Should Share Repurchases Be Dividends to Remaining Holders?

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Under current law, holders of common stock pay less tax than holders of debt, and arguably less tax than might be deemed desirable from a utilitarian perspective. The most frequently proposed solution is to require investors to mark publicly traded stocks to market and pay current tax on their associated gains. But there is a more modest alternative that might present fewer problems and better target the simple objective of ensuring that most shareholders pay at least some amount of tax.

Much of the tax that would otherwise be imposed on shareholders is effectively avoided under current law because corporations do not make taxable dividend distributions. Instead, they use their accumulated earnings to redeem outstanding shares. Those earnings effectively leave corporate solution to fund an increase in the remaining shareholders’ proportionate interests in the corporation. Yet the transaction does not subject those remaining shareholders to any dividend tax. Hariton suggests that those earnings might be deemed distributed pro rata to shareholders as taxable dividends. (Shareholders would then be deemed to use them to acquire more stock in the corporation and would therefore have a corresponding increase in stock basis.) This treatment would not be a great departure from current rules under section 305 or proscribed by constitutional concerns.

Anyone with enough financial wealth to invest outside a tax-exempt retirement account is aware of the radical difference in tax treatment between the ownership of debt and the ownership of common stock. Investors in debt must accrue income and pay tax regardless of whether they receive anything on a current basis.1 Indeed, they must accrue income and pay tax regardless of whether they ever receive anything at all.2

Investors in stock are supposed to likewise pay tax on dividends, but they avoid much of that tax when they invest in companies that don’t pay any dividends, or that pay only small ones, and instead use their earnings to repurchase outstanding shares. Moreover, such investors generally avoid paying tax on the resulting systematic increase in the value of their shares. They rarely sell their appreciated stocks, and if they do, they also sell some of their depreciated stocks, so that they realize losses to offset their gains.3 If they still need additional funds, they can borrow against their appreciated stocks; and if they are worried about risk, they can hedge separately against potential future declines in their value. When they die, their heirs will get a step-up in basis, so that no tax will ever be paid on their appreciated stocks.

This difference in tax treatments is a strong incentive to invest wealth in diversified portfolios of common stock, rather than in debt. For many investors, the aggregate marginal rate of federal, state, and local tax on interest income is close to 50 percent. Thus, even if corporate stock and debt have the same pretax return, the after-tax return on stock may be twice as great. In the long run, this makes a big difference.

Considered solely from the perspective of horizontal equity, the difference seems a bit troubling. If the pretax return on common stock is greater than the pretax return on debt, why should debt owners bear the lion’s share of the tax on financial investment?4 The economic theory used to be that because corporations were entitled to deduct interest payments, they would offer debt owners higher pretax

1 The original issue discount rules of sections 1272 and 1273 require cash basis holders to accrue on a current basis the excess of the stated redemption price of instrument over its issue price.
2 The so-called contingent debt regulations of reg. section 1.1275-4 require current accrual on the issue price of a contingent debt instrument even though the instrument may never pay more than its issue price. They require the same of inflation-indexed debt instruments under reg. section 1.1275-7.
3 This is often done for them by diversified investment funds. Those funds can also rely on a special provision of the Internal Revenue Code to distribute appreciated stock out of the fund on a tax-free basis. See, e.g., section 852(b)(6).
4 I discuss the corporate integration issue further below.
returns. Thus, market forces would lead the two groups of investors to equally bear the implicit cost of the tax imposed on corporate capital and wind up with similar after-tax returns. Clearly that is not how things are working out. Moreover, the radical difference in tax treatment encourages investors to take on more risk than they otherwise would.

One might also consider the traditional normative and utilitarian rational for imposing a tax on capital to begin with: Adapting the words of Justice Oliver Wendell Holmes, surely tax is a reasonable price to pay for the privilege of maintaining wealth in a civilized society. After all, how can someone who relies on society to maintain wealth — its communication, legal, and financial systems; its marketplace; its police force; and its armies — object to using a little of that wealth to help maintain society? Moreover, people tend to save outside of tax-exempt retirement accounts when they cannot profitably consume more goods and services today. Paying tax arguably hurts less under those circumstances than it does when people lack wealth and must therefore pay tax out of foregone current consumption. Put differently, spending money has a declining marginal utility. Compare the marginal utility of the next dollar spent by someone with $10,000 with that of the next dollar spent by someone with $10 million. Thus, asking people who are maintaining wealth to bear at least some of the cost of maintaining society is arguably good social engineering, in the sense that it reduces the true cost of taxation as a whole.

Today, the most common proposal for requiring common stock owners to pay more tax is to require them to “mark to market” their publicly traded stocks. That means, of course, that they would be treated as if they had sold and repurchased their stock at the end of each year, and so would recognize their unrealized gains (and losses) accordingly. Obviously, this would serve to eliminate the deferral of shareholder-level tax on corporate accumulated earnings, because the value of those accumulated earnings is generally reflected in the trading price of the shares. But it would do far more than that. It also would require investors to pay large amounts of tax on paper gains relating to speculation about future earnings, gains that might vanish the following year. It would require the government to hand out large refunds on account of similar paper losses. And it would create a dramatic cliff between the tax treatment of publicly traded stocks and that of nonpublicly traded stocks and other investments, which would give rise to definitional problems and skew investment behavior.

I’m therefore not sure it would make sense to enact such a proposal merely to force shareholders to pay a little more tax. There may be other, more ambitious reasons to propose a mark-to-market system of taxation. Some might advocate one to force entrepreneurs to pay meaningful amounts of tax on their accumulated wealth (which might otherwise go untaxed because the entrepreneurs never have taxable receipts). Some might propose one as an alternative to the corporate-level tax under an entirely new approach to taxing invested capital. But this article focuses on typical investors who have already earned income (and already paid full tax on it) and who are now investing that income in order to trade consumption today for consumption tomorrow. The objective here is to allow the government to collect at least some amount of current tax on those investments to ensure fair and equitable taxation, both vertically and horizontally, for the privilege of maintaining wealth.

Thus, before we deem those investors to have receipts from deemed sales of their stock in publicly traded corporations, I submit that we might consider a more modest proposal: We might deem them to have received their pro rata shares of the earnings that are used by publicly traded corporations to redeem outstanding shares. Those earnings would of course likewise be deemed re-contributed to the corporation by the shareholders, so the shareholders would receive a corresponding increase in the basis of their stock.

What are the arguments for doing this? Well first, of course, it would prevent accumulated earnings from leaving corporate solution and being effectively returned to shareholders without anyone paying dividend tax. It would recognize the fact


7See Bankman, supra note 5. See also Martin A. Sullivan, “Can Marking Stock to Market Replace the Corporate Tax?” Tax Notes, Apr. 14, 2014, p. 139 (discussing a proposal by Eric Toder and Alan Viard).
that shareholder redemptions increase the proportionate interests of the remaining shareholders in the corporation, an increase that is in effect funded on the remaining shareholders’ behalves out of their pro rata shares of accumulated earnings. When a corporation buys some of its stock on the market, the economic result is no different than if it had paid a pro rata dividend to its shareholders and the remaining shareholders had used their dividend proceeds to purchase the stock that the corporation acquired.\(^9\) Congress already imposes dividend tax under section 305(c) in similar circumstances. If, for example, a corporation periodically redeems some of the stock of Shareholder A but none of the stock of Shareholder B, Shareholder B is effectively deemed to receive taxable dividends and use them to acquire a greater interest in the corporation.\(^9\)

Equally important, this treatment would help ensure that shareholders paid some amount of tax on their wealth regardless of whether their stocks increased in value. It would therefore be better targeted to the objective of taxation than would a mark-to-market approach. As explained above, that objective is to require citizens to contribute something to the maintenance of society in exchange for the privilege of maintaining wealth. It is not to make the government a secret partner of investors that shares on a current basis in both their winnings and their losses.

I realize some people believe that because corporate earnings are already taxed once at the corporate level, it is “double taxation” to tax them again at the shareholder level. But that concern speaks to how we treat distributed earnings, not to whether and when we treat them as distributed. Partly for that reason, we currently tax dividends at a preferential rate, and that rate would extend to dividends that were deemed distributed under this approach. If and when we decided to integrate the corporate level tax, perhaps those dividends would not be taxed at all.

In the meantime, however, no one intends to integrate the corporate-level tax through the back door by inviting corporations to repurchase shares rather than pay dividends. Moreover, while I certainly don’t wish to touch on the debate about how to tax corporate earnings that are accumulated outside the United States, I do observe that for whatever reason, the after-tax return on corporate equity significantly exceeds the after-tax return on corporate debt. That makes it a bit more difficult to assert that it’s unfair to tax shareholders because they’ve already paid full tax at the corporate level. Conversely, if the government were collecting at least some meaningful amount of tax from all shareholders, it could better afford to tax U.S. corporations at a lower rate on earnings derived outside the United States so that U.S. corporations could be more competitive in foreign jurisdictions.

That leaves us with the constitutional issue. As explained below, it is an issue that likewise applies to mark-to-market proposals and to any other regime that involves taxing deemed receipts (including the current law tax treatments of zero-coupon debt and contingent debt). I don’t think it presents an impediment, but first I must take a moment to explain it.

Article 1 of the Constitution forbids Congress to impose a direct tax on property without “apportioning it among the states in accordance with population.”\(^10\) Needless to say, this requirement would make any direct tax on property almost impossible to impose. That is why in 1913, the states ratified the 16th Amendment, which allows Congress to impose an “income tax” on U.S. residents without apportioning it among the states. And it is for that reason that Congress cannot impose a tax on accumulated wealth, financial or otherwise. There must be at least a reasonable basis for asserting that what is being taxed is “income,” rather than wealth per se.

Shortly after the first income tax was enacted, the IRS commissioner insisted on treating a pro rata stock dividend as income, even though a pro rata stock dividend does not change the economic rights of its recipient or confer anything of value on the shareholder.\(^11\) In Eisner v. Macomber,\(^12\) the Supreme Court held against the commissioner in a 5-4 decision, but not on the perfectly adequate grounds that a pro rata stock dividend was not the sort of income that Congress had in mind when it enacted the

\(^8\)For example, suppose 10 shareholders each own 100 shares — i.e., 10 percent — of Corporation X. Corporation X uses $1 million of accumulated earnings to buy in all of the stock of one of the shareholders. As a result, the remaining nine shareholders each own 11.1 percent (1/9) of Corporation X. That is economically equivalent to (a) Corporation X declaring a $1 million dividend pro rata ($100,000 per shareholder), and (b) nine shareholders each using their $100,000 to buy 11.1 shares of stock from the 10th shareholder.

\(^9\)Reg. section 1.305-3(e), examples 8 and 9.

\(^10\)That means that if there are the same number of people in New York and Florida, the residents of New York cannot be made to pay more tax in the aggregate than the residents of Florida, even if the residents of New York have more capital than the residents of Florida have.

\(^11\)For example, suppose a corporation has two shareholders, each of which owns 100 shares, and the corporation declares a stock dividend of 100 additional shares, so that each shareholder now has 150 shares. Each shareholder is still in the same economic position, owning 50 percent of the company.

\(^12\)252 U.S. 189 (1920).
income tax. Rather, it did so on the grounds that Congress had no constitutional right to tax a pro rata stock dividend (whether it wanted to or not) because such a tax would not be an income tax, and Congress could therefore not impose it without apportioning it among the states. Justice Holmes and Justice Brandeis wrote the dissenting opinions.

It is of course not the holding of *Eisner v. Maconber* that creates the issue, because no one today wants to tax pro rata stock dividends. It is rather the reasoning of the Court’s majority and the limited conception of income from capital upon which it is bottomed. The majority thought that financial income was limited to something that a taxpayer could dispose of separate and apart from the capital that gave rise to it, like a fruit plucked from a tree. Justice Mahlon Pitney wrote:

Here, we have the essential matter: not a gain accruing to capital; not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being “derived” — that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal — that is income derived from property. Nothing else answers the description.13

Despite this limited conception of financial income, Congress later enacted the rules that are now in sections 1272 and 1273. Under them, the holder of any note purchased at a discount is taxed on so-called original issue discount income that accrues in the absence of any receipts, and indeed no receipts may ever be received if the holder disposes of the note before maturity. Such a holder clearly has not plucked from the tree any fruit that can be separately disposed of. At the same time, Congress enacted section 305(c), which effectively requires shareholders to include in income an increase in their proportionate interests in a corporation that arises from the redemption of the stock of *other* shareholders, even though the first set of shareholders has not received anything at all.14

Nor has Treasury felt constrained by the *Eisner v. Maconber* majority’s limited vision. For example, under current regulations, a taxpayer may be taxed on income accruing currently on a contingent debt instrument, or on an inflation-indexed Treasury note, but ultimately, the instrument may return no more than its original issue price.15 And recently proposed regulations would deem foreign investors to earn phantom taxable dividend equivalent payments on cross-border options, forwards, and other equity derivative contracts, which payments will clearly never materialize, because the relevant financial instruments do not provide for them.16

In truth, we have come a long way since 1920, and so have our financial markets. I doubt that today’s Supreme Court would find all of these treatments unconstitutional, and so I think it’s fair to suppose that like our conception of the right to due process, our conception of the nature of income has evolved along with society.17 But even if it

13252 U.S. at 207. Holmes’s dissenting opinion was, as usual, pragmatic and brief:
The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. 252 U.S. at 220.
Brandeis wrote at considerable length, but along the same lines:
Hitherto, powers conferred upon Congress by the Constitution have been liberally construed, and have been held to extend to every means appropriate to attain the end sought. In determining the scope of the power, the substance of the transaction, not its form, has been regarded. . . . Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a departure from these rules of construction and compel this Court to hold that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder? 252 U.S. at 226.
Indeed, Brandeis might have allowed the commissioner to tax shareholder’s share of corporate earnings in the absence of any dividend at all:
The government urges that it would have been within the power of Congress to have taxed as income of the stockholder his pro rata share of undistributed profits earned even if no stock dividend representing it had been paid. Strong reasons may be assigned for such a view. See *Collector v. Hubbard*, 12 Wall. 1. The undivided share of a partner in the year’s undistributed profits of his firm is taxable as income of the partner although the share in the gain is not evidenced by any action taken by the firm. Why may not the stockholder’s interest in the gains of the company? The law finds no difficulty in disregarding the corporate fiction whenever that is deemed necessary to attain a just result. 250 U.S. at 230.
14See reg. section 1.1275-4 and -7.
15Reg. section 1.1275-4 and -7.
16Interestingly, it appears that Congress actually contemplated a deemed distribution approach for some cases when it first enacted the income tax. Shortly after the states ratified the 16th Amendment, the Tariff Act of 1913 provided that if a corporation was “formed or fraudulently availed of” to avoid
hasn’t, I still think it’s possible to reconcile all of these treatments with the majority’s opinion in *Eisner v. Macomber*, for that opinion did not forbid Congress to recast the form of a transaction that has real economic consequences in a manner that gives rise to taxable receipts. It merely held that Congress cannot tax receipts — deemed or otherwise — arising from a transaction that does nothing at all as an economic matter. Without its ability to recast the form of a transaction by legislative fiat, Congress could not successfully impose a realization-based tax on capital; the tax could otherwise always be avoided by choosing a form that didn’t give rise to receipts. But clearly, the Constitution does allow Congress to recast the form of a transaction that has economic consequences for a taxpayer and tax the resulting deemed receipts as income.

Thus, section 305(c) doesn’t run afoul of *Eisner v. Macomber* because the relevant redemptions increase the proportionate interests of the remaining shareholders in the company, and it is therefore reasonable for Congress to deem the remaining shareholders to have received taxable stock dividends. This logic would apply equally to any redemption of stock for cash that was not itself treated as a dividend (that is, to any non-pro rata redemption), because any such redemption would likewise increase the proportionate interests of the remaining shareholders.  

Anyway, I don’t think proponents of a mark-to-market approach are better placed on the issue of constitutionality. Obviously, the majority in *Eisner v. Macomber* would not have agreed that a shareholder has income that can be subject to an income tax merely because the shareholder’s stock has increased in value. Such a shareholder has not received anything of value that can be separately disposed of — no fruit has left the tree. The constitutionality of a mark-to-market approach is therefore also based on a recasting of the relevant transaction as giving rise to taxable deemed receipts.  

I see no constitutional reason to consider a deemed sale approach ahead of a deemed dividend approach. And for the reasons I have set out, I see no practical reason either. Clearly, a deemed dividend approach would be a smaller and more incremental means of increasing the amount of tax imposed on shareholders, but that might be a good thing. We would in any case have greater assurance that it was a step in the right direction, and greater hope that it was a step that might ultimately be taken.

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20 There is, of course, an academic definition of income that was first proposed by professors Robert Haig and Henry Simons in the late 1930s and that is often embraced by proponents of a mark-to-market system of taxation: Income equals “consumption plus changes in wealth.” But regardless of whether one views taxing something that conforms to that definition as an aspirational objective, it seems clear that none of the states had that sort of income in mind when they enacted the 16th Amendment (and Haig and Simons were little boys). As *Eisner* suggests, both the average person and the average state legislator conceived (and still conceive) of an income tax primarily as a tax on receipts. It is, of course, a tax on net receipts — i.e., the excess of that which is received over that which is expended to produce receipts — and the calculation of net income can be very complicated and require many rules of interpretation. But the concept cannot be stretched so far as to assert that the tax applies in the absence of any receipts at all. Rather, as noted above, the constitutional basis for imposing tax under a mark-to-market approach is that Congress is entitled to treat shareholders as if their shares had been sold and had therefore given rise to receipts that can then be taxed under an income tax. It therefore does not differ meaningfully in the constitutional sense from a proposal to tax distributions of accumulated earnings that are deemed received and re-contributed by shareholders.