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The Redemption Puzzle

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Before 2003, a common theme of tax and corporate law scholarship was the "dvidend puzzle."[2] The dividend puzzle referred to the tendency of US public corporations to pay dividends to their shareholders despite the fact that until 2003 dividends were subject to a significantly higher level of tax than redemptions. For a publicly traded corporation, it is easy to structure an open-market share repurchase program in a way that ensures that shareholders that participate and offer their shares for redemption would qualify for capital gain treatment under IRC section 302(b). Since redemption treatment permitted shareholders to both qualify for the lower capital gain tax rate and to use part of their basis, whereas dividend treatment resulted in both a higher tax rate for upper bracket taxable shareholders and no offset for basis, the question arose why US public corporations ever paid out dividends.

Various explanations have been given for this puzzle, and I will not go into them here.[3] Importantly, the factual background underlying the puzzle changed in 2003, when Congress amended the Code to provide (through 2010) for the same 15% rate for dividends and for capital gains. Part of the rationale for this adoption of partial corporate/shareholder tax integration was that the higher dividend rate encouraged corporations to needlessly retain earnings, even though public corporations could achieve the same result via redemptions.[4]

This paper briefly explores what happened after 2003. As summarized in a recent article by Bratton and Wachter:

Figure 1 below tracks shareholder payouts in the form of dividends and stock repurchases by the companies in the S&P 500 from 1987 to 2007. The year 1987 is taken as the start date because it marks the beginning of a three-decade trend of increased resort to

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[1] Irwin I. Cohn Professor of Law, The University of Michigan. I would like to thank Bill Bratton and Ethan Yale for very helpful comments.

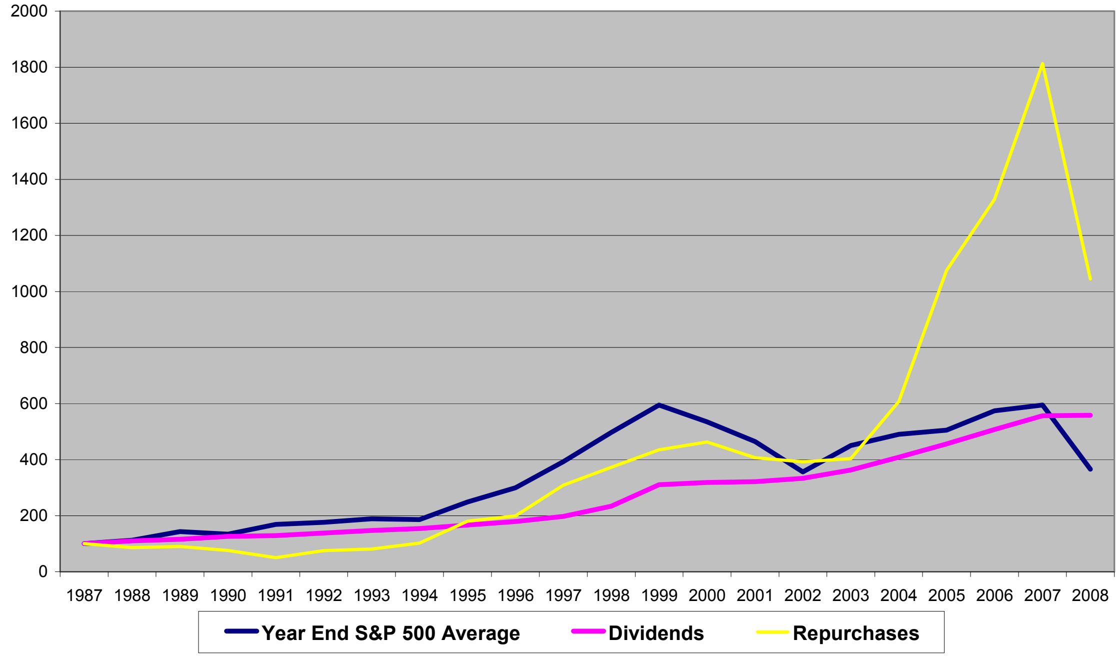
[2] William W. Bratton, The **New Dividend** Puzzle, 93 GEO. L.J. 845, 849-52 (2005).

[3] See Bratton, supra.

[4] I am doubtful this rationale was convincing, and in fact the data show that an increase in dividend payouts started before 2003 and continued thereafter, so that it is unclear whether adopting integration actually encouraged dividend payouts. Nor do I find the other reasons to adopt integration particularly convincing. See Reuven S. Avi-Yonah, Back to the 1930s? The Shaky Case for Exempting Dividends, 97 Tax Notes 1599 (Dec. 23, 2002).

open-market repurchases by public companies. The 1987 year-end S&P 500 average (247), the companies' total annual dividend payments in 1987 ($44.3 billion) and their 1987 total repurchases ($32.5 billion) are pegged at 100 on the vertical axis. Figure 1 shows relative increases and decreases to 2008, when the S&P 500 closed at 366, total dividends were $247 billion, and total repurchases were $340 billion. A break in two longstanding trends occurred in 2004. Prior thereto, increases in levels of dividends and levels of repurchases roughly tracked increases in stock prices (with both tending to lag behind the market). There was also a trend of rough parity between total dividends and total repurchases. Both trends ended in 2003 in favor of an increase in net amounts paid out, with the lion's share of the increase in the form of repurchases. In 1987, repurchases amounted to 1.6% of average market capitalization, and total payout amounted to 3.8%; in 2007, repurchases amounted to 4.6%, and total payout amounted to 6.3%. The dollar amount of annual repurchases increased eighteen-fold from 1987 to the peak year of 2007.[5]

Figure 1: Payouts 1987-2008



The data assembled by Bratton and Wachter indicate a remarkable fact: Following the adoption of partial integration, there was only a modest increase in dividends during the period 2004-7, from about 300 to about 500 (if 1987 levels are set at 100). Redemptions, however, showed a remarkable increase, jumping

[5] Bratton and Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653 (2010), 685-686.

from about the same as dividends (300) to 1,800.[6] This, therefore, leads to a new puzzle: Why the sudden sharp increase in redemptions following 2003?

Bratton and Wachter explain the total increase in both types of distribution as a response by public corporations to increased pressure by shareholders to distribute earnings. This pressure came especially from hedge funds, which played an increasingly important role as shareholder activists in this period.[7]

But this hypothesis, while persuasive, does not explain the form of the distributions. Why engage in more redemptions precisely when the tax bias against dividends was reduced? This is the “redemption puzzle”.

Like the dividend puzzle, the redemption puzzle is susceptible to several explanations. For example, Bratton and Wachter note that managers who hold stock options tend to favor redemptions over dividends.[8] But in this case, I believe there is also a tax explanation for the puzzle, related to the different treatment of redemptions and dividends to foreign shareholders.

In the case of taxable US shareholders, under post-2003 law, a dividend and a redemption that qualifies as a capital gain transaction under one of the tests set out in IRC 302(b) are both taxed at 15%. The only difference is that in a qualifying redemption taxpayers may offset basis, which has led some commentators to suggest erasing this remaining difference.[9] However, it seems unlikely that basis offset is enough to explain the remarkable post-2003 preference for redemptions.

For foreign shareholders, on the other hand, a significant difference remains between redemptions and dividends after 2003. A redemption that qualifies as a capital gain transaction would result in no tax to a foreign shareholder because capital gains are generally sourced to the residence of the seller. A dividend by a US corporation, on the other hand, is subject to a withholding tax of 30% (reduced to 15% under treaties, but not below that).

If Bratton and Wachter are correct in attributing most of the post-2003 increase in total corporate payouts to pressure from hedge funds, then this difference in the treatment of foreign shareholders may account for a significant part of the post-2003 preference for redemptions, and therefore help resolve the redemption

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[6] Both forms of payouts declined sharply in 2008 as the result of the financial crisis, but are likely to grow again in 2010.

[7] William Bratton, Hedge Funds and Governance Targets, 95 Geo. L.J. 1375 (2007).

[8] Bratton and Wachter, supra.

[9] Ethan Yale, "A Better Way to Tax Corporate Distributions: Allow Basis Recovery on Ordinary Dividends", working paper (2010).

puzzle. Most hedge funds operate offshore for both tax and regulatory reasons, and therefore dividend payouts to them would generally be subject to the 30% withholding tax (and generally not the lower 15% treaty rate, because most of them are in non-treaty jurisdictions). Redemptions, on the other hand, would not be subject to tax to foreign hedge funds.

A recent report by the Senate Permanent Subcommittee on Investigations has illustrated the tax sensitivity of foreign hedge funds to dividend withholding taxes.[10] The report showed that many foreign-based hedge funds avoided withholding taxes on dividends by instead holding total return equity swaps on the equity of US corporations. Before 2010, payments of dividend equivalents on such swaps were deemed not to be US source and therefore not subject to withholding tax, even though they were economically equivalent to the dividends on the underlying stock. This finding led Congress to enact IRC 871(l) in 2010, subjecting most dividend equivalents to withholding tax.

If I am correct in supposing that foreign hedge funds are a primary beneficiary from the recent rise in redemptions, then I would suggest that Congress should take one further step by excluding foreign shareholders from the scope of IRC 302 and 304. The result would be that redemption payments by US corporations to foreign shareholders would be treated as dividends and subject to withholding tax, thus eliminating the bias in favor of redemptions.

To understand this proposal, it is important to step back and ask why are dividends and capital gains treated differently to foreign shareholders. After all, a capital gain is simply the sum of the value of the current earnings of a corporation plus the present value of its future earnings, and both of those are the funds from which dividends are paid. Thus, as an economic matter, dividends should be treated in the same way as capital gains.

In the case of foreign shareholders, however, there is an important administrability difference between dividends and capital gains. Dividends are paid out by a US corporation and therefore can easily be subject to a withholding tax. Capital gains, however, result from a sale that may occur offshore between a foreign seller and buyer of the US corporation's stock. Such a sale is difficult to subject to withholding tax in most cases.[11] Therefore, capital gains have always been excluded from the scope of "fixed or determinable, annual or periodic"

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10 See Avi-Yonah, Testimony on Dividend Tax Abuse, U.S. Senate Permanent Subcommittee on Investigations, Sept. 11, 2008, and Subcommittee report.

11 The exception is where the buyer cares about the transfer of an underlying asset, such as title to US real estate, which has been subject to withholding tax since 1980. Similarly, many countries subject sales of large corporate participations to tax because the buyer cares about the transfer of the vote, and I would support such a move for the US as well (subject to our treaty obligations).

(FDAP) income that is subject to withholding under IRC 871 and 881, and in most cases have also been deemed to be foreign source.

However, this rationale does not apply in the case of redemptions. In a redemption, the US corporation is the source of the funds that are paid to the foreign shareholder, just as it is in the case of a dividend. In both situations, the funds can easily be subject to withholding.[12]

The reason redemptions are not subject to withholding under current aw is that IRC section 302 (and its corollary in IRC 304) have not explicitly been limited to taxable US shareholders, even though that was clearly Congress' intent. IRC 302 was intended to prevent taxable US shareholders from "bailing out" earnings and profits at capital gains rate by means of redemptions, and IRC 304 has the same intent for sales between commonly controlled corporations.

The application of IRC 302 and 304 to foreign shareholders and to foreign corporations has already had several perverse effects that are unrelated to the redemption puzzle. The application of IRC 304 to foreign corporations has enabled US corporate shareholders to repatriate profits as deemed dividends while avoiding the foreign tax credit limitations.[13] The application of IRC 302 to foreign corporations and foreign shareholders underlay the notorious KPMG FLIP (Foreign Leveraged Investment Program) tax shelter.[14] In both cases, the IRS was limited in its ability to argue against the inappropriate results because it had approved the application of IRC 304 to foreign corporations in some cases.

The solution is Congressional action. Congress should simply modify IRC 302 and 304 by excluding foreign shareholders and corporations from their scope, just like it did in IRC 367 in regard to the reorganization provisions. Arguably, tax-exempt domestic shareholders should be excluded as well, for the same reason: IRC 302 and 304 were drafted with taxable US shareholders in mind.

This would not be a revenue raiser, because presumably foreign shareholders would simply sell their shares to other foreigners rather than participate in redemptions subject to withholding tax. But it would relieve the tax-induced pressure on corporate management to structure distributions as redemptions

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[12] It may be necessary to require a statement of US ownership in the case of redemptions, like the one that currently applies to transfers of stock in potential US Real Property Holding Companies, so that the US payor knows if it has to withhold.

[13] Charles Kingson, Bhada and Zero Basis, 114 Tax Notes 961 (Mar. 5, 2007).

[14] Calvin Johnson, 39 Tax Notes Int'l 435 - TALES FROM THE KPMG SKUNK WORKS: THE BASIS-SHIFT SHELTER. (Release Date: JULY 06, 2005) (Doc 2005-14507).

rather than dividends. Excessive pressure on corporate management to distribute earnings in any form may lead to short-termist behavior, as Bratton and Wachter point out.[15] But even if one believes that distributions are appropriate, there is no reason to have tax-based distinctions between otherwise identical forms of distribution.

Of course, if Congress were to make the 15% rate for dividends permanent, then it could go further and repeal IRC 302 and 304 (as well as other complex provisions like IRC 306 and 344). But this seems unlikely at present, and in fact if Congress does nothing this year the full rate differential for dividends comes back in 2011. This would put further pressure on IRC 302 and 304 and exacerbate the tendency to favor redemptions over dividends.

We have gone from a dividend puzzle to a redemption puzzle, but perhaps the redemption puzzle is easier to solve. Congress should act to make both a thing of the past by equalizing the rates on redemptions and dividends for both domestic and foreign shareholders.[16] For domestic shareholders the solution is to make the rate equalization of current law permanent. For foreign shareholders, since we cannot as an administrative matter tax all capital gains, we should at least tax redemptions in the same way as we tax dividends.

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[15] Bratton and Wachter, supra.

[16] And possibly eliminate the basis recovery distinction as well, see Yale, supra.