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Original Paper

How did a Previously Unscrupulous Tactic Become a Popular Corporate Strategy?….. Time to Discuss the Impact of an Excise Tax on Treasury Stock

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Abstract

The problematic history of stock buybacks, known more familiarly as Treasury Stock acquisitions, has at times been described as unscrupulous transactions resulting in stock manipulation tactics engaged in by corporate America (Kotter, 1952). However, when the Securities and Exchange Commission (SEC) passed rule 10b-18, the definition of share buybacks changed from problematic manipulative strategies to brilliant corporate maneuvers (SEC Act 1934.). The SEC's enactment of Rule 10b-18 opened Pandora's Box for corporations to engage in unfettered access of their own issued stock shares. The 10b-18 SEC Rule provided a pathway for corporations to buyback their own previously sold stock shares within an accepted legal framework. Unfortunately, the SEC Rule 10b-18 has been viewed as sanctioning the use of corporate funds for valueless purchases depleting the liquidity of the corporate balance sheet. But should these transactions, be subject to tax as a means to rectify the problematic buyback mania?

Keywords

treasury stock, excise tax earnings per share

1. Introduction

An interesting aspect of an accounting transaction identified as treasury stock is the fact, the transaction has been viewed through multiple lenses for financial reporting purposes ranging from assets to contra-equity accounts. Ironically, from a pure accounting viewpoint, both assets and contra-equity accounts have debit balances but will result in the opposite impact on the balance sheet. An asset, viewed as an expected future value or benefit, is an extremely beneficial account. The latter, a contra-equity account, represents a financial negative resulting in a decrease in the net worth of the company. A reduction in business value is an extremely problematic result for the future value of any entity. This opposing viewpoint, commencing in 1720 was debated until the Securities and Exchange Commission issued the SEC Act of 1934 along with the Internal Revenue Act of 1934 (Rueschhoff, N., 1978).

1.1 Impact of Legislation on Treasury Stock

The SEC ACT of 1934 stated: *"S. E. C. Reg. S-X, Rule 3.16 provides: "Reacquired shares (treasury stock), if significant in amount, shall be shown separately as a deduction from capital shares, or from the total of capital shares and surplus, or from surplus, at either par or stated value, or cost, as circumstances require."* Therefore, the current Generally Accepted Accounting Principles (GAAP) are consistent with the SEC Act of 1934. GAAP Guidelines required that treasury stock is not to be reported as an asset but as a deduction from equity at historical cost (SEC ACT 1934).

According to Harry Kotler, the author of Treasury Stock; A Corporate Anomaly stated: "*Strictly speaking, a corporation cannot become its shareholder. That is to say, it obviously cannot have a proprietary interest in itself, and yet the corporation, upon the acquisition of its shares, must know the legal status of such shares for a variety of purposes. Are they to be regarded as assets of the corporation, much as its machinery and equipment? Or are they merely chooses in action, remaining in suspended animation until the assertion of some corporate right which revitalizes them and gives them force and personality?* That issue has continued to plague the accounting community as they attempted to accurately report the status of the account known as treasury stock (Kotler, H., 1952)".

Therefore, as the ambiguity of the treasury stock status remained unanswered, the argument related to assets vs. contra-equity accounts continued to be discussed within the legal, tax, and accounting regulatory authorities (Sheldahl, 1982). The SEC believed treasury stock could be viewed as a current asset, investment, long-term asset, or as a deduction from capital stock. A very wide-ranging viewpoint and, adding to this confusion, the IRS opined on the tax consequences of the treasury stock conundrum. From 1920-1934 the IRS considered the sale of treasury stock a non-taxable event. Then, beginning in 1934, gains or losses were required to be reported on the corporate tax return (IRC SEC 1032).

So, it seemed, once the SEC Act of 1934 combined with the Internal revenue Act of 1934 was enacted, the confusion regarding the financial reporting and taxation of treasury stock would finally be decided. Unfortunately, the debate was not silenced and the confusion over the status of treasury stock transactions remains a discussion point even in today's dynamic world of commerce.

2. Impact of Treasury Stock Acquisitions on the Financial Statements

There are many reasons why a company would embark on repurchasing shares of their stock that had been sold or issued in a prior period. Once the issued shares are repurchased by the corporation, they become treasury stock and will transition from a positive value to a contra-equity designation. The reacquired shares will remain issued or sold but will no longer be a part of the outstanding stock category. Only outstanding shares are allowed to vote for corporate issues or to be able to share in dividends declared. Additionally, treasury stock can no longer exercise any preemptive rights or receive assets in a corporate liquidation. Treasury stock falls into a category akin to a child's "time-out" prohibiting the shares from participating in any of the above-listed stockholder benefits.

Interestingly, the treasury shares will be reported as a deduction from the stockholder's equity section of the balance sheet at the price the company paid for the shares. This is in contrast to when the shares are initially issued or sold and are recorded at par value. Par value is a value assigned by the corporation during inception and will be stated in its corporate charter. Par value has no relationship to current market value. The difference between the issue or market price and par or assigned value is reported in a "paid-in capital in excess of par" account also included as part of the equity portion of the balance sheet.

According to GAAP guidelines, treasury shares are reported on the financial statements until they are retired or resold at a later date. If the treasury shares are retired at a cost that exceeded the initial price, the loss on retirement of treasury shares will buy-pass the income statement and be reported as a reduction to either paid-in capital from the sale of treasury stock or retained earnings (GAAP, Topic 505-30, 2009). If the shares are retired at a cost that was below the original issue price, the equity section will increase by the amount of the gain on retirement of treasury stock (GAAP, Topic 505-30, 2009).

2.1 Impact of Treasury Stock on the Home Depot Financial Statements

The Home Depot financial statements detail a noteworthy financial statement storyline replete with the consequential impact share buybacks have had on their financial results. On Jan 30, 2022, Home Depot reported the following data according to their 2021 Annual Report: https://ir.homedepot.com/~/media/Files/H/HomeDepot-IR/2022/2021_AnnualReport_IR_Site_FINAL.pdf

The Home Depot Consolidated Income Statement reported the following selected data:

(In millions except per share data)

	2021	**2020**
Net sales	$151,157	$132,110
Gross Profit	$50,832	$44,853
Net Income	$16,433	$12,866
Outstanding Shares	1,054	1,074
EPS	$15.59	$11.98

According to the fiscal year 2021 Annual Report, Home Depot had issued 1,792 shares with 1,035 shares outstanding, which indicates that a 42% of the issued shares have been reacquired by the company leaving a mere 58% still outstanding. Therefore, if the company had not engaged in a massive share buyback program the earnings per share (EPS) would decline by 41% to $9.17 for 2021 along with a decline of 40% to $7.18 for the fiscal year-end 2020. A notable difference in EPS due to the share buyback activity. The impact of share buybacks positively increases the EPS by merely reducing the shares outstanding not by increasing the net income sending a confusing message to the investor.

The Home Depot Consolidated Balance Sheet reported the following selected balances:

(In millions except for per-share data)

	2021	**2020**
Current Assets	$29,055	$28,477
Total Assets	$71,876	$70,581
Current Liabilities	$28,693	$23,166
Total Liabilities	$73,572	$67,282
Retained Earnings	$67,580	$58,134
Treasury Stock, at cost	($80,794)	($65,793)
Total Equity (Deficit)	($1,696)	$3,299

As the balance sheet indicates, for January 30, 2022, Home Depot's Current Ratio = Current Assets /Current Liabilities, demonstrates an extremely problematic liquidity issue:

$29,055 / $28,693 = 1.01% vs. an industry norm for the retail-hardware industry of 1.68% according to Credit Guru Inc. Additionally, for fiscal year-end (FYE) January 30, 2022, Home Depot's Total Liabilities of $73,572 exceeded the Total Assets of $71,876, a further indication of a liquidity crisis.

Another interesting fact, embedded within the Home Depot Balance Sheet, concerns the treasury stock balance for FYE January 30, 2022. The share buybacks aggregated $80,794 which exceeded the retained earnings balance of $67,580, and as such, triggered a stockholder's equity deficit of ($1,696) indicative of extreme business problems. Furthermore, the financial statements of Home Depot report a 22.80% increase in the treasury stock balance from $65,793 in FYE January 31, 2021, to $80,794 in FYE January 30, 2022, resulting in an erosion of both liquidity and net worth.

Ironically, in May 2021 the Home Depot Annual Report included the following note:

"In May 2021, our Board of Directors approved a $20.0 billion share repurchase authorization that replaced the previous authorization. This new authorization does not have a prescribed expiration date."

Therefore, it is obvious Home Depot intends to continue engaging in massive share buybacks in the future regardless of the problematic liquidity issues that the financial statements detail along with a growth in EPS driven by the substantial corporate buyback activity.

3. The Top 20 Corporations Engaging in Share BUYBACKS

According to the S & P 500 statics, the first quarter of 2022 set records with a total of $281.0 billion in buybacks as compared to the previous record-breaking amount of $270.1 billion in the fourth quarter of 2021 (S & P 500 Indices, 2022). As the chart below indicates that for the 12 months ending Sept 30th, 2022, the top 20 firms engaging in buybacks aggregated $392.146 B. The entire S & P 500 buybacks totaled $981.953 B, indicating the top 20 entities engaged in 40% of total buybacks for a 12 month period, as indicated below. In 2021, the total share buybacks for the same period aggregated $742.21 B indicating a 32.25% increase over the prior period (S & P 500 Indices, 2022).

The buybacks for year-end Sept 24, 2022, represented an average cost of $159.31 (S & P 500 Indices, 2022). Unfortunately, the year-end Dec 31st, 2022, stock price was $128.61, or a 23.87% price decline. Interestingly, the treasury stock will remain reported at the higher cost on the balance sheet essentially obscuring a holding loss of $15.51 B.

Table 1. Top 20 S & P 500 Dow Jones Indices Share Buyback Companies (S & P 500 Indices, 2022)

Corp Name	Stock Symbol	Buybacks 12 Mos Sept 2022	Change prior 12 Mos Sep 2021	% Increase
Apple	AAPL	$95.625 B	$92.527 B	+3.35%
Alphabet	GOOGLE	$57.362 B	$44.705 B	+28.31%
Meta	META	$45.600 B	$31.532 B	+44.61%
Microsoft	MSFT	$30.585 B	$28.326 B	+8%
Exxon Mobile	XOM	$10.634 B	$101 M	*+893.71%*
Proctor & Gamble	PG	$11.253 B	$11.759 B	-4.30%
Lowe's	LOW	$ 16.140 B	$12.422 B	+30%
Marathon	MPC	$9.496 B	$1.912 B	*+396.65%*
NVIDIA	NVDA	$10.579 B	$1.508 B	*+601.53%*
Chevron	CVX	$5.386 B	$618 M	*+771.52%*
Comcast	CMCSA	$11.868 B	$2.722 B	+336%
Cigna	CI	$7.295 B	$8.011 B	-8.93%
Walmart	WMT	$11.127 B	$8.807 B	*+263.43%*
Conoco Phillips	COP	$7.928 B	$2.390 B	*+231.72%*
Morgan Stanley	MS	$11.973 B	$9.278 B	+29.05%
S & P Global	SPGI	$11.091 B	$60 M	*+1,738.5%*
Charter Comm	CHTR	$13.842 B	$15.183 B	-9%
Johnson & Johnson	JNJ	$5.711 B	$2.781 B	*+105.36%*
Visa	V	$11.709 B	$8.820 B	+32.76%

Union Pacific	UNP	$6.942 B	$6.595 B	+.05%
Top 20 Total		**$392.146 B**	**$290.077 B**	**+35.19%**
S & P 500 Total		**$981.953 B**	**$742.209 B**	**+32.30%**

Based on the analysis provided by the S & P Dow Jones Indices presented above, seventeen of the top twenty largest companies increased their buybacks from the prior twelve-month period (S & P 500 Indices, 2022). Nine of the twenty companies more than doubled their share buybacks and one in particular, S & P Global increased their buybacks by 1,738% (S & p 500, 2022).

3.1 Impact of Treasury Stock on Corporate Ratio Analysis

Given the data presented in Table 1, it is apparent that many of the most successful corporations engaged in the share buyback frenzy. The primary reasons are rooted in the fact that once shares are reacquired they are no longer included as part of the outstanding share population and, the financial value of the earnings per share (EPS), the return on equity (ROE), and the return on assets (ROA) all increase as the number of shares outstanding decrease (Bargerstock, 2022). This positive financial maneuver has increased over the past few years and has now culminated in more than $500 billion in acquisitions according to the S & P 500 data (Bargerstock, 2022). Additionally, despite the discussion above of Home Depot's massive share buybacks, they are not even in the top 20 of the S&P 500 companies engaging in the most share buybacks for 2022.

The impact on a corporation's return on equity ratio (ROE) can also be positively improved through an aggressive share buyback strategy. The interesting market reaction is that as earnings per share (EPS) increase in direct correlation to stock buyback activity, the stock price of the shares will also increase. Unfortunately, the stock price increase is merely in response to a perception of earnings growth driven merely by the EPS increase. Unfortunately, many investors fail to understand that the increase in EPS is not driven by profit growth but rather a decline in the shares the earnings are being allocated toward. In other words, the EPS formula = Net Income / Outstanding Shares, will increase as the outstanding shares decline due to the share buybacks *not* because the company has reported greater net income.

In the chart presented below, the top ten companies with extremely high ROE presented as of May 2022 by Schwab.com is as follows (Bargerstock, 2022):

Table 2. Companies with High ROE

COMPANY	ROE
Oracle Corp.	7412.75%
North European Royalty Trust	3213.35%
Permian Basin Royalty Trust	2915.23%
First Physicians Capital Group Corp.	2635.44%

The Home Depot	***2050.28%***
DJSP Enterprises, Inc.	1864.19%
Amerisourcebergen Corp.	1286.11%
Dell Technologies	1246.35%
DAVIDsTeas Inc.	917.23%
First Hartford Realty Corp.	907.66%

Unfortunately, the ROE calculation (Net Income/Common Shareholder's Equity) will increase as common shareholder's equity decreases due to share buyback activity. Once again, the increase in ROE will not be driven by increased net income but rather by a decline in equity due to the contra-equity treasury stock deduction. Ironically, as equity declines, the ROE ratio will increase providing misinformation regarding the impact of the share buyback activity on the future value of the entity. A rising ROE would appear to indicate a positive in the company's future outlook, but this is an example of how numbers *can* lie. Additionally, as the chart illustrates, Home Depot's ROE is 2050.28% driven by the massive amount of treasury shares that are no longer a part of the calculation and as discussed above, the equity section of the balance sheet depicts a much more problematic story than this ratio reflects.

4. Time to Tax the Share Buyback Strategy

According to the Cornell Law School Legal Information Institute, an analysis of IRC section 26 CFR *Sec1.1032-1*, indicates there are no tax consequences when shares of treasury stock are sold. Therefore, a taxpayer will not recognize a taxable gain or a deductible loss on their tax returns.

If the treasury shares selling price exceed the initial cost of the shares, the excess would be reported as an increase to the equity section of the balance sheet. The paid-in capital from the sale of treasury stock would be increased by the amount of the excess or gain. However, if the treasury stock was sold below cost, that loss would be initially deducted from any balance in the paid-in capital from the sale of treasury stock and, once the paid-in capital from the sale of treasury stock was eliminated, any remaining loss would be charged to the retained earnings account balance. As a result of this IRC Sec 26 guidance, a taxpayer could increase their corporate net worth without any tax consequences.

4.1 Unintended Consequences of a Tax Reduction Policy

As the Trump era 2017 TCJA tax cuts became law, it become apparent, that as corporate tax rates declined from a 15-39% range to a flat 21% rate, many of these tax savings were being used to buy back shares of treasury stock (Remely, 2021). In 2018, the first year of the tax reduction act, share buybacks exceeded $1 trillion (Shaw, 2022). These activities of massive share buybacks have resulted in skewed data resulting in increases to EPS and ROE along with a lack of enthusiasm in additional research and development (R & D) expenditures as had been anticipated since R & D investment was already a major part of corporate strategy prior to the tax cuts (Knott, 2019).

In response to both the nontaxable nature of the treasury stock transactions and the excessive share buyback activity exhibited by a plethora of corporate decision-makers, the federal government has proposed a 1% excise tax to dampen the enthusiasm of the treasury stock buying spree (Friedlich, 2022). The Inflation Reduction Act of 2022 (H.R. 5376) includes this last-minute provision of a 1% excise tax aimed at diluting the tax reduction incentives the Trump era 2017 tax cuts provided (Friedlich, 2022). The imposition of the nondeductible excise tax effective beginning after 2022, is intended to serve as an incentive for the corporate decision-makers to invest their excess cash in areas other than share buybacks (Shaw, 2022). Additionally, the Biden Administration has recently proposed a quadrupling of the excise tax to 4% in an attempt to further dampen the aggressive nature of many corporate buyback activities.

Now returning to the Home Depot FYE January 30, 2022, financial reports, the increase of $15.001 billion in treasury stock from the prior year would now trigger an excise tax of $600 million assuming the excise rate enacted is 4% as the Biden Administration has proposed resulting in a further erosion the liquidity of the entity. Whether this additional cost would change the Home Depot management’s buyback strategy in the future remains to be seen.

5. Conclusion

Corporations have historically engaged in share buybacks dating back to the 1700s (Harry, 1952). Corporate stock buybacks have increased following the lowering of corporate income tax rates and in response, new excise taxes are being implemented currently. Just recently, share buybacks have become the preferential corporate strategy instead of dividends (Bargerstock, 2022). Whether the share buyback preferential tax treatment is the cause of the current buying frenzy remains an unanswered query (Shaw, 2022). Interestingly, dividends are taxed as ordinary income, however, share buybacks are taxed to the holder at a lower preferential capital gains tax rate (Remely, 2021). Therefore, both the nontaxable treasury stock impact on the corporate level along with the capital gain tax rate preferences on the individual level provides a double tax benefit for any share buyback transaction.

A 4% excise tax has been floated by the current Biden Administration as a response to the perceived tax inequity of the current share buyback tax landscape (Bogage, 2022). Whether this additional excise tax will reduce the current share buyback activities remains to be seen. In addition, whether tax consequences are critical to the share buyback decision-making of corporate America is another question that will remain unanswered until the excise tax is imposed. The stock buyback journey continues to evolve as a fascinating corporate strategy.

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