The Daily Dish

Tax Policy, Valentine's Day Edition

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Eakinomics: Tax Policy, Valentine's Day Edition

Senator Marco Rubio sent an early valentine to the populist policy crowd Tuesday with his "new proposal that tackles one of Democrats' favorite talking points: stock buybacks." According to CNBC, "The plan, unveiled Tuesday, would eliminate the preferential tax treatment of share repurchases as a way to discourage that behavior. Instead of falling under the capital gains rate, they would be taxed as dividends, which are subject to a wide range of rates."

The plan is laid out in just two sentences in a report by the Senate Committee on Small Business and Entrepreneurship that say, "Finally, share repurchases are tax-advantaged over dividends, due to the structure of capital gains taxes. Tax policy changes to end this preference might, on their own, increase investment by shifting shareholder appetite for capital return. To the extent structural incentives remain for capital return, an increased tax rate on repurchases might raise revenue to finance other incentives for capital investment like full expensing." These have been interpreted to mean that the cash used for share repurchases would be treated as a dividend distribution. That's a terrible idea.

First, it is unfair. Suppose that a firm has 200,000 shares outstanding, each valued at $10 per share. To make things simpler imagine I own 100,000 and you own 100,000. It can buy back 100,000 of those shares for $1 million. If it does so, this is a dividend distribution of $5 per share taxable for both of us. But I could choose to sell my shares and you choose to hold yours. You have done nothing and received nothing, but the tax bill is in the mail. I have sold, received a million dollars, and the tax bill for half of that is in the mail. It is an unfair tax imposed randomly on some shareholders.

Second, it is a tax in part on the value of the original investment and not the return on that investment. To see this, imagine that each of us had originally contributed $750,000 ($7.50 per share) for an original capitalization of $1.5 million. The "dividend" of $5 per share represents $2.50 of actual return and $2.50 of original capital contribution. The tax is an unfair random tax on wealth and not income.

Third, it is unclear as to whether the tax will be imposed on net buybacks. It would be strange to impose a tax if a firm bought back shares and later in the year offset those bought shares with new share issues. Would the tax, for example, pretend that a 2-for-1 stock split was an entire buyback followed by new issuance?

Of course, it could be the case that the real intent is to instead simply tax any capital gain from buybacks as ordinary income instead of at the preferential capital gains rate. But this raises the question of what is "capital gain from buybacks." As I've explained previously, buybacks *per se* have no effect on share prices, so there is <u>no</u> capital gain. Changing the tax rate on capital gains for any year in which a firm bought back shares makes no sense whatsoever.

The real issue, of course, is that there is no problem to be solved, so any proposal would simply create new ones. My mentor Alan Blinder once wrote a book whose title I love: Hard Heads, Soft Hearts. In the spirit of Valentine’s Day, the problem is not that one has a soft heart toward issues of fairness, distribution, or poverty. The problem is the absence of hard-headed analysis about actual problems and real solutions.