MEMORANDUM

To: Commission File No. S7-21-21

From: Division of Economic and Risk Analysis

Date: December 7, 2022

Re: Supplemental Analysis of the Potential Implications of the Recently Enacted Excise Tax on Share Repurchases for the Economic Effects of Share Repurchase Disclosure Modernization Amendments

I. Background

On December 15, 2021 the Securities and Exchange Commission (the "Commission") proposed amendments to modernize and improve disclosure about repurchases of an issuer's equity securities that are registered under the Securities Exchange Act of 1934 (the "Proposed Amendments").[1]

The Inflation Reduction Act of 2022 ("the Act") was signed into law by President Biden on August 16, 2022.[2] Section 10201 of the Act adds section 4501 to the Internal Revenue Code of 1986 (the "Internal Revenue Code"),[3] which imposes upon "covered corporations" a non-deductible excise tax equal to 1% of the fair market value of any stock of the corporation which is repurchased by such corporation during the taxable year. A covered corporation is defined in section 4501(b) as any domestic corporation[4] the stock of which is traded on an "established securities market" (within the meaning of section 7704(b)(1) of the Internal Revenue Code[5]). The excise tax applies to share repurchases after December 31, 2022.

Repurchase is defined in section 4501(c) to mean a redemption within the meaning of section 317(b) of the Internal Revenue Code with regard to the stock of a covered corporation, and any transaction the Secretary of the United States Department of the Treasury (the "Treasury Department") determines to be economically similar. It also includes the acquisition of stock of a covered corporation by a specified affiliate[6] of such covered corporation, from a person who is not the covered corporation or a specified affiliate of such covered corporation. Section

[1] *See Share Repurchase Disclosure Modernization*, Release No. 34-93783 (Dec. 15, 2021) [87 FR 8443 (Feb. 15, 2022)]("Proposing Release").

[2] *See* Pub. L. No. 117-169, 136 Stat. 1818 (2022).

[3] *See* 26 U.S.C. 4501.

[4] A domestic corporation means a corporation created or organized in the U.S. or under the law of the U.S. or of any State or the District of Columbia. *See* 26 U.S.C. 7701(a)(4).

[5] "Established securities market" as used in section 7704(b)(1) is defined in 26 CFR 1.7704-1(b). The definition includes national securities exchanges registered under Section 6 of the Securities Exchange Act of 1934, national securities exchanges exempt from registration because of the limited volume of transactions, certain foreign securities exchanges, regional or local exchanges, and certain interdealer quotation systems.

[6] For purposes of this section, the term "specified affiliate" means, with respect to any corporation, any corporation more than 50 percent of the stock of which is owned (by vote or by value), directly or indirectly, by such corporation, and any partnership more than 50 percent of the capital interests or profits interests of which is held, directly or indirectly, by such corporation. *See* 26 U.S.C. 4501(c)(2)(B).

4501(c)(3) provides for an adjustment whereby the amount taken into account with respect to any stock repurchased by a covered corporation is reduced by the fair market value of any stock issued by the covered corporation during the taxable year, including the fair market value of any stock issued or provided to employees of such covered corporation or employees of a specified affiliate of such covered corporation during the taxable year, whether or not such stock is issued or provided in response to the exercise of an option to purchase such stock. Section 4501(d) sets forth special rules applicable to the acquisition of stock of certain foreign corporations.[7]

Section 10201(e) of the Act sets forth certain exceptions to the applicability of the excise tax. These exceptions apply to: repurchases that are a part of a reorganization (within the meaning of section 368(a) of the Internal Revenue Code) where no gain or loss is recognized on such repurchase by the shareholder; repurchases in which the stock or the amount of stock equal to the value of the stock repurchased is contributed to an employer-sponsored retirement plan, employee stock ownership plan ("ESOP"), or similar plan; repurchases in which the total value of the stock repurchased during the taxable year does not exceed $1 million; repurchases by a dealer in securities in the ordinary course of business under regulations prescribed by the Secretary of the Treasury Department; repurchases by a regulated investment company (within the meaning of section 851 of the Internal Revenue Code)[8] or a real estate investment trust; or repurchases that are treated as a dividend under the Internal Revenue Code. This memorandum describes the potential economic effects of the new excise tax on the current market baseline and also the impact that the new excise tax is expected to have on the potential economic effects of the Proposed Amendments. We welcome public comment on this analysis and potential effects of the excise tax on the current market baseline and on the economic effects of the Proposed Amendments.

II. Potential economic effects of the new excise tax on the current market baseline

Below we discuss potential economic effects of the new excise tax on the incidence and level of share repurchases, which are a part of the market baseline for the Proposed Amendments. We start by outlining data limitations that make it difficult to estimate with certainty how many issuers subject to the Proposed Amendments (based on historical filing and financial data) would also be subject to the new excise tax. With these limitations, we estimate how many filers subject to the Proposed Amendments may also be subject to the new excise tax. Next, we outline other limitations that make it difficult to forecast how many filers that engaged in repurchases in the past would cease or reduce the number of repurchases after the effectiveness of the new excise tax. Finally, we provide a qualitative analysis, based on prior research on payout and related settings, of the likely directional effects of the new excise tax on share repurchases.

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[7] *See* 26 U.S.C. 4501(d).

[8] *See* 26 U.S.C. 4501(e)(5) (scoping this exception to "regulated investment companies" as defined in 26 U.S.C. 851). Section 851(a) generally defines "regulated investment companies" as domestic corporations that are registered under the Investment Company Act of 1940 ("Investment Company Act") as management companies or unit investment trusts, have in effect an election under the Investment Company Act to be treated as business development companies, or are certain common trust funds or similar funds. *See* 26 U.S.C. § 851(a).

A. Data limitations on estimating number of affected issuers.

There are four data limitations that make it difficult to estimate how many issuers subject to the Proposed Amendments (based on historical filing and financial data) would also be subject to the new excise tax: (1) differences in the quality and availability of machine-readable data on the amount repurchased across affected filers;[9] (2) lack of machine-readable data on repurchases associated with retirement, ESOP, and similar plans under the Act, and differences in the availability of data on the amount of stock issued in connection with such plans; (3) lack of data on repurchases taxed as dividends; and (4) lack of data to comprehensively quantify the application of Section 4501(d) and determine which of the foreign issuers included in the estimate may be subject to the tax.[10]

With these caveats, based on year 2020 (2021) data, of the approximately 3,300 (3,600) operating company issuers engaged in repurchases that would be subject to the Proposed Amendments, we estimate that approximately 2,300 (2,700) issuers[11] could also be affected by

[9] Research studies customarily rely on Standard & Poor's Compustat (Compustat) data to measure the level of share repurchases. This data is standardized across companies, but the database has limited coverage of small and unlisted registrants and Form 20-F filers. For purposes of identifying companies engaged in share repurchases, consistent with the Proposing Release, we supplemented data from Compustat with XBRL structured data from financial statements. Due to variation in the tags used across companies, we identified a variety of tags likely associated with share repurchases to capture affected filers. However, the use of different tags, including custom tags, particularly by smaller companies, introduces data noise, making it difficult to extract comparable and standardized information on the size of share repurchases. Share repurchases are also required to be disclosed in operating company periodic reports by existing Item 703 of Regulation S-K (on a quarterly basis) and by Form 20-F (on an annual basis); however, this disclosure is not structured in a machine-readable language, requiring manual extraction and analysis of unstructured data, which could be subject to human error and give rise to corresponding reliability issues.

[10] Financial data available to us does not disaggregate share repurchases based on their tax treatment for purposes of personal taxes. Generally, Internal Revenue Code Section 302 enables shareholders other than majority shareholders to effectively elect whether a given repurchase will be treated as a dividend or instead as a sale resulting in capital gains for purposes of personal taxes, by electing whether to substantially reduce their stake. For minority shareholders selling securities held in taxable accounts, the capital gains treatment would typically be preferred. Thus, it is plausible to assume that selling shareholders will optimize their own personal tax burden and elect the capital gains treatment rather than dividend treatment when the latter treatment would trigger a higher personal tax rate. To the extent that selling shareholders elect capital gains treatments, issuers may be ineligible for the statutory exemption from the excise tax for buybacks being taxed as dividends for personal tax purposes.

[11] The number of issuers that repurchased shares was identified using the methodology in the Proposing Release from a combination of Compustat & XBRL data (the numbers in the parentheses were updated for 2021). *See* Proposing Release at 8452 & n. 56. The following exclusions were applied to approximately estimate the number of companies among those issuers that could be subject to the excise tax: REITs identified based on SIC code 6798 (based on data in Audit Analytics or Compustat); business development companies (based on EDGAR filings data); companies not identified as exchange-listed or OTC-quoted (exchange listing and OTC status are identified based on a combination of EDGAR filings data on Section 12(b) registration status, Audit Analytics and Compustat data on trading venue, and OTC Markets data on OTC trading venue); companies that repurchased a total amount not exceeding $1 million during the year (where either Compustat or XBRL data (limited to standard tags only in 10-Ks for this filter, for comparability) was non-missing). As a caveat, the estimate of the number of issuers subject to the excise tax likely represents an upper bound because we lack certain data. For example, we lack data to comprehensively quantify the application of Section 4501(d), based on which some foreign issuers may be subject to the tax, and therefore have not excluded any foreign issuers. Similarly, we cannot fully account for, and therefore, exclude all small repurchasers based on the data available to us. We also lack comprehensive data to identify and exclude companies whose share repurchases fall under other exceptions (repurchases that are a part of a reorganization (within the meaning of section 368(a) of the Internal Revenue Code) where no gain or loss is recognized on such repurchase by the shareholder; repurchases in which the stock or the amount of stock equal to the value of the stock repurchased is contributed to an ESOP, or similar plan; repurchases by a dealer in securities in the ordinary course of business under regulations prescribed by the Secretary of the Treasury Department; and repurchases that are treated as a dividend under the Internal Revenue Code). Further, because the above estimates are based on gross repurchases, they may provide an upper bound on the number of affected operating company issuers projected to be subject to the excise tax. Replacing gross repurchases with repurchases net of issuance lowers the estimate to 1,600 (1,800) affected issuers subject to the excise tax based on year 2020 (2021) data. In addition, as discussed in the Proposing Release, Form N-CSR filers are subject to the Proposed Amendments. However, they are not considered in the above estimates due to being exempt from the excise tax.

the excise tax. Because these estimates rely on prior years' data and do not account for any decrease in the number of repurchases as a result of the excise tax, relative to the pre-excise tax conditions, they are likely to be an upper bound on the number of affected issuers.

B. Possible limitations on predicting the magnitude of shifts in company behavior.

While it is likely that the new excise tax will cause some issuers to reduce the frequency and/or size of their repurchases or choose to declare a dividend instead, several limitations make it difficult to forecast how many filers that engaged in repurchases in the past will cease or reduce repurchases after the excise tax takes effect. There are potential confounding macroeconomic and regulatory factors that may affect the composition of issuers and their propensity to undertake share repurchases at the same time as the new excise tax (*e.g.,* trends in inflation and interest rates that may affect financing conditions and therefore corporate financing decisions that may be jointly determined with corporate payout decisions, economic growth and stock market risk factors, changes in investor sentiment and investor composition that may shape investor preferences regarding payout, corporate investment trends that may affect free cash flow, other tax and economic reforms that may affect corporate cash flows, executive compensation, outlook for growth opportunities, and other factors found to be associated with share repurchases in academic research). In addition, there is a lack of a directly comparable prior regulatory intervention that would have provided data on the effects of such a tax on domestic issuers' corporate payout behavior that could then be used to estimate the effects of the Act.[12] There also is a lack of comprehensive information to predict how individual companies will weigh investors' potential personal tax preferences for repurchases instead of dividends against the corporate excise tax on repurchases.[13] We also note that, because our analysis is based on the upper bounds of affected issuers, it is possible that future Treasury regulations or guidance would mean that a smaller pool of issuers would be impacted.

C. Potential effects of the new excise tax on the incidence and level of share repurchases.

Absent post-implementation data on how the new tax has affected repurchases or historical data on a similar regulatory intervention that we can use to estimate the quantitative economic effects of the new tax, we perform a forward-looking qualitative analysis of the effects of this regulatory intervention, drawing on a combination of conceptual arguments regarding payout in prior studies, as well as related, but different, settings involving the interplay between taxation and corporate financial decisions. This informs our understanding to date of the

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[12] India implemented a corporate tax on buybacks for exchange-listed companies in 2019. *See* Income-tax Act, 1961, § 115QA, No. 43, Acts of Parliament, 1961 (India). It is difficult to infer the potential effects of the U.S. excise tax from the India tax change for several reasons: the much higher level of the buybacks tax in India (20% plus surcharges); significant changes in corporate and personal tax treatment of dividends and capital gains in India around the same time period; confounding aggregate effects of the COVID-19 pandemic and subsequent economic stimulus around the time the tax took effect; and significant tax, regulatory, and macroeconomic differences between India and the U.S. that may confound potential analysis of repurchase trends.

[13] *See infra* note 20 and accompanying text.

changes to the baseline against which the economic analysis of the Proposed Amendments was performed.

The number of issuers that would be subject to the Proposed Amendments is likely to decrease to the extent that issuers eliminate share repurchases or replace those share repurchases with dividends.[14] Whether repurchases can be viewed as the issuer's attempt to purchase the company's shares when they are relatively undervalued, or a method of distributing free cash flow to shareholders, the excise tax would essentially represent a cost to the company and its shareholders akin to transaction costs, which have been shown to reduce share repurchases.[15]

In other contexts, studies have examined the effect of taxation on corporate decisions—taxes have been shown to affect the activity levels of firms and the way that they structure their activities. Notably, extensive research demonstrates the effect of taxes—namely, the interest tax deduction - on corporate capital structure decisions.[16] Other research has found that repatriation tax costs can affect multinational companies' payout behavior.[17]

Among issuers that continue to engage in share repurchases after the effectiveness of the new excise tax, and that therefore would remain subject to the Proposed Amendments, some may decrease the level of share repurchases, with all else being equal.[18] Issuers with relatively small repurchases that marginally exceed $1 million per tax year may decrease their repurchases to be below the threshold for the new excise tax.

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[14] *See* Letter from Tom Quaadman, Executive Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (September 20, 2022), *available at* https://www.sec.gov/comments/s7-21-21/s72121-20143475-308983.pdf ("CCMC Letter").

[15] *See, e.g.*, Paul Brockman, John S. Howe, & Sandra Mortal *Stock Market Liquidity and the Decision to Repurchase*, 14 J. FIN. ECON. 446 (2008); *see also* Alexander Hillert, Ernst Maug, & Stefan Obernberger *Stock Repurchases and Liquidity*, 119 J. FIN. ECON. 186, Table 6 (2016).

[16] *See, e.g.*, Dan Givoly, Carla Hayn, Aharon R. Ofer, & Oded Sarig, *Taxes and Capital Structure: Evidence from Firms' Response to the Tax Reform Act of 1986*, 5 REV. FIN. STUD. 331 (1992) (finding, in the setting of the Tax Reform Act of 1986, a substitution effect between debt and nondebt tax shields and a positive relationship between leverage and corporate tax rates); John R. Graham, *Debt and the Marginal Tax Rate*, 41 J. FIN. ECON. 41 (1996) (finding that high-tax-rate firms issue more debt than their low-tax-rate counterparts); John R. Graham, *Proxies for the Corporate Marginal Tax Rate*, 42 J. FIN. ECON. 187 (1996) (refining estimates of marginal corporate tax rates); Roger H. Gordon & Young Lee, *Do Taxes Affect Corporate Debt Policy? Evidence from U.S. Corporate Tax Return Data*, 82 J. PUB. ECON. 195 (2001) (finding that lower corporate tax rates reduce the fraction of assets financed with debt and concluding that taxes have had a strong and statistically significant effect on debt levels); Michael Faulkender & Jason M. Smith, *Taxes and Leverage at Multinational Corporations*, 122 J. FIN. ECON. 1 (2016) (finding that that multinational firms operating in higher-tax rate countries have higher leverage ratios and lower interest coverage ratios). *See also* John R. Graham & Mark Leary *A Review of Capital Structure Research and Directions for the Future*, 3 ANN. REV. FIN. ECON. 309 (2011) (surveying empirical capital structure research, focused on post-2005 papers).

[17] *See, e.g.*, Michelle L. Nessa *Repatriation Tax Costs and U.S. Multinational Companies' Shareholder Payouts*, 92 ACCT. REV. 217 (2017) (finding, during the 1987–2004 sample period, that "repatriation tax costs decrease U.S. MNCs' dividend payments", no evidence "that repatriation tax costs decrease U.S. MNCs' share repurchases, on average," and "cross-sectional variation in the effect of repatriation tax costs on share repurchases based on U.S. MNCs' opportunities to fund repurchases through external borrowing and to minimize the incremental U.S. cash tax cost of repatriations"). *See also* Benjamin Bennett & Zexi Wang, *Stock Repurchases and the 2017 Tax Cuts and Jobs Act*, (Working paper, 2021) (showing that a one-time tax holiday that decreased the tax on cash repatriation from foreign subsidiaries from 35% to 15.5% as part of the 2017 Tax Cuts and Jobs Act reduced the tax incentive for US corporations to hold cash overseas and was associated with an increase in repurchases and dividends for multinationals with higher foreign profits).

[18] In response to an earlier but related legislative proposal to introduce a 2% excise tax on share repurchases, in a September 2021 survey by CNBC of 20 U.S.-based companies 55% of U.S. CFOs surveyed said that the proposed 2% share repurchase tax would reduce the volume of share repurchases, but 40% said that such a tax would have "no impact." Eric Rosenbaum, *What a tax on stock buybacks would, and wouldn't, mean for the bull market*, CNBC THE BOTTOM LINE (Oct. 8, 2021), *available at* https://www.cnbc.com/2021/10/08/what-a-tax-on-stock-buybacks-would-mean-for-the-bull-market.html.

To the extent that dividends and repurchases are partial substitutes as methods of distributing excess cash flow,[19] issuers may shift some of their payout from repurchases to dividends. However, dividends and repurchases are not perfect substitutes for several reasons analyzed in prior research. Notably, issuers may continue to favor repurchases over dividends for some of their payout because of the tax preferences of their investor base. For issuers whose investor base incurs a personal tax disadvantage of dividends relative to share repurchases (and is not primarily tax-exempt), this may be a reason to continue to use share repurchases, even if they involve a higher corporate tax burden.[20] Dividends and repurchases may also differ in their level

[19] *See, e.g.*, Gustavo Grullon & Roni Michaely, *Dividends, Share Repurchases, and the Substitution Hypothesis*, 57 J. FIN. 1649 (2002) (finding that "firms finance their share repurchases with funds that otherwise would have been used to increase dividends"); Douglas Skinner, *The Evolving Relation Between Earnings, Dividends, and Stock Repurchases*, 87 J. FIN. ECON. 582 (2008) (showing that "[r]epurchases are increasingly used in place of dividends, even for firms that continue to pay dividends"); Manoj Kulchania, *Catering Driven Substitution in Corporate Payouts*, 21 J. CORP. FIN. 180 (2013) (hypothesizing and presenting evidence that "firms cater to investor demand by repurchasing shares when investors place a premium on the stock price of firms that repurchase shares, and by paying dividends when investors place a higher value on dividend-paying firm"); Zhan Jiang, Kenneth A. Kim, Erik Lie, and Sean Yang, *Share Repurchases, Catering, and Dividend Substitution*, 21 J. CORP. FIN. 36 (2013) ("consistent with the notion that managers consider dividends and share repurchases to be substitute payout mechanisms, we find that the dividend premium negatively affects the repurchase choice, whereas the repurchase premium negatively affects the choice to pay dividends").

[20] Companies whose investors are less averse to dividends for tax reasons are more likely to pay dividends, and vice versa. *See, e.g.*, Mihir A. Desai & Li Jin, *Institutional Tax Clienteles and Payout Policy*, 100 J. FIN. ECON. 68 (2011) (arguing that dividend-averse institutions gravitate towards low dividend paying firms and that corporate managers adapt their payout policies to the interests of their institutional shareholders and finding that "exogenous changes in the tax cost of institutional investors receiving dividends results in changes in firm dividend policy"). As further evidence that some companies may take into account personal tax implications when making payout decisions, studies show the effects of personal dividend and capital gains taxes on payout structure. One relevant example is the passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA"), which reduced personal tax rates on dividends, ordinary income, and capital gains, with the most pronounced reduction in the personal tax disadvantage of dividends. Prior to JGTRRA, dividends were taxed at the investor's ordinary income tax rate. JGTRRA lowered the tax rate on qualified dividends to 15%, setting it equal to the tax rate on long-term capital gains. Several studies found a relative increase in the share of dividends in payout after JGTRRA. *See, e.g.*, Raj Chetty & Emmanuel Saez, *Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut*, 120 Q. J. ECON. 791 (2005); Raj Chetty & Emmanuel Saez, *The Effects of the 2003 Dividend Tax Cut on Corporate Behavior: Interpreting the Evidence*, 96 AM. ECON. REV. 124 (2006); David Aboody & Ron Kasznik, *Executive Stock-Based Compensation and Firms' Cash Payout: The Role of Shareholders' Tax-Related Payout Preferences*, 13 REV. ACCT. STUD. 216 (2008); Jennifer L. Blouin, Jana S. Raedy, & Douglas A. Shackelford, *Dividends, Share Repurchases, and Tax Clienteles: Evidence from the 2003 Reductions in Shareholder Taxes*, 86 ACCT. REV. 887 (2011). *See also* Michelle Hanlon & Jeffrey L. Hoopes, *What Do Firms Do When Dividend Tax Rates Change? An Examination of Alternative Payout Responses*, 114 J. FIN. ECON. 105 (2014) (examining an anticipated personal tax increase and concluding that "managers consider individual-level taxes in making corporate payout decisions"). *But see* Eric Floyd, Nan Li, & Douglas Skinner *Payout Policy through the Financial Crisis: The Growth of Repurchases and the Resilience of Dividends*, 118 J. FIN. ECON. 299 (2015) (pointing to confounding aggregate trends while acknowledging that tax rates matter on the margin) and Brandon Julio & David L. Ikenberry, *Reappearing Dividends*, 16 J. APP. CORP. FIN. 89 (2004) (concluding that JGRTRRA cannot account for the entirety of the reversal of dividend disappearance).

Although JGTRRA equalized the tax rates on qualified dividends and long-term capital gains (subsequently raised to 20% in 2013), "share repurchases retain a real fiscal advantage relative to dividends because realized gains resulting from share repurchases are taxed net of basis (deferral tax advantage) and can also be timed." *See* Chetty & Saez (2005). The different personal tax treatment of domestic and foreign investors may also play a role at companies with significant foreign ownership stakes. *See* Stanley Veliotis, *Equating U.S. Tax Treatment of Dividends and Capital Gains for Foreign Portfolio Investors*, 56 AM. BUS. L. J. 345 (2019); Reuven S. Avi-Yonah, *The Redemption Puzzle*, 128 TAX NOTES 853, 854 (2010) (noting that "[f]or foreign shareholders, on the other hand, a significant difference remains between redemptions and dividends after 2003").

of financial flexibility[21] and signaling potential.[22] To the extent that dividends and repurchases are not perfect substitutes, issuers may reduce share repurchases after the excise tax takes effect but not increase dividends, resulting in a decrease in total payout to shareholders. The resulting excess retention of free cash flow inside the firm may not have otherwise been optimal (*e.g.*, if the payout to shareholders was motivated by a combination of excess free cash flow and a lack of positive-net present value ("NPV") investment opportunities).[23]

Issuers that are subject to one of the exceptions from the new excise tax are not expected to be directly affected. They may incur indirect effects, for example, as part of competitive spillovers of a decrease in repurchases among issuers subject to the excise tax, or if investor sentiment regarding repurchases evolves in response to the decline in share repurchases among a

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[21] Dividends are generally viewed as a less flexible form of payout than repurchases because companies generally experience a negative market reaction to dividend (but not repurchase) cuts and therefore seek to maintain smooth or steadily increasing dividends (compared to more variable repurchases). Consequently, companies with uncertain cash flows may favor repurchases to initiating or raising dividends. *See, e.g.,* Murali Jagannathan, Clifford P. Stephens, & Michael S. Weisbach, *Financial Flexibility and the Choice Between Dividends and Stock Repurchases*, 57 J. FIN. ECON. 355, 355 (2000) (finding that "[s]tock repurchases are very pro-cyclical, while dividends increase steadily over time," that "[d]ividends are paid by firms with higher 'permanent' operating cash flows, while repurchases are used by firms with higher 'temporary', non-operating cash flows," and that "[r]epurchasing firms also have much more volatile cash flows and distributions"); Wayne Guay & Jarrad Harford, *The Cash-Flow Permanence and Information Content of Dividend Increases versus Repurchases*, 57 J. FIN. ECON. 385, 385 (2000) (hypothesizing that "firms choose dividend increases to distribute relatively permanent cash-flow shocks and repurchases to distribute more transient shocks" and finding, consistent with this prediction, that "post-shock cash flows of dividend increasing firms exhibit less reversion to pre-shock levels compared with repurchasing firms").

Some issuers that decide to switch to dividends after the excise tax takes effect may opt for special dividends over regular dividends in an attempt to preserve some financial flexibility. *See, e.g.*, Phillip Braun, *The New 1% Tax On Share Buybacks Will Not Have Intended Consequence of Changing Corporate Behavior*, FORBES (Aug. 19, 2022), https://www.forbes.com/sites/phillipbraun/2022/08/19/the-new-1-tax-on-share-buybacks-will-not-have-intended-consequence-of-changing-corporate-behavior/?sh=4f8e95077835 (noting, among other points, that "the effect of the new share buyback tax is that companies will start paying out more cash in special dividends than they have in the past relative to their share buybacks"). *See also* Harry DeAngelo, Linda DeAngelo, & Douglas J. Skinner, *Special Dividends and the Evolution of Dividend Signaling*, 57 J. FIN. ECON. 309 (2000) (noting that "special dividends were once commonly paid by NYSE firms, but are now rarely paid").

[22] In one theoretical model, repurchases convey a stronger signal that the firm's shares are undervalued than dividends do. *See, e.g.*, Aharon R. Ofer & Anjan V. Thakor, *A Theory of Stock Price Responses to Alternative Corporate Cash Disbursement Methods: Stock Repurchases and Dividends*, 42 J. FIN. 365 (1987).

[23] The agency theory of payout was originally developed in the context of dividends. According to this theory, companies pay dividends to decrease the agency costs of free cash flow, which arise when self-interested managers spend free cash flow earnings on negative-NPV investment projects. Therefore, distributing free cash flow by paying dividends improves shareholder value. *See, e.g.*, Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984); Larry H.P. Lang & Robert H. Litzenberger, *Dividend Announcements: Cash flow Signaling vs. Free Cash Flow Hypothesis?,* 24 J. FIN. ECON. 181 (1989). In the context of dividend taxation, companies that need to address agency costs of free cash flow can choose to make payouts despite the tax cost. *See also*, *e.g.*, Raj Chetty & Emmanuel Saez, *Dividend and Corporate Taxation in an Agency Model of the Firm*, 2 AM. ECON. J.: ECON. POL'Y 1 (2010) (demonstrating in a theoretical framework that "dividend taxation induces managers to undertake unproductive investments by retaining earnings"). *See also*, generally, Janis Berzins, Øyvind Bøhren, & Bogdan Stacescu, *Dividends and Taxes: The Moderating Role of Agency Conflicts*, 58 J. CORP. FIN. 583 (2019) (showing in the setting of Norway's personal dividend tax rate increase that companies trade off tax costs and agency conflicts, decreasing dividends less after the dividend tax rate increase when agency costs are high); Martin Jacob & Roni Michaely, *Taxation and Dividend Policy: The Muting Effect of Agency Issues and Shareholder Conflicts*, 30 REV. FIN. STUD. 3176 (2017) (showing, in the context of Swedish dividend taxation, that "taxation has a first-order impact on dividends, but agency issues and shareholder conflicts mute its impact substantially").

While repurchases are a weaker commitment device to distribute cash flow compared to dividends because companies face more market pressure to continue paying dividends, once dividends have been initiated, and to avoid dividend cuts or omissions, repurchases may also serve as a method of distributing free cash flow. *See, e.g.*, Tom Nohel & Vefa Tarhan, *Share Repurchases and Firm Performance: New Evidence on the Agency Costs of Free Cash Flow*, 49 J. FIN. ECON. 187 (1998); George W. Fenn & Nellie Liang, *Good News and Bad News About Share Repurchases* (Working Paper, 1998) ; Amy Dittmar, *Corporate Cash Policy and How to Manage it with Stock Repurchases*, 20 J. APP. CORP. FIN. 22 (2008) ; Chuan-San Wang, Norman Strong, Samuel Tung, & Steve Lin, *Share Repurchases, the Clustering Problem, and the Free Cash Flow Hypothesis*, 38 FIN. MGMT. 487 (2009).

considerable number of issuers. For example, several studies have shown in other contexts that issuers may mimic their peers' payout policies.[24]

It is difficult to analyze the effects discussed above because the excise tax on buybacks is only one factor affecting payout decisions. Besides the excise tax on repurchases, issuers are likely to consider the other tax implications of their financing and payout strategy, which can affect the repurchase decision to a greater extent than the excise tax.[25] As one example, issuers that undertake debt-financed share repurchases[26] are making joint debt issuance and payout decisions. Finally, in equilibrium, taxes are not the only determinants of the level and structure of corporate payout as issuers jointly optimize investment, leverage,[27] and payout decisions[28] (incorporating considerations such as the availability of positive-NPV investment opportunities,[29] agency costs of debt,[30] bankruptcy costs, time-varying valuation of equity vs.

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[24] *See, e.g.*, Massimo Massa, Zahid Rehman, & Theo Vermaelen, *Mimicking Repurchases*, 84 J. FIN. ECON. 624, 624 (2007) (arguing that "[r]epurchases are chosen as a strategic reaction to other firms' repurchase decisions and are not motivated by the desire to time the market" and showing that competing firms "mimic the behavior of the repurchasing firm by repurchasing themselves"); Binay K. Adhikari & Anup Agrawal, *Peer Influence on Payout Policies*, 48 J. CORP. FIN. 615 (2018) (showing "that firms' payout policies, *i.e.,* dividends and share repurchases, are significantly influenced by the policies of their industry peers" and concluding that "peer influence on dividends, and, to a less[er] extent, on repurchases, are consistent with a rivalry-based theory of imitation, which posits that firms imitate peers' actions to maintain their competitive parity."). *But see* Jillian Grennan, *Dividend Payments as a Response to Peer Influence*, 131 J. FIN. ECON. 549 (2019) (finding peer effects in dividends but not repurchases).

[25] The Act makes other changes to corporate tax burden, besides the excise tax on share repurchases. In particular, the Act includes a 15% tax similar to the Alternative Minimum Tax for certain large corporations. Based on prior research, tax reforms can simultaneously affect investment, financing, and payout decisions, which are jointly affected by corporate taxation. *See, e.g.*, Brooke Beyer, Jimmy Downes, Mollie Mathis, & Eric T. Rapley, *Early Evidence on the Use of Foreign Cash Following the Tax Cuts and Jobs Act of 2017*, (Working Paper, 2021) (considering the effects of the Tax Cuts and Jobs Act of 2017 on investment, capital structure, and share repurchases). *See also* the theoretical framework in Robert M. Dammon & Lemma W. Senbet, *The Effect of Taxes and Depreciation on Corporate Investment and Financial Leverage,* 43 J. FIN. 357 (1988).

[26] *See, e.g.*, Zicheng Lei & Chendi Zhang, *Leveraged Buybacks*, 39 J. CORP. FIN. 242 (2016) (finding that "[d]ebt-financed share buybacks generate positive short-term and long-run abnormal stock returns"). *See also* Joan Farre-Mensa, Roni Michaely, & Martin Schmalz, *Financing Payouts* (Working Paper, 2021).

[27] Companies that undertook repurchases as a way of adjusting upward their leverage ratio may instead elect to issue more debt, or reduce the issuance of equity.

[28] *See, generally, e.g.,* Michael R. Roberts & Toni M. Whited, *Chapter 7 - Endogeneity in Empirical Corporate Finance*, 2 HANDBOOK OF THE ECONOMICS OF FINANCE 493 (2013) .

[29] Even with the tax cost, shareholders may expect companies to continue to pay out excess cash flow, so it is not wasted when the firm lacks positive-NPV investment opportunities, and shareholders can instead redeploy it to other investment opportunities and companies. *See supra* note 23.

The comparatively lesser flexibility associated with dividends, compared to share repurchases, may cause repurchases to remain the preferred payout method for companies with volatile cash flows and companies experiencing temporary cash windfalls, even after the excise tax is effective. *See supra* note 21.

[30] Agency costs of debt may include inefficient underinvestment due to overhang (*see, e.g.*, Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977) ; Jie Cai & Zhe Zhang, *Leverage Change, Debt Overhang, and Stock Prices*, 17 J. CORP. FIN. 391 (2011)). Agency costs of debt may also include excessive risk-taking (risk-shifting) (*see, e.g.*, Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469 (1979); Keming Li, Jimmy Lockwood, & Hong Miao, *Risk-Shifting, Equity Risk, and the Distress Puzzle*, 44 J. CORP. FIN. 275 (2017)).

debt,[31] and signaling[32] considerations), discussed in prior research and in a study by the Commission's staff in 2020.[33]

III. Potential changes to the economic effects of the proposed disclosure amendments following the effectiveness of the new excise tax

Below we discuss some preliminary considerations related to the potential changes in the anticipated economic effects of the Proposed Amendments as a result of the new excise tax and the potential changes in the market baseline of share repurchases discussed above.

As the Proposing Release notes, there may be various reasons why companies undertake share repurchases to maximize shareholder value and engage in efficient uses of funds.[34] The Proposed Amendments are intended to improve the quality, relevance, and timeliness of information related to issuer share repurchases. For example, the proposed enhanced disclosures about repurchases could benefit investors (including existing shareholders contemplating a sale or purchasing more securities) by enabling them to value the issuer's securities more accurately, resulting in better informed investment decisions.

The effects of the new excise tax on share repurchases may interact with the direct and indirect economic effects of the Proposed Amendments, which we discuss below.

A. The aggregate economic effects of the Proposed Amendments will likely decrease.

While we do not expect the excise tax to change the direction and the qualitative nature of the economic effects of the Proposed Amendments with respect to any particular share

[31] It is commonly argued that companies may attempt to repurchase shares when they are relatively undervalued. Some survey evidence shows that CFOs consider the price of the stock when deciding whether to repurchase stock. *See* Alon Brav, John Graham, Campbell Harvey, & Roni Michaely *Payout Policy in the 21st Century*, 77 J. FIN. ECON. 483 (2005). As noted in the Proposing Release (footnote 66), evidence is mixed on companies' ability to time their purchases to periods of such undervaluation. *See, e.g.*, Amy Dittmar & Laura C. Field, *Can Managers Time the Market? Evidence Using Repurchase Price Data*, 115 J. FIN. ECON. 261 (2015); Azi Ben-Rephael, Jacob Oded, J., & Avi Wohl, *Do Firms Buy Their Stock at Bargain Prices? Evidence From Actual Stock Repurchase Disclosures*, 18 REV. FIN. 1299 (2014); Konan Chan, David Ikenberry, & Inmoo Lee, *Do Managers Time the Market? Evidence from Open-Market Share Repurchases,* 31 J. BANKING & FIN. 2673 (2007); Douglas Cook, Laurie Krigman, & J. Chris Leach, *On the Timing and Execution of Open Market Repurchases*, 17 REV. FIN. STUD. 463 (2004) (finding that larger firms in the sample perform better than smaller firms in timing the price at which repurchases are executed). However, other studies do not find evidence that repurchases are driven by market timing. *See, e.g.*, Stefan Obernberger, *The Timing of Actual Share Repurchases* (Working paper, 2014) (concluding that contrarian trading rather than market timing ability explains the observed relation between returns and actual share repurchases); Dittmar & Dittmar (2008); Alice Bonaimé, Kristine Hankins, & Bradford Jordan, *The Cost of Financial Flexibility: Evidence From Share Repurchases*, 38 J. CORP. FIN. 345 (2016) (finding that "actual repurchase investments underperform hypothetical investments that mechanically smooth repurchase dollars through time by approximately two percentage points per year on average"). The differences in the conclusions may be due to differences in empirical methodology and sample period. *See also* Yueran Ma, *Nonfinancial Firms as Cross-Market Arbitrageurs*, 74 J. FIN. 3041 (2019). Factoring in the 1% excise tax costs may reduce or eliminate the potential gains from repurchasing undervalued shares.

[32] For example, companies may repurchase shares to send a signal to the market about their positive outlook on the company's future share price. Even with corporate tax costs, companies may still repurchase shares. Costly signaling models in the dividend context expressly build the tax cost of payout into the framework driving the credibility of the signal to market participants. *See, e.g.*, Kose John & Joseph Williams, *Dividends, Dilution, and Taxes: A Signalling Equilibrium*, 40 J. FIN. 1053 (1985); B. Douglas Bernheim & Adam Wantz, *A Tax-Based Test of the Dividend Signaling Hypothesis*, 85 AM. ECON. REV. 532 (1995).

[33] *See* Staff of the U.S. SEC. & Exch. Comm'n, *Response to Congress: Negative Net Equity Issuance* (Dec. 23, 2020), *available at* https://www.sec.gov/files/negative-net-equity-issuance-dec-2020.pdf.

[34] *See* Proposing Release at 8454.

repurchase that takes place, we do expect that the excise tax may affect the total number of share repurchases and the level of share repurchase activity, as well as the relative magnitudes of some costs and benefits (as discussed below), and thus may affect the overall impact of the Proposed Amendments. The aggregate economic effects of the Proposed Amendments, including the benefits, costs, and effects on efficiency, competition, and capital formation, as well as investor protection, are expected to depend on the number of share repurchases undertaken in any year. If the excise tax leads to either a decrease in the number of filers engaging in share repurchases each year or a decrease in the number of share repurchases that a particular filer engages in each year, then the aggregate economic effects of the Proposed Amendments are expected to be smaller than described in the Proposing Release.

To the extent that the costs of compliance with the Proposed Amendments might contribute to a decrease in share repurchases for some issuers, including potentially efficient, shareholder value-maximizing repurchases[35]—that effect may compound any decrease in share repurchases resulting from the excise tax.[36]

B. The categories of benefits described in the Proposing Release will likely remain the same, but the magnitude may change.

For filers that continue to engage in share repurchases and therefore would be subject to the Proposed Amendments, the general categories of *benefits* discussed in the Proposing Release are expected to continue to apply, with the modifications discussed below.

The proposed disclosures are likely to continue to offer information benefits to investors. It is difficult to gauge whether the magnitude of such benefits for each filer that remains subject to the Proposed Amendments would change. On the one hand, a decrease in the level of share repurchases may decrease the usefulness of information about recent share repurchases for estimating the fundamental value of the company and may reduce the variable component of the information benefits (the portion that varies with the overall level of repurchase activity) provided by the proposed disclosure, namely the benefit of informing investors in a timely manner about the company's outlook on the future share price as reflected in repurchase activity on individual dates. On the other hand, the additional excise tax cost may amplify the signaling impact of the costly signal of undervaluation that share repurchases send to the market, per dollar repurchased, in which case the proposed higher-frequency disclosure of issuer repurchases may convey greater information content to investors after the new excise tax takes effect than prior to its introduction.

[35] *See* Proposing Release at 8459 ("For example, the described costs of the proposed disclosure might discourage some issuers from repurchases that would otherwise be optimal for shareholder value (e.g., as a more flexible and tax-efficient method of payout compared to dividends). Issuers might instead overweigh dividends or reduce overall corporate payouts and inefficiently retain excess cash within the firm. Further, if the costs of the proposed disclosure requirements cause issuers to decrease overall payouts, even if issuers lack positive-net present value investment opportunities, it would limit the ability of investors to efficiently reallocate cash to other, higher-net present value investment opportunities, potentially resulting in inefficiencies in the aggregate allocation of capital across issuers.")

[36] *See* CCMC Letter at 2 ("[i]t is likely that these harms will be compounded by the new excise tax, because the cost of that tax plus the costs of complying with the Proposed Rule may ultimately price out an even greater number of buybacks that otherwise would have been 'optimal' for shareholders").

Any decrease in the level of share repurchases by issuers that would be subject to the Proposed Amendments (because they continue to undertake some repurchases) is also likely to reduce the variable component of the information benefits of the proposed narrative and quantitative disclosures that help investors assess the contribution of share repurchases to shareholder value maximization. For example, to the extent that agency conflicts may continue to play a role in some issuers' decisions to repurchase shares but the level of such inefficient repurchase activity decreases, along with the overall decrease in share repurchase levels, after the excise tax takes effect, the incremental information benefits of learning about such agency conflicts are likely to be lower. Nevertheless, the non-variable ("fixed") component of such information benefits of the proposed disclosures may remain. For instance, identifying issuers that have had *any* repurchases potentially driven by insider selling, executive compensation, or earnings management reasons (to the extent that such repurchases continue to occur after the excise tax takes effect[37]) may provide incremental qualitative insights about the robustness of the company's governance and about the presence of agency conflicts, which may continue to inform investor assessment of the contribution of share repurchases to shareholder value maximization, and therefore, potential investment decisions. Relatedly, the information benefits of the narrative disclosures about the rationale for share repurchases and the policies related to insider trading around share repurchases in the Proposed Amendments also are likely to have a fixed component.

C. The categories of costs described in the Proposing Release will likely remain the same, but the magnitude of fixed and variable costs may change.

For filers that continue to engage in share repurchases and therefore would be subject to the Proposed Amendments, the general categories of *costs* discussed in the Proposing Release are expected to continue to apply, with modifications discussed below.

To the extent that filers that continue to engage in share repurchases after the effectiveness of the new excise tax (and therefore would be subject to the Proposed Amendments) are likely to decrease the level of share repurchases, as discussed above, the relative magnitudes of certain costs and benefits of the Proposed Amendments may change. The effect of this change in the case of each company will depend, in large part, on the relative magnitude of fixed and variable components of the costs of the Proposed Amendments. We lack the data to evaluate their relative magnitudes.

If the decrease in share repurchases results in fewer filings required on proposed new Form SR than we estimated in the Proposing Release, the variable portion of the direct costs of the Proposed Amendments for such filers would decrease. However, the direct costs of the Proposed Amendments also are likely to have a fixed component[38] (for example, the costs of

[37] *See* CCMC Letter at 2 (pointing to the possibility that "the tax itself will sufficiently deter what it sees as 'opportunistic' buybacks (as opposed to 'optimal' ones)"). We do not have information on which to predict whether the excise tax will have disproportionate impacts on 'opportunistic' versus 'optimal' repurchases. It is equally likely, ex ante, that companies will decrease repurchases across the board in response to the excise tax. As a result, the incidence of "opportunistic" repurchases may decline, along with the incidence of repurchases overall. This would decrease the information benefits of the proposed disclosure.

[38] *See also* CCMC Letter at 2 (referring to "fixed" compliance costs and stating that "the fixed costs of the Proposed Rule will likely dwarf any investor benefits" given the likely decline in the volume of buybacks following the excise tax).

establishing systems and processes to aggregate and compile information about executed repurchases for Form SR that issuers do not presently compile for periodic reporting, as well as the costs of preparing additional narrative disclosure for periodic reports, including the disclosure of the rationale and structure of repurchase programs). The fixed component of the direct costs of the Proposed Amendments is likely to have a relatively greater impact on small issuers and on issuers that repurchase a small number of shares in a given year. The relative share of issuers that repurchase a small number of shares in a given year among all issuers that undertake share repurchases and are therefore subject to the proposed disclosure amendments is likely to increase under the new excise tax, as discussed above. As a result, the fixed cost component of direct costs may comprise a larger portion of the cost for those issuers.

The ratio of fixed to variable indirect costs may be similarly affected. If the decrease in share repurchases decreases the frequency of disclosures on Form SR, the variable portion of indirect costs of the Proposed Amendments introducing new Form SR would decrease. Nevertheless, to the extent that even with a decreased number of Form SR disclosures, potentially sensitive information about the issuer's repurchase program, outlook on the future share price, and repurchase trading strategy would be revealed to market participants and competitors,[39] the issuers (and those shareholders that do not sell shares during the repurchase program) would continue to incur a fixed component of such indirect costs. As a result, the fixed cost component of indirect costs may comprise a larger portion of the costs for those issuers following the excise tax.

D. The effects on efficiency, competition, and capital formation described in the Proposing Release will likely remain the same.

The general *efficiency, competition, and capital formation* considerations discussed in the Proposing Release are expected to continue to apply, with the modifications discussed below.

As discussed in Section II above, the excise tax may have differential effects on different filers subject to the Proposed Amendments. To the extent that the varied effects of the excise tax result in further differences between affected filers in the level of share repurchases they continue to undertake and therefore, the relative costs of the proposed disclosures for such filers, the introduction of the excise tax may affect the competitive effects of the rule.

[39] *See* Proposing Release at 8458-59.