CPE

CURRICULUM:
Accounting and Auditing, Management

LEVEL:
Basic

DESIGNED FOR:
CPAs in business and industry and public practice

OBJECTIVES:
To explain stock repurchase advantages and disadvantages, accounting methods, and excise tax liability

KEY TOPICS:
Accounting for stock repurchases, benefits to companies, paying for buybacks, the impact on equity, and the application and reporting requirements of excise taxes

PREREQUISITES:
None

ADVANCED PREPARATION:
None

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Today's CPA offers the self-study exam for readers to earn **one hour of continuing professional education credit.** The questions are based on technical information from the following article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA).

Take the CPE quiz online. Go to the News & Publications section of TXCPA's website and select *Today's CPA* Magazine. Then scroll down on the page and click on "CPE: Share Repurchases - Playing in the Big Leagues."

The State Board stipulates that the quiz is valid for one year from its publication in *Today's CPA*. Quizzes submitted after this one-year period will not be accepted.

Share Repurchases:

Playing in the Big Leagues

Although share repurchases return more cash to shareholders than dividends, the financial-reporting and tax risks that large share repurchases create must be managed – from negative equity and distorted ratios to rising excise-tax costs

BY KAREN M. OXNER, CPA, DBA, MBA, BS, AND ASHLEY D. PHILLIPS, LL.M., JD, BSBA

For decades, U.S. corporations provided cash returns exclusively through dividends and share repurchases were considered off limits due to perceptions of market manipulation. Returning cash to shareholders through buybacks first began in 1982 when the Securities and Exchange Commission (SEC) issued Rule 10b-18, which eliminated an unwritten ban on share repurchases.

Within about 15 years, cash spent on buybacks had eclipsed cash spent on dividends. For 2024, total S&P 500 repurchases were about 1.5 times dividends ($942.5 billion in buybacks versus $629.6 billion in dividends). Over 85 percent of the S&P 500 companies executed buybacks in 2024; however, 20 companies with the largest buybacks accounted for nearly half of the repurchases (S&P Dow Jones Indices 2025).

Since stock repurchases are accounted for similarly regardless of their size, the very large buyback programs can create undesired effects on the balance sheet and have also attracted government attention in the form of excise taxes.

ACCOUNTING FOR STOCK BUYBACKS

Two methods exist for recording stock buybacks: the treasury stock method and the par value method. The treasury stock method records the cost of the shares in the contra-equity treasury stock account and it is subtracted to compute total equity (FASB Accounting Standards Codification 505-30-30-6).

The par value method instead directly reduces the stock and paid-in capital accounts by the amount for which the shares were originally issued. If the cash paid to repurchase shares is greater than the original amount received at issuance, then either paid in capital from previous repurchase transactions or retained earnings will also be decreased using the par value method (ASC 505-30-30-8). In fact, some companies simplify this method by debiting the entire amount to retained earnings. Debiting the cost of repurchased shares to retained earnings has the same accounting effect as a cash dividend.

No gains or losses can be recorded when companies buy, sell or hold their own stock. Thus, share repurchases and reissuances do

not directly affect net income or comprehensive income. However, certain repurchases are now subject to a 1 percent federal excise tax, which will decrease net income due to excise tax expense.

BENEFITS OF BUYBACKS TO COMPANIES

If companies can use both dividends and repurchases to return cash to shareholders, why have buybacks outstripped dividends? Investors often expect dividends to be an every-quarter distribution and they may be seeking a target dividend yield. Thus, dividends typically become a recurring cash budget item. In addition, once a cash dividend is declared, it is a true liability and must be paid.

In contrast, stock repurchase plans can be announced and then reduced or never executed if conditions change. Consequently, repurchase plans have the benefit of flexibility and are less likely to establish investor expectations of specific cash returns in the future. From the shareholder's perspective, buybacks may be taxed at lower capital gains rates on their personal tax returns.

Equally important as flexibility, stock buybacks have an antidilutive effect on earnings per share. Thus, an adequate number of shares can be repurchased to offset the dilutive impact on earnings per share of issuances related to employee stock purchase plans, stock option plans and acquisitions purchased with stock. In fact, large repurchase plans can result in a net decrease to the number of outstanding shares, increasing earnings per share.

As examples, Apple Inc.'s (ticker AAPL) buyback programs are some of the largest in the U.S. and Apple's total outstanding shares have decreased by over 5 percent during the three-year period from fiscal 2022 - 2024. Apple's earnings per share have increased by 3 percent for each fiscal year 2022 - 2024 due to the impact of buybacks.

General Motors' (ticker GM) share buybacks increased earnings per share over the same three-year period by as much as 18 percent. Overall, approximately 12 percent of the S&P 500 reduced their share counts by 4 percent or more in 2024 by repurchasing more shares than they issued (S&P Dow Jones Indices 2025). (Note that all company information cited is available in filings on the SEC Edgar database.)

PAYING FOR BUYBACKS

Buybacks require cash and for companies with large programs, they can be a huge outlay. During 2022 - 2024, Apple's buybacks were between 70 percent and 80 percent of cash flows from operations. General Motors' repurchases ranged from 16 percent to 53 percent of cash flows from operations during those three years.

The use of cash for buybacks has met with criticism for not being in the best long-term interest of the company. The detractors of large repurchase programs propose that the money could be invested in revenue-producing assets, used to enhance core competencies or pay off debt. In addition, some companies issue debt to fund the share repurchases because cash from operations is not sufficient to pay for the stock. Debt that does not provide a means to earn additional revenue is especially risky.

As a case in point, in 2023, RTX (defense and aerospace company; ticker RTX) used a combination of debt and cash on hand

Key Points to Consider

Cash Return: Buybacks now exceed dividends as the primary method of returning cash to shareholders

Equity Impact: Accounting methods related to share repurchases reduce equity, and large programs can drive equity very low or negative

Balance Sheet Impact: Negative or minimal equity distorts key ratios (debt ratio, ROE) and can create covenant issues

Earnings Per Share: Buybacks boost EPS and offer flexibility but can strain cash flow or increase leverage when funded with debt

Excise Tax: Repurchases above $1M are now subject to a 1% federal excise tax with new reporting requirements

Advantages vs. Disadvantages: Companies must balance EPS benefits with financial-reporting impacts, liquidity risks and tax costs to fund their accelerated share repurchase program of approximately $10 billion. RTX repurchases in 2023 amounted to 160 percent of its cash flows from operations. The RTX debt ratio (total liabilities/total assets) increased from 53 percent in 2022 to 62 percent in 2023, remaining at 62 percent in 2024.

IMPACT ON EQUITY

Large, long-running repurchase programs can deplete equity balances to the extent that the balance sheet equation has little representational faithfulness to the financial position of the company. In other words, assets still equal liabilities plus equity, but the equity amount is so small that liabilities are disproportionate related to assets. Normally, a financial statement user might assume such a company is in financial distress, but this mismatch can be an unintended result of the fact that repurchase accounting always decreases equity.

The debt ratio loses its usefulness when equity is very low or negative. Other financial statement ratios would also be affected by small or negative total equity, such as return on equity (ROE) and the debt-to-equity ratio. Because of this impact, companies with restrictive debt covenants tied to financial statement ratios must consider these effects when undertaking share repurchases. Large share repurchases can create an accounting "elephant in the room" when equity gets extremely low or negative.

The financial reporting community has not addressed the impact of large buyback programs. Absent a change in accounting standards, a solution to this problem does not currently exist.

Share Repurchases and Equity Deficits: A Closer Look at Boeing and McDonald's

Boeing (ticker BA) has executed large buyback programs for many years and in 2023, their total shareholders' equity was a deficit of $17.2 billion because the combination of treasury stock of $49.5 billion and accumulated other comprehensive loss of $10.3 billion was larger than the sum of the other equity accounts. Thus, liabilities are greater than assets and the debt ratio is greater than 1.0 at 1.13 for 2023. During 2024, Boeing had significant reissuances of stock, bringing the stockholder's equity deficit down to $3.9 billion.

McDonald's (ticker MCD) also typically repurchases stock and its total equity is likewise a deficit of $3.8 billion for 2024, with a debt ratio of 1.07. McDonald's bought back stock each year 2022 – 2024.

EXCISE TAX ON REPURCHASES

Federal regulators have also taken notice of share repurchase programs. On August 16, 2022, the U.S. Congress enacted the Inflation Reduction Act of 2022 (IRA), which was codified as Internal Revenue Code Section 4501. Among many other provisions, the IRA imposed a 1 percent excise tax on share repurchases by covered corporations that exceed $1 million in a calendar year beginning with repurchases in 2023. (H.R. 5376).

In April 2024, the IRS issued two sets of proposed regulations. The first set of proposed regulations provide substantive guidance regarding the application of the tax. The second set of regulations addresses reporting requirements.

APPLICATION OF THE EXCISE TAX

Most stock repurchased by a covered corporation and transactions that are economically similar to a stock repurchase are subject to the 1 percent excise tax. A covered corporation includes a domestic corporation whose stock is traded on an established stock exchange.

While the excise tax targets domestic corporations, a U.S. affiliate of a publicly traded foreign corporation in certain circumstances may be subject to the 1 percent excise tax. The proposed regulations treat instruments that are treated as stock for federal tax purposes as stock for purposes of the excise tax. Furthermore, the proposed regulations do not provide a safe harbor for privately held corporations for which stock price quotes are regularly available.

Generally, the excise tax liability is calculated by multiplying 1 percent by the excise tax stock repurchase base. The excise tax stock repurchase base is the aggregate fair market value (FMV) of all stock repurchased by a covered corporation, less the FMV of stock that qualifies for a statutory exception and less the FMV of the stock issued by the covered corporation under the netting ruling.

Corporations can select one of four methods to determine FMV for purposes of the repurchase rule: (1) daily volume-weighted average price on date of repurchase; (2) daily closing price on date of repurchase; (3) average high and low price on date of repurchase; or (4) trading price of the stock at the time of repurchase.

There are several statutory exemptions to the excise tax that reduce the excise tax stock repurchase base. These exemptions include the following:

- Stock repurchased to the extent it is part of a tax-free reorganization pursuant to IRC Section 368 and where no gain/loss is recognized by the shareholder;
- Stock repurchased and contributed to an employer-sponsored retirement plan or employee stock ownership plan;
- Stock repurchases that do not exceed $1 million during the taxable year;
- Stock repurchases by a dealer in securities in the ordinary course of business;
- Stock repurchases by real estate investment trusts and regulated investment companies; and
- Stock repurchases treated as a dividend.

REPORTING REQUIREMENTS

The proposed regulations relating to reporting requirements for the excise tax were finalized on June 28, 2024. In accordance with the final regulations, a covered corporation reports its stock repurchases annually on Form 720, Quarterly Federal Excise Tax Return. Repurchases are to be included on Form 720 for the first calendar quarter after the corporation's tax year-end.

In addition, the company must also attach Form 7208, Excise Tax on Repurchase of Corporate Stock, to Form 720. Form 7208 is used to compute the excise tax owed. The estimated tax impact for 2024 repurchases made by the S&P 500 was $8.41 billion and $7.24 billion for 2023 buybacks. This tax represents less than ½ percent of operating income, but the tax could certainly be increased in the future (S&P Dow Jones Indices 2025). Alternatively, the federal government could institute a distributed profits tax or decide to treat buybacks as dividend for tax purposes (Osborn 2024).

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- Key Financial and Economic Issues Facing the Financial Executive

WEIGHING THE FINANCIAL IMPACT OF SHARE REPURCHASES

Based on aggregate data for the S&P 500, share repurchases return more cash to shareholders than dividends. However, large buybacks can leave unintended financial reporting consequences in their wake: very low or negative equity. This impact on the balance sheet reduces its representation faithfulness and decision-usefulness, and it negates the value of ratio analysis based on total equity, such as the debt ratio and ROE.

On the income statement, buybacks can have a significant antidilutive effect on earnings per share by reducing shares outstanding. While an increase in earnings per share is desirable, issuing debt to fund the repurchases may compromise the financial stability of the firm, since no income-producing asset is acquired.

To the extent buybacks are subject to the excise tax, share repurchases now have a negative effect on both cash from operations as well as net income. Thus, taxable repurchases have both dilutive and antidilutive effects on earnings per share.

The first excise tax payment was due October 31, 2024, and it is entirely possible that the excise tax rate will be increased in the future. No such excise tax exists on corporate dividends. Companies making repurchase vs. dividend decisions should carefully consider the financial reporting impacts and the tax consequences of their choices.

Works Cited

"Accounting Standards Codification, Topic 505, Subtopic 30 Treasury Stock." Financial Accounting Standards Board. www.asc.fasb.org/.

Internal Revenue Code Section 4501, 26 U.S. Code § 4501

Inflation Reduction Act of 2022, Pub. L. No. 117-169 (2022) www.congress.gov/bill/117th-congress/house-bill/5376

Excise Tax on Repurchase of Corporate Stock – Procedure and Administration, 26 CFR Part 58 (TD 10002), www.federalregister.gov/d/2024-14426

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