

2010

The Redemption Puzzle

Reuven S. Avi-Yonah

University of Michigan Law School, aviyonah@umich.edu

Available at: <https://repository.law.umich.edu/articles/819>

Follow this and additional works at: <https://repository.law.umich.edu/articles>

 Part of the [Securities Law Commons](#), [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Avi-Yonah, Reuven S. "The Redemption Puzzle." *Tax Notes* 128, no. 8 (2010): 853-5.

This Article is brought to you for free and open access by the Faculty Scholarship at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Articles by an authorized administrator of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

The Redemption Puzzle

By Reuven S. Avi-Yonah

Reuven S. Avi-Yonah is the Irwin I. Cohn Professor of Law at the University of Michigan. He would like to thank Bill Bratton and Ethan Yale for very helpful comments.

After the adoption of partial integration in 2003, there has been only a modest rise in dividends, but a sixfold increase in redemptions. This article argues that the explanation for that lies in the different treatment of dividends and capital gains to foreign shareholders and that Congress should respond by making sections 302 and 304 inapplicable to foreign shareholders.

Before 2003, a common theme of tax and corporate law scholarship was the “dividend puzzle.”¹ The dividend puzzle referred to the tendency of U.S. 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 who participate and offer their shares for redemption would qualify for capital gain treatment under section 302(b). Because redemption treatment permitted shareholders to both qualify for the lower capital gain tax rate and 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 public corporations ever paid out dividends.

Various explanations have been given for this puzzle, and I will not go into them here.² Importantly, the factual background underlying the puzzle changed in 2003, when Congress amended the code to provide (through 2010) the same 15 percent 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.³

¹William W. Bratton, “The New Dividend Puzzle,” 93 *Geo. L.J.* 845, 849-852 (2005).

²*Id.*

³I 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 it is unclear whether adopting

(Footnote continued in next column.)

This paper briefly explores what happened after 2003. A recent article by William W. Bratton and Michael L. Wachter summarizes the later developments as follows:

Figure 1 tracks shareholder payouts in the form of dividends and stock repurchases by the companies in the S&P 500 from 1987 to 2007. 1987 is taken as the start date because it marks the beginning of a three-decade trend of increased resort to 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.⁴

A break in two long-standing trends occurred in 2004. Before 2004, 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 percent of average market capitalization, and total payout amounted to 3.8 percent; in 2007 repurchases amounted to 4.6 percent, and total payout amounted to 6.3 percent. The dollar amount of annual repurchases increased eighteenfold from 1987 to the peak year of 2007.

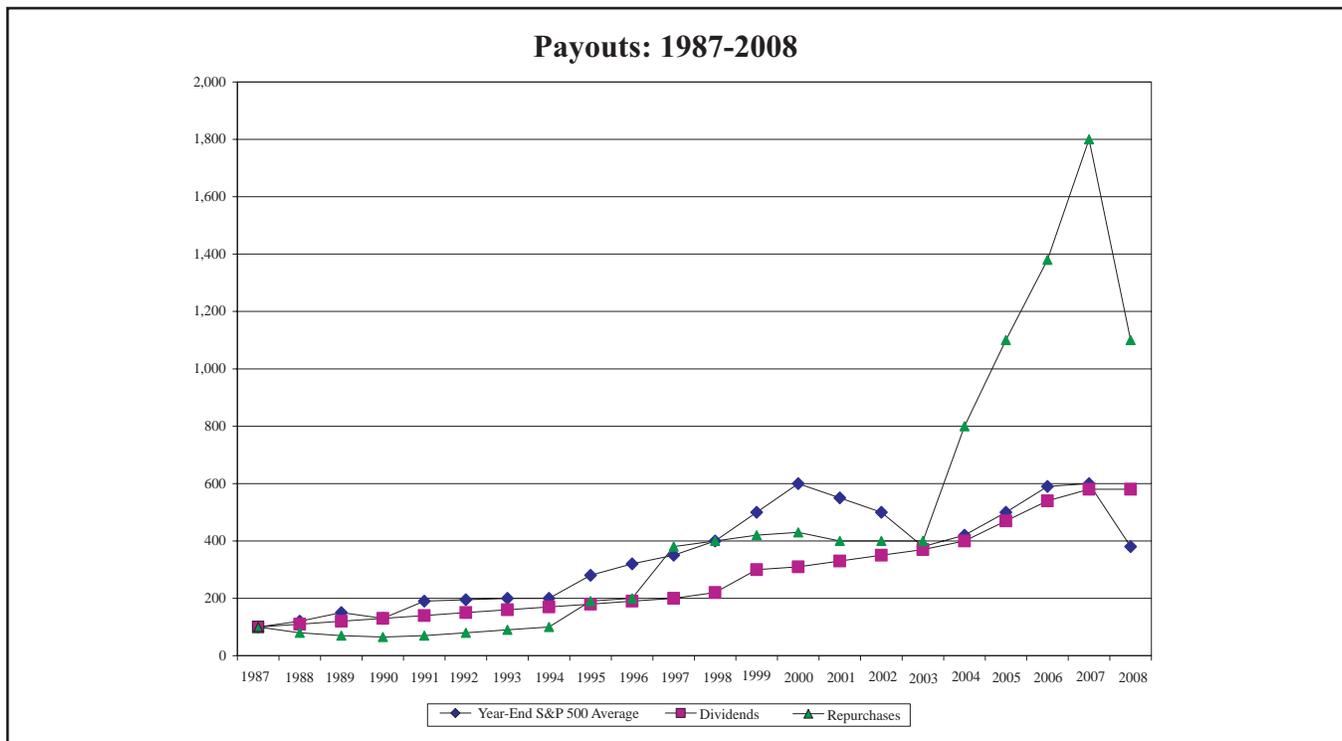
The data assembled by Bratton and Wachter indicate a remarkable fact: Following the adoption of partial integration, there was only a modest increase in dividends during the period 2004-2007, from about 300 to about 500 (if 1987 levels are set at 100). Redemptions, however, showed a remarkable increase, jumping from about the same as dividends (300) to 1,800.⁵ This, therefore, leads to a new puzzle: Why the sudden sharp increase in redemptions after 2003?

Bratton and Wachter explain the total increase in both types of distribution as a response by public corporations

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,” *Tax Notes*, Dec. 23, 2002, p. 1599, *Doc 2002-27880*, or *2002 TNT 247-29*.

⁴Bratton and Michael L. Wachter, “The Case Against Shareholder Empowerment,” 158 *U. Pa. L. Rev.* 653 (2010), 685-686.

⁵Both forms of payouts declined sharply in 2008 as the result of the financial crisis, but are likely to grow again in 2010.



to increased pressure by shareholders to distribute earnings. This pressure came especially from hedge funds, which played an increasingly important role as shareholder activists during this period.⁶

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.⁷ 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 U.S. shareholders, under post-2003 law, a dividend and a redemption that qualify as a capital gain transaction under one of the tests set out in section 302(b) are both taxed at 15 percent. The only difference is that in a qualifying redemption taxpayers may offset basis, which has led some commentators to suggest erasing this remaining difference.⁸ However, it seems unlikely that this 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 divi-

dends 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 U.S. corporation, on the other hand, is subject to a withholding tax of 30 percent (reduced to 15 percent 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 preference for redemptions, and therefore help resolve the redemption 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 percent withholding tax (and generally not the lower 15 percent treaty rate, because most of them are in nontreaty jurisdictions). Redemptions, on the other hand, would not be subject to tax.

A recent report by the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations has illustrated the tax sensitivity of foreign hedge funds to dividend withholding taxes.⁹ 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 U.S. corporations. Before 2010, payments of dividend equivalents on such swaps were deemed not to be U.S. source and therefore

⁶Bratton, “Hedge Funds and Governance Targets,” 95 *Geo. L.J.* 1375 (2007).

⁷Bratton and Wachter, *supra* note 4.

⁸Ethan Yale, “A Better Way to Tax Corporate Distributions: Allow Basis Recovery on Ordinary Dividends,” working paper (2010).

⁹See Avi-Yonah, Testimony on Dividend Tax Abuse, U.S. Senate Permanent Subcommittee on Investigations, Sept. 11, 2008, and Subcommittee Report, *Doc 2008-19344* or *2008 TNT 178-27*.

were not subject to withholding tax, even though they were economically equivalent to the dividends on the underlying stock. This finding led Congress to enact section 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 of the recent rise in redemptions, I would suggest that Congress take one further step by excluding foreign shareholders from the scope of sections 302 and 304. The result would be that redemption payments by U.S. 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 dividends and capital gains are treated differently for 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 U.S. 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 U.S. corporation's stock. Such a sale is difficult to subject to withholding tax in most cases.¹⁰ Therefore, capital gains have always been excluded from the scope of fixed or determinable annual or periodic income that is subject to withholding under sections 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 U.S. 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.¹¹

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

¹⁰The exception is when the buyer cares about the transfer of an underlying asset, such as title to U.S. 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 United States as well (subject to our treaty obligations).

¹¹It may be necessary to require a statement of U.S. ownership in the case of redemptions, like the one that applies to transfers of stock in potential U.S. real property holding companies, so that the U.S. payer knows if it has to withhold.

The application of sections 302 and 304 to foreign shareholders and foreign corporations has already had several perverse effects that are unrelated to the redemption puzzle. The application of section 304 to foreign corporations has enabled U.S. corporate shareholders to repatriate profits as deemed dividends while avoiding the foreign tax credit limitations.¹² The application of section 302 to foreign corporations and foreign shareholders was a core part of the notorious KPMG foreign leveraged investment program tax shelter.¹³ In both cases, the IRS was limited in its ability to argue against the inappropriate results because it had approved the application of section 304 to foreign corporations in some cases.

The solution is congressional action. Congress should simply modify sections 302 and 304 by excluding foreign shareholders from their scope, just like it did in section 367 regarding reorganization provisions. Arguably, tax-exempt domestic shareholders should be excluded as well, for the same reason: Sections 302 and 304 were drafted with taxable U.S. 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 rather than dividends. Excessive pressure on corporate management to distribute earnings in any form may lead to short-term behavior, as Bratton and Wachter point out.¹⁴ 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 percent rate for dividends permanent, it could go further and repeal sections 302 and 304 (as well as other complex provisions like sections 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 sections 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 things of the past by equalizing the rates on redemptions and dividends for both domestic and foreign shareholders.¹⁵ 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 we tax dividends.

¹²Charles Kingson, "Bhada and Zero Basis," *Tax Notes*, Mar. 5, 2007, p. 961, *Doc 2007-4945*, 2007 TNT 44-42.

¹³Calvin Johnson, "Tales From the KPMG Skunk Works: The Basis-Shift or Defective-Redemption Shelter," *Tax Notes*, July 25, 2005, p. 431, *Doc 2005-14507*, 2005 TNT 142-30.

¹⁴Bratton and Wachter, *supra*.

¹⁵And possibly eliminate the basis recovery distinction as well; see Yale, *supra* note 7.