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Internal Revenue Code Section 170 and the Great Corporate Giveaway

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Article

Internal Revenue Code Section 170 and the Great Corporate Giveaway

Charity has no business to sit at boards of directors quâ charity.[*] -- Lord Bowen

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I. INTRODUCTION

In 1989, corporations gave five billion dollars to charitable organizations.[1] This represented an increase of 4.2 percent over the previous year, although after adjusting for inflation, corporate giving actually was down 0.5 percent. Corporations simply gave away five billion dollars in profits in a single year. The obvious question is: How can corporations, through their managers and directors, justify giving away five billion dollars in shareholders' profits?

Section 170 of the Internal Revenue Code provides a deduction for certain charitable contributions made by corporations but section 170 certainly does not authorize managers or directors to make such contributions. Authorization to make charitable

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* Hutton v. West Cork Ry., 23 Ch.D. 654, 673 (1883).

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1. McMillen, *Americans Gave More to Charity Again in 1989; Total Topped $100-Billion for 2nd Straight Year*, Chronicle of Higher Education, June 13, 1990, at A1, col. 3.

contributions is contained in the corporation statutes of all states and the District of Columbia.[2] These statutes are based on a theory of corporate social responsibility. In 1969, Professor J. A. C. Hetherington stated that "this one aspect [corporate charitable giving] of corporate good citizenship seems therefore to be legally settled."[3] However, this area is legally settled only in the sense that these statutes have been enacted and are in effect. This area is not settled philosophically or economically. In the absence of a section 170 deduction, these statutory authorizations would become meaningless. Given the state of the federal budget and the now expressed need to raise taxes, we can not afford to continue to let as much as $1.7 billion dollars annually leak out of the federal treasury through the section 170 corporate charitable deduction.[4]

2. *See* ALA. CODE § 10-2A-20(13) (1975); ALASKA STAT. § 10.06.010(13) (1989); ARIZ. REV. STAT. ANN. § 10-004(13) (1990); ARK. STAT. ANN. § 4-25-103 (1987); CAL. CORP. CODE § 207(e) (West Supp. 1990); COLO. REV. STAT. § 7-3-101(m) (1986); CONN. GEN. STAT. ANN. § 33-291(d) (West 1987); DEL. CODE ANN. tit. 8, § 122(9) (1974); D.C. CODE ANN. § 29-304(13) (1981); FLA. STAT. ANN. § 607.011(2)(k) (West 1977); GA. CODE ANN. § 14-2-302(13) (1990); HAW. REV. STAT. § 415-4(13) (1985); IDAHO CODE § 30-1-4(m) (1980); ILL. ANN. STAT. ch. 32, para. 3.10(m) (Smith-Hurd 1990); IND. CODE ANN. § 23-1-22-2(13) (West 1989); IOWA CODE § 490.302(13) (West 1990); KAN. STAT. ANN. § 17-6102(9) (1988); KY. REV. STAT. ANN. § 271.A-020(13) (Baldwin 1989); LA. REV. STAT. ANN. § 12:41(B)(12) (West 1969); MD. CORPS & ASS'NS CODE ANN. § 2-103(13) (1985); MASS. GEN. LAWS ANN. ch. 155, § 12C (West 1970); MICH. COMP. LAWS ANN. § 450.1261(k) (West 1990); MINN. STAT. ANN. § 302A.161, subd. 11 (West 1985); MISS. CODE ANN. § 79-1-3 (1989); MO. ANN. STAT. § 351.385(15) (Vernon 1990); MONT. CODE ANN. § 35-1-108(13) (1990); NEB. REV. STAT. § 21-2004(13) (1987); NEV. REV. STAT. § 78.070(6) (1989); N.H. REV. STAT. ANN. § 293-A:4 (1987); N.J. STAT. ANN. § 14A:3-4 (West Supp. 1990); N.M. STAT. ANN. § 53-11-4(M) (Supp. 1989); N.Y. BUS. CORP. LAW § 202(a)(12) (McKinney 1986); N.C. GEN. STAT. § 55-3-02(a)(13) (1990); N.D. CENT. CODE § 10-19.1-26(11) (1985); OHIO REV. CODE ANN. § 1701.13(D) (Anderson 1989); OKLA. STAT. ANN. tit. 18, § 1016(9) (West 1986); OR. REV. STAT. § 60.077(n) (1989); PA. STAT. ANN. tit. 15, § 1502(9) (Purdon 1990); R.I. GEN. LAWS § 7-1.1-4(13) (1985); S.C. CODE ANN. § 33-3-102(13) (Law. Co-op. 1990); S.D. CODIFIED LAWS ANN. § 47-2-58(13) (1990); TENN. CODE ANN. § 48-13-102(13) (1988); TEX. BUS. CORP. ACT ANN. art. 2.02A(14) (Vernon 1990); UTAH CODE ANN. § 16-10-4(m) (Supp. 1990); VT. STAT. ANN. tit. 11, § 1852(13) (1984); VA. CODE ANN. § 13.1-627(12) (1989); WASH. REV. CODE ANN. § 23B.03.020(o) (1990); W. VA. CODE § 31-1-8(m) (1990); WIS. STAT. ANN. § 180.04(12) (West 1957); WYO. STAT. § 17-16-302(a)(xiii) (1990).

3. Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248, 279 (1969).

4. $5 billion times the top corporate tax rate of 34% is $1.7 billion. It is not possible to say exactly how much would be saved as a result of repeal of the section 170 charitable deduction for corporations because certain current charitable deductions might otherwise qualify as deductions for ordinary and necessary business expenses under section 162. *See* I.R.C. § 162 (West 1990).

This Article analyzes corporate charitable giving and the section 170 corporate deduction from economic, moral, and legal perspectives. In economic terms, this Article considers profit maximization, the principal-agent problem, and the tax effect on corporate giving. From a moral standpoint, this Article discusses the issues of corporate social responsibility and moral agency. Next, this Article examines the laws of agency, trusts, and corporations as applied to corporate giving. Based on the foregoing analysis, this Article recommends that Congress repeal the section 170 corporate deduction provision and require corporations to justify all expenditures in terms of profit maximization and business purpose.

II. LEGAL BACKGROUND

A. Pre-section 170 Amendment

Before Congress amended the predecessor section to section 170 to allow corporations a charitable contribution deduction, courts limited charitable contributions to those gifts which the directors reasonably thought would financially benefit the corporation. In *Armstrong Cork Co. v. H. A. Meldrum Co.*,[5] the court permitted charitable contributions to the University of Buffalo and Canisius College where there was a reasonable probability of direct benefit to the corporation and there was no objection by shareholders or creditors.[6] If a shareholder or creditor objected, the result may have been different. The directors regarded the contributions as proper incidental business expenses.[7] The corporation benefitted by having the future ability to secure employees trained and skilled in corporate business and industrial affairs from these colleges as well as the benefits from advertising the gifts, although the court noted that the advantage derived was

5. 285 F. 58 (W.D.N.Y. 1922).
6. *Id.* at 58.
7. *Id.*

tantamount to a personal benefit.[8] Certain gifts such as those to assist in the erection of a theater building, to assist in paying expenses of a festival or fair, and to assist in a political campaign, the court deemed *ultra vires.*[9]

In many of the early cases addressing corporate contributions, the courts understandably focused on whether the expenses were ordinary and necessary expenses incurred in carrying on a trade or business.[10] In *Corning Glass Works v. Lucas,*[11] the court held that a $25,000 contribution to a hospital building fund was an ordinary and necessary business expense.[12] The court reasoned that by contributing to the hospital building fund the corporation would not have to expand its dispensary.[13] The court pointed out that individuals could give away their money and property, but corporate directors could not do so unless the donation was reasonably calculated to further the corporation's general business interest.[14] It appears from *Armstrong Cork Co.* and *Corning Glass Works* that directors, within limits, could give corporate assets in support of charities important to the welfare of the community in which the corporation operated.[15] This view was the forerunner of the theory of social responsibility of corporations.[16]

B. Section 170

The charitable contribution deduction for contributions made to religious, educational, and other charitable organizations was enacted in 1917[17] and, hence, has a history nearly as long as federal income tax itself. Initially, only individuals were allowed

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8. *Id.* at 59. *See infra* text accompanying notes 44-59.
9. *Armstrong Cork Co.*, 285 F. at 59.
10. *See* I.R.C. § 162 (West 1990) (current codification of the ordinary and necessary business expense deduction).
11. 37 F.2d 798 (D.C. Cir. 1929).
12. *Id.* at 801.
13. *Id.*
14. *Id.* at 800.
15. *See supra* text accompanying notes 5-16 (discussing *Armstrong Cork Co.* and *Corning Glass Works*).
16. *See infra* text accompanying notes 93-119 (discussing the social responsibility theory).
17. Act of October 3, 1917, ch. 63, tit. XII, § 1201(2) (40 Stat. 330) (1917).

a charitable contribution deduction.[18] Corporate charitable contributions became deductible under section 23(q) of the Internal Revenue Code of 1939.[19] Today, section 170 of the Internal Revenue Code of 1986, within limits, allows a deduction for charitable contributions for both individuals and corporations.[20] A charitable contribution is a contribution or gift to or for the use of--

> 1. A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or District of Columbia, but only if the contribution or gift is made for exclusively public purposes.
> 2. A corporation, trust, or community chest, fund, or foundation -- (A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States; (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; (C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.
> 3. A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization -- (A) organized in the United States or any of its possessions, and (B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.
> 4. In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.
> 5. A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial

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18. *Id.*
19. Internal Revenue Code of 1939, ch. 2, 53 Stat. 15-16 (1939).
20. I.R.C. § 170 (West 1990).

> purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual.[21]

Other tax exempt organizations do not qualify to receive deductible charitable contributions. A contribution or gift to an individual, regardless of how needy or charitable the purpose, is not deductible.[22] A contribution to a foreign charitable organization is not deductible;[23] yet, United States-based charitable organizations may use charitable contributions abroad, except for contributions by corporations to a trust, chest, fund, or foundation, which must be used within the United States or its possessions.[24] However, a domestic charitable organization may not act as a mere conduit for transferring contributions to a foreign organization.[25]

The Code imposes limitations on the amount deductible by individuals, based on the type of property contributed, how the donee uses the contributed property, and what kind of charitable organization receives the contribution.[26] The Code limits corporations to a maximum deduction equal to ten percent of taxable income computed without regard to charitable deductions, most special deductions for corporations,[27] net operating carrybacks,[28] or capital loss carrybacks.[29]

The growing importance of the charitable contribution deduction can be seen by comparing amounts donated over a period of years. Charitable giving in 1970 amounted to $21 billion, with

21. *Id.* § 170(c) (West 1990).
22. *See id.* § 170 (West 1990) (stating what is deductible as a contribution).
23. *Id.*
24. *Id.*
25. Rev. Rul. 63-252, 1963-2 C.B. 101.
26. *See* I.R.C. § 170(b)(1) (West 1990) (describing particular restrictions).
27. *See id.* §§ 241-47, 249-50 (West 1990) (special deductions for corporations exempted from section 170).
28. *See id.* § 172 (West 1990) (defining net operating carrybacks).
29. *Id.* § 170(b)(2) (West 1990). *See id.* § 1212(a)(1) (West 1990) (listing capital loss carrybacks).

$797 million donated by corporations.[30] This amount more than doubled to $49 billion in 1980, with $2.4 billion given by corporations.[31] As the amount of charitable contributions deducted nearly doubled in 1985, so did charitable giving over its 1980 figure to $79.8 billion, with $4.3 billion by corporations.[32] Reports of charitable giving in 1989 indicate that of the record amount of $114.7 billion donated, corporations donated $5 billion.[33] Nearly one half of all charitable giving ($37.7 billion in 1985) goes to religious organizations, while educational organizations, hospitals, health organizations, and social welfare organizations combined accounted for approximately thirty-eight percent of the total ($31 billion in 1985).[34] Forty-two percent of corporate giving goes to education while human services, public/society benefit, arts, culture, and humanities, health, religion, and miscellaneous account for the rest of corporate giving.[35] Charitable giving consistently amounts to approximately two percent of gross national product.[36]

These statistics reflect the altruism and generosity of the American people. Corporations, however, do not give based on altruism or generosity but on tax consequences. The economic literature shows that the corporate tax has a price and net-income

30. AMERICAN ASSOCIATION OF FUND-RAISING COUNSEL, GIVING U.S.A.: ESTIMATES OF PHILANTHROPIC GIVING IN 1985 AND THE TRENDS THEY SHOW 33, 41 (1986) [hereinafter 1985 GIVING REPORT].

31. *Id.*

32. *Id.* at 6. Individuals deducted $25.8 billion in 1980 and $50 billion in 1985. *See* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME - 1980: INDIVIDUAL TAX RETURNS 57 (1982) and INTERNAL REVENUE SERVICE, STATISTICS OF INCOME - 1985: INDIVIDUAL TAX RETURNS 62 (1988).

33. McMillen, *Americans Gave More to Charity Again in 1989; Total Topped $100-Billion for 2nd Straight Year*, The Chronicle of Higher Education, June 13, 1990, at A1, col. 3; *id.* A23, col. 1.

34. 1985 GIVING REPORT, *supra* note 30, at 7.

35. AMERICAN ASSOCIATION OF FUND-RAISING COUNSEL, GIVING U.S.A.: ESTIMATES OF PHILANTHROPIC GIVING IN 1987 AND THE TRENDS THEY SHOW 65 (1988). The exact percentages of noneducational corporate giving in 1987 were: Human services, 23.6%; public/society benefit, 13.2%; arts, culture, and humanities, 11.9%; health, 4.4%; religion, .03%; and miscellaneous, 3.97%. *Id.*

36. 1985 GIVING REPORT, *supra* note 30, at 41.

effect on corporate giving.[37] Corporate charitable contributions are proportional to after-tax income.[38]

Corporations are treated more favorably under the Code than individuals. Unlike individuals, corporations do not have a standard deduction, therefore, every dollar of charitable contributions is deductible up to the statutory limit.[39] Moreover, the problem of equity between individual taxpayers who itemize and those who do not does not arise in the corporate context, since all corporations, in effect, itemize. Given the magnitude of the amounts involved and the relationship between the profit motive and corporate giving, an examination of that relationship follows.

III. ANALYSIS

Congress based the section 170 deduction on a public welfare theory.[40] The public welfare theory is that charitable organizations perform services that the government would otherwise have to provide in their absence.[41] Therefore, any loss of revenue resulting is more than offset by shifting the financial burden for providing those services from the federal treasury to charitable organizations.[42] Thus, Congress encourages the private sector to actively engage in activities regarded as "fundamental" or "socially desirable" to thereby promote the general welfare.[43] Corporate contributions aid the advancement of education and science, provide relief for the poor, distressed, and underprivileged, advance religion, erect and maintain public buildings, monuments, and works, lessen the burden of government, and promote the social welfare. Nonetheless, there are compelling reasons why Congress should not permit corporations to take a section 170

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37. *See* C. CLOTFELTER, FEDERAL TAX POLICY AND CHARITABLE GIVING 275 (National Bureau of Economic Research Monograph, 1985) (detailing a good, although technical, economic analysis of the price and income effects).

38. *Id.*

39. *See* I.R.C. § 170 (b)(2) (West 1990).

40. H.R. Rep. No. 1860, 75th Cong., 3d Sess., 1939-1 (Part II) C.B. 742.

41. *Id.*

42. *Id.*

43. *Id.*

charitable contribution deduction. One of these compelling reasons is profit maximization which is generally assumed to be the driving force behind corporate decisions.

A. *Profit Maximization and the Principal-Agent Problem*

1. *Profit Maximization Theory*

In microeconomics, it is a tenet of the theory of the firm that firms are profit maximizers.[44] Profit maximization is justified on the grounds that if competitive firms did not maximize profits they would be inefficient and hence would be forced out of business by the efficient firms.[45] Monopolists are presumed to be profit maximizers by virtue of their position.[46] Moreover, if the shareholders of a corporation were able to directly run the corporation they would opt for profit maximization and its corresponding cost minimization. Of course, the shareholders may not prefer profit maximization if they are risk-averse or have a vested interest in the price of one of the firm's products as a result of consumption of the firm's goods. Empirically, the evidence for this view is weak since most shareholders diversify their portfolios to reduce market risks, and shareholders consume a relatively small amount of the firm's goods. Pragmatically, economists prefer the profit maximizing theory of a unitary firm because it presents a mathematically clean, solvable minimax problem. However, there is a growing body of economic research on the principal-agent problem which hypothesizes that firms are not necessarily profit maximizers.[47]

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44. H. VARIAN, MICROECONOMIC ANALYSIS 6 (2d ed. 1984).
45. *Id.*
46. *Id.*
47. *See, e.g.*, K. Arrow, *The Economics of Agency*, PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (J. Pratt and R. Zechhauser eds. 1985); D. Baron, *Design of Regulatory Mechanisms and Institutions*, HANDBOOK OF INDUSTRIAL ORGANIZATION (R. Schmalensee and R. Willig eds. 1986); D. Sappington and J. Stiglitz, *Information and Regulation*, PUBLIC REGULATION: NEW PERSPECTIVES ON INSTITUTIONS AND POLICIES (E. Bailey ed. 1987) (analyzing the economics of the principal agent problem).

2. Principal-Agent Theory

The non-profit maximization theory in the economic literature is largely associated with corporations where ownership is separated from control.[48] Corporations are owned by shareholders who do not run them, and run by managers who do not own them.[49] Not only is there a separation between ownership and control, there is a loss of control by the board of directors.[50] The horizontal expansion of corporations accounts for the loss of supervisory control. The expansion shifts the role of auditing and allocating resources among competing divisions from the boards of directors to the lower levels of management. Those in control of the corporation are supposed to act in the best interests of the corporation and its shareholders; however, corporate managers may have objectives other than profit maximization, such as maximizing firm or department growth, maximizing sales volume, reducing effort by increasing the number of managerial personnel, obtaining managerial perquisites such as a large office, executive bathroom, company car, first class accommodations, personal satisfaction or career development, or directing money or property to charitable institutions of their choice. Under the principal-agent theory, inside information allows managers this discretion.[51] Managers have inside information not otherwise available to the shareholders. The shift from large numbers of widely dispersed shareholders to institutional shareholders does not seem to have altered the

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48. *See* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 32-33, (2d ed. 1980) (discussing the separation of ownership and control and its effects).

49. Ownership of a small percentage of the corporation's stock by managers does not undercut the analysis, because managers still control property they do not own: the percentage of the corporation owned by shareholders other than management.

50. *See, e.g.,* A. CHANDLER, STRATEGY AND STRUCTURE (1966) (discussing the function of board of directors in modern corporation).

51. *See, e.g.,* K. Arrow, *The Economics of Agency,* in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (J. Pratt and R. Zechhauser eds. 1985); D. Baron, *Design of Regulatory Mechanisms and Institutions* in HANDBOOK OF INDUSTRIAL ORGANIZATION (R. Schmalensee and R. Willig eds. 1986); D. Sappington and J. Stiglitz, *Information and Regulation* in PUBLIC REGULATION: NEW PERSPECTIVES ON INSTITUTIONS AND POLICIES (E. Bailey ed. 1987) (economic analysis of the principal agent problem).

asymmetric information condition.[52] With incomplete information, shareholders cannot accurately monitor managers' performances. This has tremendous ramifications for the stock market. Common stock evaluation is based on discounting net income streams and analyzing profit centers.[53] Discounting a submaximum profit stream distorts the value of the firm and its stock price.[54] Without adequate knowledge concerning the corporation's technology development, for example, the shareholders and investors have no way of knowing whether an expansion of the research and development division is justified by the firm's technology or whether it represents empire building such as inflated need for more personnel, high priced toys, or ego of the division director. Without more information, the shareholder or investor cannot determine whether to invest, disinvest, or maintain his or her stock interest if the managers are not profit maximizers. Managerial objectives could involve prestige, ego, power, number of subordinates, size of budget, conviviality, friendship, career development, and other non-profit maximizing behavior such as charitable contributions to the manager's favorite charity or alma mater. The corporation reduces shareholder profits by the amount that management siphons off corporate profits for these purposes. Charitable contributions that would not otherwise be deductible are not consistent with profit maximization.

3. Tax Effects

The econometric literature suggests that the corporate tax has both a price and net-income effect on corporate giving, which is consistent with non-profit maximization models.[55] The "price" or cost of giving for an itemizer, individual or corporate, is (1-MTR) X $1, or simply $(1-MTR). MTR is the taxpayer's marginal tax

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52. *See* E. RASMUSEN, GAMES AND INFORMATION 133-79 (1989) (theoretical discussion of the asymmetric information problem).

53. *See* HAMILTON, FUNDAMENTALS OF MODERN BUSINESS § 11.10 (1989) (discussing valuation of stock).

54. *See id.*

55. C. CLOTFELTER, *supra* note 37, at 275.

rate. The net-income effect means that in years of high profits, firms make or increase charitable contributions, while in lean years firms cutback or eliminate contributions.

The loss of profits to the shareholders can be somewhat ameliorated by the tax law which may allow the corporation a deduction under section 162 or 170.[56] If a deduction is allowed, the marginal cost to the shareholders of one dollar donated to a charitable organization is one minus the corporation's marginal tax rate. Under the Tax Reform Act of 1986, the corporate tax schedule contains higher rates than for individuals.[57] In this respect shareholders benefit from corporate charitable contributions if the contributions are substitutes for individual giving, which may be the case for closely held corporations, but is highly unlikely for publicly held corporations except for a few controlling persons. With only these few exceptions, firms reduce shareholder profits with no corresponding benefit when managers exercise their discretion by giving money or property to charitable organizations.

4. Remedy

The question then becomes: Whose charity is it anyway? The situation is even more vexing if the shareholder would not otherwise contribute to or support the particular charitable organization. The power or ability to make charitable contributions is a perquisite of management under a principal-agent analysis and should constitute part of the manager's compensation. Perhaps the amount of the charitable contribution should be included in the manager's compensation, the deductibility of which by the corporation will be subsequently judged under the "ordinary and

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56. *See* I.R.C. §§ 162 (West 1990) (allowing deductions for ordinary and necessary business expenses); 170 (providing deductions for charitable contributions)

57. The top marginal tax rate for individuals is 28 percent although there is a five percent surtax, increasing the top rate to 33 percent for certain income brackets through taxable year 1990 and 31 percent after taxable year 1990. Pub. L. No. 101-508, 104 Stat. 1388 (1990). The top corporate tax rate is 34 percent for taxable income in excess of $75,000; however, there is a five percent surtax on corporate taxable income in excess of $100,000 up to a maximum additional tax of $11,750. *See* I.R.C. § 11(b)(1) (West 1990) (codification of tax brackets).

necessary'' rule of section 162.[58] The manager would then be entitled to a section 170 deduction within the statutory limitations.[59] The corporation would not be entitled to a section 170 deduction.

B. Law of Agency

Not only does the economic theory of principal-agent undermine the case for corporate giving, the legal relationship between principal and agent undermines the case as well. A corporation can only act through agents.[60] Since a corporation can only act through agents, it must necessarily have the capacity to appoint them; however, its status as principal confers no consciousness or individual being.[61] In general, the officers and employees of a corporation are its agents.[62]

The board of directors situation is rather unique. Although shareholders elect and can remove directors, the directors are not agents of the shareholders, and they are not principals.[63] The corporation's agents owe their allegiance to the corporation, not the directors.[64] The directors are not agents of the corporation because of their statutory powers of management; they are not subject to control by anyone, which is a requirement of the principal-agent relationship.[65] Since the development of the multidivisional form, boards of directors have lost much of the control given to them by the state corporation acts.[66] Directors of publicly held corporations generally delegate their authority to manage to the officers and

58. *See id.* I.R.C. § 162(a)(1) (West 1990); Treas. Reg. §§ 1.162-7, 1.162-8, & 1.162-9 (1990) (detailing limitations on deductions for compensation).

59. *See* I.R.C. § 170 (West 1990) (allowing charitable contribution deductions).

60. W. SELL, AGENCY 13 (1975).

61. *Id.*

62. *See* HENN & ALEXANDER, CORPORATIONS 586, 593-94 (3rd ed. 1983) (discussing officers as agents of corporations).

63. *Id.* at 562-63.

64. *Id.* at 586-606 (discussing the duties of officers as agents of the corporation).

65. *Id.* at 611 (outlining the roles of the officers and directors in a corporation).

66. *Id.* at 593.

content themselves with ratifying the officers' actions. The concern here, then, is with the officers as agents of the corporation.

An agent who receives money or property from the principal for the benefit of the principal is under a duty to account for that money or property.[67] Generally, an agent must attempt to earn a profit for the principal, and, hence, the agent is under a duty to account for any such profits earned.[68] An agent has a duty not to act adversely to the interests of the principal, an example of which is appropriating the principal's assets for the agent's benefit or giving away the principal's assets. One such set of transactions consists of an agent dealing with a close friend or relative where, in effect, the transaction is for the benefit of the agent.[69] This is similar to the charitable contribution case where the officer authorizes and makes corporate charitable contributions to his or her favorite charities or alma mater. In such cases of adverse action the principal has the right of rescission.[70] This is true even if the principal suffered no harm or gained from the transaction.[71] The agent essentially is acting in his or her own behalf, thereby violating the duty of loyalty. An agent who converts the principal's money or property is liable to the principal for the full amount of the property or money converted.[72]

Of course, the officer is an agent of the corporation, not an agent of the shareholders, so that the rights of rescission and restitution belong to the corporation and not the shareholders.[73] The corporate principal, being controlled by the very persons who are violating their duties owed to the corporation, may not proceed

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67. *See, e.g.*, Alexopoulos v. Dakouras, 48 Wis. 2d 32, 179 N.W.2d 836, 840 (1970).

68. *See, e.g.*, Stuber v. Taylor, 200 N.W.2d 276, 280 (N.D. 1972); Sears, Roebuck & Co. v. Kelly, 1 Misc. 2d 624, 149 N.Y.S.2d 133, 135 (1956).

69. *See, e.g.*, Blakeley v. Bradley, 281 S.W.2d 835, 837 (Mo. 1955).

70. *See, e.g.*, Donovan & Schuenke v. Sampsell, 226 F.2d 804, 812 (9th Cir. 1955).

71. *See, e.g.*, Boulevard Plaza Corp. v. Campbell, 254 Minn. 123, 94 N.W.2d 273, 281 (1959).

72. RESTATEMENT (SECOND) OF AGENCY § 402 (1957).

73. *See* text accompanying notes 60-76 (discussing the role of the officer as an agent of the corporation).

against the agents.[74] At this point, the shareholders do have a remedy--the shareholder derivative suit.[75]

If an officer makes a corporate charitable contribution to his or her favorite charity or alma mater and the corporation acting through its board of directors refuses to seek rescission or restitution, a shareholder should bring a derivative suit in behalf of the corporation to recover the amount dispersed. Of the two remedies--rescission and restitution--from a public policy viewpoint, restitution is preferred so that charitable organizations can depend on contributions made and received. If restitution is ordered, the officer pays back the corporation and should be allowed the individual section 170 deduction to the extent allowable. The corporation, having recovered the sum, is not entitled to a section 170 deduction.[76] In the event that the officer is unable to make full restitution, the individual section 170 deduction should be limited to the amount repaid within each taxable year. The corporation should be entitled to deduct a section 165 loss for amounts unrecoverable but no section 170 deduction.

C. *Fiduciary Duties and the Business Judgment Rule*

The law of agency deals with the relationship between principal and agent, but since directors are neither principals nor agents, new law had to be created or old law modified to deal with the relationship between director and corporation. Based on their analysis of a series of early corporation cases, Adolf Berle and Gardiner Means contend that:

> [A]ll powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears. The *use* of the power is subject to equitable limitation when the power has been exercised to the detriment of their interest,

74. HENN & ALEXANDER, *supra* note 62, at 1037.
75. *See id.* at 1035-40 (discussing the shareholder derivative cause of action).
76. *See* I.R.C. § 165 (West 1990) (discussing the amounts unrecoverable deduction).

> however absolute the grant of power may be in terms, and however correct the technical exercise of it may have been. . . . And that, in every case, corporate action must be twice tested: [F]irst by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a *cestui que trust* to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary.[77]

In effect, Berle and Means believed that corporate law, in substance, was a branch of the law of trusts.[78] Acknowledging, however, that this position was more theory than practice Berle and Means stated:

> "In fact, if not in law, at the moment we are thrown back on the obvious conclusion that a shareholder's right lies in the expectation of fair dealing rather than the ability to enforce a series of supposed legal claims."[79]

The cases analyzed by Berle and Means are the precursors of the business judgment rule.[80] The chancellor in *Bodell v. General Gas and Electric Corporation*[81] held that while not "trustees in the strict sense of the term, yet for convenience [directors] have been described as such."[82] Since then, directors have stood in the position of fiduciaries.

The business judgment rule is a standard of proof. The rule creates a presumption that the board of directors acted in good faith and in furtherance of the best interests of the corporation after

77. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 248 (1932) (emphasis added).

78. *Id.* at 275. *See also* Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931).

79. A. BERLE & G. MEANS, *supra* note 77, at 276.

80. *See* H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 661-663 (1983) (summarizing the business judgment rule). *See also* Manning, *The Business Judgment Rule in Overview*, 45 OHIO ST. L.J. 615 (1984).

81. 15 Del. Ch. 119, 132 A. 442 (1926).

82. *Id.* at 129, 132 A. at 446.

exercising due care.[83] The purpose of the business judgment rule is to protect directors from continuously having to justify their decisions made in the ordinary course of business to shareholders.[84] This is true even if the decisions turn out to be wrong, provided the directors acted in good faith and exercised due care.[85] Courts are reluctant to substitute their judgment for that of boards of directors because courts perceive the boards as possessing skills, information, and judgment not possessed by the courts.[86]

The business judgment rule only protects boards that act in good faith in accord with their duty of loyalty.[87] If the directors are disinterested, in all probability they will be deemed to have acted in good faith.[88] However, if the directors are not disinterested and are beneficiaries of the action, they will have breached their duty of loyalty, and the business judgment rule will not protect them.[89] If the plaintiff is able to establish that the board did not act in good faith or breached its duty of due care, the burden of proof shifts to the defendant directors to show that the transaction was entirely or intrinsically fair.[90]

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83. *See, e.g.*, Tate & Lyle PLC v. Staley Continental, Inc., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,764 (Del. Ch. 1988).

84. BNS, Inc. v. Koppers Co., 683 F. Supp 458, 473 (D. Del. 1988).

85. Mathes v. Cheff, 41 Del. Ch. 166, 175, 190 A.2d 524, 529 (1963), *rev'd on other grounds*, 41 Del. Ch. 494, 199 A.2d 548 (1964).

86. Auerbach v. Bennett, 47 N.Y.2d 619, 630-31, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); Solash v. Telex Corp., [1987-1988 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶¶ 93,608, 97,722 (Del. Ch. Jan. 19, 1988).

87. HENN & ALEXANDER, *supra* note 62, at 661 (discussing business judgment rule).

88. *Beard v. Elster*, 39 Del. Ch. 153, 165, 160 A.2d 731, 738 (1960).

89. *See, e.g.*, Maldonado v. Flynn, 597 F.2d 789, 794 n.7 (2d Cir. 1979), *on remand*, 477 F.Supp. 1007 (S.D.N.Y. 1979); Beard v. Elster, 39 Del. Ch. 153, 160 A.2d 731 (1960); Puma v. Marriott, 283 A.2d 693 (Del Ch. 1971) (directors found to be disinterested). *See also, e.g.*,Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980); Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981); Grynberg v. Farmer, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,683 (D. Colo. Oct. 8, 1980) (directors found to be interested).

90. "[The] plaintiff... must be able to make specific allegations of malfeasance or bad faith. Where an improper motive is claimed, plaintiff must allege that it was the sole or primary reason for the directors' actions." Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 777, 230 Cal. Rptr. 815, 820 (1986). "At a minimum, the Delaware cases require that the plaintiff must show some sort of bad faith on the part of the defendant." Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). "Once a plaintiff demonstrates that a director had an interest in the transaction at issue, the burden shifts to the director to prove that the transaction was fair and

In the case of charitable contributions, it is fair to say that the directors are beneficiaries of the action and have breached their duties of loyalty to the corporation. Corporate decisions ultimately come down to the decision of relatively few individuals. Such decisions are based on the knowledge, biases, and preferences of the decision-maker. Directors do not make charitable contributions to organizations of which they do not approve or do not have some contact.[91] A director might well be an alumnus, trustee or director of the university or may be a volunteer worker for the charitable organization. The director may be connected with a research area because of some malady or disease contracted by a family member. At the very least, a director benefits from the prestige, notoriety, ego boost, and acclaim that accompanies charitable gifts--the very perquisites that accompany non-profit maximization.[92] Under these circumstances, the business judgment rule should not protect the directors, who must show the intrinsic fairness of giving away corporate assets. The corporation or the shareholders by a shareholder derivative suit should seek rescission or restitution from the directors. Rescission puts the parties back where they were so that no section 170 deduction is allowable to any party. If restitution were ordered, the director should be entitled, within the statutory limits, to a section 170 individual deduction for the amounts actually repaid. The corporation would not be entitled to a section 170 deduction. If the restitution is for less than the full amount, the corporation should be entitled to a section 165 loss deduction for unrecoverable amounts, but not a section 170 deduction.

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reasonable to the corporation." Treadway Cos. v. Care Corp, 638 F.2d 357, 382 (2d Cir. 1980).

91. For example, gifts to universities are often made because an officer or director is an alumnus. Corporate donors are reluctant to give money to environmental law or research groups because they do not want those same groups later picketing the corporate offices. Wall St. J. (Midwest ed.), July 11, 1990, at B6, col.3.

92. *See supra* notes 44-59 and accompanying text.

D. Social Responsibility and Third Party Beneficiaries

The internal relationships between officer, shareholder, and corporation are governed by the law of agency, the fiduciary concept including the business judgment rule, and state corporation laws.[93] Now courts are considering the relationship between the corporation and society. The theory of corporate social responsibility is developing in the wake of environmental concerns, product safety, and social justice.

A corporation is private property owned by the shareholders and operated for their benefit.[94] The traditional or classical view of corporate social responsibility[95] is that corporations are to make profits for their shareholders.[96] Nonetheless, there always has been some constraint on the means, but no constraint on the goal. The profit motive remains the ultimate legal purpose for which persons form corporations.

At common law, it is a tenet of sovereignty that a government may regulate the manner in which citizens use their own private property, when necessary for the common good.[97] As the Supreme Court of the United States once stated:

> Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which

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93. *See supra* notes 60-92 and accompanying text.

94. 204 Mich. 459, 170 N.W. 668, 684 (1919).

95. *See* Eisenberg, *Corporate Legitimacy, Conduct, and Governance--Two Models of the Corporation*, 17 CREIGHTON L. REV. 1 (1983); Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979); Epstein, *Societal, Managerial, and Legal Perspectives on Corporate Social Responsibility--Product and Process*, 30 HASTINGS L.J. 1287 (1979); Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248 (1969); Mangrum, *In Search of a Paradigm of Corporate Social Responsibility*, 17 CREIGHTON L. REV. 21 (1983); Mashaw, *Corporate Social Responsibility: Comments on the Legal and Economic Context of a Continuing Debate*, 3 YALE L. & POL'Y REV. 114 (1984); Solomon & Collins, *Humanistic Economics: A New Model for the Corporate Responsibility Debate*, 12 J. CORP. L. 331 (1987) (discussing theoretical aspects of corporate social responsibility).

96. Dodge v. Ford Motor Company, 204 Mich. 459, 170 N.W. 668, 684 (1919). *Also see* M. FRIEDMAN, CAPITALISM AND FREEDOM 133-136 (1962) (providing a good discussion of directors responsibility to make profits for their shareholders).

97. *See* Munn v. Illinois, 94 U.S. 113, 125 (1876) (stating the common law position).

> the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use; but, so long as he maintains the use, he must submit to the control.[98]

More recent case law requires that corporate directors recognize that there are other interests to be considered aside from the interests of shareholders. A watershed in the case law regarding corporate social responsibility was reached in *A. P. Smith Manufacturing Co. v. Barlow*,[99] in 1953. A. P. Smith Manufacturing Company had regularly contributed to the local community chest and occasionally to Upsala College.[100] In 1951, the board of directors adopted a resolution to contribute to the Annual Giving to Princeton University.[101] The justification was the usual sound investment, business purpose rhetoric.[102] The court, picking up the thread of the common law as articulated in *Munn v. Illinois*, carried the common law further, stating: "It seems to us that just as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate."[103]

Significantly, the court held that not only that the gift had been made in the reasonable belief that it would advance the interests of the corporation, but the court added that the gift would aid the public welfare and advance the interests of the plaintiff as a part of the community in which the gift operates.[104] This was an extension of the common law.[105] Corporations were authorized to further social welfare. Still, the court was careful to say that the

98. *Id.* at 126.
99. 13 N.J. 145, 98 A.2d 581 (1953).
100. *A.P. Smith Manufacturing Co.*, 98 A.2d at 582.
101. *Id.*
102. *Id.* at 583
103. *Id.* at 586.
104. *Id.* at 590.
105. *Id.*

charity in question was not a pet charity of the directors in furtherance of personal, rather than corporate, ends.[106]

Even assuming corporations have social responsibilities, there is no agreement as to what the responsibilities are or who should decide. One approach is to adopt a moral minimum. A moral minimum is a negative injunction not to do harm, rather than an imposition of affirmative duties.[107] A moral minimum is not entirely satisfactory from the viewpoint of the more liberal advocates of corporate social responsibility[108] because a moral minimum imposes no duty to act, however egregious the circumstances.[109] The affirmative duty advocates justify their position on the proposition that social power gives rise to social responsibility.[110] These advocates argue that corporations as depositories of social power must share the same kinds of citizenship costs that individuals bear.[111] This view ignores the moral agency problem.[112] Citizenship is an individual attribute and involves individual freedom of choice. Corporate social responsibility is meaningless in terms of moral agency.[113] Because a corporation is a nonhuman, artificial entity, it can not have

106. *Id.*

107. *See* J. SIMON, C. POWERS, AND J. GUNNEMANN, THE ETHICAL INVESTOR: UNIVERSITIES AND CORPORATE RESPONSIBILITY (1972) (discussing the moral minimum).

108. There is no one accepted view of corporate social responsibility. "By the mid-1970's managers, business scholars and policymakers finally acknowledged what now appears to be obvious--that no single, comprehensive, and universally applicable definition of corporate social responsibility is possible." Epstein, *Corporate Social Policy Process and the Process of Corporate Governance*, 25 AM. BUS. L.J. 361, 374 (1987).

109. *See supra* note 107 and accompanying text (discussing moral minimum).

110. *See generally* Davis, *Five Propositions for Social Responsibility*, 18 BUS. HORIZONS 19 (1975) (discussing the affirmative duty position with a rationale for the position).

111. *Id.*

112. *See infra* text accompanying notes 120-43.

113. *See, e.g.*, T. DONALDSON, CORPORATIONS AND MORALITY (1982); P. FRENCH, COLLECTIVE AND CORPORATE RESPONSIBILITY (1984); Donaldson, *Personalizing Corporate Ontology: The French Way*, in SHAME, RESPONSIBILITY, AND THE CORPORATION (H. Carter ed. 1986); French, *The Corporation as a Moral Person*, 16 AM. PHIL. QUAR. 207 (1979); Goodpastor, *The Concept of Corporate Responsibility* in JUST BUSINESS (T. Regan ed. 1983); Ladd, *Morality and the Ideal of Rationality in Formal Organizations*, 54 THE MONIST 488 (1970); Ladd, *Persons and Responsibility: Ethical Concepts and Impertinent Analogies* in SHAME, RESPONSIBILITY, AND THE CORPORATION (H. Carter ed. 1986) (discussing philosophical aspects of moral agency).

integrity and, hence, can not be held morally responsible as a citizen.

There are other dangers in corporate social responsibility.[114] Social welfare has been the prerogative of government. The government decides what is socially desirable for the benefit of all the people. Corporate social responsibility shifts the decision from the government to the corporation--in other words, to the corporate directors and officers who are not accountable to the public nor even to the shareholders[115] except by virtue of being able to elect new directors.[116] However, proxy fights are rarely won by outsiders.[117] Incumbent corporate directors are almost as entrenched as members of Congress. As a matter of public policy, social welfare decisions should not be made in corporate board rooms. The allocation of limited resources is critical. The optimum allocation of resources is best left to society, not business. The functions of business and government must be kept separate, since the sole reason for the corporation's existence is to make a profit.

The debate on corporate social responsibility goes far beyond the bounds of charity. Within the context of section 170, the government has put limits on the types of organizations which may receive charitable contributions.[118] However, altruism, self-denial, and charity are human characteristics best left to individual conscience, outside the collectiveness of the corporate boardroom.

Corporate social responsibility should be limited to the moral minimum: to do no unnecessary harm while making a profit. Corporate social responsibility does not imply that the directors and officers are excused from maximizing profits, but only imposes

114. "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible." M. FRIEDMAN, *supra* note 96, at 133.

115. *See* P. BLUMBERG, THE MEGACORPORATION IN AMERICAN SOCIETY: THE SCOPE OF CORPORATE POWER 11 (1975) (stating "Shareholders have become investors in corporate equity securities. They are no longer in a position to act as owners in the traditional sense . . . .").

116. *See* M. FRIEDMAN, *supra* note 114, at 133-136 and T. Levitt, *The Dangers of Social Responsibility*, HARVARD BUS. REV. 41-50 (Sept.-Oct. 1958) (stating the dangers of unaccountability of directors).

117. *See, e.g.*, R. NADER, M. GREEN, & J. SELIGMAN, TAMING THE CORPORATE GIANT 81 (1976) (describing the futility of proxy fights).

118. *See supra* notes 120-43 and accompanying text.

limits on the means by which profits are maximized.[119] Corporate social responsibility does not alter the goal of profit maximization. Corporations have no affirmative duty to be charitable.

E. Moral Agency

There are fundamental differences between individuals and corporations. Corporations are creatures of the state, created for profit, with authority to operate only within the parameters set forth in state law.[120] Corporate decision-making is therefore limited. Individuals are endowed with freedom of choice and "owe their existence to a higher sovereign."[121] Professor Jeffrey Nesteruk analyzed and compared the decision-making process of individuals and corporations by examining the corporate analogues of individual reason and desire in the corporate context.[122] Professor Nesteruk equates desire with profit seeking shareholders, and equates reason with corporate management charged with making the daily corporate decisions,[123] concluding that the corporate decision-making process distorts the dynamics of individual moral

119. A classic example is cigarette advertising, which appeals to targeted groups such as young people and women, but which simultaneously downplays the health hazard associated with cigarette smoking.

120. HENN & ALEXANDER, *supra* note 62, at 41.

121. First Nat'l Bank of Boston v. Bellotti, 435 U.S. 765, 828 (1978) (Rehnquist, J., dissenting).

122. Professor Nesteruk describes the roles of desire and reason in individuals as follows:

> All individuals experience tensions at least at times, between what they want to do and what they ought to do. This tension may be expressed as a conflict between reason and desire. Desire is the motivational, wanting aspect of the psyche, while reason is the evaluating aspect, the setter of standards. To do what is right entails using reason to evaluate either conflicting desires or conflicts between desires and some standard of proper behavior. For while each desire has as its aim some end--it can only want such an end--not evaluate its worthiness. The evaluation of competing ends is reason's role.

Nesteruk, Bellotti *And the Question of Corporate Moral Agency*, 1989 COLUM. BUS. L. REV. 683, 690-91.

123. *Id.* at 691.

choice.[124] This conclusion leads Professor Nesteruk to the further conclusion, of importance here, that corporations are not moral agents.[125]

A moral agent is an entity capable of making a moral choice based on a concept of right and wrong. This issue is important because the value of the first amendment speech and religious freedoms as well as of other individual rights and freedoms is premised on the concept of moral agency.[126] To have a religious belief presumes the ability to embrace moral choice. Other individual freedom of choice matters such as who or what charitable organization is the most worthy of receiving charitable contributions, what is the best allocation of resources, which is the most pleasing or aesthetic work of art,[127] what direction should science take, which scientific projects should be supported, what constitutes good citizenship, how should society be structured, and

124. *Id.* The distortion is caused by the separation of ownership and control in the modern corporation which results in the lack of an intimate and interactive relationship between the two corporate analogues of reason and desire--management and shareholders--whereas in a natural person reason and desire are united and reason's evaluation of the ends of desire is an act of self-determination. *Id.* at 696-99. Professor Nesteruk describes two distortions--the distortion of displaced reason and the distortion of unrestrained desire. *Id.* The distortion of displaced reason is the result of the corporate analogue of reason--management--usurping the function of desire by not having to respond to the multiple personal ends of the individual shareholders who do not meaningfully participate in modern corporate decision-making. *Id.* The second distortion--the distortion of unrestrained desire--also is caused by the separation of control from ownership in the modern corporation. *Id.* The shareholder desire for profit is a controlling end for management which only may choose among means to that end rather than among competing ends. *Id.* The dynamic of the moral agent is then reversed because desire determines the legitimacy of reason's actions rather than reason evaluating desire. *Id.*

125. *Id.* at 701.

126. James Madison wrote in his *Memorial and Remonstrance Against Religious Assessments*:

> Religion then of every man must be left to the conviction and conscience of every man; and it is the right of every man to exercise it as these may dictate. This right is in its nature an unalienable right. It is unalienable; because the opinions of men, depending only on the evidence contemplated by their own minds, cannot follow the dictates of other men.

2 WRITINGS OF JAMES MADISON 183 (G. Hunt ed. 1901), as reproduced in the Appendix to the dissenting opinion of Rutledge, J., in *Everson v. Board of Educ.*, 330 U.S. 1, 63 (1947).

127. This issue is at the heart of the controversy over the National Endowment of the Arts funding for exhibitions of works of art some consider obscene. There is a moral choice being exercised here.

how our children should be educated all involve moral choice, and all require the ability to make moral choices. Corporations, being mere creatures of the state, must operate within the parameters of state corporation law and are, therefore, incapable of making decisions based on moral considerations. They are constrained by the framework of the profit motive.

The landmark case in this area is *Dodge v. Ford Motor Co.*[128] In *Dodge*, the court addressed whether a corporation organized for profit could divert its profits from the shareholders to society-at-large. The court drew a distinction between incidental humanitarian expenditure of corporate funds for the benefit of employees and a general purpose plan to benefit humankind.[129] The court unequivocally stated:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes . . . . [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others . . . .[130]

This statement is in effect a reflection of the underlying moral agency issue. Corporations are restricted to deciding the means to the end, because what the end is to be is decided by the state.

More recent cases tend toward a social responsibility theory for corporations.[131] Nonetheless, the profit motive remains the driving force behind corporate existence, and social responsibility is constrained by reasonableness.[132] The reasonableness test,

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128. 204 Mich. 459, 170 N.W. 668 (1919).

129. *Id.* at 506-507, 170 N.W. at 684.

130. *Id.* at 507, 170 N.W. at 684.

131. *See, e.g.*, Theodore Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969) (adopting a social responsibility theory).

132. "[T]he test to be applied in passing on the validity of a gift such as the one here in issue is that of reasonableness . . . ." *Id.* at 405.

however, should be applied within the framework of moral agency, because what is "reasonable" is a value judgment. Corporations should be prohibited from making decisions involving individual freedom of conscience because they do not have an "intellect" or "mind,"[133] and are, therefore, incapable of exercising individual freedom of conscience. It would be unreasonable to expect or allow a corporation to make a decision which ordinarily involves the exercise of individual freedom of conscience.

Making a charitable contribution to a religious organization is an exercise of the individual freedom of conscience. Giving to a religious organization is predicated on a belief in certain religious tenets and dogma, and their propagation. Corporations, not being moral agents, cannot make value judgments, have religious beliefs, or worship. To allow corporations to make charitable contributions to religious organizations undermines the concept of individual conscience which is at the base of religious belief. Making choices involving civic organizations and citizenship requires a belief in a particular political philosophy and form of government. Educational choices require a subscription to a philosophy of public and private education. Scientific choices require a formulation of the role of science in society. All of these choices and more are beyond the capabilities of corporations.

Economic studies of corporate charitable giving confirm that corporations do not exercise any moral choice in making charitable contributions. The studies show that the corporate tax has a price and net-income effect on corporate giving.[134] Corporate charitable contributions are proportional to after tax income,[135] and corporations tend to make charitable contributions when doing so has a positive effect on after tax profits.[136] In a study of corporate contributions during the period between 1936 and 1961, Professor

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133. Chief Justice Rehnquist in his dissent in *Pacific Gas & Elec. v. Public Util. Comm'n of California*, 475 U.S. 1 (1986) makes this point by stating: "To ascribe to such artificial entities an 'intellect' or 'mind' for freedom of conscience purposes is to confuse metaphor with reality." *Pacific Gas & Elec.*, 475 U.S. at 33 (Rehnquist, J., dissenting).

134. C. CLOTFELTER, *supra* note 37, at 275.

135. *Id.*

136. *Id.*

Orace Johnson established that only in years of high marginal tax rates on excess profits had corporate giving approached the former five percent[137] statutory limit, and that corporate giving dropped precipitously in the years for which the excess profits tax was removed.[138] Corporate giving is bottom line oriented. Moreover, the amount of corporate giving seems to be related to the competitive position of the firm in the industry.

In Adam Smith's ideal world of pure competition, no corporate giving would be tolerated since to make a charitable contribution is to raise the cost of goods and price oneself out of the market.[139] Monopolists, at the other extreme, have no incentive to make charitable contributions if they are profit maximizers. The only corporations with an incentive to make charitable contributions are the so-called "rival" firms. The rival firms are corporations that are oligopolistic[140] or imperfectly or monopolistically competitive,[141] which seek a comparative advantage over each other by such means as contributions, public relations, advertising, and innovative marketing and management.[142] Professor Johnson has established that these predictions are true.[143] Corporate charitable giving, consistent with corporate status, is motivated by profits.

The profit motive is diametrically opposed to the values underlying individual freedom of choice. The choice is between what is right and wrong, not between what is profitable or not. Corporations distort the whole concept of social welfare. The

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137. The corporate limit is currently 10%. *See* I.R.C. § 170(b)(2) (West 1990).

138. Johnson, *Corporate Philanthropy: An Analysis of Corporate Contributions*, 39 J. BUS. 489, 492 (1966).

139. Hovenkamp, *Technology, Politics, and Regulated Monopoly: An American Historical Perspective*, 62 TEX. L. R. 1263, 1268 (1984) (discussing Adam Smith's theory).

140. An oligopoly is a market where there are only a few competing producers, forcing each producer to take into account what each other producer does. *See* B. T. ALLEN, MANAGERIAL ECONOMICS 117 (1988) (discussion of an oligopoly).

141. Monopolistic competition is the result of having many sellers of only slightly differentiated products, but not enough sellers to make the market purely competitive. *See id.* at 116-17 (discussion of a monopolistic corporation).

142. *Johnson, supra* note 138, at 497.

143. *Id.* at 496-98.

myopia can be cured by repealing the section 170 deduction for charitable contributions made by corporations.

IV. CONCLUSION

The existence of the section 170 deduction for corporations conflicts with the basic laws and rationales of agency and trusts as they have been applied in the corporate context. When analyzed in economic terms, the section 170 deduction for corporations results in a misallocation of scarce resources and a distortion of social welfare. Charitable giving by corporations is not consistent with moral agency, nor is it required by corporate social responsibility.

Repeal of section 170 with respect to corporate charitable contribution deductions would effectively stop corporate charitable giving, whether authorized by state statute or justified on the basis of corporate social responsibility, because corporate giving is bottom line oriented. In the absence of a tax deduction, corporations would have no incentive to give corporate assets to charity. Some limited corporate giving might still be justified as ordinary and necessary business expenses and, hence, would be deductible under section 162; however, if section 170 were repealed the courts would scrutinize such expenditures more carefully. By eliminating deductibility except under section 162, managers are forced to consider profit maximization and business purpose rather than charity *quâ* charity.