividends. Repurchases almost doubled in 2018 to more than $1 trillion, following the corporate tax cuts in the Tax Cuts and Jobs Act (P.L. 115-94), and remained high in 2019, although they fell in 2020. News articles indicate that almost $900 billion of repurchases have already occurred in 2021.

Concerns about stock repurchases have led to both nontax (such as disallowing stock repurchases on the open market) and tax proposals. Tax approaches have included proposals to allocate share repurchases to shareholders and tax them as dividends or to impose excise taxes. Senator Brown has introduced legislation (S. 2758) to impose a 2% excise tax on stock repurchases.

Why Are Stock Repurchases Tax Favored?

A dividend is subject to tax, although at a lower rate than ordinary income (a top rate of 20% compared to a top rate of 37% on ordinary income). Capital gains are also subject to the same tax rate, although the tax applies only to the sales price minus the basis (the amount originally paid for the stock). Therefore, a shareholder pays a larger amount of tax on a dividend distribution than on a sale of the share.

Different types of shareholders have different preferences for repurchases compared to dividends. Stockholders who are tax exempt (such as pension plans and nonprofit organizations) will be indifferent to the tax treatment. Taxpayers who have a low basis (e.g., because they have held the stock for a long time or because the stock has appreciated significantly) will have a small preference for a repurchase because most of the sale price will be taxable. Taxpayers who have a high basis (e.g., if they recently bought the stock) would prefer a share repurchase because little of the sales price would be taxable. In addition to this tax differential, the firm's purchase of corporation stock can allow stockholders a choice about how or whether to receive distributions.

Explanation of Excise Tax Provision in the Build Back Better Act

A provision in H.R. 5376 would impose a 1% excise tax on the repurchase of stock by a publicly traded corporation. The amount subject to tax would be reduced by any new issues to the public or stock issued to employees. The tax would not apply if repurchases were less than $1 million or if contributed to an employee pension plan, an employee stock ownership plan, or other similar plans.

The tax would not apply if repurchases were treated as a dividend. It would not apply to repurchases by regulated investment companies (RICs) or real estate investment trusts (REITs). It also would not apply to purchases by a dealer in securities in the ordinary course of business.

The excise tax would apply to purchases of corporation stock by a subsidiary of the corporation (i.e., a corporation or partnership that is more than 50% owned by the parent corporation). The tax would also apply to purchases by a U.S. subsidiary of a foreign-parented firm. It would apply to newly inverted (after September 20, 2021) or surrogate firms (i.e., firms that merged to create a foreign parent with the former U.S. shareholders owning more than 60% of shares). The tax will apply to repurchases after December 31, 2022.

In general, excise taxes can be deducted to determine profits subject to the corporate tax, so that the tax is reduced by the corporate tax rate (21%). That is, for a profitable corporation each dollar of excise tax reduces profits taxes by 21 cents. The language specifies that this tax would not be deductible, so there would be no corporate profits tax offset.

Non-Tax Issues

Whereas one factor favoring stock repurchases over dividends is the tax treatment, other concerns have been raised regarding stock repurchases that may be the motivation for discouraging these repurchases through an excise tax.

Firms normally return earnings to shareholders, traditionally through dividends. Repurchases serve the same purposes. An increase in distributions may occur when the firm does not have desirable investment projects. Both dividends and stock repurchases can also signal that the firm is doing well.

If all parties have full information, a distribution should reduce the value of the firm. For dividends, the shares remain constant and the price per share falls. For repurchases, the price per share should remain constant while the overall number of shares fall.

In practice, other forces may affect per share prices. Evidence suggests that share repurchases cause stock prices to rise. This rise may simply reflect the increase in demand from the repurchase if supply does not keep pace at the going price. This rise in price has been an issue of concern. For example, some research has suggested that executives use stock repurchases to push the price of the stock up and generate gains for sales of these executives' stock. At the same time, much of the executives' stock is in options that cannot be traded. (See CRS In Focus IF11506, *Stock Buybacks and Company Executives' Profits*, by Gary Shorter for a discussion.) Others argue that stock buybacks help to concentrate stock among corporate insiders by buying back shares on the open market from the public and that these corporate insiders initiate buybacks knowing that the firm's shares are undervalued. (See CRS Legal Sidebar LSB10266, *Stock Buybacks: Background and Reform Proposals*, by Jay B. Sykes.) Still others have expressed concerns about leveraged buybacks that may increase debt too much or that buybacks displace investments in capital and research and development that are essential for the firm's long-term health. (See CRS In Focus IF11393, *Stock Buybacks: Concerns over Debt-Financing and Long-Term Investing*, by Gary Shorter.)

Revenue Effects

The Joint Committee on Taxation estimated a gain of $124 billion over 10 years in the original bill. News reports indicate a $74 billion gain under the current version. This smaller gain may reflect the later effective date given large repurchases in 2022 and the possibility that companies will repurchase shares prior to the effective date. A 1% tax is relatively small compared to the top tax rate on dividends and capital gains of 23.8% (20% plus the 3.8% net investment income tax). However, it would also apply to repurchases by tax-exempt investors who hold about half of corporate shares of U.S. firms and by foreign investors who pay no capital gains tax and typically low dividend taxes due to treaties. Foreign investors hold about a quarter of shares.

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