Stock Buybacks Don't Always Signal Smooth Sailing Ahead

If a company is buying back its own shares on the open market it's clearly a sign the board thinks the company is poised to do well. Right?

Well, not necessarily. Just because a company starts repurchasing its shares, one shouldn't automatically conclude that their future is bright. There are many reasons for stock buybacks.

Sometimes companies buy back their shares as a public statement of confidence, and sometimes they are trying to send a message to the market and fire-breathing investment bankers that they feel their shares are underpriced. Sometimes they're doing both simultaneously.

Another reason companies give for buying back shares is to shore up a sagging stock price. A company might want to do this when contemplating a secondary stock offering or merely to give a short-term boost to the price so insiders can sell their own stock at an inflated price.

A third reason for a company to buy back its own shares is to reduce dilution, particularly dilution caused by excessive option grants to top executives. Antidilution has the effect of increasing earnings per share, as the fewer shares there are, the more profits are allocated to each. This certainly worked for International Business Machines Corp. under Louis Gerstner. IBM's revenue grew only modestly under Mr. Gerstner, yet EPS growth was fueled in part by the company aggressively repurchasing its own shares.

This of course doesn't explain all of IBM's earnings gains. Pension assets and liabilities, which exist off balance sheets, can be manipulated to help "manage" earnings. Earlier this year IBM raised its rate or return on its pension assets from 9.5% to 10%. In simple terms, that increases the company's pension assets, decreases the pension liability the company is exposed to, and thereby boosts earnings.

Companies buy back their stock when they have cash on hand. They could also choose to pay out a dividend to shareholders, if they so desired, but paying dividends has become less and less
common in recent years. This strategy has been adopted for many reasons: financial, tax, managerial and cosmetic among them. The government has also provided powerful disincentives for them to do so. The payment of a dividend causes income to be taxed twice (once at the corporate level when the money is earned, and a second time at the individual level, when it is paid out in a dividend). It may be time for these policies to be reconsidered.

Companies accumulate earnings for many reasons: to fund their future expansion, to conduct research and development or simply to save up for a rainy day. It is when companies start to accumulate earnings beyond the "reasonable" needs of the business that things get controversial.

Internal Revenue Code section 531 frowns on the "unreasonable accumulation of earnings" by corporations. If a company is deemed to have unreasonably accumulated earnings, the IRS slaps them with a penalty tax equal to the highest individual tax rate on the excess amount. This has the same effect as if the company actually did pay out a dividend to taxpaying shareholders.

Often, closely held companies want to accumulate earnings since corporate tax rates can often be lower than individual tax rates. But how do you know if a public corporation is unreasonably accumulating earnings? The answer can be very subjective. In practice, this tax is rarely imposed, since a company can usually come up with some credible reason not to pay dividends. For instance, Microsoft Corp. claims it won't pay a dividend because of potential future litigation awards and competition. Other companies claim they need the money for future expansion projects, new construction, or R&D.

One place to look for possible alternative treatments is real-estate investment trusts, or REITs. They receive favorable tax treatment if they do pay dividends, so long as the dividends equal at least 90% of their income. Paying that minimum dividend legally avoids double taxation. The REIT gets a tax deduction for the dividend, similar to the tax deduction they would get for paying interest to bondholders or lenders. As a result of this favorable tax treatment, small investors can now be part owners of mammoth real-estate projects.

Perhaps it is time to consider giving "regular" corporations at least some of the tax benefits afforded to REITs, such as a partial tax deduction for dividends it pays to shareholders. For example, if a corporation pays out 20% of its net income, it would get a tax deduction for that amount, still enabling it to accumulate the remaining earnings for the business' future. Certainly this would create an economic incentive for companies to pay dividends rather than hoarding cash. In some cases -- like for companies that have incorporated in Bermuda to avoid U.S. tax, for example, the income will be taxed as personal income tax -- it would cause corporate income to be taxed that has otherwise gone untaxed.

To give investors incentives to get back into the market, we believe there should again be serious discussion on seeking ways to encourage companies to pay dividends as an alternative to repurchasing their stock. But that isn't likely to happen without changes to tax and accounting laws.

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