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Deductio' *ad absurdum*: CEOs donating their own stock to their own family foundations ☆

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ABSTRACT

I study large charitable stock gifts by Chairmen and Chief Executive Officers (CEOs) of public companies. These gifts, which are not subject to insider trading law, often occur just before sharp declines in their companies' share prices. This timing is more pronounced when executives donate their own shares to their own family foundations. Evidence related to reporting delays and seasonal patterns suggests that some CEOs fraudulently backdate stock gifts to increase personal income tax benefits. CEOs' family foundations hold donated stock for long periods rather than diversifying, permitting CEOs to continue voting the shares.

1. Introduction

Successful business executives often have noteworthy second careers as philanthropists. Examples have spanned the history of American industry, from John Jacob Astor, Andrew Carnegie, and John D. Rockefeller through Warren Buffett, Ted Turner, and Bill Gates. For tax reasons, modern donors often finance their good works by giving away appreciated shares of stock. Under U.S. tax law, charitable gifts of stock allow the donor to obtain a personal income tax deduction for the market value of the shares, while also nullifying the capital gains tax that would be due if the shares were sold.

Unlike open market sales, gifts of stock are generally not constrained by U.S. insider trading law, and company officers can often donate shares of stock to charities at times when selling the same shares would be prohibited. This exemption has evolved from a combination of federal caselaw, prosecutorial indifference, and recent amendments to Securities and Exchange Commission (SEC) rules (Sulcoski, 1989). This paper explores whether executives exploit the insider trading gift loophole to make well-timed charitable donations of stock in advance of price declines, a strategy that would allow the donors to use their access to inside information to obtain personal income tax benefits.

I focus upon Chairmen and Chief Executive Officers (CEOs) of U.S. public companies who establish private

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family foundations and then make large contributions to these foundations out of their personal holdings of company shares. Because these donors generally control the entities on either side of these transactions, while also having private information about the future prospects of their companies, one might expect well-timed donations to private family foundations to be relatively easy to accomplish and document.

I study a sample of 150 stock gifts worth at least $1 million by public company Chairmen or CEOs to their own family foundations. Identifying this sample requires cross-checking stock gifts reported by executives on SEC Form 4 and Form 5 filings against donations disclosed by private foundations on annual Internal Revenue Service (IRS) Form 990-PF filings. The 150 large gifts in my sample are made by 89 different executives between mid-2003, when the SEC established electronic filing requirements for stock transfers, and the end of 2005. The aggregate value of the gifts, about $670 million, represents nearly one-quarter of all stock gifts made by all public company Chairmen and CEOs for charitable purposes during this time period.

Consistent with their exemption from insider trading law, I find a pattern of excellent timing of Chairmen and CEOs' large stock gifts to their own family foundations. On average these gifts occur at peaks in company stock prices, following run-ups, and just before significant price drops. The price path of the underlying company stocks forms an inverted V-shape over the two-month period centered around the reported gift date, with the stock rising and then falling by an abnormal 3% and peaking exactly on the reported gift date. For comparison purposes I look at stock gifts by Chairmen and CEOs to all other recipients besides family foundations. These other transfers are also well-timed, as they occur at local maximums in company stock prices, but the typical price decline after these gifts is less pronounced than for gifts to CEOs' own family foundations.

I explore two explanations for the good timing of CEOs' family foundation stock gifts. One clear possibility is a variation on classical insider trading. CEOs might use their knowledge of inside information to donate shares at opportune times in order to increase their personal income tax benefits. A variety of tests give some support for the hypothesis that CEOs time their gifts based on inside information. For instance, a few CEOs make gifts of stock just before adverse quarterly earnings announcements, a time at which company "blackout" periods would almost always prohibit open market sales (Bettis, Coles, and Lemmon, 2000). Other CEOs delay stock gifts until just after positive quarterly earnings announcements.

A second explanation is that CEOs' stock gifts might be backdated to local maximum points in company stock price histories, again in a way that would increase the personal income tax benefits to the CEO. Such backdating would require coordination between the foundation's trustees (generally the CEO and his family) and the company's stock transfer department (which reports, at least indirectly, to the CEO). This sort of collusion is not difficult to imagine given the abundant evidence of backdating of executives' stock compensation that has emerged since 2006 in academic studies (Heron and Lie, 2007) and investigations by the IRS, SEC, and Department of Justice. Stock gift backdating, if followed by the filing of a personal tax return claiming a charitable gift deduction, would likely represent tax fraud in violation of IRS rules that look to the actual transfer date for determining a stock gift's value.[1]

Tests used to infer the backdating of executive stock option awards yield results consistent with the backdating of CEOs' family foundation stock gifts. For instance, I find that the apparent timing of certain subsamples of family foundation stock gifts improves as a function of the elapsed time between the purported gift date and the date on which the required stock gift disclosure is filed by the donor with the SEC. This association between reporting lags and favorable gift timing does not hold for CEOs' stock gifts to other recipients. Stock gifts of all types, including family foundation gifts, are also timed more favorably if they are larger and if they occur in months other than December, when many tax-driven charitable contributions ordinarily take place.

These results suggest an odd juxtaposition of motives on the part of corporate executives who donate stock. While nominally transferring part of their fortunes to charitable foundations for civic purposes, many appear simultaneously to exploit gaps in the regulation of insider trading or even to backdate their donations to increase the value of personal income tax benefits. The results loosely parallel a series of older tax fraud cases related to donations of artworks to museums, in which the recipients were found to have colluded with donors to generate inflated appraisal values that could be used to claim larger income tax deductions (Speiller, 1980).[2]

[1] IRS Publication 561, "Determining the Value of Donated Property," rev. April 2007, p. 2, gives the rules for identifying the date of a stock contribution in order to value it for tax purposes. If a stock certificate is delivered physically to a charity, the date of delivery is the valuation date. If it is mailed, valuation occurs on the date of mailing. Assuming that most CEO-donors follow the modern practice of arranging the stock transfer electronically through a bank or broker, "the date of the contribution is the date the stock is transferred on the books of the corporation," according to the IRS. This language is somewhat elastic, as it does not appear to require the corporation to record a transfer in a timely way and may even accommodate retroactive dating of stock transfers. However, other bodies of law dealing with fraudulent accounting would likely require company bookkeepers to record stock transfers accurately.

[2] Probably the most famous case of a fraudulently backdated charitable gift came to light in the 1974 Congressional investigation of President Richard M. Nixon's personal income tax returns. While serving as president, Nixon donated his vice presidential papers from the Eisenhower administration to the National Archives and claimed that the gift had occurred in early 1969, entitling him to a $576,000 tax deduction. Subsequent Congressional testimony by a federal archivist revealed that the true date of the gift was approximately one year later, after an intervening change in federal law had made the deduction worthless. See Patricia Sullivan, "Mary Livingston: Spotted Illegal Nixon Tax Move," *The Washington Post*, March 25, 2007, C1. Nixon, who denied knowledge of the backdating, was ordered to pay restitution to the U.S. Treasury. His tax advisor pleaded guilty to fraud and received a four-month jail sentence. See Eric Pace, "Edward Morgan, 61, Nixon Aide Convicted in Tax Fraud Case," *The New York Times*, August 20, 1999.