# Legal and Policy Implications of Gifts of Stock by Corporate Executives: Proposals for Reform[+]

S. Burcu Avci[*]
Cindy A. Schipani[**]
H. Nejat Seyhun[***]

University of Michigan, Ross School of Business

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[*] Visiting researcher at the University of Michigan, Ross School of Business, Ann Arbor, Michigan.
[**] Merwin H. Waterman Collegiate Professor of Business Administration and Professor of Business Law, University of Michigan, Ann Arbor, Michigan.
[***] Jerome B. & Eilene M. York Professor of Business Administration and Professor of Finance, University of Michigan, Ann Arbor, Michigan.

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Studies have shown that corporate insiders tend to make favorable charitable gifts just prior to a severe decline in the company's share prices.[1] The timing of these gifts is troubling, as it seems to suggest that the corporate insiders may have acted using material, non-public information to reap an unfair benefit. Many of these donations were made at a time when it would have been illegal to make a sale of the same securities due to their access to this information.

Finding that executives' gifts are well-timed has economic and policy implications for the federal tax laws. Under U.S. tax law, the donor of gifts of stock to public or private charitable foundations may obtain a personal income tax deduction for the market value of the shares while simultaneously avoiding the capital gains tax that would be due if the shares were sold.[2] Furthermore, although open market sales of stock are undoubtedly within the purview of federal insider trading law, whether stock gifts to charity are so constrained is an unresolved question.[3] These loopholes create an opportunity for exploitation: empirical evidence suggests that corporate insiders use their access to inside information to time their stock donations prior to price declines, thereby increasing their federal income tax deductions.[4]

To address these issues, this paper proceeds as follows. Section I analyzes the legal issues presented by timing gifts of stock. Section II addresses public policy considerations. In Section III, we offer hypotheses to explain the behaviors and address the legal implications of each hypothesis. Section IV includes proposals for reform, followed by our concluding remarks.

## I. Legal Analysis

### A. Federal Tax Laws

The tax benefits stemming from the charitable donation of stock depend on the length of time the stock is held, whether the stock is closely or publicly held, and whether the recipient of the gift is a public or private entity. Generally, for the charitable contribution of stock, any excess not deductible in the year of contribution is carried forward for up to five subsequent tax years.[5] The contribution of any stock held long-term – that is, for more than one year[6] – permits

[1] *See* David Yermack, *Deductio ad absurdum: CEOs Donating their own Stock to their own Family Foundations*, 94 J. FIN. ECON. 107 (2009).
[2] *See* 26 U.S.C. § 170 (2012) (setting out the general parameters of this rule). Suppose that a stock purchased at $100 was gifted when the stock price reached $200 and subsequently, the stock price declined back to $50 after the gifting. In this case, the individual can take a deduction for $200 instead of holding a share worth $50. *See id.*
[3] Yermack, *supra* note 1, at 107.
[4] *Id.*
[5] 26 U.S.C. § 170(d)(1).
[6] *Id.* § 1222(3) (defining long term capital gain as "gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income").

the donor to deduct the fair market value of contributed stock.[7] The contribution of any securities held short-term – for one year or less – limits the deduction to the lower of the donor's cost basis and the fair market value of the security.[8]

The contribution of long-term marketable stock to public charities permits the donor to deduct the fair market value of the donated stock in an amount up to 30% of the donor's adjusted gross income (AGI), with a five-year carry-forward; cost basis is not taken into account.[9] In the case of short-term marketable stock contributed to public charities, the donor's deduction is the lower of donor's cost basis and the stocks' fair market value, and is limited to 50% of the donor's AGI.[10] The fair market value of the contributed marketable stock is the mean between the high and low price on the date of the contribution.[11]

Taxpayers who contribute marketable stock to a private foundation receive more limited tax benefits. Donors are subject to a maximum deduction of 20% of AGI for contributions to private foundations.[12] Generally, for contributions of stock held long-term, the donor is still entitled to deduct the full fair market value of the donated shares for up to 10% of the value of the corporation's outstanding shares.[13] For contributions of short-term stock, the donor's cost basis deduction is limited to 30% of AGI.

Contributions of closely held stock to public charities or donor-advised funds are subject to the same deduction, AGI limitation, and carry-forward rules as those for contributions of marketable securities. For transfers of closely held stock to private foundations, donors are permitted only a deduction equal to the lower of their cost basis or fair market value, subject to a cap of 20% of AGI with the five-year carry-forward.[14] Furthermore, if the donor claims a value in excess of $5,000 for the donation of securities that are not publicly traded, the value of the donation must be established by an independent appraisal conforming to Internal Revenue Service (IRS) Regulations.[15] In a nutshell, the appraisal must be prepared by a qualified appraiser who has earned a designation from a recognized professional organization.[16] The appraisal must include a description of the property transferred, the date of contribution, any terms or conditions put on the property transferred, information on the qualified appraiser, the basis for making the valuation, the appraiser's signature, and the date of the appraisal.[17] Further, the appraisal must be

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[7] *Id.* § 170(b)(1)(c).
[8] *Id.* § 170(e)(1)(A).
[9] *Id.* § 170(b)(1)(C).
[10] *Id.* § 170(b)(1)(A).
[11] 26 C.F.R. § 20.2031-2(b)(1) (2015).
[12] 26 U.S.C. § 170(b)(1)(D)
[13] *Id.* § 170(e)(5).
[14] *Id.* § 170(b)(1)(C).
[15] 26 C.F.R. § 1.170A-13(c)(7)(xi)(C).
[16] According to the IRS Regulations, a qualified appraiser is an individual who (a) "holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis," (b) pursuant to 26 C.F.R. § 1.170A-13(c)(3)(ii)(F), "is qualified to make appraisals of the type of property being valued," and (c) is *not* i) the donor, donee, or a party to the transaction in which the donor acquired the relevant property, ii) any employee or relative of any persons described in (c)(i), iii) any appraiser who performs the majority of her appraisals for a person described in (c)(i). 26 C.F.R. § 1.170A-13(c)(5)(i), (iv). However, a person cannot be a qualified appraiser if "the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property." *Id.* § 1.170A-13(c)(5)(ii).
[17] *Id.* § 1.170A-13(c)(4)(ii).

made within 60 days prior to the date of gift.[18] The donor must attach an appraisal summary (IRS Form 8283), signed by both donee and appraiser, to her tax return.[19]

The federal income tax law may also impose an "excess business holdings" tax on private foundations.[20] This rule penalizes a private foundation's ownership of voting stock in a particular corporation that is over 20% of the corporation's outstanding shares, less the percent of voting stock owned by "any disqualified persons."[21] This 20% ceiling is increased to 35% if the voting control of the corporation is effectively held by unrelated third parties who are not disqualified persons.[22] A private foundation that violates this rule will be subject to an initial tax equal to 10% of the excess holdings.[23] If the foundation continues to have excess business holdings, it will be penalized with an additional 200% excise tax.[24]

The category of disqualified persons include "any person . . . in a position to exercise substantial influence over the affairs" of the foundation, such as substantial contributors, officers, directors, trustees, and related parties.[25] Thus, a high-level corporate executive, such as a CEO, who wishes to contribute her company's stock to her own foundation may be particularly likely to be subject to the excess business holdings tax. The federal tax law provides very limited safe harbors: 1) a de minimis exception which allows the private foundation to hold up to 2% of the voting stock, regardless of the percent of voting stock held by disqualified persons,[26] and 2) a five-year time frame for the foundation to reduce its excess business holdings before the tax is imposed, so long as the foundation receives the stock by gift or bequest.[27]

The corporate insider benefits from the gift in two ways. First, the fair market value of a gift of stock held long-term is deductible from her taxable income, decreasing the overall tax paid. The tax benefits are especially substantial for top-bracket taxpayers. A donor who is a corporate executive is likely to be subject to the highest marginal tax bracket of the Alternative Minimum Tax, which is 28%;[28] such a donor would receive a federal tax benefit of 28% of the fair market value of the stock.[29] Second, the donor is able to escape the capital gains tax on the difference between the fair market value of the stock and her cost basis, which is particularly advantageous if the stock has significantly appreciated in value.

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[18] *Id.* § 1.170A-13(c)(3).
[19] *Id.* § 1.170A-13(c)(2)(i).
[20] 26 U.S.C. § 4943 (2012).
[21] *Id.* § 4943(c)(2)(A).
[22] *Id.* § 4943(c)(2)(B).
[23] *Id.* § 4943(a).
[24] *Id.* § 4943(b).
[25] *Id.* § 4943(f)(3).
[26] *Id.* § 4943(c)(2)(C).
[27] *Id.* § 4943(c)(6).
[28] *Id.* § 55. An individual U.S. taxpayer must pay the lower of regular tax and the alternative minimum tax ("AMT"). The AMT ostensibly limits the tax benefits available to "taxpayers with high economic income." INTERNAL REVENUE SERV., TOPIC 556 – ALTERNATIVE MINIMUM TAX (2016), https://www.irs.gov/taxtopics/tc556.html.
[29] The donor would also potentially benefit from any charitable deductions available in state income taxes.

### B. Analysis of Liability under Federal Securities Laws

When the donor of securities is also a corporate insider, the question of liability for insider trading becomes important.[30] This Part addresses the securities laws at issue with respect to potential liability for insider trading. This includes Sections 16(b) and 10(b) of the Securities Exchange Act,[31] as well as Rule 10b-5.[32] In addition, implications for the charity arising under Rule 144 are discussed.

#### 1. Short Swing Profits: Section 16(b) of the Securities Exchange Act

The short-swing profit prohibition of Section 16(b) of the Securities Exchange Act of 1934 mandates that corporate insiders may not obtain a security and dispose of it at a higher price (or vice versa) in less than six months.[33] This rule requires that corporate officers, directors, and 10 percent shareholders publicly report all attainment and disposition of stock, which includes gifts.[34] This implies that a charity with at least 10 percent ownership of a publicly traded company's stock is also subject to Section 16.[35]

SOX provides further details regarding time requirements for reporting. According to SOX, all open market sales and purchases must be disclosed on Form 4 within two business days.[36] SOX, however, did not update the reporting rules for bona fide gifts of stock, which are subject to less stringent requirements: gifts are reported on Form 5, which must be filed within 45 days after the end of the company's fiscal year.[37] David Yermack found that nearly half of the executives in his study sample delayed reporting their gift beyond two business days.[38]

Importantly, current law also provides an exemption to insider trading liability for bona fide gifts. In proposing an amendment to Rule 16b-5(a), which removed gifts from the scope of short-swing profit liability, the SEC stated that it believed "[b]ona fide gifts represent less likelihood for opportunities for abuse."[39] This exemption originated in *Truncale v. Blumberg*, where the court stated: "[b]y no stretch of the imagination . . . can a gift to charity . . . when made in good faith and without pretense or subterfuge, be considered a sale or anything in the nature of a sale" within the meaning of Section 16(b).[40]

Furthermore, Section 16(b) requires that any insider's "short-swing" profit (the difference between purchase and sale prices for any two transactions within any six-month period) be forfeited to the company.[41] The short-swing profit rule bars corporate insiders from acquiring a

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[30] Richard A. Tulli, *Insider Gifts of Securities to Charities*, FROM THE SOX UP (Dec. 20, 2011), http://www.fromthesoxup.com/2011/12/insider-gifts-of-securities-to-charities.
[31] Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).
[32] 17 C.F.R. § 240.10b-5 (2015).
[33] 15 U.S.C. § 78p(b).
[34] *Id*. § 78p(a).
[35] *Id.*
[36] Sarbanes-Oxley Act of 2002 (SOX), Pub. L. No. 107-204, § 403, 116 Stat. 745, 788.
[37] *See* 17 C.F.R. § 240.16a-3.
[38] Yermack, *supra* note 1, at 110.
[39] *Id*. at 111, n.8 (quoting Ownership Reports on Trading by Officers, Directors, and Principal Stockholders, Exchange Act Release No. 26,333, Investment Company Act Release No. 16,669, 53 Fed. Reg. 49,997 (Dec. 13, 1988)).
[40] *Id*. (quoting Truncale v. Blumberg, 80 F.Supp. 387, 391 (S.D.N.Y. 1948)).
[41] 15 U.S.C. § 78p(b) (2012).

security and then disposing of it at a higher price (or vice versa) within any interval shorter than six months. But bona fide gifts to a charity are exempt from Section 16(b) matching.[42]

Any charity that owns at least 10% of a publicly traded company's stock will be subject to Section 16.[43] A donor who is required to report under Section 16 and who transfers shares to a charity, including a private foundation created by the donor and for which the donor serves as a director, must report the transfer in the annual filing of (the more lenient) Form 5, or voluntarily reported earlier on Form 4.[44] Ordinarily, assuming the shares cannot be used for the donor's benefit, the donor will no longer have beneficial ownership in the stock once the charity owns the shares. The charity will therefore be the Section 16 reporting party as long as it owns at least 10% of the shares. The donor will no longer have any Section 16 reporting responsibility with respect to the transferred shares.

### 2. Anti-Fraud Provisions: Section 10b and SEC Rule 10b-5

Section 10b of the 1034 Act[45] and the corresponding SEC Rule 10b-5[46] prohibit fraud "in connection with the purchase or sale of any security."[47] Unlike Section 16(b), there is no exemption for anti-fraud liability. Those who violate this prohibition will have to disgorge any profit, may be liable for damages, and may face criminal charges.[48] A corporate insider making a charitable gift and realizing a tax benefit may be in violation of Rule 10b-5 if the donation was made with knowledge of yet-to-be-announced negative news that will drive the value of the stock down shortly after the grant.[49] As Yermack points out, although a charity could sue a donor under Rule 10b-5 if it relied upon the fair market value of the stock donated, such litigation would have a "chilling effect" on future donations.[50]

There is a question regarding whether an ostensibly charitable transfer should be considered a sale under Section 10(b) of the Act. This question has not yet been considered by the courts. The 1934 Act defines "sale" broadly: "[t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of [securities]."[51] Therefore, the main question that arises is whether the gift is a "sale" or is "in connection with" a sale for the purposes of a violation of Section 10b and Rule 10b-5. To determine whether a gift will be treated like a sale under the anti-fraud provision, case law establishes a three-prong test: (1) change of ownership, (2) donor receives consideration of pecuniary value, and (3) the treatment is "consistent with the remedial purposes of the 1934 Act."[52] Furthermore, there must be scienter, "meaning an intent to deceive, manipulate or defraud."[53]

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[42] 17 CFR § 240.16b-5 (2015).
[43] SEC. & EXCH. COMM'N, EXCHANGE ACT SECTION 16 AND RELATED RULES AND FORMS (2010), https://www.sec.gov/divisions/corpfin/guidance/sec16interp.htm.
[44] *Id.*
[45] 15 U.S.C. § 78j(b).
[46] 17 C.F.R. § 240.10b5.
[47] 15 U.S.C. § 78j(b).
[48] Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 983–84 (1985).
[49] Yermack, *supra* note 1, at 111.
[50] *Id*. at 112 n.9.
[51] 15 U.S.C. § 78c(a)(14).
[52] Yermack, supra note 1, at 11 (citing Carol J. Sulcoski, Note, *Looking a Gift of Stock in the Mouth: Donative Transfers and Rule 10b-5*, 88 MICH. L. REV. 604, 615 (1989)).
[53] *Id*. (citing Sulcoski, *supra* note 52, at 623–24*).*

Generally, the gift is not a sale as there is no consideration for the donor for the transfer of the securities.[54] Yet, the gift may be a disguise for a sale if the donor receives some type of economic benefit from the transfer. Courts have construed the personal benefit requirement quite broadly, including elusive expectation of future economic gain, improvement of friendship, or reputation.[55] It can quite easily be argued that the donor receives a personal benefit when making a gift, as there is a tax benefit. A corporate insider who "controls or significantly influences" the organization to which the securities are being donated is more likely to be perceived by a court to have a personal benefit.[56]

In addition, if the charity has knowledge of material inside information through the insider, it also follows that it should be prohibited from transferring those shares until the information becomes public. If the charity will immediately or shortly thereafter sell the securities, a gift may be an action "in connection with" a sale of securities, making the donor potentially liable.[57] This establishes a similar tipper and tippee relationship discussed in *Dirks v. SEC*,[58] where the Supreme Court stated that "an insider's tipping with a prompt trade by the tippee resembles the insider's (improper) trading followed by a gift of the proceeds."[59] Therefore, a corporate insider's gift of securities that are then quickly sold seems to resemble tipping with a prompt trade and thus could be in violation of Rule 10b-5 for both parties.[60]

Although there are no court cases specifically addressing what type of charitable donation may constitute a "sale" within the context of insider trading, the SEC has brought a number of actions in federal court based on, at least in part, claims of illicit profits by insiders through charitable donations of stock. Although not involving donation of stock specifically, in *SEC v. Zomax*,[61] the SEC successfully brought an insider-trading action against executives who sold stock through a charitable remainder annuity trust. The SEC filed a civil injunction alleging that James T. Anderson, the former Chairman of the Board of Directors and CEO, and his wife, Michelle Bedard-Anderson, the former Executive Vice-President of Sales and Marketing of Zomax conducted insider trading when they liquidated their 821,250 shares of stock on the basis of material, non-public information that the company's revenue and earnings would be considerably lower than expected in the third quarter of 2000.[62] The two executives sold hundreds of thousands of shares in August 2000 on the open market and later used the Jim and Mikki Anderson Charitable Reminder Annuity Trust (the Trust) to sell the rest. By doing so, the two allegedly avoided $9 million in losses. The Commission also claimed that Anderson tipped his friend to sell shares of the company as well.[63]

The SEC argued that Zomax violated Section 10(b) and 13(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, and 13a-13 when it filed a materially misstated Form 10-Q.[64] In addition, it claimed Anderson and James Flaherty, Zomax's previous CFO, violated

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[54] Tulli, *supra* note 30.
[55] *Id*.
[56] *Id*.
[57] *Id*.
[58] 463 U.S. 646, 664 (1983).
[59] Tulli, *supra* note 30.
[60] *Id*.
[61] SEC. & EXCH. COMM'N, LITIG. RELEASE NO. 19262, SEC FILES INSIDER TRADING CHARGES AGAINST TWO OF ZOMAX INC.'S FORMER OFFICERS AND FILES SETTLED FINANCIAL REPORTING CHARGES AGAINST ZOMAX, INC. AND TWO OF ITS OFFICERS (2005), https://www.sec.gov/litigation/litreleases/lr19262.htm.
[62] *Id*.
[63] *Id*.
[64] *Id*.

Section 10(b) and Rule 10b-5 when they made material misstatements or omissions and aided and abetted Zomax in violating Section 13(a) and Rules 12b-20 and 13a-13.[65] It further alleged Anthony Angelini, Zomax's former COO and President, also aided and abetted Zomax's violations and that Anderson, his wife, friend, and the Trust violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 by trading the securities and tipping others.[66] Anderson was also said to have violated Section 16(a) of the Exchange Act and rules promulgated thereunder when he failed to report the sales of the stock by the Trust.

Zomax, Flaherty, and Angelini consented to the permanent injunction against them without admitting or denying the wrongdoing.[67] Zomax agreed to pay $2 million in civil penalties.[68] Flaherty agreed to disgorge over $16,000 (plus prejudgment interest) and pay a $75,000 civil penalty, and Angelini agreed to disgorge over $43,000 and pay $50,000 in civil penalties.[69] Litigation against all other parties continues.

In another case, *SEC v. Buntrock*,[70] the SEC alleged that "[t]hrough the gift of inflated stock, Buntrock was unjustly enriched in form of the increased tax benefit."[71] The executives in the case committed fraud and misrepresented the financial situation of the company for years and also gave away the company's stock to non-profit organizations, thereby, recognizing an inflated tax benefit. Buntrock, Waste Management's CEO, gave a gift of 100,000 shares to his college alma mater 10 days before the new management stated that the previous year's statements were inflated.[72] The case was settled with entry of an injunction against future violations of the Exchange Act and disgorgement.[73]

### 3. Rule 144

Rule 144 of the Securities Act of 1933 applies to 1) sales of unregistered stock ("restricted securities," that is, shares that were not issued in registered public offerings) and 2) sales of stock by "affiliates" of a public corporation ("control securities").[74] Restricted securities are subject to information availability, minimum holding period, and a variety of other requirements before they may be publicly resold without registration.[75] For shares in reporting companies, the required holding period is a minimum of six months after the shares have been fully paid for, and for shares in non-reporting companies, the minimum holding period is one year after the shares have been fully paid for.[76] Once the restricted securities are donated to a

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[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] Complaint, SEC v. Buntrock, No. 02C 2180 (N.D. Ill. Mar. 26, 2002).
[71] *Id.*
[72] *Id.*
[73] SEC. & EXCH. COMM'N, LITIG. RELEASE NO. 19351, WASTE MANAGEMENT, INC. FOUNDER AND THREE OTHER FORMER TOP OFFICERS SETTLE SEC FRAUD ACTION FOR $30.8 MILLION (2005), https://www.sec.gov/litigation/litreleases/lr19351.htm.
[74] *See generally* 17 C.F.R. § 230.144 (2015) (laying out the parameters of Rule 144). An "affiliate" of a stock-issuing corporation is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." *Id.* § 230.144(a)(1).
[75] *Id.* § 230.144
[76] *Id.* § 230.144(d).

charitable organization, the organization is treated as having acquired the shares at the time they were acquired by the donor.[77]

Even when the stock earmarked for donation is already registered, if the donee organization is deemed to be an "affiliate" of the issuer corporation (due to, for example, significant ownership of the issuer corporation's shares), Rule 144 requirements—other than the holding period requirement—may apply to any subsequent sales of the stock by the donee.[78] The rule would not, however, apply to the gifting of the stock from the donor to the donee.

## II. Public Policy Implications

The War Income Tax Revenue Act of 1917 provided the original charitable deduction and was enacted to encourage private philanthropy.[79] In fact, one purpose of the deduction was as a "reprieve from the wartime burden of income taxes on the wealthy in World War I."[80] The original deduction was limited to 15% of a taxpayer's taxable net income.[81] In 1924, Congress proposed, but ultimately did not enact, in the Revenue Act of 1924, a repeal of the 15% ceiling for taxpayers who contribute more than 90% of their income during the current taxable year and the preceding ten taxable years.[82] The Senate Finance Committee seemed to be balancing incentives to donate (increasing the percentage cap) and potential tax abuse (limiting the increase to taxpayers who contribute over a long period of time).[83] As for property, the Treasury Regulations explained that the deducted value under the 1917 Act would be FMV.[84] A year later, the Regulations quickly backtracked and returned to the donor's cost basis, but just as quickly, three years later, the Treasury returned to FMV.[85] Again in 1938, the House voted to revert again to the donor's basis, but the Senate disagreed, explaining that limiting the deduction to cost basis would discourage charitable donations.[86] This vacillation demonstrates the confusion and uneasiness behind allowing a FMV deduction for property donations.

Congress eventually raised the overall ceiling on the deduction; first, by changing the limit from 15% of taxable net income to adjusted gross income ("AGI") in 1944;[87] and second, increasing the percentage from 15% to 20% of AGI in 1952.[88] Two years later, the limit was

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[77] *Id.* § 230.144(d)(3)(v).
[78] *Id.* § 230.144(e)(3)(iii).
[79] Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056, 1061 (2003).
[80] Patrick E. Tolan, Jr., *Compromising the Safety Net: How Limiting Tax Deductions for High-Income Donors Could Undermine Charitable Organizations*, 46 SUFFOLK U. L. REV. 329, 333 (2013).
[81] War Income Tax Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330 ("Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's taxable net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury").
[82] J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, at 733 (1938).
[83] *See* Lindsey, *supra* note 80, at 1061.
[84] Roger Colinvaux, *Charitable Contributions of Property: A Broken System Reimagined*, 50 HARV. J. ON LEGIS. 263, 271 (2013)
[85] *Id.*
[86] S. REP. NO. 1567, at 14 (1938).
[87] Individual Income Tax Act of 1944, ch. 210, 58 Stat. 231.
[88] Act of July 8, 1952, ch. 588, 66 Stat. 443.

again raised to 30% AGI, but Congress started down a new path by limiting the increase to certain types of donations and to certain types of organization. First, the 10% increase only applied to contributions actually paid rather than just "for the use of" the charitable organization[89] (e.g. "payments to a trust for the benefit of a charitable organization would not qualify for the additional 10%").[90] Second, the additional 10% only applied to contributions to churches, educational institutions, or hospitals.[91] Finally, in 1964, Congress enacted an unlimited deduction for taxpayers who contribute over 90% of the taxpayer's income in the current taxable year and eight out of the previous ten taxable years.[92]

The background to the enactment of the Tax Reform act of 1969 was the House's and Congress's perception that the highest earners were not paying their fair share of taxes, primarily by using itemized deductions.[93] The House noted that the unlimited charitable contribution deduction allowed some high-income earners to pay little or no tax primarily due to this deduction.[94] Congress responded to perceived tax abuse by phasing out the unlimited deduction, between 1969 and 1974, and settling on a maximum deduction of 50% of AGI.[95] At the same time, the House wanted to strengthen the incentive for charitable donations and proposed increasing the 30% limit of AGI for overall charitable contributions to 50% of AGI, which was ultimately enacted.[96] The 1969 Tax Reform Act also dealt with contributions of appreciated property.

### A. Rules for Contribution of Appreciated Property under the 1969 Tax Reform Act

In 1966, charitable contribution deductions comprised nearly $79 million out of $130 million of total itemized deductions, and 70% of this $79 million were from contributions of property, the majority of which was untaxed appreciated property.[97] Congress pinpointed a problem that some taxpayers were getting greater tax benefits for donating appreciated property than if they sold the same property, and that this result was motivating donations for tax-planning purposes rather than donative intent—both situations which Congress did not intend.[98] In response, the 1969 Act limited the deduction for contribution of appreciated property to 30% of the contribution base unless the taxpayer elected to limit the deduction to the adjusted basis of the property in which the maximum would be 50% of contribution base.[99] Also, under the 1969 Act, the taxpayer must reduce the deduction by the amount of short-term capital gain or ordinary income that the taxpayer would have recognized had the taxpayer sold the property for FMV.[100] In other words, the deduction was limited to cost basis "unless the taxpayer elected to recognize

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[89] H.R. REP. NO. 83-1337, at 99 (1954), *as reprinted in* 1954 U.S.C.C.A.N. 4017, 4190.
[90] Lindsey, *supra* note 80, at 1063.
[91] 26 U.S.C. § 170(b)(1)(A)(i)–(iii) (1954).
[92] Revenue Act of 1964, Pub. L. No. 88-272, § 209, 78 Stat. 43–47.
[93] H.R. REP. NO. 91-413 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 1645, 1653.
[94] J. COMM. ON INTERNAL REVENUE TAXATION AND THE COMM. ON FINANCE, 91ST CONG., SUMMARY OF H.R. 13270, THE TAX REFORM ACT OF 1969, at 32 (Comm. Print 1969).
[95] JOSEPH S. ROBINSON, A PRACTITIONER'S GUIDE TO THE TAX REFORM ACT OF 1969, at 74 (Miriam I. R. Eolis ed., 1970).
[96] SUMMARY OF H.R. 13270, at 32.
[97] Lindsey, *supra* note 80, at 1065 n.56 (citing 1969 U.S.C.C.A.N. 1645, 1654).
[98] SUMMARY OF H.R. 13270, at 33.
[99] Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 201(a)(1)(B), §§ 170(b)(1)(D), 170(e)(1)(A), 83 Stat. 487, 549–48.
[100] ROBINSON, *supra* note 96, at 72.

gain on the transfer."[101] "A primary focus of this change was to prevent businesses from structuring a deal as a donation of appreciated property and receiving deductions equal to the fair market value of the property, rather than claiming a business expense, which would be deductible at cost."[102] Congress also passed the provision to close "the loophole whereby high-bracket taxpayers are able to realize a greater after-tax profit by making a gift of appreciated property to charity than they are by selling it, paying the tax on the gain, and keeping the proceeds."[103] At that time, however, Congress's greater concern, at the time, seemed to be the donation of easily overvalued artwork rather than stock.[104]

### B. Theories behind the Allowance for Charitable Contribution Deductions

A statement by Senator Henry F. Hollis sheds light on one of the rationales for the original charitable contribution deduction in 1917:

> If the Government takes all, or nearly all, of one's disposable or surplus income, it must undertake the responsibility for spending it, and it must then support all those works of charity and mercy and all the educational and religious works which in this country have heretofore been supported by private benevolence.[105]

Scholars argue that this view is consistent with Tocqueville's framework of a small central government and an engaged individual and community role in charity.[106] This is also argued to be important as this system preserves individual autonomy while a tax on all taxpayers to pay for government selected social programs would simply be compulsory.[107]

The subsidy theory posits that the deduction is necessary otherwise public goods, such as cancer research, will be underfunded due to the free rider problem, undervaluing common goods that do not have ready market prices, and to give incentive to donors that otherwise would not if others could receive identical benefits without contributing.[108]

The equity theory and base-defining approach view the deduction as fair because donations diminish one's ability to pay income tax[109] and donations are unlike other forms of private consumption.[110] Also, taxpayers that donate for moral or altruistic reasons are giving up the opportunity to use the same income in more selfish ways.[111]

Another rationale for the deduction is that the government's loss of revenue is offset by the direct expenditures the government avoids if it had to spend directly for the general welfare in absence of charity expenditures funded partly by the tax subsidy.[112] Also, direct expenditures could be problematic—for example, direct expenditures to religious organizations can raise Establishment Clause issues.[113]

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[101] Lindsey, *supra* note 80, at 1066.
[102] ROBINSON, *supra* note 96, at 73.
[103] SUMMARY OF H.R. 13270, at 34.
[104] *Id*.
[105] Tolan, *supra* note 81, at 334 (quoting Senator Hollis's address).
[106] *Id*. at 335.
[107] *Id*. at 347.
[108] *Id*. at 345.
[109] *Id*. at 350
[110] Colinvaux, *supra* note 85, at 267–68.
[111] Tolan, *supra* note 81, at 350.
[112] ROBERT W. WILLAN, INCOME TAXES, CONCISE HISTORY AND PRIMER 31 (1994).
[113] *See* Lindsey, *supra* note 80, at 1073–78.

### C. Disparity between Short-Term and Long-Term Gain Property

The disparity between the tax treatment of donating long-term capital gain property and short-term capital gain property likely has its roots in the previously huge difference between ordinary and capital gain income. In 1969, the highest marginal tax rate for ordinary income topped out at 70% compared to just 25% for long-term capital gains.[114]

> Thus, as the Senate Finance Committee explained, if a taxpayer in the seventy-percent bracket donated an (ordinary income) asset worth $ 100 with a $ 50 cost basis, the benefit to the taxpayer was a $ 100 deduction (worth $ 70 to the taxpayer) plus an exclusion of $ 50 of gain (worth $ 35). The combined tax benefit of $ 105 from the deduction and the exclusion exceeds by $ 5 the amount the taxpayer could receive upon sale.[115]

To halt this windfall, Congress changed the rule to essentially only allow a cost-basis deduction for the donation of property that would produce ordinary income if sold, such as stock held less than one year.[116] There was less worry for long-term capital gain property because the lower rate meant that generally the taxpayer was economically better off simply selling the property rather than donating it.[117]

The cost is hard to estimate, but over $10 billion per year is deducted due to property contributions in addition to the costs to administer and enforce a FMV system for contributed property. Moreover, there are theoretically reputational costs to charitable organizations and the tax system itself to allow a deduction that gives such an outweighed benefit to the wealthy.[118]

Thus, Congress established and continues to maintain a deduction for charitable contributions in order to incentivize individuals, particular wealthy individuals, to donate to charitable causes.[119] Congress's efforts, however, have been tempered by a need to prevent and respond to abuses that disproportionately benefit the wealthy, lower tax revenues, and encourage giving for tax-planning rather than donative reasons. As the long-term capital gains and short-term capital gains rates have converged and abuses increase, the policy rationale behind the distinction in the treatment between the two for purposes of the charitable contribution deduction loses force. Congress has shown willingness to react in such situations, such as with the donation of artwork, and perhaps would be receptive to change in this realm as well.

## III. Possible Explanations for the Timing of Gifts

We offer five hypotheses to explain the timing of gifts of stock by executives: executives 1) wait until after the stock has appreciated naturally to maximize their donation as well as their tax-deduction (passive-timing); 2) accelerate the good news prior to the gifts to further increase their donation and tax deductions (spring-loading); 3) delay the release of bad news until after the gifting of the stock to again increase their donation as well as tax deductions (bullet-dodging); 4) engage in backdating of the gift date in order to maximize their donation and tax

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[114] Colinvaux, *supra* note 85, at 272.
[115] *Id*.
[116] *Id*. at 272–73.
[117] *Id*. at 273.
[118] *Id*. at 281–290.
[119] *See* Tolan, *supra* note 81.

deductions (backdating); and 5) use material, undisclosed inside information about the future prospects of their firm's stock to maximize their donation and tax-deductions (inside-information). The legal implications of these hypotheses are analyzed below.

### 1. Waiting for Natural Appreciation of Stock Value

The first behavior which may explain some executive gift timing, waiting until the stock appreciates naturally then making a donation, does not raise any of the tax or securities law issues described in Part IIB above. Although this pattern provides a way for the owner of securities to avoid paying capital gains on the appreciation, this is no different than donating other property that has appreciated in value. This would be a legally appropriate way for an insider to donate stock to a charity.

Under federal tax law, charitable contributions receive significant preferred treatment. The charitable deduction, which is available to corporations and individuals who choose to itemize their deductions, has continued to be one of the largest federal tax expenditures in terms of estimated revenue cost.[120] This tax subsidy ostensibly motivates donors to provide financial support for a variety of organizations that the U.S. Tax Code has designated as charities.[121] The tax preference is greater for higher-income individuals because the amount of the charitable deduction is a function of the donor's marginal tax bracket.[122]

Donating appreciated property, such as stock that has increased in value, provides further tax advantages by allowing the donor of such property to avoid paying capital gains tax on the appreciation.[123] Furthermore, charitable contributions of appreciated property are treated differently from other transfers of appreciated property because the allowable deduction is equal to the fair market value of the entire property, rather than the difference between fair market value and basis—that is, cost basis is disregarded for purposes of the charitable deduction.[124]

Although recent studies have shown that the tax deduction for charitable giving may be an inefficient tax subsidy,[125] there is no debate about its legality. Maximizing one's charitable deduction by waiting for the value of stock to appreciate before donating it is comparable to maximizing one's stock option compensation by waiting for the underlying stock to appreciate before exercising the option. In both scenarios, the owner of the relevant securities does not take any steps to mislead the public, nor does she use any material inside information to increase her personal wealth. Waiting for stock to appreciate naturally before donating it to charity is consistent with the 1933 and 1934 Acts' "philosoph[ies] of full disclosure."[126]

### 2. Spring-Loading and Bullet-Dodging

The second and third hypotheses of executive behavior, accelerating good news prior to the gifts, or spring-loading and delaying the release of bad news, or bullet-dodging, raise securities law concerns. These behaviors have not been without controversy when occurring in

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[120] Joseph J. Cordes, *Re-Thinking the Deduction for Charitable Contributions: Evaluating the Effects of Deficit-Reduction Proposals*, 64 NAT'L TAX J. 1001, 1001 (2011).
[121] *Id.* at 1002.
[122] *Id.*
[123] *Id.*
[124] *See* 26 U.S.C. § 170 (2012).
[125] *See* Cordes, *supra* note 121 (discussing various criticisms of the tax subsidy for charitable contributions).
[126] SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

the context of dating games played to maximize executive compensation through stock options.[127] In the options context, spring-loading refers to the practice of either manipulating the date of the options grant so that it occurs just before information is released or delaying the release of positive information to a date just after the option is granted. In either case, the executive's stock options become immediately more valuable after the release of good news. This is analogous to spring-loading the donation of securities, in that the executive is manipulating information to the market in order to make the gift of stock provide greater personal benefit—in this case a higher tax deduction—although the practice involves acceleration of the release of positive information rather than delay.

Bullet-dodging, in the context of the grant of executive stock options, refers to the practice of accelerating the release of bad news to just before the grant of options, or to manipulating the grant date of the option so that the option is granted just after the release of bad news. Our data shows analogous behavior with respect to the executives' gifting of securities, except that rather than accelerate the release of bad news, the news is delayed until after the gift, yielding a higher tax deduction than the executive would be afforded had the news been released prior to the gift.

It would seem against the legislative intent of the federal securities laws to allow executives to manipulate information flow to shareholders solely for personal benefit. Indeed, one of the major purposes of the 1934 Act was the hope of Congress to curb an "unscrupulous insider . . . [from using] inside information for his own advantage."[128] Increased transparency was a key motivator of the 1934 Act: "devices designed to create a misleading appearance of activity with a view to enticing the unwary into the market on the hope of quick gains" were explicitly frowned upon,[129] and Congress called on "the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations"[130] to spur a renewal of investor confidence. Executives who engage in spring-loading and bullet-dodging practices—whether in the context of executive stock options or charitable contributions of stock—harm investor confidence by deliberately misrepresenting the value of their stock. Decreased investor confidence may also lead to stock values plummeting, and stockholders may have a viable argument that executives' manipulation of information flow to increase their own tax deductions runs contrary to executives' fiduciary duties of care and loyalty to the corporation and its shareholders.[131]

Assuming that charitable contributions of stock could be viewed as disguised sales, bullet-dodging and spring-loading such contributions should violate Rule 10b-5's anti-fraud provisions. Bullet-dodging—the practice of withholding negative information until after the gift is made—is particularly egregious because it involves actively concealing material information from the public. It also artificially inflates the value of the donation at the time it is made; the later release of the negative information reduces the value of the stock in the hands of the charity, while the donor is still permitted a high tax deduction for the contribution.

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[127] *See, e.g.*, Matthew E. Orso, Comment, *"Spring-Loading" Executive Stock Options: An Abuse in Need of a Federal Remedy*, 53 ST. LOUIS U. L.J. 629 (2009) (examining stock option backdating and how it is used to increase executive compensation).
[128] H.R. REP. NO. 73-1383, at 13 (1934).
[129] *Id*. at 10.
[130] *Id.* at 13.
[131] *See id*. at 14 (noting that one primary purpose of the bill is to "encourage the voluntary maintenance of proper fiduciary standards by those in control" of registered companies).

In addition, particularly with respect to bullet-dodging, the practice also seems to run afoul of the disclose or abstain from trading rules as articulated by the court in *SEC v. Texas Gulf Sulphur Co.*[132] In that case, where stock options were at issue, the court found that the recipients were required to disclose the positive information before accepting stock options.[133] It follows that executives should not be permitted to gift shares of stock until the negative information in their possession has been disclosed. In the stock donation context, the "disclose or abstain" requirement articulated in *Texas Gulf Sulphur* would seem to dictate that CEOs disclose negative information before donating the stocks to charity.

### 3. Backdating

Backdating, in the charitable stock-gift context, occurs when the transfer date of the stock gift is changed ex-post to artificially increase the amount of appreciation, and in turn, the amount of the associated tax deduction. Changing the date that a gift of securities was granted in order to reap higher tax deductions is clearly fraudulent behavior under the federal tax laws—the IRS rules analyze the stock gift's value on the actual transfer date.[134]

Backdating of executive option grants was reported in the financial press as early as February 2005.[135] Researchers showed that managers falsified grant dates to receive options with lower strike prices.[136] The stock price of the company would decline right before the

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[132] 401 F.2d 833 (2d Cir. 1968).

[133] *Id.* at 848.

[134] *See* INTERNAL REVENUE SERV., PUBLICATION 561, DETERMINING THE VALUE OF DONATED PROPERTY (2007), https://www.irs.gov/pub/irs-pdf/p561.pdf.

[135] *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005); M. P. Narayanan & H. Nejat Seyhun, *Do Managers Influence Their Pay? Evidence from Stock Price Reversals Around Executive Option Grants* (Ross Sch. of Bus., Working Paper No. 927, 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=649804 (finding that executive options are backdated); M. P. Narayanan & H. Nejat Seyhun, *Effect of Sarbanes-Oxley Act on the Influencing of Executive Compensation* (Nov. 2005), http://ssrn.com/abstract=852964 (again finding that options are backdated and that SOX mandatory grant date reporting decreases, but does not eliminate opportunism); Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271 (2007) [hereinafter Heron & Lie, *Does Backdating Explain*] (finding significantly less abnormal stock returns after SOX passed, and that "in those cases in which grants are reported within one day of the grant date, the pattern has completely vanished, but it continues to exist for grants reporting with longer lags, and its magnitude tends to increase with the reporting delay"); M.P. Narayanan & Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?*, 21 REV. FIN. STUD. 975 (2008); *see also* Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 856–57 (2008) ("[T]housands of firms continued to secretly backdate options by weeks or months after SOX, even though it entailed—in addition to other legal violations—a blatant disregard of the Act's two-day requirement"); Jay Ritter, *Forensic Finance*, 22 J. ECON. PERSP. 127, 133 (2008); Mark Hulbert, *Timing of Managers' Options a Good Litmus Test*, MARKET WATCH (Feb. 18 2005, 12:15 AM), http://www.marketwatch.com/story/timing-of-managers-option-grants-a-good-litmus-test.

[136] Jay Ritter writes:

> On January 19, 2000, when computer manufacturer Apple's stock closed at $106.56 per share, Apple announced that one week previously it had granted options to buy 10 million shares to CEO Steve Jobs with an exercise price of the January 12 closing market price of $87.19. The January 12th close was the lowest closing price of the two months prior to January 19. Seven years later, Apple admitted that the dates of many options grants had been chosen retroactively, and that documents purporting to show that the board of directors had approved the grants on the dates chosen had in some cases been fabricated. Wealth transfers from option backdating can be large. For the January 2000

exercise of the grant and increase thereafter.[137] Research conducted in more recent years further suggests that managers are likely to make accounting adjustments favorable to the CEO before option grant dates.[138]

Options backdating is a practice whereby the date of the option grant is changed to a date prior to when the option was in fact granted. This practice was even easier when the SEC rules did not require reporting of the issuance of stock options until two months after the grant date.[139] This reporting delay allowed companies to wait until the company's stock price fell low and moved higher within that two-month period.[140] The option would then be backdated to its lowest point or near that point, so that this lower exercise price could then be reported to the SEC.[141] Backdating of stock options thus allows the person who owns the stock options to realize larger potential gains, without requiring the company to show these gains as compensation on the financial statement.[142]

Shortly after SOX was signed into law, the SEC changed its rule to also require disclosure within two days of the option grant.[143] This information must be disclosed electronically, allowing shareholders access to the information almost instantly.[144] Furthermore, the SEC approved changes to New York Stock Exchange and the NASDAQ Stock Market listing standards, which require shareholder approval of nearly all equity compensation plans.[145] The terms of the grant must be disclosed, as well as whether the option grant allows for the exercise price to be less than the fair market value at the time of the grant.[146] The evidence in options backdating scandal, however, also shows that executives easily avoided the SEC's new rules by simply ignoring the timely reporting requirements. Because the SEC did not explicitly provide penalties for late-reporting, executives simply ignored the SEC's rule. The SOX requirements and the SEC Rule have been completely ineffective in controlling executives' incentive or their opportunities to backdate their option grants.

In December 2004, the Financial Accounting Standards Board (FASB) issued the Statement of Financial Accounting Standards (FAS) 123R, which again attempted to eradicate

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> grant alone, if there was a 70 percent chance that the options would eventually be exercised, the difference between the January 12th and 19th dates for the exercise price was worth almost $140 million to Jobs due to the difference between the $87.19 and $106.56 exercise prices.

Ritter, *supra* note 136, at 131–32 (2008); *see also* Robert M. Daines et al., *Right on Schedule: CEO Option Grants and Opportunism* (Stanford Graduate Sch. of Bus., Working Paper No. 3314, 2015), http://web.law.columbia.edu/sites/default/files/microsites/law-economics-studies/DainesR-2013FallBS.pdf; Heron & Lie, *Does Backdating Explain*, *supra* note 136; Randall Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?*, 55 MGMT. SCI. 513 (2009).

[137] This is illustrated by a V-shape on a graph.

[138] *See, e.g.*, Mary L. McAnally et al., *Executive Stock Options, Missed Earnings Targets, and Earnings Management*, 83 ACCT. REV. 185 (2008); Terry A. Baker et al., *Incentives and Opportunities to Manage Earnings around Option Grants*, 26 CONTEMP. ACCT. RES. 649 (2009).

[139] Christopher Cox, Chairman, Sec. & Exch. Comm'n, Testimony Concerning Options Backdating (Sept. 6, 2006), https://www.sec.gov/news/testimony/2006/ts090606cc.htm.

[140] *Id*.

[141] *Id*.

[142] *Id*.

[143] SEC. & EXCH. COMM'N, RELEASE NOS. 34-46421, 35-27563, IC-25720, OWNERSHIP REPORTS AND TRADING BY OFFICERS, DIRECTORS AND PRINCIPAL SECURITY HOLDERS (2002), https://www.sec.gov/rules/final/34-46421.htm.

[144] Cox, *supra* note 140.

[145] *Id*.

[146] *Id*.

the accounting advantage of stock options issued at-the-money.[147] The Standards require that all stock options granted to an employee be recorded as an expense on the financial statements regardless of whether the exercise price is at fair market value.[148] In 2006, the SEC began to require all public companies to also report information including: "the grant date fair value under FAS 123R (which is aggregated in the total compensation amount that is shown for each named executive officer); the FAS 123 grant date; the closing market price on the grant date if it is greater than the exercise price of the option; and the date of the compensation committee or full board of directors took action to grant the option, if that date is different than the grant date."[149] Companies are also required to explain the goals and policies of the executive compensation plans.[150] Reports to investors must discuss whether the company has engaged in backdating or might do so in the future and, if so, how.[151]

In addition, in 2007, the SEC enacted rules requiring full disclosure of all aspects of executive and director pay and benefits, including stock options. These rules require the company to disclose the full amount of an executive's compensation in a single number, and whether a stock option was backdated.[152] If the stock option is backdated, the corporation must provide the reason why.[153] The goal of the rule is to make executive compensation more transparent to the shareholders and thereby end the practice of executive backdating. However, as we demonstrate in this paper, additional regulatory supervision is still needed to ensure the end of the backdating practice.

Backdating gifts of stock involves many of the same economic and legal concerns that arise with backdating executive stock options. Although the link is less obvious than in the case of executive stock options, backdating charitable gifts also weakens the link between shareholder value and management incentives. Executives who backdate their donations receive the benefit of a larger deduction, without a corresponding performance in the underlying stock. Furthermore, the treasury and taxpayers in general lose when donors of backdated stock underpay their taxes. In order to raise a given amount of revenue, other taxpayers must pay higher taxes. To the extent that executive backdating practices and the executive is denounced for tax fraud, the company may incur litigation costs and costs associated with reputational damage, which in turn harm the company's investors.

### 4. Use of Insider Information

The final hypothesis presented and evidenced in the data is the inside information hypothesis—executives use inside information to time their gifts for the highest deduction. For example, they may choose to donate stock just prior to a negative announcement that causes the stock prices to plummet. Unlike in the case of spring-loading, the insider-executive does not necessarily manipulate the flow of information. She does, however, time her stock donations

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[147] FED. ACCOUNTING STANDARDS BD., PUBL. NO. 263-C, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123, Fin. Acct. Series (2004), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220124271&acceptedDisclaimer=true.
[148] Cox, *supra* note 140.
[149] *Id*.
[150] *Id*.
[151] *Id*.
[152] SEC. & EXCH. COMM'N, RELEASE NOS. 33-8732A, 34-54302A, IC-27444A, EXECUTIVE COMPENSATION AND RELATED PERSON DISCLOSURE 20–22 (2006), https://www.sec.gov/rules/final/2006/33-8732a.pdf.
[153] *Id.* at 22–23.

based on material information that, at the date of donation, is not available to the public. This behavior is analogous to the type of insider trading that is prohibited under Section 10(b) of the 1934 Securities and Exchange Act.

As mentioned previously, insider trading cases are generally brought under Section 10(b) of the Securities Exchange Act, which prohibits "any manipulative or deceptive device or contrivance" used "in connection with the purchase or sale of any security," and Rule 10b-5 promulgated thereunder; or Section 16(b). Although Section 16(b) was initially drafted with the express purpose of targeting insider trading, today it is Rule 10b-5 that is more commonly used to bring insider trading cases.[154]

One of Congress's primary concerns when drafting the 1934 Act was "to insure the maintenance of fair and honest markets."[155] This concern was articulated in In re *Cady, Roberts, & Co.,*[156] in which the administrative law court indicated that section 10(b) and Rule 10b-5 "are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others."[157] In other words, even if nondisclosure of inside information does not constitute fraud, it nonetheless "may be viewed as a . . . practice which operate[s] as a fraud or deceit upon the purchasers" in violation of Rule 10b-5.[158] Although recent insider trading cases have not read Section 10(b) and Rule 10(b)-5 so broadly, the "disclose and abstain" principle articulated in *Cady, Roberts*, whereby an insider in possession of material nonpublic information must disclose the information before trading, and further addressed in *Texas Gulf Sulphur*, still remains. In addition to encouraging "vigorous market competition,"[159] the "disclose and abstain" rule promotes fairness to public investors.[160]

Using inside information to opportunistically time gifts of stock presents similar problems of unfairness as insider trading "in connection with the purchase or sale" of stock. The ability to maximize the value of a tax deduction on the basis of inside information places insider-executives at an unfair advantage relative to other taxpayers. Moreover, like many tax loopholes, this advantage is available primarily to those in high income tax brackets, creating skewed distributional effects favoring high-income individuals.[161] Other taxpayers are indirectly harmed by strategic timing of stock gifts as they bear the brunt of decreased funding for government-funded public facilities and services, and higher tax rates than if the charitable contributions had not been opportunistically timed.[162] Further, to the extent that executives often time stock donations just before a decrease in the underlying stock price, the use of inside information to time stock gifts is dishonest to the charities who receive the contributions, who believe that they are receiving something of greater value. Such behavior, if made public, may lead to further erosion of investor confidence.

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[154] *See* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 56-57 (1980) ("The conventional wisdom is that Congress . . . expressed its concern with insiders' informational advantage by enacting section 16").
[155] 15 U.S.C. § 78b (2012).
[156] 40 S.E.C. 907 (1961)
[157] *Id*. at 911.
[158] *Id*. at 913.
[159] Jennifer D. Antolini et al., *Securities Fraud*, 34 AM. CRIM. L. REV. 983, 984 (1997).
[160] Micah A. Acoba, *Insider Trading Jurisprudence After United States v. O'Hagan: A Restatement (Second) of Torts 551(2) Perspective*, 84 CORNELL L. REV. 1356, 1365 (1999).
[161] Furthermore, "CEOs who make major stock gifts to family foundations tend to be older and considerably richer than the general population of CEOs." Yermack, *supra* note 1, at 116.
[162] Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. ECON. PERSP. 25, 41 (1999).

## IV. Proposals for Reform

Taxpayers are hurt by opportunistic stock gifting by insiders.[163] Yet, some argue that there is no easy solution. Executives often donate to take advantage of the tax subsidies and if there were stricter rules and harsher insider trading liability, perhaps insiders would not donate stock as frequently. Many studies conclude that donations increase substantially as the availability of tax deductions increase.[164] The government, however, also has an interest in ensuring that gift tax exemptions are appropriately applied for those donations that will serve the public good. Further, the government has an interest in upholding the integrity of the securities markets.

We thus propose four regulatory reforms to address these issues. First, we propose that the late-reporting exemption given to the gifts should be eliminated. Under current law, gifts can be reported up to 45 days late after the end of the fiscal year. Our research finds that executives are exploiting this exemption to backdate their gifts. We propose that the reporting requirements for gifts be similar to any other insider transactions, namely within two business days of the gift transaction. Second, we propose increased penalties for late reporting of gift transactions. These penalties must be stated as a percentage of the amount of the gift and must be increasing with the number of days gifts are reported late. Third, if any gift transactions are reported late, we propose that the executives be required to explain the circumstances that led to the late reporting and certify that the gift was not backdated.

Because insiders use a variety of manipulative games to time their gifts, insiders' incentives to use inside information, spring-loading or bullet-dodging must also be controlled. To address these issues, we suggest an ex-post settlement device. Following the lead of the Private Securities Litigation Reform Act of 1995, [165] we suggest that a look-back provision be implemented for tax-deductions for insider gifts of stock. If the stock price drops over the 90 days following the date of gift-giving, then the average share price during the 90-day period following the gift should be used for the purpose of the corresponding tax deduction, instead of the price at the date of the gift. This provision will help de-incentivize both inside-information-motivated donations, as well as spring-loading and bullet-dodging. Executives would have little or no incentive to manipulate information flow in the immediate short-term to increase the tax deduction because the deduction allowed would be a value averaged over a 90-day period.

## Conclusion

This paper explores five non-mutually exclusive hypotheses regarding executives' motivations timing the gifting their own firms' stock: 1) wait until after the stock has appreciated

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[163] Yermack, *supra* note 1, at 122.

[164] *See id*.

[165] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in various sections of 15 U.S.C.). The Private Securities Litigation Reform Act (PSLRA) was enacted in response to concerns that large damage awards potentially available in securities fraud class action lawsuits was encouraging the proliferation of frivolous suits. *See, e.g.*, Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000) ("Legislators were apparently motivated in large part by a perceived need to deter strike suits wherein opportunistic private plaintiffs file securities fraud claims of dubious merit in order to exact large settlement recoveries"). The PSLRA addresses this in part by a 90-day "look back provision," which reduces a plaintiff's recovery to the difference between the purchase price and mean price of the security at issue during the ninety-day period after corrective disclosure. 15 U.S.C. § 78u-4(e) (2012).

naturally to maximize their donation as well as their tax-deduction (passive-timing); 2) accelerate the good news prior to the gifts to further increase their donation and tax deductions (spring-loading); 3) delay the release of bad news until after the gifting of the stock to again increase their donation as well as tax deductions (bullet-dodging); 4) engage in backdating of the gift date in order to maximize their donation and tax deductions (backdating); and 5) use material, undisclosed inside information about the future prospects of their firm's stock to maximize their donation and tax-deductions (inside-information). The first timing motivation involves no illicit behavior, but as discussed above, there are serious legal and policy issues raised by the other four motives.

Due to the differing motives that may be in play when gifts are well-timed and the difficulty in determining whether the motive is legitimate, we propose relatively simple regulatory reforms to curb incentives for illicit timing. Our policy recommendations should improve the compliance of gifts with anti-fraud provisions and decrease tax fraud by replacing the exemption for late-reporting with a penalty, as well as support the general anti-fraud provisions of securities laws by imposing a 90-day look-back period for determining the stock value for purposes of the tax deduction. Furthermore, these proposals should strike a balance among competing policy considerations—by continuing to provide incentives for insider charitable donations of stock while at the same time reducing tax and securities fraud.

Finally, in light of data showing that stock returns following gifts of insider stock are negative, a charity receiving shares of executives' own firm's stock as a donation might well be advised to sell the stock immediately, provided that the charity is not subject to Section 16(b). It is probably also a good idea to institutionalize this rule for all stock donations in order to combat any resistance from the donors.