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ON THE TAXATION OF STOCK REPURCHASES

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Introduction

In recent years, stock repurchases have emerged as a key transaction for companies seeking to optimize stockholder value. However, the net benefits of this practice are not consensual, which has motivated significant debate among scholars, market participants and policymakers. In this regard, one of the key topic discussed is the potential taxation of these operations (Batchelder, 2017), a proposal that may have huge implications for corporate behavior towards capital allocation and financial policy, but also to other issues such as investor returns, corporate governance, financial market efficiency and overall economic growth (Chen-Obizhaeva, 2022). This paper aims to explore the main considerations that inform this debate, hoping to contribute to a better understanding of the issues relating to stock repurchases and their potential taxation in order to inform policymakers, corporate managers and financial investors which may be interested in the topic.

In particular, the paper discusses (i) the benefits and downsides of stock repurchases and the potential role of their taxation, and (ii) provides some international evidence and suggestions for policymakers. The main conclusion is that the only strong argument to implement the taxation of stock repurchases is to raise additional government revenue to finance public spending, and even that is not guaranteed in light of other alternatives to distribute cash.

In the first section, this paper aims to shed some light on the controversy by discussing the main arguments for and against of stock repurchases. That discussion will set the stage for evaluating the alternatives in presence about the taxation of stock repurchases, including some international evidence related to this issue. The conclusions and suggestions for policymakers will follow.

Arguments for and against stock repurchases

Stock repurchases can be beneficial for companies, investors and the economy as a whole (Michaely et al., 2019; Chen-Obizhaeva, 2022). We can identify four (big) arguments for stock repurchases.

First, stock repurchases can provide a potential more efficient allocation of capital and cash flow in relation to alternatives such as debt reduction, acquisitions and capital expenditures (Dittmar, 2000; Lie, 2005). When companies have excess cash that they can not reinvest in value creation projects, stock repurchases can be an effective way to return capital to stockholders. This allows stockholders to reinvest that capital in other areas of the economy that may have higher potential risk-return combinations. Essentially, stock repurchases is a mechanism for reallocating capital from mature, cash-rich companies to other sectors or companies with more growth potential.

Second, stock repurchases can provide information to the market (Benartzi et al., 1997; Grullon- Michaely, 2004). A company engaging in stock repurchases ocn signals to the market that its management has confidence in its future prospects and therefore believes the stock is in some way undervalued. Such a signal can help correct market mispricing in a more direct approach than alternatives such as dividends (Brav et al., 2005).

Third, stock repurchases provide financial flexibility to firms when they distribute cash flow to their stockholders (Jagannathan et al., 2000; Pacheco-Raposo, 2007). Unlike dividends, which once initiated or increased, create an expectation for regular, ongoing payments, stock repurchases programs are considered as transitory and, as such, they offer more flexibility in using excess cash. This flexibility is particularly valuable in uncertain economic times or for companies in cyclical industries (Grullon-Michaely, 2002).

Finally, some literature also shows that stock repurchases help market efficiency and liquidity by providing more informed buyers on the markets, if this increased activity is known in advanced by markets and jointly with public accouncements of stock repurchase programs (Jagannathan-Stephens, 2003; Busch-Obernberger, 2017).

The literature identifies other arguments for stock repurchases, but they are clearly less compealing. For instance, by reducing the number of shares outstanding, stock repurchases may increase the earnings per share and lead to a higher stock prices, benefiting all stockholders (Bens et al.; 2002). In particular, for long term investors, stock repurchases increase their stake in the company and can potentially lead to higher capital gains in the future. Other common effect of stock price appreciation related to repurchases is the expected effect on executive compensation and therefore on the degree of management-stockholder alignment, whereas this is a very controversial issue, as is the case of using stock repurchases to “protect” companies against the risk of hostile takeovers (Bagwell-Shoven, 1988; Harford, 1999). Finally, in some jurisdictions, capital gains are taxed at a lower rate than dividends (Allen-Michaely, 2002). Therefore, returning capital to stockholders through repurchases can be more tax- efficient than paying dividends (which get double taxed: first when a company pays taxes on its profits, and again when investors pay an income tax on their dividends.). Also this tax efficiency can be achieved because stock repurchases are not a pro rata transaction and some investors can avoid tax payments event if they benefit from the likely stock price appreciation related to repurchase transactions.

While these points highlight the benefits of stock repurchases, it's also important to consider the potential, and ocen symmetric, negative implications. The most common argument is that the capital used to repurchase their own stock can be used by companies to more productive alternatives, such as research and development, employee training and capital expenditures (lazonick, 2014; Aramonte, 2020). This can potentially lead to long-term economic growth, higher productivity and job creation, as opposed to financial returns associated with stock repurchases. In addition, excessive focus on stock repurchases can lead to “short-termism” bias, where companies prioritize immediate increases in stock prices over long-term strategic growth (Shorter, 2019; Turco, 2021). This behavior can lead to underinvestment in critical businesses for the economy. One argument related to financial markets is the asymmetric effect of repurchasing stock because most benefits are captured by larger investors that own higher stakes on those companies. In addition, some literature argue that stock repurchases can be used by management and insiders to manipulate price-to-earnings and outsiders’ expectations (even without clear inside information advantages) and to artificially increase executive compensation (Fenn-Liang, 2001). The effect of stock repurchases on the increase in debt ratios is also an issue, especially in the context of the empirical increase in the repurchasing activity in the 21th century (Aramonte, 2020). As some literature shows, stock repurchases account, currently, for a significantly larger share of total payouts to stockholders

than dividends and any other stockholder distributions, such as spin-offs. Since 1997, stock repurchases have surpassed cash dividends and become the dominant form of corporate payout in the United States (Zeng-Luk, 2020). Similar trends can be found on other markets (Manconi et al., 2014; ECB, 2017; Aramonte, 2020).

The taxation of stock repurchases

In summary, a list of benefits and downsides of stock repurchases can be made and it is not a trivial task for policymakers to clearly understand the best courses of action in deciding about the taxation of stock repurchases. However, it can also be argued that stock repurchases may be part of a well-considered strategy that aligns the company's long-term goals with the interests of stockholders and the development and liquidity of financial markets. In addition to the potential benefits related to disincentivizing the stock repurchase activity, the taxation of stock repurchases has some arguments of its own, mostly related to increasing government revenues and to better redistribution of wealth.

Recent empirical literature and factual evidence seems to indicate that the growth of the main Western economies, especially the European economy, is somewhat limited and apparently insufficient to increase the prosperity and standard of living of its citizens (Lazonick, 2014; Leogrande, 2022; Erixon et al., 2023). As such, some literature argues about the huge negative impact of stock repurchases to growth and development (Lazonick, 2014), to firms' long term investing (Shorter, 2019; Turco, 2021; Bonaime-Kahle, 2022), to overleveraging and cost of debt (Aramonte, 2020; Elgouacem-Zago, 2023), to insiders' personal gain (Palladino, 2019) and even to hurt workers (CWA, 2020).

Taxing stock repurchases provides a new source of government revenue. Some literature measures this impact, arguing that would be a substantial stream of revenues (Penn Wharton Budget Model report), which could be used to fund public goods and services, such as infrastructure, education and healthcare, which are essential for a well-functioning economy and society. This macroeconomic effect on growth could leverage the most common argument related to this subject: the potential shift in capital allocation of companies. By taxing stock repurchases, a government can incentivize companies to pay down debt or to reinvest their cash flows into more productive investments and economic assets and therefore encouraging companies to focus more on innovation, productivity and long-term value creation. Taxing stock repurchases may also contribute to discourage the present anecdotal overemphasis on stock repurchases and therefore contributing to less underinvestment in the business and in the economy, as stated before, to decrease debt ratios and to discourage excesses in executive compensation.

However, in relation to the first argument, Diamond (2021) does not support the huge tax revenue creation view, arguing that companies will adjust their payout decisions according to relevant tax disadvantages, thus decreasing the expected government revenues collected from taxing stock repurchases. In relation to shifts in the capital allocation of companies, Edmans (2017) and Fried-Wang (2018) argue that stock repurchases does not cannibalize long term investments because most companies first make their value enhancing investments available and only then use potential surplus cash to repurchase stock. Also, Fried-Wang (2018) argue that companies that repurchase stock the most, also have higher capital expenditures in R&D and innovation.

International evidence on stock repurchases taxation

Internationally the rule about the taxation of stock repurchases is towards a tax exemption for listed companies, but the selling stockholders are subject to capital gains taxation. One notable exception about the former is the United States. The Inflation Reduction Act of 2022 has a provision for taxing stock repurchases. This tax provision stipulates that if a publicly traded company repurchases stock, net of new share issues, for over 1 million dollars within a fiscal year, the fair market value of the net stock repurchased is subject to a 1% non-deductible excise tax. The Joint Committee on Taxation estimates that this new tax will raise \$74 billion from 2022 to 2031. Most recently, in his State of the Union address on Feb. 7, 2023, the United States President Mr. Biden called for quadrupling the tax on stock repurchases, in order to "to address the continued tax advantage

for buybacks and encourage corporations to invest in productivity and the broader economy rather than windfalls for investors", according to fact sheet issued by the White House.

Also, taxing share repurchases is on the political agenda in the Netherlands and several parliamentary parties proposed to end the existing tax exemption for stock repurchases by listed companies, with an estimated tax revenue of about 1.2 billion euro a year.

Conclusions and suggestions for policy making

The main difficulties of deciding on the potential stock repurchasing taxation are related to balancing the goals of raising government revenue and ensuring the right incentives to better capital allocation in the economy, while maintaining capital market efficiency and liquidity and companies' financial policy flexibility. This paper suggests that the only strong argument to implement the taxation of stock repurchases is the raising government revenue, and even that is not guaranteed in light of other alternatives to distribute cash. In particular, the efficient allocation of capital is probably better handled itself by each company, because stock repurchases can be an effective mechanism to return capital to investors, which can be reinvested in other sectors and companies (including start-ups) with more growth potential and risk adjusted returns. In addition, the implementation of such a tax could have unintended consequences. For instance, it could push companies to find other ways to return cash to stockholders, like increasing dividends, which may not address the underlying concerns, such as avoiding underinvestment and higher debt ratios. Additionally, the negative impact on market liquidity and corporate flexibility must be taken into account, especially in low capitalization markets like the Portuguese stock exchange. Aligning with international tax standards is another argument against taxation of stock repurchases to ensure that domestic companies are not put at a competitive disadvantage in international terms. The more advanced discussion of this issue in the United States only shows that North American financial markets are a very different reality, not to be extrapolated to other realities without solid based research.

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