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Encouraging Corporate Charity

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ENCOURAGING CORPORATE CHARITY

*Linda Sugin**

The tax law governing corporate philanthropy is stuck in an archaic notion of corporate charity that does not necessarily benefit either charities or corporate stakeholders. Four developments in the last few years provoked this reexamination of the Internal Revenue Code and its awkward dichotomy between business expenses and charitable contributions. They offer new reasons for replacing the charitable contribution deduction for corporations with a business expense deduction: (1) a statutory reduction in the rate of tax on dividends received by individual shareholders, (2) empirical evidence showing very low effective tax rates paid by corporations, (3) death of the preeminent model of corporate philanthropy — Berkshire Hathaway's shareholder-designation program, and (4) adoption of final capitalization regulations that significantly weaken the capitalization requirement and no longer pose much of an obstacle to immediate deduction of corporate payments to charities. This seemingly small legal change offers many benefits in today's climate: it would increase the coherence of a corporation's tax treatment, help to minimize the agency costs in corporate philanthropy, and change the way that corporations define their charitable endeavors, encouraging greater overall corporate commitment to charitable and community needs, both within and outside their business operations.

* Professor of Law, Fordham University. I would like to thank Laurie Malman for helpful comments and Shadi Shukri and Bing Luke for research assistance.

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I. INTRODUCTION

The tax law's charitable deduction for corporations is a quaint anachronism, but not because corporate charity is dead. Rather, corporate charitable giving may now be more important than ever to both charities and corporations. Charities are struggling with declines in government funding and corporations, having suffered some very bad press in the post-Enron world, are increasingly conscious of the need to burnish their images.¹ The amount that corporations give to

¹ See Ian Wilhelm, *Big Business Doing More for Charity*, CHRON. PHILANTHROPY, Aug. 5, 2004, at 7, 8. The statistics on corporate giving over the last few years have been somewhat affected by the tremendous outpouring of charitable support following the September 11 terrorist attacks, showing a decline in the

charities has been growing² and consumers increasingly believe that corporations should participate in philanthropy.³ Nevertheless, the tax law governing corporate philanthropy is stuck in an archaic notion of corporate charity that does not necessarily benefit either charities or corporate stakeholders. As the important issues of corporate social responsibility have shifted and relevant aspects of the tax law have evolved, the charitable deduction for corporations has become functionally obsolete. Today, the shining model of corporate philanthropy has died,⁴ corporate charitable giving is decreasingly distinguishable from other business expenses, and ordinary business expenses increasingly implicate social responsibility issues that are shared across philanthropic and profit-making endeavors.⁵

The corporate deduction for charitable gifts was never completely consistent with the theory or doctrine of section 170⁶ and changes in both the tax law's treatment of dividends and the accepted practices of business suggest that the special deduction for charitable giving by corporations be replaced by the ordinary business deduction, which broadly governs ordinary and necessary business expenses. While it may seem unremarkable to alter the treatment of corporate philanthropy by shifting a deduction from one Internal Revenue Code (Code) section to another, in light of recent developments, it offers significant promise for improving the law. It would offer significant advantages for corporate shareholders, the tax system, and charities: it

succeeding year. See Ian Wilhelm, *Corporate Giving Takes a Dip*, CHRON. PHILANTHROPY, July 24, 2003, at 6, 6.

² Charitable donations from corporations and their foundations increased 4.2% in 2003, to \$13.46 billion. CTR. ON PHILANTHROPY AT IND. UNIV., GIVING USA FOUNDATION, GIVING USA 2004, at 83 (2004) [hereinafter GIVING USA 2004]. However, corporate giving has declined as a percentage of profits over time. Michael E. Porter & Mark R. Kramer, *The Competitive Advantage of Corporate Philanthropy*, HARV. BUS. REV., Dec. 2002, at 56–57.

³ See Press Release, Cone Inc., 'Tis the Season for Cause-Related Shopping (Nov. 17, 2003), http://www.coneinc.com/Pages/pr_22.html (describing the 2003 Cone Holiday Trend Tracker).

⁴ See *infra* Part III.

⁵ In a recent study, consumers favored support of community philanthropy but cared even more about employee benefits and human rights in manufacturing, which are core business issues as well as social issues. See Press Release, Cone Inc., Multi-Year Study Finds 21% Increase in Americans Who Say Corporate Support of Social Issues Is Important in Building Trust (Dec. 8, 2004), http://www.coneinc.com/Pages/pr_30.html (describing the 2004 Cone Corporate Citizenship Study).

⁶ See generally Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1 (1994).

would increase the coherence of a corporation's tax treatment, simplify the Code's approach to corporate expenses, operate to minimize the agency costs in corporate philanthropy, and help rationalize the tax treatment of charitable giving for individuals. It could also change the way that corporations give to charity and define their charitable endeavors, encouraging a greater overall corporate commitment to charitable and community needs, and promoting better tailoring of corporate gifts to those needs.

Four developments in the last few years require reexamination of the Code's awkward dichotomy between business expenses and charitable contributions and provide new reasons for considering whether the Code's treatment of corporate charity is defensible: (1) a statutory reduction in the rate of tax on dividends received by individual shareholders,⁷ (2) empirical evidence showing very low average effective tax rates paid by corporations,⁸ (3) cessation of Berkshire Hathaway's charitable giving program, and (4) adoption of final capitalization regulations that significantly undercut the traditional capitalization requirement that limits deductions otherwise allowable under section 162.⁹

This article is organized as follows: Part II describes the problems created by the section 170 deduction for corporations. It discusses the unintended bias the Code has long contained in favor of charitable giving by corporations instead of their shareholders and how the recent changes in the tax treatment of dividends and the tax profile of corporations turn that bias around. It describes the invitation to managerial abuse that section 170 may encourage and which section 162 may control. It explains why section 170's standard for deductibility is incoherent for corporations, encourages corporate foundation building, and privileges in-kind gifts compared to cash.

⁷ In the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Congress amended section 1(h) to provide that dividends received by individuals are taxed as "net capital gain," subject to a preferential rate of tax that does not exceed 15%. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760-61 (codified as amended at I.R.C. § 1(h)(11)). Prior to that legislation, dividends were taxed at ordinary income rates, which are currently as high as 35%. See I.R.C. § 1(a).

⁸ According to a recent General Accounting Office (GAO) study, 61% of U.S. corporations reported no tax liabilities and 94% reported liabilities of less than 5% of their total income. U.S. GEN. ACCOUNTING OFFICE, TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN- AND U.S.-CONTROLLED CORPORATIONS, 1996-2000, at 6-7 (2004), available at <http://www.gao.gov/new.items/d04358.pdf> [hereinafter GAO, COMPARISON].

⁹ T.D. 9107, 2004-1 C.B. 447.

Part III reviews Berkshire Hathaway's unique resolution of both the bias problem and the related agency-cost problem created by corporate philanthropy. It analyzes that company's decision to end its shareholder-designation program and the failure of other companies to adopt its exemplary corporate-governance model on this issue. Part IV assumes that the section 170 deduction for corporations for "payments" to charity was functionally necessary because the capitalization requirement that attaches to accrued section 162 deductions would have effectively negated the deduction in many instances. It argues that the recently finalized capitalization regulations¹⁰ would allow corporations to deduct most of their charitable gifts immediately under section 162. Finally, Part V argues that the availability of only a section 162 deduction might do more to encourage total corporate spending on a broad range of desirable goals — such as living wages and health insurance for workers and environmental protection, in addition to payments to nonprofit organizations — and there is no reason to privilege corporate gifts to section 501(c)(3) organizations over current expenditures for workers, community, and the natural environment in which the company operates, or vice versa.

II. CURRENT LAW PROBLEMS

A. Bias

The tax law has long contained a bias in favor of charitable giving by corporations compared to charitable giving by individual shareholders following distributions by corporations. In a system with a separate corporate tax, a charitable contribution made by a corporation and deducted at the corporate level can generally be larger than a contribution that an individual shareholder can make out of a corporate distribution of the same available funds because the corporate tax burdens the funds distributed to shareholders, but not the funds contributed to charity.¹¹ The tax law's bias in favor of corporate philanthropy compared to individual philanthropy out of corporate distributions could suggest a governmental policy in favor of charitable giving by corporations. But there is no evidence that Congress purposely adopted such a policy; the bias arose out of the basic operation of a classical system of taxation in conjunction with an

¹⁰ Treas. Reg. § 1.263(a) (2004).

¹¹ The section 170 deduction zeroes out the tax on the contributed amount, regardless of the corporation's marginal rate.

ordinary-income rate applicable to dividends received by shareholders, rather than out of any articulated federal policy in favor of corporate philanthropy over shareholder philanthropy. A review of the history surrounding the adoption of the deduction for charitable giving by corporations makes it clear that Congress was unaware of the bias that it was creating. It seems rather that Congress believed that it was putting corporate philanthropy on a level equivalent to individual philanthropy.¹²

Despite the fact that the bias was accidental, policymakers should long ago have considered whether it makes sense to have a tax system that privileges giving by corporations. There was never any compelling reason to subsidize corporate contributions more than contributions made by shareholders out of dividends they have received. If there is no connection to corporate business or the better information or expertise that corporations have, there is no reason to have a federal policy in the Code that prefers giving at the corporate level.¹³ In addition, as discussed below, under current law the bias might be in favor of corporate giving for some taxpayers and in favor of individual giving out of dividends for other taxpayers, demonstrating an incoherent federal policy concerning charitable giving by corporations and shareholders.

What is the bias? Consider the following example: A corporation, which has a marginal tax rate of 35%, has just earned \$100 cash income that it does not need for operations. It can either pay the amount out to its shareholders as a dividend or it can give the amount to charity. For purposes of this comparison, assume that the shareholders who receive a distribution would contribute that amount to charity. The Code provides a charitable deduction to whichever taxpayer makes the contribution, the corporation or the shareholder. If they are each subject to a marginal rate of 35%, then it would not seem to matter where the contribution was made.

But it always has mattered because of the corporate tax. If the

¹² When Congress adopted the deduction for corporations in the Revenue Act of 1935, the Ways and Means Committee Report stated: "If corporations are public spirited enough to make contributions to charities, we believe their contributions for such purposes should be exempt from taxation *exactly as is done in the case of individuals.*" H.R. REP. NO. 74-1681, at 20 (1935), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, at 286 (1938) (emphasis added).

¹³ I have previously made this argument. See Linda Sugin, *Theories of the Corporation and the Tax Treatment of Corporate Philanthropy*, 41 N.Y.L. SCH. L. REV. 835 (1997).

corporation makes the contribution, the amount received by the charity is \$100 because the \$100 taxable income to the corporation is offset by a \$100 section 170 deduction on account of the gift. If the individual makes the contribution, the corporation receives no deduction for the distribution and must pay tax at the corporate level. Consequently, the shareholder only starts out with \$65, the net dividend from the corporation. If the shareholder donates that amount to charity, the inclusion of the dividend in income is offset by a deduction for the contribution, allowing the shareholder to pay the full amount of the dividend to charity, without any diminution on account of tax. This is illustrated as Example 1 in the succeeding chart.

Prior to the adoption of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA),¹⁴ the rate of dividend inclusion and charitable deduction to shareholders was the same, so that an individual shareholder would always have a wash on the receipt of a dividend followed by a charitable contribution (assuming full deductibility).¹⁵ The amount of the bias depended solely on the rate of tax to which the corporation was subject because it was a by-product of the corporate tax. If a corporation had a 30% rate of tax and \$100 earnings, the corporate contribution could be \$100 compared to the shareholder's equivalent contribution of \$70. A 50% corporate rate would mean a \$100 corporate contribution compared to a \$50 shareholder contribution. The higher the corporate rate, the more bias existed.

The JGTRRA's reduction in the tax rate applicable to dividends received by individual shareholders changes this analysis because the inclusion and deduction at the shareholder level are now likely to be at different rates of tax. The rate change created a mismatch for shareholders between the inclusion of the dividend and the corresponding charitable deduction. New section 1(h)(11) thereby reduced the bias in favor of corporate giving, but did not eliminate it altogether. Under current law, it may still be true that the corporate tax makes giving at the corporate level more attractive than giving at the shareholder level.

JGTRRA changes the prior example as follows: When the shareholder receives the \$65 dividend, she will include it in income at

¹⁴ Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752.

¹⁵ This analysis ignores the dividend received deduction for corporations because it models the problem of corporations compared to individuals.

the 15% rate, but she can still deduct her charitable contribution at her marginal rate of tax, which may be as high as 35%.¹⁶ This allows the taxpayer to gross up her dividend received by her marginal rate less 15%. The \$65 distribution is subject to \$9.75 in income tax, netting \$55.25 after tax.¹⁷ Following through on the comparison, if she contributes it to charity, she will deduct the full amount of the contribution at her marginal rate. So she can deduct $\$55.25 \times 1/(1 - 0.35) = \85 . The extra \$29.75 is essentially financed by the federal government on account of the difference between the rate of tax applicable to the deduction and the rate on the inclusion, a mismatch in the charity's favor. While the individual contribution here is larger than in Example 1, the \$85 equivalent donation at the shareholder level is still less than the \$100 contribution possible at the corporate level. Therefore, the greatest federal subsidy of charitable giving still occurs when the corporation makes the donation, rather than the shareholder. Although the difference between the size of the corporate and shareholder gifts is smaller than it was prior to 2003, it is still large enough to detect a bias in favor of charitable gifts at the corporate level. In short, under these assumptions, a charity gets a bigger donation if it comes straight from the corporation than if it is paid out to the shareholder as a dividend first, with the federal fisc making up the difference. This is illustrated in Example 2 in the succeeding chart.

Both of these examples assume the corporation pays tax at the statutory 35% rate.¹⁸ But in addition to the 2003 cuts in the dividend rate, relevant changes have been occurring in the corporate tax. While the statute has remained the same, the tax actually paid by corporations has declined over time,¹⁹ and most corporations pay little or no tax.²⁰ This additional consideration fundamentally changes the bias question because it creates the possibility that a shareholder could make a larger donation out of dividend funds than a

¹⁶ See I.R.C. § 1(a).

¹⁷ This is the amount the shareholder could spend on non-deductible consumption out of the dividend received.

¹⁸ I.R.C. § 11.

¹⁹ See Adam Carasso, *The Corporate Income Tax in the Post-War Era*, 98 TAX NOTES 1415, 1415 (Mar. 3, 2003) ("The corporate income tax has been in steady decline since World War II . . ."); Patrice E. Treubert, *Corporation Income Tax Returns, 2001*, STAT. OF INCOME BULL., Summer 2004, at 118, 118 (finding that corporate income tax paid to the federal government decreased by 18.3% from 2000 to 2001).

²⁰ See GAO, COMPARISON, *supra* note 8, at 6–7.

corporation could have made with those same funds.

Consider this example: Assume that a corporation pays tax at a lower rate than its shareholders.²¹ If a corporation is subject to a 15% rate of tax and the shareholders are subject to a 35% rate, then a contribution would be bigger at the shareholder level than the corporate level. With \$100 in earnings that it can either distribute to shareholders or contribute to charity, the corporation can (as in the other examples) contribute \$100 to charity because regardless of its tax rate, the \$100 inclusion is offset by a \$100 section 170 deduction. If instead it distributes the amount to shareholders as a dividend, the shareholders will receive \$85 after payment of the corporate tax. Because dividends are taxed to individuals at a maximum rate of 15%, the shareholders then have \$72.25 to spend on consumption. But, if the shareholders contribute the amount received to charity, the deduction is at 35%, allowing the shareholder to gross up her contribution to an amount in excess of the corporation's would-be contribution. Grossed-up, the contribution is equal to the dividend received divided by one minus the tax rate. Thus, the shareholder can fund a \$111 contribution with the dividend received and the tax savings.²² This is illustrated as Example 3 in the succeeding chart.²³

This gross-up effect is magnified as the corporate rate goes down. Where the corporation pays no tax, the bias is significantly in favor of dividends followed by shareholder charitable giving. When dividends were taxed at the same rate as ordinary income, a zero rate on corporate income would erase any bias because \$100 earnings would produce \$100 dividend or \$100 contribution at either the corporate or shareholder level. The final example in the chart illustrates the advantages of shareholder giving under the post-JGTRRA tax regime

²¹ This is not an unrealistic assumption since the statutory top rates are the same, but corporations have been very successful in reducing their effective rates of tax. See *id.*; see also George K. Yin, *How Much Tax Do Large Public Corporations Pay?: Estimating the Effective Tax Rates of the S&P 500*, 89 VA. L. REV. 1793, 1799 (2003) (finding that various industries had six-year average effective tax rates of as low as 25.72%). The data in the GAO study compares average rates, not marginal rates. Marginal rates are relevant for determining the value of deductions. The 61% of corporations with no tax liability have a marginal rate of zero. Corporations with low effective (average) rates of tax may have marginal rates of 35% because the graduation of rates in section 11 is minimal. In those cases, Example 2 would provide the relevant analysis.

²² $72.75 / (1 - 0.35) = 111.15$.

²³ These examples assume that the individual taxpayer can use the charitable deduction in full, without the limitations in section 170(b).

for corporations that have managed to reduce their rate of tax to zero.²⁴

ILLUSTRATION 1.

	Example 1	Example 2	Example 3	Example 4
Corporate Rate	35%	35%	15%	0%
Individual Rate	35%	35%	35%	35%
Dividend Rate	35%	15%	15%	15%
Corporate Earnings	\$100	\$100	\$100	\$100
Corporate Gift	\$100*	\$100	\$100	\$100
Individual Income	\$65	\$65	\$85	\$100
Individual Gift	\$65	\$85	\$111	\$131

*The optimal gifts are in bold. Figures have been rounded.

These examples illustrate why the section 170 deduction for corporations should no longer be understood to reflect a strong policy in favor of corporate charitable giving. Depending on the tax profile of corporations and their shareholders, maximizing the federal subsidy for charitable giving is a tricky exercise. It is unlikely that corporations could reasonably engage in this analysis to determine whether the policy is in their favor in any particular case because they need too much information about their shareholders. If shareholders are subject to no tax on their ordinary income, there is no gross-up effect from the mismatch.²⁵

These examples also show how the federal subsidy for charitable giving is subject to the vagaries of tax rates and the unique circumstances of particular corporations and individual shareholders, conditions that may change without any attention paid to their coincidental effects on section 501(c)(3) organizations. Why should the Code encourage corporations to give to charity when shareholders would be encouraged to give even more, as is most starkly the case in

²⁴ To compute the individual gift amount: $85/(1 - 0.35) = 130.77$.

²⁵ For low-income taxpayers, dividends are taxed at 5% (0% after 2007), preserving the arbitrage effect for them. See I.R.C. § 1(h)(1)(B).

the last example above? If the goal is to maximize charitable giving, the Code should encourage the taxpayer with the largest value deduction to make the gift.

Critics may argue that the Code should encourage corporate giving in this way because the alternative may reduce overall charitable giving. If section 170 were repealed for corporations, then corporations might reduce their charitable giving, without any guarantee that shareholders would pick up the slack. It is possible that section 170 best supports charities by splitting the deduction among potential donors. But, as I argue below, corporations would still be likely to make the most welfare-enhancing contributions they make today, using the section 162 deduction. The welfare-reducing contributions are the ones most likely to decline. Of course, it is impossible to predict whether corporations would, in fact, change either their overall level of philanthropy or the recipient organizations. If they would, policymakers need to consider whether current policy, which effectively tricks shareholders into making larger total charitable gifts than they otherwise would, is desirable. If we want to encourage shareholders to give more to charity, a better policy would be to adjust the incentives more directly to target their behavior.

Technically, the bias problem is the same under section 162 — the Code privileges corporate business expenses, compared to dividends. This is the well-known discrepancy between the treatment of dividends and the treatment of interest expense. There is an important difference, however, which should make us comfortable with the section 162 expenses at the corporate level. By definition, section 162 expenses are incurred in the production of income. They are necessary to determine the corporation's profitability and they are incurred so as to increase that profitability. Section 162 expenses maximize the corporation's wealth because they contribute to the business. In contrast, section 170 expenses can be wealth-reducing for the corporation. Therefore, there are synergies in the business expense model that can create greater overall welfare than are possible in section 170's wealth-transfer model.²⁶ Bias is only

²⁶ The corollary issue within the section 162 context is connected to the more broadly studied issue concerning the reduction in rates on dividends received by individuals. That is, whether corporations would (and should) pay more out in dividends on account of that change. With a reduced tax toll charge on paying dividends, corporate managers need to justify retaining earnings by providing higher rates of return in the corporation than they would have needed to produce prior to the rate reduction. This is because shareholders receiving dividends have less to

troublesome if the expenses are not income-producing; section 162 explains why the corporation is the proper taxpayer to have the deduction.

B. Agency Costs

In the last few decades, the agency-cost problem of corporate philanthropy has received an increasing amount of attention. Both the popular press and the academic literature are replete with discussion of corporate philanthropy that does more to achieve the private interests of managers than either the public interest, which is the concern of charitable organizations, or the shareholders' interest, which is the concern of corporate governance.²⁷ The problem seems primarily to be one related to executive compensation; corporate philanthropy that allows managers to support their favorite causes and enjoy the prestige benefits of that support is simply a managerial perquisite.²⁸

Conrad Black of Hollinger embodied the abuses that corporate managers could commit in the context of corporate philanthropy, as the internal investigation of the company reported:

Between 1996 and 2003, Hollinger and its subsidiaries donated at least \$6.5 million to hundreds of charities in the

invest, after payment of the tax, than retaining corporations, which can effectively invest a pre-tax amount. The most recent evidence suggests that corporations have responded to the rate cuts by increasing dividend payout rates. See Gene Amromin et al., *How Did the 2003 Dividend Tax Cut Affect Stock Prices and Corporate Payout Policy?* (Fin. & Econ. Discussion Series, Working Paper No. 2005-57, 2005), available at <http://ssrn.com/abstract=873879>; Steven Bank, *Dividends and Tax Policy in the Long Run* (UCLA Sch. of Law, Law-Econ Research Paper No. 06-06, 2006), available at <http://ssrn.com/abstract=886583>; Jennifer L. Blouin et al., *The Initial Impact of the 2003 Reduction in the Dividend Tax Rate* (Oct. 2004) (unpublished manuscript, available at <http://ssrn.com/abstract=462542>).

²⁷ See Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem*, 41 N.Y.L. SCH. L. REV. 1147 (1997); Melvin Aron Eisenberg, *Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure*, 28 STETSON L. REV. 1 (1998); Faith Stevelman Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997); Sugin, *supra* note 13; Symposium, *Corporate Social Responsibility: Paradigm or Paradox?*, 84 CORNELL L. REV. 1282 (1999).

²⁸ I have argued that the tax law should recognize this as executive compensation where appropriate and tax the executives accordingly. See Sugin, *supra* note 13, at 871-72.

United States, Canada, the United Kingdom and Israel. The Special Committee recognizes the value and importance of charitable giving by corporations, and believes that the Company should make contributions to charitable causes in reasonable amounts, and under appropriate approval procedures. The beneficiaries of corporate charitable donations ought to be the charities (through their receipt of the funds) and the donating corporations (through reputational and other intangible benefits, as well as any tax benefits). As detailed below, however, Hollinger's charitable giving during this time period was tainted by a number of factors, including Black's and Radler's usurpation of public credit for Hollinger's charitable giving. While [the company] had charitable trusts with established donation parameters, Black and Radler also arranged on many occasions for donations to be made without adhering to those strictures. Moreover, many of Hollinger's charitable donations were made to organizations selected by Black, Amiel Black, and Radler, and often were publicly attributed to them, not to the Company. . . . Without consulting outside experts, the Audit Committee or the Board, Black and Radler directed thousands of Hollinger's dollars in contributions to pet charities of their friends and other Hollinger directors, even in years when Hollinger reported a net loss. In return, they often served on charity boards or attended lavish events, particularly in New York. Hollinger never publicly disclosed its charitable donations or the benefits that the Blacks and Radlers received through the shareholders' gifts.²⁹

The section 170 deduction for corporations may be the reason why corporate philanthropy is an agency-cost problem that benefits managers in the same way as executive compensation. Section 170 is oblivious to corporate governance issues; it does not require that contributions be in the best interest of the business of the corporation, does not require that the public benefits outweigh any loss suffered by the corporation, and provides no limit on the discretionary power of managers.

²⁹ GORDON A. PARIS ET AL., REPORT OF INVESTIGATION BY THE SPECIAL COMMITTEE OF THE BOARD OF DIRECTORS OF HOLLINGER INTERNATIONAL INC. 409-10 (2004), available at <http://www.sec.gov/Archives/edgar/data/868512/000095012304010413/y01437exv99w2.htm>.

The Delaware courts have incorporated this insensitivity into state law by adopting the Code's standards in determining whether a contribution is reasonable in amount and reasonable in purpose under Delaware law, so any amount that would be properly deducted under section 170 is presumed acceptable under state law.³⁰ In addition, there is no federal regulation outside of the Code — no substantive Securities and Exchange Commission (SEC) regulation and not even a requirement that corporations disclose their charitable activities.³¹

Although these costs can add up, as agency-cost problems go, corporate philanthropy is low on the list.³² The problem of explicit executive compensation in the forms of cash, stock, and perks — compared to the implicit compensation in controlling corporate philanthropy — so dwarfs the agency costs of corporate charitable giving that it is reasonable to argue that we should just ignore the problem in corporate philanthropy.³³ The egregious examples like

³⁰ *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969); see also Sugin, *supra* note 13, at 857.

³¹ There have been efforts to adopt such a rule. In 1997, Rep. Paul Gillmor proposed two bills requiring corporate disclosure and shareholder participation in charitable giving. H.R. 944, 105th Cong. (1997); H.R. 945, 105th Cong. (1997). Rep. Gillmor introduced a similar bill in 2002 targeting donations to organizations affiliated with corporate officers and directors. H.R. 3745, 107th Cong. (2002). An initial draft of the Sarbanes-Oxley Act in the House, H.R. 3763, 107th Cong. § 7(a)(2) (as passed by House, Apr. 24, 2002), included a disclosure requirement for a corporation's charitable gifts and its board members' charitable organization affiliations but the adopted legislation failed to do so. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. The New York Stock Exchange Listing Standards include the following rule:

[A] listed company shall disclose . . . contributions made by the listed company to any tax exempt organization in which any independent director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year from the listed company to the organization exceeded the greater of \$1 million, or 2% of such tax exempt organization's consolidated gross revenues.

NYSE, Inc., Listed Company Manual § 303A.02(b) (2004). For a fuller discussion of these developments, see Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

³² Einer Elhauge argues that agency-cost donations are likely to substitute for other agency costs, rather than increase total agency costs, and therefore, on net, are more likely to increase shareholder welfare than other agency costs. See Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 835-39 (2005).

³³ Even in the Hollinger debacle, charitable giving abuses were only one of many examples of overreaching and self-interest described in the report. See PARIS ET AL.,

Hollinger, in which a founding shareholder treated a public company like his personal fiefdom, or the Delaware case of *Kahn v. Sullivan*,³⁴ in which Occidental built a museum to satisfy the ego of its megalomaniacal CEO, are few and far between. Most managers are not that powerful or shameless, nor are they that creative in their self-aggrandizement. The Delaware courts have long taken a passive approach, which explains why Armand Hammer succeeded in building his museum despite chancery court review.³⁵ The implicit assumption underlying this hands-off approach is that the public benefits from section 501(c)(3) organizations are sufficient to justify a wealth transfer from corporate shareholders to a charity's beneficiaries. In fact, the classic cases explicitly highlight the benefits to the recipient charitable beneficiaries, compared to the magnitude of the loss to the corporation's shareholders.³⁶ From a welfarist perspective, transferring money from shareholders to charitable organizations of all sorts is likely to increase overall societal welfare, either because the organizations produce public goods that benefit more people than the corporation or because the beneficiaries of charitable organizations have higher marginal utility for the benefits they receive. Even with the loss of value from agency costs, the total welfare gains to society from corporate philanthropy are likely to dwarf the loss to shareholders.

Nevertheless, the welfare gains could be increased if the law could better distinguish agency-cost philanthropy from welfare-maximizing

supra note 29, at 60–71. Conrad Black and his associates managed to siphon off virtually all the corporation's profits. *See id.* at 1.

³⁴ 594 A.2d 48 (Del. 1991).

³⁵ In *Kahn*, the court reviewed a settlement of shareholder litigation that allowed the challenged project to go forward with minor changes. *Id.*

³⁶ *See Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969). In this case, the court stated:

It is accordingly obvious, in my opinion, that the relatively small loss of immediate income otherwise payable to . . . stockholders, had it not been for the gift in question, is far out-weighted by the overall benefits flowing from the placing of such gift in channels where it serves to benefit those in need

Id.; *see also* *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581, 590 (N.J. 1953) (“[T]here is now widespread belief throughout the nation that free and vigorous non-governmental institutions of learning are vital to our democracy and the system of free enterprise and that withdrawal of corporate authority to make such contributions within reasonable limits would seriously threaten their continuance.”). In *Theodora*, the court also noted that the contribution only cost the shareholders fifteen cents per dollar of contribution. 257 A.2d at 405.

philanthropy. The choice is not only between allowing all corporate philanthropy or prohibiting it all. The challenge is to isolate only the welfare-reducing examples of agency-cost philanthropy while allowing the rest to flourish. Scholars have suggested that shareholders could decide if they approve of the corporation's charitable choices and a disclosure requirement would enable shareholders to sell their stock if they disagreed with the philanthropic choices the managers made.³⁷ But a disclosure requirement is likely to be ineffectual because shareholders do not pay attention to disclosure, and even if they did, they would be unlikely to make ownership decisions based on the corporation's decision to give away a very small percentage of the company's profits. The only exception to this expectation of reasonable shareholder apathy might be highly publicized gifts to politically charged causes.³⁸ Replacing the section 170 deduction with a deduction under section 162 is a better approach than disclosure because it does not rely on shareholder activism, but rather imposes obligations on the corporate bureaucracy to substantiate its expenses. It also reins in the unfettered freedom that section 170 now gives managers to donate up to 10% of the corporation's income to any section 501(c)(3) organization they choose, subject only to internal governance constraints that a board might choose to adopt.³⁹ It is only for the small set of corporate contributions that are not justified by the corporation's business that a separate deduction under section 170 is necessary, and as the next section discusses, those are a shrinking subset of all corporate philanthropic expenditures.

C. *Strategic Philanthropy, Philanthropic Operations, and the Duberstein Standard*

The use of the word "bias" in Part II.A, rather than "incentive," is deliberate because there is no evidence that the deduction for charitable contributions of corporations causes them to give amounts to charity, rather than paying the amount out as a dividend. Rather than providing an incentive to give, section 170 is more likely to provide a safe harbor because it insulates the corporation from any inquiry regarding business connection under either state or federal tax law. In fact, there is significant evidence that corporations generally make charitable donations in furtherance of their business — either

³⁷ See *supra* note 31 and accompanying text.

³⁸ See *infra* Part III.B.

³⁹ Hollinger had corporate procedures in place, so the mere existence of such procedures is clearly insufficient to prevent abuse.

with respect to their employees, customers, or the communities in which they operate. Most corporate charitable giving can easily fit within the requirements of section 162's deduction for ordinary and necessary business expenses. This is ironic because the strong business flavor of most corporate giving should create a problem for claiming a charitable deduction. Section 170 requires that the taxpayer claiming a deduction make a "contribution or gift," which means that the payor has no expectation of return benefits.⁴⁰ At this point, it seems purely historical that section 170 controls these payments.

At the same time that corporate payments to charities look less like "gifts," some ordinary business decisions appear to be quite "philanthropic" because they sacrifice profits in the ordinary operations of the business in order to satisfy moral or cultural norms.⁴¹ The traditional view of corporate charitable donations as the paradigm case of a profit-sacrificing decision⁴² has broken down as greater attention focuses on the social issues raised by corporations' ordinary business operations.⁴³ Today, expenditures made in the ordinary course of operations might be less profit-maximizing than payments made to charities.⁴⁴ When a corporation chooses to operate in a manner that costs more, but preserves the environment or workers' jobs, the tax law treats those costs as ordinary and necessary

⁴⁰ I.R.C. § 170(c). The regulation states:

Transfers of property to an organization described in section 170(c) which bear a direct relationship to the taxpayer's trade or business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. See section 162 and the regulations thereunder.

Treas. Reg. § 1.170A-1(c)(5) (2005).

⁴¹ See generally Elhauge, *supra* note 32.

⁴² The basic corporations textbooks use it as a case study for ultra vires activities. See, e.g., JEFFREY D. BAUMAN ET AL., CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS 125-43 (5th ed. 2003); MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 134-43 (9th ed., unabr. 2005).

⁴³ See Brennen Jensen, *Good Works Not Enough to Bolster Business Image*, CHRON. PHILANTHROPY, Aug 4, 2005, at 20, 20 (reporting survey results in which consumers expressed more concern about corporations treating their employees well and less concern about donations to charity); Williams, *supra* note 31, at 1284-89.

⁴⁴ Einer Elhauge concludes that corporate donations to charity are more likely to increase corporate profits as compared to other agency-cost decisions that managers make. See Elhauge, *supra* note 32, at 835-37. This makes the section 162 and section 170 dichotomy appear to be backwards.

business expenses, even if they were demonstrably unnecessary to the production of business income. It is similarly insensitive to the profit-maximizing payments to charities.

The Supreme Court's interpretation of "gift" implies something given out of "detached and disinterested generosity."⁴⁵ Obviously, a corporation never does anything with feelings of generosity.⁴⁶ But the application of section 170 has finessed that problem by using a quid pro quo analysis to determine whether there has been a gift.⁴⁷ Thus, a deduction is allowed under section 170 if the taxpayer gets no benefit in return for the payment. For individuals, this makes a lot of sense. The quid pro quo requirement operates to distinguish personal consumption, which is taxable, from other reductions in a taxpayer's resources that do not constitute consumption and therefore reflect reductions in personal resources that do not need to be taxed. But a taxable-consumption analysis is incoherent for corporations because corporations never enjoy taxable consumption — all expenses should be deductible for corporations. In computing the corporate tax, the challenge is to identify nondeductible distributions, as opposed to consumption. Thus, incorporation of the individual consumption-based standard into the corporate realm is a poor fit. Section 170's quid pro quo analysis authorizes a deduction for corporations only in cases in which there is no benefit to the corporation, but the corporation would also be entitled to a deduction, albeit under section 162, if it did receive a benefit.⁴⁸ The distinction in the corporate

⁴⁵ Commissioner v. Duberstein, 363 U.S. 278, 285 (1960). See also DeJong v. Commissioner, 309 F.2d 373, 379 (9th Cir. 1962) (imposing this requirement on taxpayers claiming charitable contribution deductions).

⁴⁶ See, e.g., United States v. Transamerica Corp., 392 F.2d 522 (9th Cir. 1968). In *Transamerica*, the court stated:

It does not seem appropriate, however, to demand of a corporate entity such impulses as affection, respect or admiration. Further, an absolute requirement of detached and disinterested generosity or lack of any business purpose would tend to render ultra vires substantially all charitable contributions and thus to frustrate the congressional intent that corporations should enjoy such deductions.

Id. at 524. See Sugin, *supra* note 13, at 846–55, for a discussion of the personification of the corporation in connection with the section 170 deduction.

⁴⁷ See Douglas A. Kahn & Jeffrey H. Kahn, "Gifts, Gifts, and Gifts" — *The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441, 495–512 (2003) (providing an overview of corporate charitable deduction gift requirements).

⁴⁸ The Joint Committee on Taxation explains that "a business transfer made

context is without a meaningful difference, even though that difference is crucial for individuals. The absence of return benefit might serve to distinguish the agency-cost situations that corporations should best avoid from the profit-maximizing donations and, incongruously, make them deductible. But most corporate philanthropy should fail a rigorous application of the quid pro quo requirement precisely because the corporation does expect a benefit. If the Internal Revenue Service (Service) decided to enforce that requirement, we could expect many expenditures moving to the section 162 column.

A further problem with the quid pro quo analysis is that it could be applied to disallow deductions for many items that have long seemed to fall squarely within section 162. Corporate managers have discretion to choose more expensive methods for doing business over less expensive ones, for whatever reason they determine is appropriate because their decisions on business matters are protected from judicial scrutiny by the business judgment rule. This is true for simply foolish decisions that corporate managers make as well as decisions made purposely to provide public benefits. For example, a mining company might engage in more expensive shaft extraction, rather than cheaper strip mining in order to preserve the environment, even if there is demonstrably no difference in revenues that it would make using one or the other method. While the extra cost for the more environmentally responsible method is in the nature of expenditures without corresponding return, there is no argument that the extra cost is a section 170 expense, rather than a section 162 expense. But the impulse behind the decision is precisely the same as giving the equivalent sum to an exempt organization that engages in land reclamation or environmental preservation.

Similarly, some of the most salient issues in corporate responsibility, such as living wages or health benefits, could also be in the gray area between profit-maximizing and profit-sacrificing behavior. The argument can surely be made that increased wages translate into increased productivity. But that is not necessarily the case. If Wal-Mart increases its health insurance coverage for employees in response to social pressure, the company is likely to be

with a reasonable expectation of financial return commensurate with the amount of the transfer is not deductible as a charitable contribution, but may be deductible under section 162.” STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., DESCRIPTION AND ANALYSIS OF PRESENT LAW AND PROPOSALS TO EXPAND FEDERAL TAX INCENTIVES FOR CHARITABLE GIVING, at 5–6 (Joint Comm. Print 2001), *available at* <http://www.house.gov/jct/x-13-01.pdf>.

less profitable, not more.⁴⁹ The ability to argue away the issue by pointing to corporate benefits is precisely the same for both external and internal philanthropic expenses.

There are two seemingly inconsistent trends in corporate philanthropy. One powerful trend is a clear movement toward “strategic philanthropy,” in which corporations use charitable giving as a mechanism for producing corporate benefits beyond marketing and goodwill building.⁵⁰ The other trend is toward segregation of corporate giving into independent foundations that address the agency-cost problems by formally separating corporate management from philanthropic decisions.⁵¹ The strategic approach to corporate giving makes it integral to the business of a corporation and virtually indistinguishable from a wide range of other corporate investments, but for the fact that nonprofit organizations carry out the operations. Proponents of strategic philanthropy encourage corporations to create synergistic relationships with nonprofit organizations that will inure to both the short-term and long-term benefits of the corporation. They claim that corporations can create the most social value in the charitable context by harnessing the unique skills they have developed conducting their businesses. For example, Cisco created the Cisco Networking Academy, which teaches network administration to secondary and post-secondary school students, particularly in needy communities. The program is a good example of strategic philanthropy because it makes good use of Cisco’s expertise to create social benefits, prepares students for technology careers, and also increases the demand for Cisco’s products by developing the skills that demand the type of products that Cisco makes.⁵²

Strategic philanthropy creates little trouble for corporate law. It presents minimal agency-cost problems because it is integral to the business and designed to maximize business benefits.⁵³ Because it

⁴⁹ See Jason Furman, *Wal-Mart: A Progressive Success Story* (Nov. 28, 2005) (on file with author), available at http://www.americanprogress.org/atf/cf/{E9245FE4-9A2B-43C7-A521-5D6FF2E06E03}/WALMART_PROGRESSIVE.PDF (stating that if Wal-Mart expanded its health benefits or increased wages \$5000 per employee, “it would be virtually wiped out”).

⁵⁰ See Porter & Kramer, *supra* note 2, at 57.

⁵¹ See James D. Werbel & Suzanne M. Carter, *The CEO’s Influence on Corporate Foundation Giving*, 40 J. BUS. ETHICS 47, 48 (2002).

⁵² See Porter & Kramer, *supra* note 2, at 64–65.

⁵³ Michael Porter and Mark Kramer argue:

Moving to context-focused philanthropy will . . . mean tightly integrating the management of philanthropy with other company activities. Rather

capitalizes on the unique expertise that a business possesses, the social benefits are potentially much larger than they would be with other kinds of corporate philanthropy, a factor that courts have found important.⁵⁴ If Cisco simply donated its products, without teaching people how to use them, the social value from its philanthropy would be much lower than it is with the knowledge component attached.⁵⁵

Nevertheless, strategic philanthropy does create confusion in the tax law because the Code requires that corporations separate payments that are contributions from those that are business expenses, whereas strategic philanthropy is about entwining those two things in such a way that there is no principled distinction between them. The Code encourages strict separation between payments that are gifts and payments that are strategic, even though the business literature has powerfully argued that the most social value is created when that separation is abandoned.⁵⁶ We do not have a rule that calls all payments to exempt organizations “charitable.” Fees for services and product purchases from nonprofit organizations have never been deductible under section 170.

The Code’s classification is particularly problematic in a growing area of strategic philanthropy — international giving. Companies invest in health, education, and the environment in areas in which they operate. Americans are becoming increasingly attuned to the substantial needs for charities overseas, as evidenced by the tremendous outpouring of support for victims of the 2004 tsunami.⁵⁷

than delegating philanthropy entirely to a public relations department or the staff of a corporate foundation, the CEO must lead the entire management team through a disciplined process to identify and implement a corporate giving strategy focused on improving context.

Id. at 67.

⁵⁴ See *supra* note 36 and accompanying text.

⁵⁵ One problem with strategic philanthropy is that it may overlook the neediest, who are likely to be too poor, sick, or old, to engage in the dynamic that mutually benefits nonprofits and businesses. An understanding of corporate philanthropy that recognizes its distinction from altruism should inform the law so that the Internal Revenue Code (Code) better encourages individual giving and Congress provides government funding where it is most needed.

⁵⁶ See Betty S. Coffey & Jia Wang, *Board Diversity and Managerial Control as Predictors of Corporate Social Performance*, 17 J. BUS. ETHICS 1595 (1998); Debbie Thorne McAlister & Linda Ferrell, *The Role of Strategic Philanthropy in Marketing Strategy*, 36 EUR. J. MARKETING 689 (2002); Porter & Kramer, *supra* note 2; Craig Smith, *The New Corporate Philanthropy*, HARV. BUS. REV., May 1994, at 105.

⁵⁷ See CTR. ON PHILANTHROPY AT IND. UNIV., GIVING USA FOUNDATION, GIVING USA 2005, at 59 (2005) [hereinafter GIVING USA 2005] (stating that more than one-third of American households contributed to tsunami relief and more

Philanthropic investments overseas are subject to hurdles that straight business investments do not face because section 170(c) only authorizes a deduction for contributions to U.S. organizations and for use within the United States.⁵⁸

Even where it falls short of the ideal of strategic philanthropy, business benefit is undoubtedly the prime driver of corporate giving.⁵⁹ The evidence overwhelmingly suggests that corporations give because it affects customer preferences and increases their loyalty, it fosters employee recruitment and retention, and the public expects it as a normal part of business.⁶⁰ The business connection between corporations and their philanthropy is borne out not only by what they say, but also by where they give.⁶¹ Corporate charity overwhelmingly supports projects that are related to either employees, customers, or communities in which the business operates.⁶² For example, the recipients of a pharmaceutical company's generosity are health-related charities and science education, which translates into benefits for the corporation because better health care requires more medications and better science education creates more qualified employees.⁶³ Microsoft provides "technology skills" all over

money was raised from Americans than for any other crisis, except the September 11 terrorist attacks).

⁵⁸ Contributions that benefit overseas projects must go through a domestic charity that reviews and approves the overseas project and retains control over the funds. Rev. Rul. 66-79, 1966-1 C.B. 48. See generally Robert Paine, *The Tax Treatment of International Philanthropy and Public Policy*, 19 AKRON TAX J. 1 (2004).

⁵⁹ See, e.g., DORIS RUBENSTEIN, *THE GOOD CORPORATE CITIZEN: A PRACTICAL GUIDE* 11-15 (2004).

⁶⁰ See Council on Foundations Frequently Asked Questions, <http://www.cof.org/FAQDetail.cfm?ItemNumber=726> (last visited Aug. 21, 2006); see also, Ann D. Getman & Martin Cohn, *Corporate Philanthropy Comes of Age: The Benefits of Doing Well by Doing Good* (May 17, 2006), http://www.prarticlelibrary.com/NonProfit_Philanthropy/CorporatePhilanthropyComesofAge.htm (describing how corporate giving inured to the benefit of various businesses).

⁶¹ For example, Wal-Mart's website, quoting Betsy Reithemeyer, vice president for corporate affairs, states that, "[I]t has always been our goal to look for ways we can help improve the local communities where our Company associates and customers live . . ." Press Release, Wal-Mart Stores, Inc., Wal-Mart Stores, Inc. Total Charitable Giving for 2004 Exceeded \$170M (Feb. 15, 2005), <http://www.walmartfacts.com/articles/2332.aspx>.

⁶² See Ian Wilhelm, *Company Giving Habits Influence Workers, Consumers, Two Studies Find*, CHRON. PHILANTHROPY, Oct. 28, 2004, at 12, 12.

⁶³ See Merck & Co., Inc., Proxy Statement (Form DEF 14A), at 25 (Mar. 17, 1997), for the Merck board's explanation of its charitable support for medical and scientific education: "Training physicians and scientists benefits society as a whole,

the world, creating demand for its products.⁶⁴ Retail companies would be expected to appeal more to customers than companies that do not face the public. So it is not surprising that connected to America's biggest retailer is the country's most generous corporate foundation,⁶⁵ focusing its charitable efforts on two core stakeholders — customers and employees. Its largest program supports charities in the communities in which its stores are based, matching fundraising by organizations that hold their fundraising drives at its stores.⁶⁶ Those fundraising drives undoubtedly affect immediate business at the stores, in addition to producing more diffuse goodwill benefits. Wal-Mart also supports charities favored by its employees, matching their charitable contributions and donating money to the charities where employees volunteer their time,⁶⁷ and it funds scholarships for children of employees.⁶⁸ Similarly focusing on employee interests, IBM gives over 75% of its philanthropy dollars to matching employee

while enhancing and broadening the pool of scientific talent that the Company may draw upon for its employees.” It also reported that approximately 80% of its donations consisted of providing medicines that it manufactures. *Id.*; see also Pfizer Found., Inc. 2003 Form 990-PF, <http://www.guidestar.org/FinDocuments/2003/136/083/2003-136083839-1-F.pdf> (last visited Aug. 21, 2006) (listing medical-related recipients of corporate donations). Proxy statements are not required to include information about charitable giving, but Merck included the information in response to a shareholder proposal. See *infra* text accompanying note 125. While Form 990 does not give all information about recipients, foundations that support foreign organizations include significant information on their tax returns pursuant to the expenditure responsibility requirement in section 4945(h)(3).

⁶⁴ See Microsoft Community Investment Programs, <http://www.microsoft.com/citizenship/giving/programs> (last visited Aug. 21, 2006).

⁶⁵ See STEVEN LAWRENCE ET AL., FOUND. CTR., FOUNDATION YEARBOOK: FACTS AND FIGURES ON PRIVATE AND COMMUNITY FOUNDATIONS 57 (2004), available at <http://foundationcenter.org/findfunders/topfunders/top50giving.html> (listing Wal-Mart Foundation as the largest foundation by corporate giving). While Wal-Mart's cash giving makes it the most generous corporation, a number of pharmaceutical companies and Microsoft make greater total gifts in cash and products. See Wilhelm, *supra* note 1, at 14.

⁶⁶ See Community Support: Helping Local Organizations Through Community Grants, <http://www.walmartfoundation.org> (follow “Community” hyperlink) (last visited Aug. 21, 2006).

⁶⁷ See Grass Roots Giving: Our Community Involvement Policy, <http://www.walmartfoundation.org> (follow “What We Fund” hyperlink) (last visited Aug. 21, 2006); Wal-Mart Found. 2003 Form 990-PF, <http://www.guidestar.org/FinDocuments/2004/716/107/2004-716107283-1-F.pdf> (last visited Aug. 21, 2006).

⁶⁸ See 2006 Community Scholarships, <http://www.walmartfoundation.org> (follow “Education” hyperlink; then follow “Scholarships” hyperlink) (last visited Aug. 21, 2006); see also Wal-Mart Found. 2003 Form 990-PF, *supra* note 67.

gifts.⁶⁹

Even without a specific connection to identifiable individuals, any corporate sponsorship of a charitable event that identifies the corporation and associates it with the charity contributes to the corporation's reputation in the community.⁷⁰ Although halo benefits are not as concrete as the benefits associated with strategic philanthropy, they can be important. It is not purely out of generosity that Altria (which includes cigarette maker Phillip Morris) sponsors such a visible array of charitable activities — the taint of cigarette smoke may be removed by supporting the arts.⁷¹ The company expects to derive goodwill in the community out of its activities, which could prove very profitable even if customers are not directly affected because a more positive perception of the company may prevent increased governmental regulation or public mobilization against its products or practices.

Considering this wide array of benefits to corporations in light of the statutory standard for charitable giving, the interpretation of the quid pro quo standard becomes important. It is clear that only some of the benefits received by corporations flow directly from charitable recipients. Others are benefits garnered from third parties associated with the charities, the communities, and constituencies within the companies themselves. One interpretation of the quid pro quo standard that would argue for allowing deductibility of business-related philanthropy as a “gift” goes to the locus of origin of the benefit. If the charity provides no benefit in return — directly in exchange for the payment from the corporation — then it could be argued that there is no quid pro quo. This would preserve the charitable contribution deduction where the benefits come from reputation in the community and good will from the corporation's customers or employees. But there is no explicit requirement in the quid pro quo interpretation that the benefit come from the charity.⁷²

⁶⁹ See Corporate Giving: Related Charts, <http://www.philanthropy.com/premium/articles/v15/i19/19000801.htm> (last visited Aug. 21, 2006).

⁷⁰ See Knauer, *supra* note 6, at 57 (discussing the “halo effect”).

⁷¹ The Altria website lists grant recipients and amounts. In 2004, for example, Lincoln Center for the Performing Arts received over \$500,000. See Who We Fund, http://www.altria.com/responsibility/4_9_1_2_whoisfund.asp (follow “2004 Contributions: Arts” hyperlink) (last visited Aug. 21, 2006).

⁷² See *Elrod v. Commissioner*, 87 T.C. 1046 (1986) (denying section 170 deduction for land transferred for use as a roadway because the roadway would improve the value of the transferor's planned shopping center); *Saba v. Commissioner*, 40 T.C.M. (CCH) 448 (1980) (denying deduction for transfer of a

The legislative history of the charitable deduction describes gifts as amounts paid “with no expectation of a financial return commensurate with the amount of the gift.”⁷³ That language does not limit itself to only the return from the charity. In one of the leading cases, the court held that the plaintiff’s interpretation of the quid pro quo requirement as a “specific” and “direct” quid pro quo was “overly restrictive.”⁷⁴ In that case, the court held that below-market sales of sewing machines to schools were not charitable gifts because the purpose of the transfers was to create a future market for sewing machines.⁷⁵ The quid pro quo in that case came not from the recipient of the machines (i.e., the schools), but from the recipient’s beneficiaries (i.e. the students).⁷⁶ In addition, the benefit was inchoate at the time the company made the contributions, so the expectation of benefit at some unidentified time in the future was sufficient to undermine the deduction. While courts have expressed some discomfort in applying the test of detached and disinterested generosity to corporations,⁷⁷ in keeping with a focus on the intent of the donor under *Commissioner v. Duberstein*,⁷⁸ courts and administrative decisions have disallowed deductions where donors

parcel to the state because transferor received other benefits on account of transfer); *Wolfe v. Commissioner*, 54 T.C. 1707 (1970) (denying deduction for water and sewage donated to village since the facilities increased the value of taxpayer’s property); Rev. Rul. 73-113, 1973-1 C.B. 65 (denying section 170 deduction where taxpayer paid an amount to a fund administered by city, but expected benefits from tourists who would come to the city). *But see* *Morton v. Commissioner*, 39 T.C.M. (CCH) 621 (1979) (holding that transfer of property to a city for use in connection with the city’s water system constituted a charitable contribution in a situation where taxpayers intended to benefit the general public and received nothing in return for the transfer).

⁷³ S. REP. NO. 83-1622, at 196 (1954).

⁷⁴ *Singer Co. v. United States*, 449 F.2d 413, 420 (Ct. Cl. 1971). In *Singer*, the court stated:

It is our opinion that if the benefits received, or expected to be received, are substantial, and meaning by that, benefits greater than those that inure to the general public from transfers for charitable purposes . . . then in such case we feel the transferor has received, or expects to receive, a quid pro quo sufficient to remove the transfer from the realm of deductibility under section 170.

Id. at 423.

⁷⁵ *Id.*

⁷⁶ It was not a particularly confident hope. The court was unmoved by *Singer*’s survey finding that only 1.75% of its retail customers were influenced in their purchase by their school training. *Id.* at 424.

⁷⁷ *See id.* at 420.

⁷⁸ 363 U.S. 278 (1960).

gave under some sort of duress, even without a return benefit.⁷⁹ Thus, the quid pro quo requirement of section 170 is a significant hurdle for corporations.

An additional reason to move away from section 170 (and its quid pro quo standard for deductibility) concerns the obligations that it places on recipient organizations. The same standard that depends on benefits received by the taxpayer claiming a deduction creates burdens for charities that they would not have if corporations deducted their payments under section 162. Under section 6115, a charitable recipient is required to report to a donor the value of goods and services furnished by the charity in return.⁸⁰ If the service the charity provides consists of reputation burnishing or advertising that is only available to charitable sponsors, that service — though real and important — is very difficult to value. Even if the service costs the charity nothing to provide, which will rarely be the case, it still may have a significant value that would be relevant under both section 6115 and section 170(f)(8). The corporation seems to be in a much better position than the charity to determine that value and the section 170 deduction creates a tension between the corporation and the organization because the corporation is inclined to encourage the charity to understate the value so as to maximize the contribution. That tension disappears where the deduction falls under section 162 because under that section a payer is generally presumed to get what it paid for.

Finally, even if it were theoretically possible to distinguish profit-seeking philanthropy from profit-sacrificing philanthropy, the distinction between the two is nonjusticiable, so the distinction between the sections in the current Code is not enforceable. The Service and courts are ill-equipped to determine whether a particular payment to a nonprofit institution is sufficiently related to the corporation's business to qualify as a section 162 expense, or alternatively, without sufficient expectation of a return benefit to qualify for a deduction under section 170.⁸¹ As a practical matter,

⁷⁹ See *United States v. Transamerica Corp.*, 392 F.2d 522 (1968) (denying charitable deduction for corporation acting under “economic duress and threatened legal compulsion”); *Perlmutter v. Commissioner*, 45 T.C. 311, 317 (1965) (denying deduction where transfer made under compulsion of a challenged legal requirement); Rev. Rul. 79-148, 1979-1 C.B. 93 (denying deduction under section 170 for amount paid to charitable organization as a condition of probation and ordered by court).

⁸⁰ Contributions of less than \$75 are exempt from this obligation. I.R.C. § 6115(a).

⁸¹ See Elhauge, *supra* note 32, at 834.

corporations can describe their payments in whatever manner gives them the tax treatment they prefer, rendering the distinction meaningless.

D. Foundation Building

One of the most important trends in corporate philanthropy is the rise of the corporate foundation. Many large corporations have established separate charitable foundations that engage in grant making. The section 170 deduction encourages corporations to accumulate funds in private foundations because it authorizes an immediate deduction in the year in which the funds are placed in the foundation's coffers, even if the money is not paid out to ultimate beneficiaries until later years. Well-advised corporations can contribute to their foundations in years in which their taxable income is high and garner the greatest subsidy for that contribution. In years in which the corporation has no taxable income or is taxed at a very low rate, it can decline to place any money in the foundation. Thus, contributions to corporate foundations can be managed to minimize a corporation's tax liability over time.

One explanation for corporate foundations is that they are a response to the agency-cost problem of corporate philanthropy: foundations remove control from company management over giving decisions and vest it in a separate board.⁸² As discussed above, only where corporate philanthropy is not strategic is it necessary to impose safeguards to minimize agency costs because strategic philanthropy is highly unlikely to create such costs.⁸³ Therefore, the trend toward corporate foundations implicitly reflects two beliefs: (1) that corporate philanthropy is not integral enough to the corporate business to require significant participation by employees and officers of the corporation and (2) that the benefits of separating the administration of corporate philanthropy from other corporate operations outweigh both the administrative costs of maintaining a separate foundation and the loss of much of the synergy that charitable giving could create for the business. Unfortunately, the empirical evidence does not support a strong conclusion that corporate foundations reduce agency

⁸² This is not always true. Some corporations have overlap on the boards of the foundation and the corporation. Even where the CEO is not on the foundation board, the CEO seems to have influence on the foundation's decisions. See Werbel & Carter, *supra* note 51, at 56–57.

⁸³ See *supra* Part II.C.

costs⁸⁴ and it is virtually impossible to distinguish philanthropy that is good for business from agency-cost philanthropy.⁸⁵ Therefore, corporate foundations need to offer other benefits in order to justify their costs.

Some of the issues relevant to corporate foundations are similar to the issues concerning other private foundations, which are all more highly regulated under the Code than are public charities. But in some ways, corporate foundations present different policy questions than other private foundations. It is worthwhile to consider whether it is always appropriate to treat all foundations the same or whether corporate foundations should be governed by their own set of rules. It is not my task here to consider whether the rules for all private foundations are warranted, but rather to think about whether corporate foundations are properly categorized along with other foundations, whatever the rules are for those foundations.

From the perspective of recipient charities, the intermediary role that corporate foundations play between operating companies and operating charities can be both good and bad. Charities benefit to the extent that corporate foundations allow charitable recipients to rely on a steady stream of support from benefactors that might be less forthcoming directly from corporations. Corporate giving is responsive to ups and downs in the business cycle, increasing when profits are up and decreasing as profits fall.⁸⁶ Because foundations accumulate funds to be paid out to operating charities, they can buffer charities from those swings by spreading grants evenly over time, without concern for the profitability of the donor corporation. If charitable recipients were subject to the vicissitudes of a corporation's business and only received donations in profitable years, they would be impeded in carrying on their work by the unreliability of corporate support and their ability to achieve their charitable missions would be more precarious. Corporate foundations allow bumpy contribution levels from operating businesses to translate into steady streams of support for nonprofit organizations.

But those advantages may come at a price to the charitable sector. Corporate foundations might actually reduce total corporate funding of charitable activities by creating incentives to accumulate large

⁸⁴ See Werbel & Carter, *supra* note 51, at 48.

⁸⁵ *Id.* at 56 (“[A]lthough our results are supportive of an agency theory perspective, the results are also compatible with stewardship theory.” (i.e., a strategic approach)).

⁸⁶ See GIVING USA 2005, *supra* note 57, at 87.

endowments. As long as corporate foundations have endowments, those endowments can insulate the corporation from pressure to continue contributing out of its current earnings. The generosity of a corporation's founder or a past board might relieve the corporation of any further impetus to give, reducing the total amount given over time by corporations to charity.⁸⁷ In 2003, the largest corporate foundation⁸⁸ reported that it had assets worth over \$453 million, but made grants of only approximately \$15 million.⁸⁹ It could continue paying out at that rate for the next thirty years without contributing another cent to the foundation or earning anything on the endowment assets. Its tax return also indicated that the corporation donated only \$1 million to the foundation during 2003,⁹⁰ when it had \$938 million in income,⁹¹ suggesting that the company felt little pressure to continue funding the foundation. The corporate foundation may thus serve to discourage payouts to charities and consequently minimize the public pressure on operating corporations to pay in.

Nevertheless, even if the total amount devoted to charitable purposes is not reduced on account of foundations, public benefit is deferred when foundations are heavily endowed because operating charities may have to wait a long time to receive the foundation's invested assets. A low payout rate may be inconsistent with the charitable deduction's policy of encouraging gifts to charities to subsidize the works they do⁹² and a foundation's large endowment

⁸⁷ It is important to remember that corporations give a relatively small percentage of income to charity. The corporate donor identified as giving the largest income percentage to charity gave 2.86% of operating income in 2002. *See id.* at 96.

⁸⁸ *See* LAWRENCE ET AL., *supra* note 65, at 60 (ranking corporate foundations by asset size, indicating Alcoa Foundation as the largest).

⁸⁹ Alcoa Found. 2003 Form 990-PF, at 2, 10, <http://www.guidestar.org/FinDocuments/2003/251/128/2003-251128857-1-F.pdf> (last visited Aug. 21, 2006).

⁹⁰ *Id.*

⁹¹ ALCOA INC., 2003 ANNUAL REPORT 64 (2004).

⁹² On the other hand, the subsidy may be equally effective for direct gifts and future gifts through foundations because the current expense is offset by either a current charitable expenditure or a future grossed-up charitable expenditure of equal present value. For example, a \$100 contribution by a taxpayer in the 35% bracket contains a \$35 subsidy from the government. If the charity spends that money right away, it can provide \$100 of charitable services. If however it receives the money the following year from a private foundation that received it in the initial year and invested it at 10%, the \$100 would have grown to \$110 so that the charity would be able to provide \$110 of charitable services in the second year, increasing the value of the subsidy from \$35 to \$38.50. The subsidy theory for the charitable deduction is the most widely advanced. *See* JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 330 (2d ed. 1999).

may produce agency costs within the grant-making organization, diverting resources from charitable recipients to the foundation's managers.⁹³ These are issues common to all foundations and deferral may not be problematic for foundations generally. Michael Klausner has argued that it is hard to know whether endowment building is generally desirable because it is impossible to compare the social benefits of expenditures made by charitable organizations today with the expenditures they might make in the future — maybe generations in the future.⁹⁴ However, if current expenditures produce both current and future benefits, then current payouts are desirable.⁹⁵ Thus, it is necessary to look at the types of charities that corporations support to determine whether the law should encourage earlier payouts to maximize social benefit. Because education is the leading beneficiary of corporate charity,⁹⁶ earlier payouts would seem to be desirable since current education may inure to the benefit of many future generations.⁹⁷ To the extent that corporate foundations encourage corporations to wait, rather than immediately pay out to the ultimate charitable recipients, they reduce social welfare.

The policies surrounding endowment preservation might be different for corporate foundations than for other types of private foundations, even though they are all subject to the same rules about minimum required payouts.⁹⁸ A private foundation endowed with the wealth of a single individual is finite, along with the benefactor, and the individual's death signals the last opportunity for contributions from that individual. Unless other donors arise,⁹⁹ the foundation's

⁹³ Cf. John E. Core et al., *Agency Problems of Excess Endowment Holdings in Not-for-Profit Firms* (Dec. 15, 2005) (unpublished manuscript, available at <http://ssrn.com/abstract=565241>) (finding agency costs in operating nonprofits with excess endowments, but note that study did not cover grant-making nonprofits).

⁹⁴ See Michael Klausner, *When Time Isn't Money: Foundation Payouts and the Time Value of Money*, STAN. SOC. INNOVATION REV., Spring 2003, at 51, 55–56.

⁹⁵ See *id.* at 57.

⁹⁶ See GIVING USA 2004, *supra* note 2, at 88 (citing William O. Brown, Jr. et al., *Corporate Philanthropic Practices*, 12 J. CORP. FIN. (forthcoming 2006), available at <http://www.sciencedirect.com/science/journal/09291199> (follow “Articles in Press” hyperlink)); see also JOSEFINA ATIENZA & JENNIE ALTMAN, FOUND. CTR., FOUNDATION GIVING TRENDS: UPDATE ON FUNDING PRIORITIES 59 (2005) (“Compared to independent and community foundations, corporate foundations devoted a larger share of their 2003 grant dollars to education (27.8 percent) . . .”).

⁹⁷ Klausner, *supra* note 94, at 57.

⁹⁸ See I.R.C. § 4942.

⁹⁹ This happens. Some private foundations eventually get broad enough support to constitute public charities.

payout policies determine the time frame for funding its purposes. If the foundation is to support something in perpetuity, it needs to protect its endowment in order to do so. It is therefore reasonable that non-corporate foundations are allowed to pay out small enough sums to ensure their continued existence. But corporate foundations are in a very different position. Unlike a human philanthropist, the funding corporation has an unlimited life and the potential to continually invest new funds in charitable projects. Therefore, the corporation does not need the endowed foundation to provide for perpetual support of charitable purposes; it can choose to perpetually support its favored charities by continuing to devote income to them. This distinction between corporations and humans suggests that the law might want to require greater payouts from corporate foundations than other private foundations. In balancing the volatility of corporate contributions against the various policies favoring payouts, corporate foundations might be required to annually pay out some percentage more than just their income. A corporate foundation in danger of going broke creates pressure for more contributions from its operating benefactor.

In addition, foundation building by corporations is problematic, given the business connection of most corporate giving. Foundation building causes mismeasurement of corporate income by accelerating deductions compared to the income those costs produce. The expense that should matter for tax purposes takes place in the year in which the foundation makes a payout to charity. But the section 170 deduction for contributions to corporate foundations recognizes the movement of the cash from one corporate pocket to another, rather than requiring that a deduction wait until the amount finds its ultimate charitable recipient. In some ways, foundation funding resembles retained earnings — they are both potentially available to further the business in a variety of ways. The major difference is that retained earnings may be paid out for corporate expenses or to shareholders as dividends, while foundations may only pay amounts out to charities.

A more profit-oriented approach to corporate philanthropy would be likely to strengthen the impulse to give. If we think of corporate giving as a business expense, it is not the equivalent of other tax-minimizing strategies that might have lower costs for the corporation. Rather, it is comparable to other important costs of doing business. In addition, a section 162 deduction would encourage greater immediate gifts to operating organizations, rather than moneyparking in corporate foundations, even by corporations without taxable income. A section 162 deduction, unlike a section 170

deduction, contributes to net operating losses (NOLs) that can be carried both back and forward under section 172.¹⁰⁰ Section 172 provides a more generous carryover regime than section 170, which allows excess contributions to be carried forward only and fails to increase NOLs.¹⁰¹

Finally, focusing on the tax-minimizing function of corporate foundation building highlights its fragility in the face of other, more aggressive and profitable schemes for minimizing corporate tax. To the extent the corporation has deductions available to it that do not require the outlay of cash, as is necessary pursuant to the “payment” requirement under section 170, those other strategies are more attractive. For example, the perfectly legal strategy of investing in capital equipment eligible for the bonus depreciation rules adopted in 2001 and expanded in 2003 can create a negative rate of tax on the corporation’s income.¹⁰² If a corporation is managing its tax liability, those deductions are more desirable than the deduction under section 170. As corporations find new and more advantageous ways to minimize their tax liability, the tax benefits of charitable giving under section 170 pale in comparison. The recipients of corporate charity are the victims of this strategy.¹⁰³

E. In-Kind Gifts

Under current law, corporations have an incentive to give certain in-kind donations to charities and a substantial percentage of corporate giving is in-kind.¹⁰⁴ Donations of property made by corporations are sometimes privileged under the Code, compared to

¹⁰⁰ Net operating losses, to which section 162 deductions contribute, can be carried back two years and forward twenty years. I.R.C. § 172(b)(1).

¹⁰¹ Excess charitable contributions by corporations cannot be carried back at all, can only be carried forward five years, and can never exceed the 10% limitation in any year, regardless of carryovers. I.R.C. § 170(b)(2), (d)(2). Thus, the treatment of section 162 deductions is much more generous than the treatment of section 170 deductions.

¹⁰² See Calvin H. Johnson, *Depreciation Policy During Carnival: The New 50 Percent Bonus Depreciation*, 100 TAX NOTES 713, 713–14 (Aug. 4, 2003).

¹⁰³ Charities are also likely to be the unintended victims of estate tax repeal and other options for tax reform. See Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 689–90 (1999).

¹⁰⁴ See CTR. ON PHILANTHROPY AT IND. UNIV, AAFRC TRUST FOR PHILANTHROPY, GIVING USA 2003, at 99 (2003) [hereinafter GIVING USA 2003] (reporting that as much as one-third of corporate contributions in 2002 were given in-kind).

both (1) donations of cash by corporations and (2) contributions of similar property by individuals. Under section 170, the deduction for contributions of ordinary income property is generally limited to the donor's basis in that property,¹⁰⁵ a rule that prevents deductions exceeding income with respect to the property. But corporations can deduct more than basis under section 170(e)(3) for inventory property if the property will be used by the charity to care for the poor, sick, or children.¹⁰⁶ Corporations also have uniquely generous rules if they donate scientific equipment that they make to organizations for scientific research or computer technology to schools.¹⁰⁷ These special rules mean that corporations can deduct amounts that have never previously been included in income, making these contributions more attractive than equal-value contributions of cash. In addition, by their terms, these increased deductions are available only to C corporations, so that individuals and S corporations receive less government subsidy for these types of contributions than do C corporations donating the same items.¹⁰⁸

While the preference for charitable contributions of property compared to cash is an important broader tax policy issue,¹⁰⁹ I focus on the narrower concern of these special preferences for certain corporate transfers. While Congress may have legitimately wanted to encourage gifts of particular types of property — such as food for the poor and computers for schools — there seems to be no explanation for favoring contributions of these types from corporations compared to other taxpayers. In extending the enhanced deduction for computer equipment, the legislative history states that schools and libraries need computer equipment.¹¹⁰ But it is not clear that Congress

¹⁰⁵ I.R.C. § 170(e)(1).

¹⁰⁶ Corporations can deduct the basis, plus half the unrealized profit inherent in the property, but the deduction may not be more than twice the corporation's basis. I.R.C. § 170(e)(3)(B).

¹⁰⁷ I.R.C. § 170(e)(4), (6).

¹⁰⁸ I.R.C. § 170(a)(3)(A). For contributions in 2005, the corporate-donor limitation for food contributions was abrogated, but non-corporate taxpayers still had to make the contribution from a trade or business and were limited to deductions of 10% of trade or business income. See Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, § 305, 119 Stat. 2016, 2025.

¹⁰⁹ Taxpayers can generally deduct the full fair market value of capital gain property, even though the built-in gain has not been included in income. Treas. Reg. § 1.170A-1(c) (2005). For an excellent treatment of the larger issue, see Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1 (2002).

¹¹⁰ See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., GENERAL

has identified the most desired property by the neediest organizations and Congress does not seem to be in the best position to determine what items organizations need most. There is little reason why the law should encourage corporations to give property rather than cash to charity because the charitable organization can better determine the goods it needs to carry out its purposes. Cash, of course, gives the organizations more power and discretion to decide that for themselves.

Pharmaceutical companies top the list of in-kind donations and such donations propel them to the top of the list of biggest corporate givers. Their generosity is appropriately encouraged because their contributions of medicines are crucial to the well-being of the sick and poor in this country and around the world. Thus, the question for the deduction of in-kind pharmaceuticals is not the simplistic one of whether drug companies should be encouraged to provide free or low-cost medicine, but rather whether it makes sense to provide the encouragement in the form that the Code currently contains. The deduction enjoyed by drug companies is real (as long as the companies can use it), which means that the government is paying for that subsidy. When analyzed from the perspective of classic tax expenditure analysis — by looking at whether the government subsidy is in the most efficient and equitable form — the encouragement that the Code provides to drug companies to contribute free or low-cost drugs becomes less compelling. Under the current regime, drug companies can determine for themselves how much to give, who receives the drugs, and how to design the program, even though the contributions are government-subsidized. These are all important public health decisions that might be better made by public health professionals than by drug companies answerable to shareholders and operating in a competitive economic environment. They might also be better made by charitable organizations that would choose food over medicine, or particular drugs compared to others, if they had money instead of products.

Because the public health concerns are substantial, the lack of governmental control that characterizes the charitable deduction is worrisome in this context. In fact, the statute seems to reflect inconsistent policies by circumscribing the terms of the contributions eligible for the deduction,¹¹¹ but maintaining the form of a section 170

EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, at 138 (Joint Comm. Print 2005), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=2005_joint_committee_on_taxation&docid=f:21118.pdf.

¹¹¹ There are an unusual number of requirements for the deduction of inventory

deduction, which cedes control over the allocation of government resources to taxpayers. When drug companies go through a difficult business period, we need to worry that the availability of medicine for the poor will decline. In addition, the medicines manufactured by different companies are not all in equal demand by needy people. Why should the availability of particular drugs to the poor depend on the tax rates paid by different drug companies? Profitable companies receive the greatest tax benefit and therefore the incentive in the law is minimal or nonexistent for newer or less profitable drug companies, even though they may have drugs that would best address a public health concern.

The rule for contributions of inventory property gives drug companies a substantial windfall by allowing deductions equal to as much as twice the company's real cost for the contributed property, while requiring an adjustment to its cost of goods sold by only the actual basis. For example, a contribution of \$1000 worth of drugs in which the company had a \$100 basis would produce a \$200 deduction for the company and a \$100 reduction in cost of goods sold. This is a windfall \$100 deduction, equivalent to a cash transfer from the government to the company equal to \$100 multiplied by the company's marginal rate of tax.¹¹² The provision is designed so that the donor of inventory property can never be in a better after-tax position than it would be in if it had sold the property,¹¹³ but it is nevertheless designed to allow the donor to be in a better after-tax position than it would have been in if it had donated money. A comparison to a donation of money seems more relevant than the comparison to a sale in the ordinary course of business.

Property donations create other problems that suggest the Code should not favor them over cash. Valuation is always difficult for in-kind contributions and donors have a tendency to inflate the

property: the property must be used by the donee in its exempt purpose and only for the care of the ill, needy or infants, the donee may not transfer the property for consideration, and the donee must provide a written statement representing compliance with these requirements. I.R.C. § 170(e)(3)(A).

¹¹² Treas. Reg. § 1.170A-4(c)(1) (1994). If the basis were higher compared to the value of the property, the deduction might not equal twice basis, but it could constitute a substantial windfall. For example, if the basis were \$600 and the value \$1000, the deduction would be \$800 and the reduction in cost of goods sold \$600. *Id.*; Treas. Reg. § 1.170A-4(d) ex. 2. This example gives the company a \$200 windfall deduction, even larger than the low-basis example.

¹¹³ See S. REP. NO. 94-938(II), at 78-79 (1976), as reprinted in 1976 U.S.C.C.A.N. 4029, 4103 (explaining reasons for provision adopted in Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520).

value of their contributions to maximize their deductions.¹¹⁴ When this occurs, the loss to the fisc may be greater than the public benefit provided through the charity's receipt of the property.¹¹⁵ In addition, the incentive for corporations to give certain kinds of inventory property may be a waste of government resources because it rewards corporations for giving away their obsolete or unprofitable products, which might have been donated anyway and may not be of much use to the recipients.¹¹⁶ The Code's provisions also favor corporations with certain kinds of property, while other businesses without the favored property might provide as valuable or more crucial support for charities.

Substitution of a section 162 deduction for the section 170 deduction would remove the incentive to give inventory, increasing the likelihood that a corporation would donate cash or goods more specifically desired by the recipient organization. That shift would also improve the coherence of the tax law because it would moot the current law's allowance of a deduction where there has been no income previously included. Section 170's deduction for what amounts to untaxed profit is an unwarranted extra tax-based subsidy available to a very small subset of taxpayers making certain types of gifts. There does not seem to be any compelling reason to allow that windfall and application of section 162 would end it.

¹¹⁴ In 2004, Congress curtailed some of what it perceived as the worst abuses of the fair market value rule by limiting certain deductions. For example, donated cars can only be claimed as deductions to the extent that the charitable recipients receive value on their sale. See American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 884(a), 118 Stat. 1418, 1632-34 (codified as amended at I.R.C. § 170(f)(12)). Nevertheless, abuses continue. See Marc Kaufman, *Big-Game Hunting Brings Big Tax Breaks: Trophy Donations Raise Questions in Congress*, WASH. POST, Apr. 5, 2005, at A1.

¹¹⁵ The more general argument made in the literature against the fair market value deduction is just as compelling for corporations as for individuals. See discussion of possible reforms to rules for charitable contributions of property in STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, at 293-307 (Joint Comm. Print 2005), available at <http://www.house.gov/jct/s-2-05.pdf>.

¹¹⁶ For example, City Harvest collects food donations from many organizations that cannot use a tax deduction (or the food, apparently). See City Harvest 2004 Annual Report: Food Donors, <http://www.cityharvest.org/about/annual/food.html> (last visited Aug. 21, 2006) (listing donors, which include many nonprofit organizations).

III. THE BERKSHIRE HATHAWAY MODEL

A. Addressing Bias and Agency Costs

For many years, Berkshire Hathaway had a much-admired system for corporate philanthropy that allowed shareholders to designate the charitable organizations that would receive corporate contributions. It brilliantly addressed both the bias issue and the agency-cost issue. On the bias issue, it maximized the federal subsidy by having the payment to charity and the consequent deduction at the corporate level; there was no dividend to shareholders that would increase the tax bite. On the agency-cost issue, it avoided abuse by managers using the corporation's money to support their favorite organizations by allowing the shareholders to designate charities. Although the corporation decided the total level of charitable giving (and shareholders could not opt to receive dividends in lieu of designating charities), the system gave shareholders the maximum possible control over corporate giving. Warren Buffet, Berkshire Hathaway's legendary chairman, recognized that corporate philanthropy was really an expenditure that came out of the pockets of the shareholders. In one of his letters to shareholders, he wrote:

When A takes money from B to give to C and A is a legislator, the process is called taxation. But when A is an officer or director of a corporation, it is called philanthropy. We continue to believe that contributions, aside from those with quite clear direct benefits to the company, should reflect the charitable preferences of owners rather than those of officers or directors.¹¹⁷

The academic literature applauded the Berkshire Hathaway approach — Victor Brudney and Allen Ferrell's article on corporate philanthropy was essentially a brief in favor of Berkshire Hathaway's program.¹¹⁸ They endorsed the approach so strongly that they suggested adoption of a tax rule that would mandate the practice by permitting corporate deductions only for charitable gifts designated by shareholders.¹¹⁹ They believed that the program struck the

¹¹⁷ BERKSHIRE HATHAWAY, INC., 1987 ANNUAL REPORT 3 (1988), available at <http://www.berkshirehathaway.com/letters/1987htm.html> (last visited Aug. 21, 2006).

¹¹⁸ See Victor Brudney & Allen Ferrell, *Corporate Charitable Giving*, 69 U. CHI. L. REV. 1191 (2002).

¹¹⁹ See *id.* at 1209.

appropriate balance by allowing managerial discretion over how much to set aside for philanthropy, while limiting the agency costs and promoting philanthropic values. Almost all of Berkshire Hathaway's shareholders were sufficiently interested in the program to participate.¹²⁰ Nevertheless, even before Berkshire Hathaway discontinued its program, it was apparently a failure as a model for corporate charitable giving.¹²¹ Shareholders at a few other companies presented shareholder proposals to be included in the companies' proxy statements, in the hopes of emulating it.¹²² Consistent with Berkshire Hathaway's approach, the uniqueness of corporate charitable giving led the SEC Office of Chief Counsel to conclude that proposals concerning shareholder-designation programs could not be excluded from proxy statements under Rule 14a-8 as ordinary business within the exclusive control of managers, not shareholders.¹²³ Despite the SEC's position,¹²⁴ management opposed them and all the

¹²⁰ The 2002 Annual Report reported that 97.3% of eligible shares participated in the program. BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 21 (2003) [hereinafter BERKSHIRE HATHAWAY 2002 ANNUAL REPORT].

¹²¹ Corporations with larger numbers of shareholders with smaller holdings would face greater administrative problems than Berkshire Hathaway encountered. See Brudney & Ferrell, *supra* note 118, at 1217–18.

¹²² Shareholder proposals to adopt a Berkshire Hathaway-type plan were presented at Merck in 1996, Union Pacific in 1991 and 1993, and New England Electric System in 1992 and 1993. See Merck & Co., Inc., Proxy Statement (Form DEF 14A), at 26–27 (Mar. 18, 1996); Union Pacific Corp., Proxy Statement (Form DEF 14A), at 45–46 (Mar. 23, 1993); Union Pacific Corp., Proxy Statement (Form DEF 14A), at 29–31 (May 31, 1991); New England Elec. Sys., Proxy Statement (Form DEF 14A), at 13–14 (Mar. 26, 1992). A proposal was also presented by a Citigroup shareholder in 2000 that resembled the shareholder-designation program. Citigroup Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 253, at *3–4 (Feb. 29, 2000).

¹²³ See Citigroup Inc., *supra* note 122, at *1; AT&T Corp., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 224, at *1–2 (Feb. 17, 2000) (stating that charitable contributions “involve a matter of basic corporate policy which is extraordinary in nature”).

¹²⁴ See Union Pacific Corp., SEC No-Action Letter, 1993 SEC No-Act. LEXIS 158 (Feb. 5, 1993); Union Pacific Corp., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 126 (Jan. 24, 1991). In the former letter, the SEC stated:

[I]t is the staff's view that a decision regarding the allocation of Company funds, the amount of which has been determined by the Board, among charitable donees, would appear to deal with a matter of basic corporate policy which is extraordinary in nature and beyond the Company's ordinary business operations.

Id. at *1.

proposals failed.¹²⁵ Thus, despite its academic stature as a model program, it never became policy at any other corporation.

The failure of the Berkshire Hathaway model to spread throughout the corporate world may be the result of administrative challenges that corporations face in adopting such a program, rather than rejection of the underlying belief that the corporation gives away the shareholders' money. After all, many corporations have smaller value shares and many more shareholders than Berkshire Hathaway. But rejection of shareholder designation by other companies may signal rejection of Buffet's perspective on corporate philanthropy. He perceived corporate charitable giving as wealth transfers out of the corporation and for certain types of corporations, such as holding companies, this might be the most reasonable way to understand it.¹²⁶ But other companies accurately perceive it as a crucial part of the business. Consider the following managerial response to the shareholder proposal presented in Merck's 1997 Proxy Statement:

The Company's charitable endeavors, encompassing contributions made directly by the Company and those made through The Merck Company Foundation, are the product of a carefully administered program designed to ensure that *the nature and magnitude of the contributions are in the best interests of the Company and its stockholders* and that the recipients are appropriate and deserving. . . . The Company's charitable endeavors . . . *earn the Company substantial respect and good will from the scientific community, local communities in the vicinity of our sites, customers and the public at large.*¹²⁷

A skeptical reader might consider these justifications a smokescreen for managers wanting to retain the power of this perquisite.¹²⁸ But the explicit connection to corporate business in the

¹²⁵ The Merck proposal received only 3% shareholder support. See Merck & Co., Inc., Quarterly Report (Form 10-Q), at 8 (Aug. 13, 1997).

¹²⁶ Berkshire Hathaway's operating subsidiaries engage in the traditional model of corporate giving and continue to do so despite cessation of the shareholder-designation program.

¹²⁷ Merck & Co., Inc., Proxy Statement, *supra* note 63, at 25 (emphasis added).

¹²⁸ The Merck board also argued that the administrative burden would be too great because it would require the company to communicate with shareholders who held their shares in street name. *Id.* Berkshire Hathaway overcame this problem by making such shares ineligible for participation in the program. See BERKSHIRE HATHAWAY 2002 ANNUAL REPORT, *supra* note 120, at 22. Of course, as the number

stated rationale for retained control by management should then act as a constraint on their later discretion. For proponents of strategic philanthropy, discussed above,¹²⁹ it is incoherent to give shareholders a voice in determining where the money goes.

Whether or not the corporate managers were accurately describing their company's philanthropic activities, in their defense of the corporation's prerogative, they undermined the legal justification of continued application of section 170 to corporations. If corporate giving is in fact as corporations describe it in their SEC filings, then Buffet was wrong in his characterization and section 162 is appropriate and sufficient to cover it. In addition, changing the tax characterization of these types of expenses should translate into ordinary business treatment for state corporate law and federal securities law and open managers to state-law claims of waste if they fail to spend the corporation's funds in furtherance of its business.

B. The Demise of Shareholder Designation

At the same time that Congress was considering repeal of the tax that individuals pay on dividends received, Berkshire Hathaway abruptly discontinued its shareholder-designation program. It did not connect its decision to the possibility of dividend-tax repeal, even though such repeal would have fundamentally changed the calculus for corporate giving. If full dividend repeal had taken place, the bias in favor of corporate giving would have completely disappeared and it would have been more likely in individual cases that shareholder giving out of dividends received would have been a more tax-efficient strategy.

Consider the consequences of full repeal compared to partial repeal, returning to the running example discussed in the analysis of bias above.¹³⁰ Everything at the corporate level remains the same because exempting dividends would do nothing to change the imposition of the corporate level tax. So \$100 corporate earnings would produce a \$100 gift to charity. If the corporation pays tax at 35%, the shareholders receive \$65, both pre- and post-tax. If the individual shareholders are subject to a 35% rate of tax also, they can make a contribution of \$100, the same as the corporation. As described above, this is because the deduction at the shareholder level allows the shareholder to gross up the cash she has available by the

of shareholders increases, the administrative costs of the program increase as well.

¹²⁹ See *supra* Part II.C.

¹³⁰ See *supra* Part II.A.

tax savings on her other income produced by the deduction. This is where there is no bias — where the shareholders and corporation have the same rate of tax and corporations can make tax-free distributions to shareholders. The amount of the contribution will be the same for the corporation and the shareholders.¹³¹ This is illustrated as Example 1 in the chart below.

Extending the illustration from above in which the shareholder has a higher rate of tax than the corporation, an \$85 distribution (assuming \$100 earnings at 15%) would produce a \$131 contribution at the individual level.¹³² This is illustrated as Example 2 in the chart below. Example 3 reflects a corporate rate of zero.¹³³ Examples 2 and 3 are more advantageous if the gift is made at the shareholder level. Thus, with full repeal of the dividend tax, the likelihood of greater tax savings from shareholder giving is higher than under current law, where there is a reduced rate, but dividends remain taxable, effectively imposing a toll charge on the transfer to shareholders.

ILLUSTRATION 2.

	Example 1	Example 2	Example 3
Corporate Rate	35%	15%	0%
Individual Rate	35%	35%	35%
Dividend Rate	0%	0%	0%
Corporate Earnings	\$100	\$100	\$100
Corporate Gift	\$100*	\$100	\$100
Individual Income	\$65	\$85	\$100
Individual Gift	\$100	\$131	\$154

*The optimal gifts are in bold. Figures have been rounded.

Thus, it would have been reasonable for Berkshire Hathaway to discontinue its shareholder-designation program as it was no longer

¹³¹ As described above, the shareholder contribution can be the dividend received divided by one minus the tax rate. In this example, $\$65/0.65 = \100 . This formula will always produce a contribution greater than the dividend itself as long as the shareholder has taxable income and a positive tax rate.

¹³² $85/(1 - 0.35) = 130.7$.

¹³³ To compute the individual gift amount: $100/(1 - 0.35) = 153.85$.

the most efficient tax strategy. If shareholder designation was a clever way to take advantage of the bias, then repeal — and even reduction — of the dividend tax negates that purpose. But it does not seem that the company acted in response to this proposed legislative change because it stated that it was giving up “some minor tax efficiencies” in discontinuing the program.¹³⁴

In fact, Berkshire Hathaway’s discontinuation of the program seems to have had nothing to do with shareholders at all. Rather, a boycott had been instituted against its subsidiary, Pampered Chef, to challenge the corporation’s contributions to Planned Parenthood, which had been designated by some shareholders under the program. The individual associates of Pampered Chef, who rely on relationship sales, suffered on account of the program and the company terminated it to protect their livelihood.

The incident was not just an unfortunate example of reproductive politics undermining good corporate governance; it was an indictment of the construct for corporate philanthropy that Berkshire Hathaway had built. Apparently, the device of giving shareholders the power to designate charities of their choice failed to spare the company — or the independent contractors who worked with it, but were not even employees of the company — public judgment for those choices. The company was deemed connected to the organizations that its money supported, despite the fact that management had carefully divested itself of control over funding decisions. The public did not believe that the company’s owners were deciding what to do with their money; it treated the company as though it were spending its money.

Ultimately, the shareholder-designation program should be considered a failure because it did not fully understand the problem that it was designed to solve. The program may have addressed the agency-cost issue from the perspective of the corporation’s shareholders, but it did not succeed in doing so from the perspective of other constituencies important to the corporation. The customers were oblivious to the separation that the corporation had created between the corporate business and its charitable giving and perceived it as invested in Planned Parenthood. This occurred despite the fact that churches were the most frequent designees¹³⁵ and that 3500 charities a year had received contributions under the program.¹³⁶

¹³⁴ BERKSHIRE HATHAWAY INC., 2003 ANNUAL REPORT 3, 22 (2004) [hereinafter BERKSHIRE HATHAWAY 2003 ANNUAL REPORT].

¹³⁵ *Id.* at 21.

¹³⁶ Press Release, Berkshire Hathaway Inc. News Release (July 3, 2003),

What the Pampered Chef fiasco should have taught corporations is that their charitable giving cannot be isolated from their businesses and cannot be carved out as something in the domain of shareholders because it is their money to spend. Consistent with its commitment to allow the shareholders to spend their own money on philanthropy, when it discontinued the shareholder-designation program, Berkshire Hathaway ceased all charitable giving.¹³⁷ If it could not adopt the model of business-benefit philanthropy, it was the only reasonable thing it could do.

IV. WHAT CHANGES IN REPLACING SECTION 170 WITH SECTION 162?

This article has so far argued that switching the treatment of corporate philanthropy from section 170 to section 162 would eliminate the bias created by section 170, reduce agency costs by legitimating business-related donations, reduce reliance on corporate foundations, remove the preference for gifts of certain kinds of inventory, and refine the legal landscape to make it more consistent with public perception and the tax treatment of corporations. This section considers some of the consequences that arise from that switch.

A. Corporations and Their Employees

A substantial portion of corporate giving is employee-related, including matching grants and a broad array of public-benefit expenditures in the communities where the corporation's employees are located. Compensation-related giving should be immediately deductible under section 162. If the services are performed in the year in which the contribution is made and the compensation for the underlying services is immediately deductible, there is no need to capitalize the related charitable payment. Even if the services relate to the creation of an asset with a long useful life, the regulations under

<http://www.berkshirehathaway.com/news/jul0303.pdf>.

¹³⁷ Acquired subsidiaries continued to make charitable donations as they had prior to their acquisition, but for what would be, for a public company, agency-cost type contributions that those subsidiaries had previously made on behalf of prior owners. See BERKSHIRE HATHAWAY 2003 ANNUAL REPORT, *supra* note 134, at 22. It is interesting to note that the charitable donations made by subsidiaries in 2002 amounted to \$20 million in cash and \$4 million in-kind, significantly more than the \$16.5 million donated through the shareholder-designation program. See BERKSHIRE HATHAWAY 2002 ANNUAL REPORT, *supra* note 120, at 21–22.

section 263 are very generous in allowing an immediate deduction for compensation and do not require capitalization of compensation expenses as long as the services facilitated the creation of an intangible asset.¹³⁸

Employee matching grants¹³⁹ produce an additional concern because characterizing them as compensation raises tax issues for the employees, as well as the corporate payor. In an earlier article, I suggested that employee matching grants should be taxed as both compensation to employees and contributions by them, producing both income and a deduction for employees who designate matching grants.¹⁴⁰ This two-step treatment fully follows through on the compensation model, but is troubling as a practical matter because the limitations on charitable deductions could result in income for employees without any offsetting deduction, most likely because employees who do not itemize are not entitled to any deduction under section 170.¹⁴¹

This problem arises because of the generally inequitable treatment of charitable contributions made by low-income taxpayers. In order to avoid imposing a tax on employees on account of their employer's matching funds, Congress could address the larger problem of deductibility for contributions made by low-income taxpayers by allowing an above-the-line deduction for charitable contributions.¹⁴² The specific case of employer matching grants offers Congress more technical flexibility because it can either address the concern on the income side or the deduction side. While a fix on the

¹³⁸ Treas. Reg. § 1.263(a)-4(e)(4) (2004); *see also* Treas. Reg. § 1.263(a)-4(b)(3)(iii) ("Amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3), regardless of whether the amounts result in the creation of an income stream under the agreement.").

¹³⁹ They are a major element of corporate giving. A study of corporate giving in St. Louis found that 20% of surveyed firms had matching grant programs for their employees. GATEWAY TO GIVING, PRIVATE DOLLARS FOR PUBLIC GOOD: A REPORT ON GIVING IN THE ST. LOUIS REGION 9 (2004), *available at* http://www.gatewaytogiving.org/Private_Dollars_for_Public_Good_Report.pdf.

¹⁴⁰ *See* Sugin, *supra* note 13, at 874–76.

¹⁴¹ There are currently proposals to change this rule. *See* Tax Relief Act of 2005, S. 2020, 109th Cong. § 301 (as passed by Senate, Nov. 17, 2005), which allows nonitemizers to deduct contributions in excess of a floor. The proposal is somewhat controversial. *See* Fred Stokeld, *Charitable Deduction Provision in Tax Relief Bill Stirs Debate* 2006 TNT 5-4 (Jan. 9, 2006).

¹⁴² The proposal in S. 2020 would be more expensive, but less controversial, if it did not contain the floor for both itemizers and nonitemizers.

deduction side would be preferable because it would address the general inequity, this specific problem could be addressed by adding matching contributions to the considerable list of excluded employee fringe benefits already in the Code.¹⁴³ Along the lines of the exclusion allowed for working-condition fringe benefits, a payment by an employer to a charitable organization under a matching gift program could be excluded by the employee if such payment would have been deductible under section 170 if the employee had made the payment herself. Just as the exclusion for working-condition fringes ignores collateral limitations that might reduce or eliminate the value of the deduction, such an exclusion could be designed to ignore the equally irrelevant question of whether the employee itemizes deductions.

In Notice 2005-68, the Service endorsed a temporary “leave-based donation” program under which employees may exchange unused vacation, sick, or leave days for their employer’s cash donations to charities helping Hurricane Katrina victims.¹⁴⁴ The Service announced that the employees would not be required to include the wages they did not actually receive and the employer would not be limited to a deduction under section 170 for payments to the charities. The Notice is interesting because it acknowledges that the contributions to charity paid by the employer are really contributions by the employees of wage income that they would otherwise have received from the employer. The tax treatment of that transaction — without the Notice — would require compensation inclusion and a corresponding charitable deduction by the employee. By allowing an exclusion, the Notice ameliorates the problem with the two-part approach for employees who do not itemize deductions or whose deductions are subject to the percentage limitation in section 170(b). Under the two-part approach, the employer’s treatment would be a straight section 162 deduction for compensation paid and section 170 would not be relevant. But under the Notice, it appears that the employer can choose to deduct the amounts under either section 162 or section 170, contrary to the general proscription contained in section 162(b).¹⁴⁵

¹⁴³ See I.R.C. §§ 105, 106, 119, 125, 127, 129, 132, 137.

¹⁴⁴ I.R.S. Notice 2005-68, 2005-40 I.R.B. 622.

¹⁴⁵ The Notice states: “The Service will not assert that an employer will be only permitted to deduct these cash payments under the rules of § 170 rather than the rules of § 162.” *Id.* Section 162(b) provides: “No deduction shall be allowed under subsection (a) for any contribution or gift which would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section.” I.R.C. § 162(b).

Employee matching grants are distinguishable from leave-based donation programs because the foregone income in the vacation-gift program has clearly already been earned by employees at the time they decide to redirect it to charity, making constructive receipt compelling.¹⁴⁶ The two-step analysis is less transparent in the matching gift program because constructive receipt of employee compensation would not apply.¹⁴⁷ It is also harder to identify the compensatory nature of the matching gift since the employee never has the right to take the matching grant for personal use and the employer could terminate the program without having accrued any obligations to employees. But that perspective is too restrictive a view of what matching-gift programs are. They exist as a global employee benefit, rather than as a particular element of individual compensation that is received by only some employees, such as performance bonuses. In recognition of the collective benefit they provide, it may be appropriate to allow their exclusion to designating individuals. Even if considered a shared benefit among employees, matching gifts more clearly reflect the charitable preferences of employees than employers and reward a combination of employee services for the employer and individual charitable giving by employees.

B. Timing

The choice between section 162 and section 170 is particularly important for timing the deduction. In some cases, a deduction under section 162 would be prior to the corresponding deduction under section 170, and in other cases, the order would be reversed. This is due to the limitations particular to each section. Under section 170, the timing of the deduction generally depends on the year in which payment is made, without regard to the matching concept of accrual accounting.¹⁴⁸ Accrual method taxpayers may deduct contributions prior to payment only if an election is made and payment is completed before the fifteenth day of the third month following the year in which it is authorized.¹⁴⁹ This requirement may delay a deduction for an

¹⁴⁶ See *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953) (allowing taxpayers to defer income without constructive receipt where agreement to defer was made before any amounts were due); Rev. Rul. 60-31, 1960-1 C.B. 174.

¹⁴⁷ See Treas. Reg. § 1.451-2 (1979).

¹⁴⁸ Section 170(a) requires generally that payment must be within the taxable year.

¹⁴⁹ I.R.C. § 170(a)(2).

accrual-method taxpayer compared to section 162, under which a deduction is allowed when the all events test is satisfied and economic performance has occurred, even if that precedes payment.¹⁵⁰ Alternatively, a deduction under section 170 will precede the deduction under section 162 if the business deduction would be subject to the capitalization requirement of section 263.¹⁵¹ The capitalization requirement trumps an immediate deduction pursuant to section 162 when an expenditure gives rise to a benefit that lasts for an extended period of time.

One explanation for the section 170 deduction for corporations may be that Congress wanted to dispense with the capitalization requirement as a way to encourage corporate philanthropy. The capitalization requirement only makes sense in the context of a section 162 analysis for expenditures incurred in pursuit of profit because capitalization is an attempt to match income with the expenses incurred to produce that income. Since a charitable gift deductible under section 170 is presumed not to be profit producing under the quid pro quo analysis, the matching of income with expenses is inapposite under that section. Therefore, the “payment” rule in section 170, which is not subject to override by the capitalization requirement, allows a more accelerated deduction than would the combined application of section 162 and section 263.

Allowing corporations to bypass the capitalization requirement and increase the federal subsidy for their payments to charitable organizations may once have been a legitimate reason to retain the section 170 deduction for corporations.¹⁵² But this reason is much less

¹⁵⁰ In some cases, the economic performance required would be payment, mirroring the basic rule in section 170, but section 461(h) contemplates economic performance prior to payment in many cases. For example, if we determine that a corporation is entitled to a section 162 deduction for an employee matching grant as a matter of employee compensation under section 162, then economic performance would occur in the year in which the employee performs the services, even if the matching grant is actually paid out in a subsequent year. See I.R.C. § 461(h)(2)(A).

¹⁵¹ See *Transamerica Corp. v. United States*, 254 F. Supp. 504, 515 (N.D. Cal. 1966) (rejecting taxpayer’s section 170 deduction and requiring capitalization of expenditure); Sugin, *supra* note 13, at 845 n.53.

¹⁵² Accelerating the deduction for a capital asset in excess of its economic depreciation reduces the rate of tax on income from the asset. Expensing in the year of acquisition, as under a cash flow consumption tax, exempts the income from the asset from tax completely. See William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974). Any prepaid expense is an asset because an asset is simply an accounting measure of something that produces future benefits.

compelling today, since the capitalization requirement has lost most of its teeth and it is unlikely to prevent immediate deductibility under section 162 of corporate payments to charities. Given the increasingly strategic nature of corporate philanthropy and the relaxation of the capitalization rules, there is very little corporate philanthropy that would need to be capitalized today.

The bulk of corporate philanthropy that is not employee-related is still business-related (except for the small amount that is agency-cost philanthropy, which I have argued would be much harder to justify without section 170).¹⁵³ Some is integral and strategic, such as the science education underwritten by drug companies and the technological training by tech companies.¹⁵⁴ Some is specifically customer-based.¹⁵⁵ The remainder may more generally be undertaken with the expectation that such support will inure to the long-term benefit of the company's business and is in the nature of advertising or goodwill building among a variety of constituents, such as customers, employees, and regulators. All these types of corporate philanthropy, while varied along the scale of business connection, are sufficiently business related to satisfy the "necessary" prong of section 162, which has been interpreted by the case law to mean "appropriate and helpful" in relation to the business.¹⁵⁶

The "ordinary" prong of section 162 goes to the capitalization question: expenses are only "ordinary" if they are not required to be capitalized and may instead be deducted immediately.¹⁵⁷ Employee-based philanthropy, as discussed above, fits well within the "current" category, along with the cash compensation that employees receive.¹⁵⁸ Similarly, the more specific customer-based giving is likely to be immediately deductible. For example, support of organizations that hold their events at a store's location is reasonably connected to bringing customers into the store at the time of the event.¹⁵⁹

¹⁵³ See *supra* Part III.A.

¹⁵⁴ See *supra* Part II.C.

¹⁵⁵ For example, customer-based philanthropy might include a scholarship program open to customers or support of local charities by providing goods or facilitating fundraising at the business locale.

¹⁵⁶ *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

¹⁵⁷ See *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) ("The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures . . .").

¹⁵⁸ See *supra* Part IV.A.

¹⁵⁹ This is Wal-Mart's model. See *Community Support*, *supra* note 66.

Therefore, any costs of that support should be immediately expensed because they are related to the income earned in that period.¹⁶⁰ Anything that resembles everyday product advertising, such as public radio and television sponsorships that appear like commercial advertising during programming, should also be immediately deductible, the same way that regular advertising is deductible.¹⁶¹

The more challenging examples of corporate philanthropy for the capitalization question arise from the long-term educational and sponsorship programs, which create future demand for products, future benefits to the workforce, and goodwill. While these expenditures are sufficiently connected to the business to be considered appropriate and helpful, they might all need to be capitalized because they produce significant future benefits to the company.¹⁶² The Supreme Court in *INDOPCO, Inc. v. Commissioner* set a very high bar for immediate deductibility of expenses, stating that expensing is the exception to the presumptive rule of capitalization.¹⁶³ A careful reading of *INDOPCO* makes the capitalization requirement a serious obstacle to immediate deductibility of much of this type of corporate philanthropy under section 162. Goodwill and community building expenditures produce long-term benefits that are unlikely to be incidental benefits and may resemble the cases in which companies were required to capitalize goodwill-building costs.¹⁶⁴

But since the high-water mark of *INDOPCO* more than a decade ago, the rigor of the capitalization principle has eroded. The Service has since allowed immediate deduction for a wide variety of expenditures that produce benefits beyond the taxable year¹⁶⁵ and

¹⁶⁰ This situation may be analogous to the customer-based incentives such as the stock warrants issued to customers in *Sun Microsystems, Inc. v. Commissioner*, 66 T.C.M. (CCH) 997 (1993). The court held that the costs were immediately deductible because the future benefits were incidental. *Id.*

¹⁶¹ See Rev. Rul. 92-80, 1992-2 C.B. 57 (ruling that regular advertising costs do not need to be capitalized, despite the long-term benefits that advertising provides).

¹⁶² This is the standard for capitalization in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

¹⁶³ *Id.* at 84.

¹⁶⁴ See *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220, 231-33 (1985) (holding that costs incurred to allay public fears of nuclear power were sufficiently tied to the company's operating license, a capital asset, and therefore required capitalization); I.R.S. Priv. Ltr. Rul. 86-11-005 (Nov. 26, 1985) (ruling that package design costs created identifiable assets, which must be capitalized).

¹⁶⁵ See Rev. Rul. 2000-4, 2000-1 C.B. 331 (allowing immediate deduction for certification costs despite some future benefits and possible facilitation of business

lower courts have repeatedly distinguished *INDOPCO*, significantly narrowing the impact of the decision.¹⁶⁶ Finally, the Treasury's regulations on the capitalization of intangibles, effective at the end of 2003,¹⁶⁷ are very generous to taxpayers seeking deductions and significantly undercut the contours of the capitalization principle described by the Supreme Court.¹⁶⁸ The regulations allow immediate deduction of significant long-term advertising expenses.¹⁶⁹ They overrule the 1969 decision in *Alabama Coca-Cola Bottling Co. v. Commissioner*,¹⁷⁰ which required that bottlers capitalize the costs of signs and other tangible items bearing their logo and displayed in retail outlets. Under the regulations, those types of costs may now be immediately deducted despite their clear relationship to future benefit. Compared to the payments that businesses make to charitable recipients, which allow their name to appear in the charity's materials, the future benefit (compared to the current benefit) reaped by businesses providing logo signs and the like seems more substantial than the future benefit provided by corporate sponsorship of charitable activities.

The regulations alter the capitalization norm by pulling back from *INDOPCO*'s future benefits inquiry and returning to the separate asset approach from earlier cases.¹⁷¹ They make clear that "enhancements" to purchased goodwill do not need to be capitalized.¹⁷² An example in the regulations describes a program

expansion). Compare *Cleveland Elec.*, 7 Cl. Ct. at 231–33 (holding that costs incurred to allay public fears of nuclear power must be capitalized), with I.R.S. Field Serv. Advice Mem. 199939035 (Aug. 9, 1999) (advising that advertising and other goodwill-building costs incurred prior to regulatory approval are immediately deductible).

¹⁶⁶ For example, loan origination costs have been allowed to be expensed in *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), and officers' salaries in a restructuring have been allowed to be expensed in *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000).

¹⁶⁷ Treas. Reg. § 1.263(a)-4 (2004).

¹⁶⁸ See Lee A. Sheppard, *More Giveaways in Final Intangibles Capitalization Rules*, 102 TAX NOTES 12 (Jan. 5, 2004).

¹⁶⁹ Treas. Reg. § 1.263(a)-4(l), ex. 11 (2004).

¹⁷⁰ 28 T.C.M. (CCH) 635 (1969).

¹⁷¹ See *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973). The preamble to the final regulations explicitly "avoid[s] any implication of a 'significant future benefits' test." T.D. 9107, 2004-1 C.B. 447, 449.

¹⁷² The preamble states:

For example, if a taxpayer acquires goodwill as part of the acquisition of a trade or business, future expenditures to maintain the reputation of the trade or business arguably could constitute amounts paid to "enhance" the

promoting energy conservation that builds goodwill with customers and reduces the company's future costs.¹⁷³ The regulation does not require capitalization of the costs to consultants connected with these programs and states: "While the amounts may serve to reduce future operating and capital costs and create goodwill with customers, these benefits, without more, are not intangibles for which capitalization is required under this section."¹⁷⁴ In addition, a Treasury Decision provides that "amounts paid with the mere hope or expectation of developing or maintaining a business relationship are not required to be capitalized."¹⁷⁵ These examples are interesting because they highlight the theoretical overlap between business expenditures that do not produce clear benefits and philanthropic expenditures that follow essentially the same model.¹⁷⁶ Following these regulations, almost all corporate philanthropy would likely satisfy the standard for immediate deductibility; reputation and goodwill-building philanthropy is only vaguely connected with the production of a specific intangible asset producing future income.

If my interpretation of the (non)application of section 263 to corporate philanthropy is correct, repeal of the corporate deduction under section 170 should require very little disruption to corporate charity — the same expenditures that were previously deducted under section 170 would now be expensed under section 162 pursuant to the regular timing rules for accrual method taxpayers, regardless of payment. But, if there are situations in which capitalization might still be significant, not much violence would be done to the Code if Congress or the Treasury adopted a relaxation of the capitalization requirement to allow corporations to deduct goodwill-enhancing

acquired goodwill. The final regulations remove the word "enhance" in favor of more specifically identifying the types of enhancement for which capitalization is appropriate.

Id. at 448.

¹⁷³ Treas. Reg. § 1.263(a)-4(l), ex. 4 (2004).

¹⁷⁴ *Id.*

¹⁷⁵ T.D. 9107, 2004-1 C.B. 447, 449. The regulations state:

An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate a financial interest with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of a financial interest with that party.

Treas. Reg. §1.263(a)-4(d)(2)(ii) (2004).

¹⁷⁶ See *supra* notes 155–57 and accompanying text.

expenditures made to section 501(c)(3) organizations.¹⁷⁷ A generous deduction regime would be worthwhile if it offered a solution to the problem of separating out the few bad, welfare-reducing corporate payments to charity from the many desirable, welfare-enhancing corporate payments to charity. Section 162 would operate to police corporate expenditures, ensuring that the payments are “appropriate and helpful” to the corporation’s business, with the wide interpretation that requirement has been given. Any payment made for the purpose of aggrandizing the corporation’s chairman — for example, providing a job for the CEO’s daughter or secretly supporting controversial political groups — would fail the section 162 standard.¹⁷⁸ The Code has long contained subsidies for contributors to charity and a relaxation of the capitalization rule, rather than a deduction section 170 for corporations, is a better approach to the subsidy because of the corporate and tax law benefits that change would bring. The opportunities for abuse and the dangers to the corporate tax base are few from a charity-only exception to an otherwise strict capitalization requirement.

Corporations have long had a choice of deduction for business-related payments to charitable organizations. The section 162 deduction preceded the adoption of the section 170 deduction for corporations and section 162 has always been available to corporations making business purchases from charitable organizations.¹⁷⁹ Section 170 limits the deduction to 10% of the taxpayer’s modified income¹⁸⁰ and taxpayers may not claim any excess over that percentage limitation as a trade or business expense.¹⁸¹

¹⁷⁷ I say this because the adopted regulations have already eviscerated the integrity of the capitalization requirement. See Calvin H. Johnson, *Destroying Tax Base: The Proposed INDOPCO Capitalization Regulations*, 99 TAX NOTES 1381 (June 2, 2003).

¹⁷⁸ See Diana B. Henriques, *A Celebrity Boss Faces Exile from 2d Corporate Kingdom*, N.Y. TIMES, Feb. 10, 1995, at A1 (detailing William and Mary Agee’s sprawling appropriation of Morrison Knudsen’s corporate resources); Leon Lazaroff, *Ex-Tyco Chief, Top Lieutenant Found Guilty; Face 25-Year Terms for Grand Larceny*, CHI. TRIB., June 18, 2005, at 1 (highlighting Dennis Kozlowski spending millions on personal use as CEO of Tyco).

¹⁷⁹ See, e.g., Rev. Rul. 73-113, 1973-1 C.B. 65 (holding that payments to an oil pollution control fund could be deducted as ordinary and necessary business expense).

¹⁸⁰ I.R.C. § 170(b)(2).

¹⁸¹ I.R.C. § 162(b). That section can be read more broadly to create a hierarchy under which any expenditure eligible for section 170 treatment must be deducted under section 170 rather than section 162 because it includes a limitation based on the

Thus, it is not surprising that corporations do not characterize their expenditures as charitable giving in excess of that amount.¹⁸² If they are going to exceed that limitation, they have long been well-advised to characterize the expenditure as a section 162 expense.

Relaxing the capitalization requirement in lieu of retaining section 170 for corporations changes the perspective on corporate contributions. Under section 170, the assumption is that the corporation takes money out of profits already earned and gives those profits away, thereby removing such profits from the tax base. Section 170 is thus backward-looking. On the other hand, relaxing the capitalization requirement is forward-looking. It treats the contribution as a cost of producing future income and exempts that income from tax when and if it is earned. Because the precise amount and timing of income earned on account of corporate giving is very difficult to measure and the duration of any corporate benefit is uncertain, neither the corporation nor the government can be sure how much income (if any) will be exempt from tax, when analyzed this way. This perspective on the treatment of corporate giving appears to cost the government, as well as the shareholders, less than the section 170 approach, but it may present a more accurate measure because it recognizes that corporate giving hopes to be, but does not always succeed in being, profit enhancing.

This change in perspective is incompatible with the 10% limitation currently applicable to corporations. Section 170(b)(2) limits deductible corporate contributions to charity to 10% of the corporation's income. But it does not make good tax sense to limit the deduction for corporate contributions if we are trying to accurately measure a corporation's income. The more compelling the argument is for treating corporate charity as a business expense under section 162, the more compelling it is to allow those deductions in full, regardless of their share of corporate income. The 10% limitation creates a badge of illegitimacy for corporate philanthropy. Even though corporations are unlikely to devote more than 10% to exempt purposes, removal of that badge increases the justification for those payments, at any level. By changing the perspective from after-profit to pre-income, any limitation based on income is inconsistent with the treatment of the expenditure as a cost of producing income

time of payment rules in section 170.

¹⁸² The statistic on corporate charity is always much lower than the 10% limit imposed by section 170, but is determined based on tax information. In 2002, corporations gave 1.8% of pretax profits to charity. GIVING USA 2003, *supra* note 104, at 97; *see id.* at 4 (describing methodology based on tax return information).

(effectively or not). This change could, potentially, lead to greater support for charity than current law. The 10% limitation signals the suspect nature of the covered expenditures. While very few corporations approach that amount, characterization of payments to charities as business expenses increase their legitimacy. If payments from corporations to charities do contribute to profit maximization, they are inappropriately deducted as gifts, which are transfers without corresponding benefits.

V. ENCOURAGING PHILANTHROPY INSIDE AND OUTSIDE THE CORPORATION

The shift to section 162 might encourage more charity than the current regime for a variety of reasons. First, it dispenses with a state-law safe harbor that relies on the existence of taxable income and the effective ceiling on contributions that the tax rule imposes. Since the charitable deduction for corporations is available for amounts up to 10% of income,¹⁸³ it depends on the existence of net income. Corporations have become increasingly adept at reducing or eliminating their tax liability: debt capitalization and corporate tax shelters allow corporations to significantly reduce their tax liability, even when they are profitable.¹⁸⁴ One study has shown that corporations with higher debt-to-value ratios give less to charity than firms with lower debt-to-value ratios.¹⁸⁵ Those firms also have substantial deductions from interest expense, minimizing their corporate tax liability and the corresponding 10% limit under section 170. If a corporation has no taxable income, then the safe-harbor benchmark of the tax statute, which has been adopted as the state-law standard for an appropriate level of corporate giving,¹⁸⁶ disappears. Would a contribution be treated as unreasonable because it is in excess of 10% of a corporation's modest taxable income? It would be unfortunate if the success of a corporation in managing its tax liability

¹⁸³ Congress temporarily lifted the 10% limitation for 2005. See Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, §301, 119 Stat. 2016, 2022–23.

¹⁸⁴ See STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION CONCERNING INTEREST AND PENALTIES AND CORPORATE TAX SHELTERS BEFORE THE SENATE FINANCE COMMITTEE, at 15–18 (Joint Comm. Print 2000), available at <http://www.house.gov/jct/x-23-00.pdf>.

¹⁸⁵ Brown et al., *supra* note 96. The authors concluded from their data that creditors are effective monitors of the agency costs of corporate giving, but the tax explanation seems more compelling. See *id.*

¹⁸⁶ See *supra* note 30 and accompanying text.

undermined its ability to give to charity on account of the percentage constraints. A corporation that reports only a small amount of taxable income, but a great deal of book income, should be justified, under the reasonableness standard applicable under state law, in both giving and deducting more than 10%, but there is no authority to support that conclusion. A section 162 deduction is available dollar for dollar on corporate income, without any percentage limitation, so it would not interact with other tax-minimizing strategies that might reduce corporate giving as a by-product.

Second, removing the percentage limitation lifts a pall that hangs over corporate giving — even for amounts that are within the limit. The 10% limit is significantly lower than the statutory limit applicable to individual giving,¹⁸⁷ making corporate giving suspect by comparison. Discomfort with corporate giving, as reflected in the limitation, may have been appropriate when corporate philanthropy was accurately conceptualized as profit-reducing gifts of shareholder property, but that view is not fitting today. Corporate philanthropy is singled out in the Code in this way, for restrictive treatment, despite the fact that there is nothing evasive about it. Removing the limitation is an important symbolic gesture about the acceptability of corporate philanthropy throughout business cycles and at significant levels.

Third, a section 162 deduction is more stable than a deduction under section 170. The difference between section 162 and section 170 could be significant in the context of tax reform, since the effects of reform are likely to differ depending on where a deduction falls in the statutory scheme. Although President Bush has declared his protection for the charitable contribution deduction, in tax reform plans, the section 170 deduction is likely to be more vulnerable than the deduction under section 162.¹⁸⁸ For example, the President's Advisory Panel on Tax Reform recommended that the charitable contribution be subject to a floor of 1% of net income for all taxpayers,¹⁸⁹ but a parallel limitation for business expenses was not suggested and would seem absurd to many people. If corporate payments to charities are ensconced safely under the auspices of section 162 prior to major reform, there will be no discussion about

¹⁸⁷ Individuals are subject to 50% and 30% of net income limitations. *See* I.R.C. § 170(b).

¹⁸⁸ The Blueprints model income tax proposal allows no deductions for charitable gifts. *See* DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 86 (2d ed., rev. 1984).

¹⁸⁹ *See* PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM 75 (2005).

limiting it; business deductions are necessary to determine “net income” under an income tax. Similarly, if major tax reform constitutes adoption of a consumption tax, business deductions remain part of that model as well, whereas charitable contributions are more controversial.¹⁹⁰ In addition, the shift to a consumption tax would solve the capitalization question for corporate giving because all business expenses are immediately deducted in a consumption tax.

Fourth, the consolidation of all aspects of corporate responsibility, assimilating business expenses with charitable gifts, under section 162 increases the integrity and coherence of the tax law because it includes the various activities executed by corporations, which fall along a continuum. By placing all those activities in the same category, it encourages them all equally, which may prove to be an important step in preserving corporate support for charity. The tax law currently treats corporate charitable giving as separate and distinct from other activities of corporations by segregating it in section 170. But it is just one small part of a corporation’s overall citizenship strategy, which blends elements of both altruism and self-interest. The separate treatment of corporate philanthropy — compared to corporate citizenship with respect to the work force, the environment, and the customer — creates an undue burden of justification on those activities, compared to the activities that are presumed to be part of the business operations. The clear division between other-regarding charity and profit-increasing business has converged from both ends, leaving the dichotomy between section 162 expenses and section 170 expenses significantly muddled. As the distinction between philanthropy and business continues to blur, the separation between section 162 and section 170 becomes harder to identify and impossible to enforce.

In a recent survey about corporate citizenship, charitable giving ranked last in a list of twelve behaviors that survey participants considered important in evaluating corporate citizenship.¹⁹¹ The most important behaviors were the corporation’s treatment of employees and its adherence to honest business practices.¹⁹² These developments pose a concern for charities and threaten the policies that the law

¹⁹⁰ The Blueprints model treats charitable gifts as consumption by the donor, which are therefore non-deductible. See BRADFORD & U.S. TREASURY TAX POLICY STAFF, *supra* note 188, at 104–05. The popular “flat tax” contains no deduction for charitable gifts. See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 105–06 (2d ed. 1995).

¹⁹¹ Jensen, *supra* note 43, at 20 (citing study by GolinHarris).

¹⁹² *Id.*

reflects towards corporate support of them. Under the current system, traditional corporate philanthropy seems destined to be an increasingly minor player, compared to the issues that pertain integrally to the corporation's business. The halo from corporate giving is apparently fainter than people might have once thought and corporations are responding by tethering their charitable contributions more closely to their core corporate initiatives, using corporate donations "as a strategy to increase profits through marketing efforts or other means."¹⁹³ Thus, charitable giving has become more responsive to the bottom line, while businesses are under increasing pressure to become more responsible to various communities within their stakeholders.

It is time to consider the full range of public benefit activities together in the tax law, by leveling the field for all such activities under a single tax standard. It should make us increasingly uncomfortable if the expansion of corporate philanthropy — as defined in and pigeonholed by section 170 — takes place in the face of contracting opportunities and unacceptable conditions for workers, degradation of the environment, and unethical business practices. How is it possible that Wal-Mart can be both a model of corporate philanthropy¹⁹⁴ and a cruel employer?¹⁹⁵ While recharacterization under the tax law alone cannot change the way that corporations conduct their operations, it can encourage all approaches to public responsibility without privileging one over any other.

Critics may argue that the shift from treating corporate giving under section 170 to section 162 reduces the transparency of corporate giving, but I would argue that the loss of transparency offers certain benefits in this case. First, since corporations are under more pressure to produce short-term earnings than to do good works, less shareholder scrutiny might allow more circumspect decisions about long-term profitability and social value. Second, less public scrutiny would be offset by greater scrutiny by the Service because switching to section 162 would allow the Service more oversight in determining

¹⁹³ Ian Wilhelm, *Corporate Giving Rebounds*, CHRON. PHILANTHROPY, Aug. 4, 2005, at 7, 18.

¹⁹⁴ In 2004, Wal-Mart, the leader in charitable giving, was most frequently named as a strong corporate citizen. See Press Release, Cone Inc., *supra* note 5. But see America's Most-Hated Companies, ECONOMIST, Dec. 24, 2005, at 91 (discussing a straw poll showing Wal-Mart as the most hated company in America).

¹⁹⁵ See Steven Greenhouse, *Parrying Its Critics, Wal-Mart Says Its Wages Must Stay Competitive*, N.Y. TIMES, May 4, 2005, at C1 (reporting that Wal-Mart workers have no health insurance and must resort to public assistance).

whether an expense is ordinary and necessary. That requirement would make it harder for managers to engage in agency-cost philanthropy than under section 170. Finally, there is not much transparency to lose in this area. While corporate foundations file Form 990s that are widely available,¹⁹⁶ there is a great deal of data on corporate giving that is not available under current law because corporate tax returns are not public and corporations are not required by SEC rules to disclose anything about their giving.¹⁹⁷ Even so, many corporations do publicize their charitable activities and the current trend is for businesses to try to more effectively use corporate giving in their business, so corporations will continue to have an incentive to provide information, regardless of their ability to withhold it.

In a post-JGTRRA world, shareholders should increasingly demand that payments to charity are wealth-enhancing to the corporation, bolstering a deduction under section 162 and reducing the attractiveness of section 170 to corporations subject to those demands. When individual rates on dividends were high, shareholders had a higher tolerance for managerial discretion over corporate funds.¹⁹⁸ Now that rates are lower for dividends, shareholder acceptance of wealth-minimizing strategies in the corporation should be less acceptable because the tax treatment of a payout is more advantageous compared to accumulation. The reduced rate of tax on dividends changes the determination about whether corporations should accumulate earnings or pay them out and the new pressure on corporations to pay dividends more generally¹⁹⁹ could impede all other internal uses of corporate earnings, including philanthropy.

VI. CONCLUSION

This paper has argued that there are many threats to corporate support of charity in the current environment, most of them by-products of other policies that may not be inherently troublesome.

¹⁹⁶ See, e.g., GuideStar, <http://www.guidestar.org>.

¹⁹⁷ In an analysis of foundation giving, "nearly half of corporate grants could not be coded by type of support for a lack of information provided by the funder." ATIENZA & ALTMAN, *supra* note 96, at 61.

¹⁹⁸ See Calvin H. Johnson, *The Incredible Shrinking Domain of Corporate Stock*, 103 TAX NOTES 871, 875-76 (May 17, 2004).

¹⁹⁹ Studies have found significant increases in dividends following the passage of JGTRRA. See Raj Chetty & Emmanuel Saez, *Do Dividend Payments Respond to Taxes? Preliminary Evidence from the 2003 Dividend Tax Cut* (Nat'l Bureau of Econ. Research, Working Paper No. 10572, 2004), available at <http://www.nber.org/papers/w10572>; see also *supra* note 26 and accompanying text.

Lower dividend taxes make corporate giving less attractive and increase pressure on corporations to pay out dividends. Low effective tax rates for corporations reduce the tax benefits of corporate giving. The death of Berkshire Hathaway's model philanthropy program — for reasons completely separate from the merits of it as a mechanism for maximizing tax benefits and minimizing agency costs — illustrates the unfortunate divergence of ideal theory and practical implementation.

We are at a crossroads for corporate philanthropy and the support of many organizations depends on how corporations respond to the many, sometimes conflicting, pressures from their shareholders, customers, and communities. I have argued that the tax law should reform to treat corporate charitable giving like all other investments corporations make in their businesses and that the recent adoption of new capitalization regulations should make that transition legally frictionless. While the change might seem technical, it has the potential to encourage more and better charitable giving, to reduce agency costs, and to improve the coherence of the tax law.

