

**CURRENT TAX LAWS AND THE FULFILLMENT OF CORPORATE
FOUNDATIONS' SOCIAL FUNCTIONS:
EVIDENCE FROM 990-RETURNS OF PRIVATE FOUNDATIONS**

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ABSTRACT

This study analyzes the relationship between the current tax laws and the fulfillment of corporate foundations' social functions. A corporate foundation is a tax-exempt private foundation that is funded by a business entity, but is legally separated from its sponsoring company. Currently, corporations may deduct charitable contributions, including donations to their sponsored foundations, up to 10 percent of their modified annual taxable income (Internal Revenue Code Section 170(b)(2)). Because of this favorable tax treatment and other advantageous tax provisions for private foundations, many firms establish corporate foundations to manage all or some of their donations (Himmelstein, 1997).

The social function of private foundations is to some extent different from that of traditional charities. While the role of traditional charities is to provide relief to the underprivileged, and to lessen the burdens of government, the functions of foundations is to fund leading research that may bring alternative solutions to social and public policy issues and explore new and uncharted directions in which society may move (Andrews, 1965; Zurcher, 1972; Roelofs, 2003). However, funding activities pertaining to social and public policy issues are more controversial and vulnerable to criticism than donations to traditional charities (Mcilnay, 1997). Thus, corporations may hesitate to fund contentious social programs, such as Planned Parenthood projects, through their private foundations. Business entities tend to avoid any involvement with social controversial issues because, as reported by Roberts (1992), corporations with foundations are more proactive in building good relationships with various stakeholders. Moreover, current tax laws neither differentiate the functions between foundations and charities nor require or provide any incentive for foundations to fund research and public policy studies. In other words, firms received the same tax benefit and perhaps similar degree of name recognitions when donating to either foundations or charities.

As a result of the discussion presented above, this study hypothesizes that corporate sponsored foundations give a significantly higher amount of grant monies to charities than they give to research and public policy studies. The findings of this study have important public policy applications because if current tax laws do not facilitate foundations to fulfill their social functions, amendments to tax provisions for private foundations appear to be desirable.

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Introduction

During the twentieth century, United States (U. S.) public policy regarding corporate managers' rights to authorize charitable donations of corporate resources has come full circle. At the beginning of the century, corporate managers were not allowed to make any charitable donations because many court rulings stated that giving business resources away without anything in return was beyond the power of management (Bormann, 1994). Currently, however, every state's corporation statute grants businesses the right to make donations¹ (Balotti and Hanks, 1999; Kahn, 1997). At present, corporations may deduct charitable donations (including giving to their sponsored foundations) up to 10 percent of their annual modified taxable income (Internal Revenue Code Section 170 (b)(2)).

Due in part to this favorable tax treatment, business corporations are believed to be more proactive in managing their charitable giving agenda and attempt to directly control the amounts, recipients, and timing of their contributions (Werbel and Carter, 2002; Jones, 1994). Many corporations use corporate (company-sponsored) foundations to handle some or all of their donations (Himmelstein, 1997). A corporate foundation is a

¹ Currently, every state and the District of Columbia have a statute enabling its corporations to make charitable donations. Although the language used by different philanthropy statutes may vary slightly, these statutes are generally unrestrictive as to the amount of the contributions and its beneficiaries. Also, these statutes do not define who within the corporation has decision-making power over corporate charitable contributions.

tax-exempt private foundation that receives its funds from a profit-seeking business corporation, but is legally separate from its sponsoring company.

The number of corporate foundations has increased 26% from 2,018 in 2000 to 2,549 in 2003. The amount of funds distributed by corporate foundations has also increased 15 % from \$3.02 to \$3.47 billion in 2000 and 2003 respectively. However, the amount of assets possessed by these foundations has decreased from \$16 billion in 2000 to \$15.5 billion in 2003 (Atienza, 2005). Using a foundation as a giving vehicle seems to be a trend of many business entities.

Corporate foundations' funds are partially subsidized through tax deductions.² In addition, tax provisions for private foundations, in comparison to tax provisions for corporations, provide many economic advantages. For instance, the current excise tax rate on a foundation's investment income is only 2%, while the top corporate rate is 35%.³ These favorable tax treatments imply that the society at large believes foundation funds are used for the public interest.

The purpose of this study is twofold. First, this study investigates the relationship between the current tax laws and the fulfillment of corporate foundations' social functions. Theoretically, private foundations are expected to fund leading research that may bring alternative solutions to social issues (Andrews, 1965; Zurcher, 1972; Heifetz, et al., 2004). Current tax laws, however, neither distinguish the functions between private foundations and charities nor require or provide any incentive for foundations to fund research. This lack of differentiation is an important public policy issue because if

² Internal Revenue Code Sections 170 and 503(c)(3).

³ Internal Revenue Code Sections 509(a) and 4941. The provision of the 1969 Tax Reform Act imposed an excise tax of 4% on the income a foundation derives from investment, but the current excise tax rate is generally around 2%.

current tax laws do not facilitate foundations to fulfill their social functions, amendments to tax provisions for private foundations appear to be needed. Second, this study examines whether the giving behavior of corporate foundations is motivated primarily by the tax advantage or by a desire to strategically manage their parent company's business environment.

This study contributes to both the accounting and nonprofit organization literature because existing corporate foundation research has concentrated only on sponsoring corporations (Webb, 1992; Werbel and Carter, 2002) with little or no consideration on the payout behaviors of corporate foundations. Corporate foundations' payout behaviors are important because the size of their endowment, donations and contributions are substantial (Atienza, 2005; Stencel, 1998), and most importantly, private foundations have specified social functions to fulfill.

The data collected and analyzed in this study are not based on perception or estimation but on the actual activities of corporate foundations. Although previous studies (Griffin and Mahon, 1997; Navarro, 1988; Wokutch and Spencer, 1987; Kedia and Kuntz, 1981; Levy and Shatto, 1980) have attempted to investigate corporations' charitable giving activities, obtaining an accurate measurement of business's direct and in-kind giving has been extremely difficult. Achieving correct measurement is difficult for two reasons. First, neither the current state corporation law nor the federal securities regulations require companies to disclose their direct charitable spending and services (Brudney and Ferrell, 2002; Kahn, 1997). Second, even if they report the amount of giving voluntarily, there are no agreed-upon standards for valuing gifts of in-kind goods and services.

Unlike direct giving and in-kind donation, the actual charitable activities of company-sponsored foundations are publicly available from their tax returns filed annually with the Internal Revenue Service (IRS). The institutionalized charitable activities undertaken by a corporate foundation are likely to reflect the social and political interests of its sponsoring corporation (Heald, 1970; Himmelstein, 1997; Kroll, 1991; Troy, 1982). As a result, the data collected from corporate foundations are considered the best measure currently available to examine corporations' charitable giving behaviors.

The remainder of this study proceeds as follows. The next section begins with a brief review of the legal history of corporate charitable giving and company-sponsored foundations. Thereafter, the social functions of foundations and charitable organizations are discussed and the first hypothesis is presented. Following that, two theoretically grounded motivations for corporate foundation giving are reviewed. The two motivations are the tax advantage hypothesis and the strategic management hypothesis. These hypotheses are then empirically tested. Finally, the findings and implications for research and public policy are presented.

Legal History and Tax Policies Related to Corporate Donations

The legal history regarding corporate donations in the U. S. reveals substantial changes in public policy. Until the early 1950s, it was beyond the power of corporate managers to make any charitable donation from which the company did not directly benefit (Werbel and Carter, 2002). However, in 1953, in *A. P. Smith Manufacturing Co. v. Barlow, et al.*, the New Jersey Superior Court judge stated that under common law

every corporation has the right and a duty to make charitable giving. As a result, the “beyond the power” policy was overruled.

Additionally, in 1955, the court ruling of the *Union Pacific Railroad* case discarded the direct benefit rule pertaining to corporate donations. The judge stated that whether or not certain business actions directly benefit the company should be determined by the executives because they knew better than the judge what was in the firm’s best interest (Webb, 1992; Werbel and Carter, 2002). As a result, many state statutes regarding business donations were amended.

Currently, a business corporation may deduct charitable donations up to 10 percent of the corporation’s modified taxable income for the year when given to any domestic 501(c)(3) organization including donations to its sponsored foundations.⁴ Any charitable donation that is not currently deductible due to the percentage limitation may be carried over for up to five years.⁵ In other words, under the current charitable tax provisions, the government is willing to subsidize business’ charitable giving through tax deduction. For instance, given a corporate tax rate of 35%, within the \$3.3 billion of grant money given by corporations to their sponsored foundations in 2003 (Atienza, 2005), approximately \$1.2 billion is subsidized by the public through tax deduction.

An additional amount of tax reduction is given by the tax treatments available to private foundations. Company-sponsored foundations held approximately \$16 billion in assets in 2003 (Atienza, 2005). The excise taxes on the return on these assets were

⁴ In 1935, the Internal Revenue Code was amended to permit charitable deduction in an amount not to exceed 5% of a firm’s taxable income, and currently the deductibility of gifts is up to 10 % of the corporation’s annual adjusted gross income (Internal Revenue Code sections 170(b)(2) was modified in 1981.)

⁵ Internal Revenue Code Section 170(c)(2).

generally 2 percent ⁶, which is substantially lower than the taxes (35 percent) on identical returns to for-profit business entities. Moreover, corporate foundations are required to pay out only 5% of its asset value for charitable purposes each year, and grants as well as administrative expenses are included in this minimum payout amount.⁷ Because of these tax advantages, business corporations appear to be more proactive in managing their giving programs (Mescon and Tillson, 1987). Many corporations use their own foundations to maintain control over the amounts, recipients, and timing of their contributions (Werbel and Carter, 2002; Himmelstein, 1997; Jones, 1994).

The current study is designed to test two hypotheses. First, this study examines whether the current public policy, as evidenced by Internal Revenue Code Section 170; 503(c)(3) and 4942, facilitates or hinders corporate foundations from fulfilling their social functions. Theoretically, the distinct function of private foundations is supposed to fund leading research that may provide alternative solutions to social issues (Andrews, 1965; Zurcher, 1972; Heifetz, et al., 2004). Second, by examining the payout activities of corporate foundations, this study analyzes whether tax advantage or strategic management is the main incentive for foundations' giving. The literature of economics, management, nonprofit organizations and political science on corporate foundations suggests two possible rationales for businesses to establish foundations as their giving vehicle--tax advantage (Clotfelter, 1985; Heald, 1970; Webb, 1992; Webb, 1996) and strategic management of corporate environment (Bormann, 1994; Webb, 1992; Werbel

⁶ Internal Revenue Code Sections 509(a) and 4941. The provision of the 1969 Tax Reform Act imposed an excise tax of 4% on the income a foundation derives from investment, but the current excise tax rate is generally 2%, and some foundations may be qualified for a reduced excise tax rate of 1%.

⁷ Internal Revenue Code Section 4942. The pay-out requirement requires foundations to pay out 5% of its asset value (including grants, and necessary and reasonable administrative expenses) for charitable purpose each year, and the Secretary of the Treasury has authority to change the rate using a formula.

and Carter, 2002; White and Bartolomeo, 1980; Zurcher, 1972). However, the previous empirical work attempting to test these different motivations is by no means conclusive.

Theoretical Development and Research Questions

Justification of Private Foundations

Roelofs (2003) states that the political system of a democratic capitalistic society, such as the United States, is maintained in two ways: the state and the civil society. The former controls through force and laws and is complemented by the latter that produces consent without resort to force. Nonprofit organizations are theorized to be critical to the effective functioning of a nation that has a strong economic market and, comparatively, a weak state. Hansmann (1980, 1981) argues that the economic, production and related tasks performed by the business and commercial world are primarily governed by the market through a contractual agreement. Private nonprofit organizations such as foundations, however, are a response to market failure. For instance, when the purchasers and the recipients of the goods or service are separated and especially when the recipients are unknown to the purchasers, the purchasers are in a poor position to determine whether the goods or services they pay for are in fact ever delivered or performed. In this situation, the purchasers would prefer to rely on a nonprofit entity than to contract with a business organization because profit-seeking business is assumed to have a relatively strong incentive to skimp on the services it promises and to divert most or all of its revenue directly to its owners (Gunn, 2004).

In addition, the concept of market failure also helps to explain the prevalence of nonprofits as private-market producers of certain specific goods such as public,

charitable, and certain mixed services. Abzug and Webb (1999) state the market failure of public and similar goods occurs when the quantity of certain specific goods and services, such as healthcare and insurance, provided by businesses is inadequate. This occurs when business entities doubt that consumers have the ability to pay for the goods and services they request, which leads to insufficient supply, and at the same time the government fails to compensate. In these situations, nonprofits are theorized to be more suitable for goods/service providers.

The Council on Foundations (1975) states that the justification of foundation and charitable giving are both primarily based on three beliefs: (1) the importance of encouraging voluntarism in the fulfilling of social needs; (2) the suitability of decentralization of funding our educational, cultural, and charitable services; and (3) the usefulness of having some alternatives to many government services, even when those government services are accepted as the norm.

Functional Differences between Foundations and Charities

Although private foundations are funded by charitable contributions, the social expectation of a private foundation is somewhat different from traditional charities. Roelofs (2003) states the distinction between foundation grant-making and charitable giving is in the “root cause” metaphor. Whereas the purpose of traditional charities is to provide relief to the poor, the distressed or the underprivileged, and to lessen the burdens of government, the purpose of foundations is to do something about the deeper causes that lead to suffering and inequality in the first place. For instance, the research on and discovery of vaccine treatment is aimed at preventing the suffering that accompanies

epidemics. Furthermore, Andrews (1965, p.5) emphasizes that the purpose of foundations “is not relief or even cure, it is prevention, research, and discovery.” Heifetz et al. (2004) argue that if foundations are to achieve their social role, they are well positioned to do so through imaginative and even controversial leadership. Society as a whole anticipates foundations (with partially public subsidized endowments) will fund innovative programs, leading research and work on the frontlines of social problems, and hope these efforts would provide alternative solutions to social issues in which society may progress (Zurcher, 1972).

Foundations also are supposed to be more flexible and adaptable to specific situations and pressing social needs than governmental appropriation and governmental agencies normally can be (Zurcher, 1972). Foundations, as independent legal entities, are able to respond to new ideas, support freedom of thought, perform research, and even to critically review governmental programs and policies. Zurcher (1972, p.3) further emphasizes:

It is particularly desirable to maintain an institution like the foundation because, among private institutions concerned with public ends, the foundation is peculiarly equipped to command the resources and the freedom of action to provide alternatives to governmental policy and, if it will, to take the lead in exploring new and uncharted directions in which society might move. All this ... makes for a more open and a more enlightened society.

The function of private foundations differs from that of traditional charities. Private foundations equipped with publicly subsidized financial resources and administrative autonomy are expected to support research projects, institutions, and scholars who investigate social problems and public policy issues (Zurcher, 1972). However, corporate foundations, being funded by business, may prefer to associate with charities rather than to be involved in social issues research or projects because many prior studies (Griffin and Mahon, 1997; Wood, 1990) suggest that corporate donations to charities is usually perceived as a friendly corporate social activity. Moreover, Roberts (1992) empirically verifies that the establishment of corporate foundations has had a positive relationship with the parent company's social responsibility disclosure level. In other words, corporations that use foundations as their donation vehicle are more proactive in demonstrating that they are socially friendly entities.

On the other hand, funding activities concerning social and public policy issues could be an extremely valuable social function of corporate foundations but it also could expose the sponsoring corporations to unnecessary business risk. Mcilnay (1997, p. 26) states:

Involvement in public policy is a two-edged sword for [corporate] foundations: at once perhaps their single most substantive opportunity for public service and their single greatest vulnerability to criticism.

Although corporate foundations are legally separated from the funding organizations, the grant-making behaviors of foundations are likely to be influenced by the giving policies and social interests of the parent company because foundations are

financially and administratively controlled by the sponsoring corporations (Heald, 1970; Himmelstein, 1997; Kroll, 1991; Troy, 1982). In a capitalistic society, business entities are believed to be more concerned with their economic benefits as long as the pursuits of their business interest are within the provisions of laws. The current tax provisions neither request nor provide any incentive for corporate foundations to support public policy studies; grant monies given to traditional charities and to policy research receives the same tax treatment. Consequently, corporate foundations operating in a capitalistic society are theorized to have a preference to provide funding to traditional charities rather than social issue research. It is because funding traditional charities not only helps organizations enjoy the same degree of tax benefits, and perhaps the same amount of name recognition, but also prevents many criticisms. Thus:

Hypothesis 1: Corporate sponsored foundations will give a significantly higher amount of grant monies to traditional charities than they will give to research and public policy studies.

Giving behavior of corporate foundations

Corporate foundations, as tax exempt private organizations, must follow the rules prescribed by Section 509(a) of the Internal Revenue Code and the Tax Reform Act of 1969 (TRA69). These rules not only provide guidelines on whom are the legitimate grant recipients but also set the annual minimum grants payout requirement. The minimum

payout rule is the amount that a foundation is required to expend for charitable purposes including grants, and necessary and reasonable administrative expenses. In general, a foundation is required to pay out at least 5 percent of the market value of its assets each year.

The combination of charitable deduction tax provisions for corporate donations and the minimum payout requirements for corporate foundations might lead to different giving behavior of corporations and foundations. For instance, assume a company with a marginal tax rate of 35% has \$100 of net taxable income available for donation. The company has at least three legitimate options: (1) no donation; perhaps dividends, (2) direct donation to charities, and (3) donation to its sponsored foundation. However, the social consequences of these three corporate actions may be different.

Table 1
The Relationship Between Corporation Actions and the Net Resource Change to Society

	No Donation Keep \$ 100	\$ 100 Donation to Public Charities	\$ 100 Donation to Its Own Foundations
Resource Kept by the Corporation	\$65	\$0	\$0
Amount paid in Taxes	\$35	\$0	\$0
Resource Available to Govern/Nonprofits	\$35	\$100	\$ 5~100
Net Change of Fund to Society Compared w/no charitable donations		\$65	\$ (30) ~ \$65

Assuming a company with a marginal tax rate of 35% has \$100 of net taxable income available for donation.

As indicated by table 1, the first option that the company can choose is to keep and reinvest the net income in its business and pay an income tax of \$35. As a result, the

company keeps \$65, and \$35 becomes tax revenue to the public, which is the primary financial resource to support governmental functions. Second, the company can donate the \$100 directly to charity. This option results in an increase of \$100 to charity and \$35 of tax loss for the government, but the overall net public resource increase is \$65 as compared to the first option. This option could be considered the intent of the charitable deduction provision. The government is willing to subsidize the tax revenue of \$35 and give the company the privilege to select the social cause it wishes to support as long as the company gives away the \$100 to socially desirable organizations. In other words, within the \$100 donation, the company's actually giving is \$65 and the \$35 is sponsored by the public via tax deduction (or forgone in tax revenue).

Finally, instead of giving to other charities directly, the company can donate the \$100 to its own foundation and received a deduction of \$35. Although the company receives the same tax benefit regardless of whether it donates directly or through its foundation, the actual resource available to the public may vary significantly. The amount may vary because foundations are only required to give out a minimum of five percent of its assets, which total \$100 in this example. If only \$5 of the \$100 is given out to socially desirable programs by the company-sponsored foundation, the public temporarily experiences⁸ a deficit of \$30 for this particular donation as compared to option 1. It is because \$35 of tax revenue is lost and only \$5 of grant money is distributed to the society. Through examining the giving behavior of corporate foundations, we might be able to infer the purpose of using foundations as a means for business charitable giving.

⁸ Over time foundations have to payout the total amount of the particular donation.

Giving motivations of corporate foundation

The literature suggests two possible rationales - tax advantage and strategic management of corporate environment— that may explain why so many corporate foundations come into being and persist indefinitely. Many researchers (Clotfelter, 1985; Heald, 1970; Webb, 1992; Webb, 1996) argue the most important reasons for using a corporate foundation have to do with the tax code. First, funds donated by the company for charitable purpose do not have to be handed over immediately to the ultimate users but can be transferred to the foundations. Thus, companies can increase donations in more profitable years to benefit from tax deduction and not immediately lose control of the funds. Second, corporations can fund foundations with appreciated property and foundations can turn around and sell the property and pay no capital gains tax on earnings. Third, foundations' funds can be distributed regularly to chosen recipients because the payout requirement is only 5% of the asset.

If the characteristics of corporate foundations are similar to other nonprofit organizations, tax benefit plays an important role in their reporting and giving behaviors. For instance, Yetman (2001) documents that nonprofit organizations allocate expenses from their tax-exempt to their taxable activities to reduce their tax liabilities. Moreover, Sansing and Yetman (2002) find that large and professionally managed foundations have a tendency to minimize their payouts. Thus, the tax advantage hypothesis is postulated:

Hypothesis 2a: The annual amount of contributions given by a corporate foundation does not significantly exceed its minimum payout requirement.

Still, others (Neiheisel, 1994; Werbel and Carter, 2002; Williams and Barrett, 2000) argue that managing the sponsoring corporation's business environment is the most important reason to set up a corporate foundation. Neiheisel (1994) argues that corporations use their foundation as an extended arm to administer their public affairs, which may reduce government interference and special interest group criticism. Werbel and Carter (2002) find that CEO's influence on corporate charitable contribution is reduced when giving is administrated by corporate foundations. This control may in turn reduce the pressure from stockholders who assume that corporate executives use corporate giving for their personal gain rather than the benefit of the business.

Additionally, William and Barrett (2000) document that corporate charitable giving mitigates unfavorable corporate reputations caused by environmental violations. This conjecture is consistent with the findings of Chen and Roberts (2005); they report that corporate charitable contribution is a legitimation action undertaken by business when their business practices are in question. Corporations, therefore, use donations as the premium of social and political insurance to "purchase" a favorable business environment that may help them continue to survive.

To maintain a favorable business environment requires continuous efforts. As a result, corporate foundations become an important strategic tool for corporations to continually purchase their "social and political insurance" through stable charitable giving even if company profits are unsound and available funds are limited (Hillman, 1965; Webb, 1992).

Moreover, as documented by Chen and Roberts (2005), corporations that receive poorer social performance evaluation scores tend to make more donations than

corporations that receive better evaluation scores. In order to control the influence of their parent company's legitimacy need in corporate foundation's payout behavior, the unfavorable social performance scores of a foundation's sponsoring corporation should be accounted for. Thus, the strategic management hypothesis suggests that:

Hypothesis 2b: The annual amount of contribution given by corporate foundations significantly exceeds the minimum payout requirement after controlling for the legitimacy need of the parent company.

The tax advantage hypothesis and the strategic management hypothesis mentioned above are used to test the payout behavior of corporate foundations. This study does not suggest that these two hypotheses are mutually exclusive. The purpose of this examination is to identify, from the empirical results, the primary incentive of using corporate foundations as a conduit for business donations.

Research Design

Sample and data collection

181 corporate foundations collected in the newest edition of *Corporate Foundation Profiles* by the Foundation Center (Jones, 2002) are used as the sample foundations. The data of these 181 foundations contained in the profiles are used to test hypothesis 1. *Corporate Foundation Profiles* (Jones, 2002) provides information on corporate foundations that gave at least \$1 million in the year of 1998 or 1999. Each profile includes foundation giving-interest areas, application guidelines, recently awarded

grants, information on the sponsoring company, types of support, international giving and others. Thus, the profiles provide standardized comparisons for corporate foundations' giving across business companies, which are required to hypothesis 1. Corporate foundations selected to test hypotheses 2a and 2b are primary based on the set of 181 foundations used to test hypothesis 1. However, in order to control for the legitimacy needs of the sponsoring firms, the parent company of a foundation must also have reported KLD social performance scores. There were 108 foundations that met the criteria.

The amount of foundation giving and required minimum payout are obtained from the annual tax returns filed by corporate foundations with the IRS in Form 990-PF (Return of Private Foundation). The 1996 Taxpayer Bill of Rights 2 requires tax-exempt organizations to disclose their tax returns. Moreover, the IRS has agreed to provide the optically scanned Form 990 (Return of Organization Exempt From Income Tax) to institutions such as The Foundation Center, Guide Star, and the National Center for Charitable Statistics (NCCS), where return data are available to the general public.

Form 990-PF presents the basic financial statements of private foundations. Although the report is financial in nature, other relevant information is also included. For instance, Part I of Form 990-PF is an analysis of revenue and expenses: the amount of all revenue, operating and administrative expenses are listed where the total amount of contribution received and given are reported. Compensation of officers, directors, trustees and key employees are stated. Part II and III contain detailed reports of balance sheet items. Part IV reports capital gains or losses on investment income. Part V provides detailed payout information for five previous years. Foundations use this

information to determine whether they qualify for the reduced 1% tax on net investment income. The payout information for the past five years and the payout amount reported in the current tax returns (in Part X to XII) make six years of panel data available.

The 990-PF tax returns for the year of 2002 of the 108 corporate foundations were collected from the Foundation Center, a non-profit research organization that archives Form 990s. The Part V of the tax returns contains six-years of data for each foundation but due to the availability of the KLD data, the years of 1998 to 2002 data were used in this study. This formed a panel data set including 540 observations that is used to examine hypothesis two.

Measurements

The measurements of hypothesis one in this study were obtained from *Corporate Foundation Profile* (Jones, 2002), which contains information of 181 corporate foundations for the year of 1998 or 1999. Hypothesis one, the relationship between the current tax policy and the fulfillment of corporate foundations' social function, is measured by the difference between the amount of grant money donated to support traditional charities and the amount donated to support research and public policies studies. The amounts given by corporate foundations are dichotomized into funds for research organizations and for charities according to the mission and the nature of the receiving organization. In this study, institutions undertaking any preventive, discovery, and policy-related studies are considered to be research organizations. On the other hand, examples of charitable organizations provided by IRS (Publication No. 557) include, but are not limited to, the following: the organization's purpose is for relief of the poor, the

distressed, or the underprivileged; advancement of religion; improvement of education or science; maintenance of public buildings, lessening the burdens of government and other activities with similar goals.

Among these charitable donations, the purpose of grants to educational organizations is unclear whether it is used to add new buildings or to support research. According to the IRS (Publication No. 557), contributions to schools can be used to improve facilities, to endow a professorial chair, to pay employees' salaries, to fund student activities, or to support research. For the purpose of this study, the contributions to higher educational institutions are assumed to be used for research purpose. Under this assumption, the amount of research grant money given by corporate foundations for research is inflated or overstated. If there is still a significant difference between the amount of grant money given to traditional charities and the amount of inflated research grant money, the test result of hypothesis one will be strongly supported. In addition, Galaskiewicz (1997) reports that the industry attributes of the sponsoring company are likely to affect the amount of grant money to certain social institutions. Thus corporate foundations sponsored by pharmaceutical companies may be more likely to support medical related studies and research. This study, however, does not control for this possible industry effect because, as stated previously, inflated research amounts may strengthen the findings if hypothesis one is supported. Hypothesis 1 is tested by paired samples T-test.

The data used to test hypotheses two were obtained directly from tax returns of corporate foundations (990-PF). Hypothesis two, which is concerned with the primary motivation for corporate foundations giving, is measured by the difference between the

amount of total grant money and the minimum amount of payout requirement. The total giving amount and the fair market value of average assets of each corporate foundation over a six- year period are reported on Part V of Form 990-PF. The minimum amount of payout requirement is equaled to 5% of the total average asset's market value.

The control variable, the legitimacy need of the parent company, is measured by the sum of the concerns scores reported by the social research firm Kinder, Lydenberg, Domini's (KLD) Socrates database⁹. Although several other corporate social performance reports are available, the numbers of companies or the dimensions of corporate social performance covered by these reports are limited. On the other hand, KLD data offer several desirable qualities. KLD has quantifiable social records of over 3,000 publicly traded U.S. companies across a range of dimensions pertaining to business related social concerns. Moreover, KLD's data have been used extensively in a growing body of largely management-based U.S. research on corporate social performance issues (e.g. Waddock and Graves, 1997a, 1997b; Griffin and Mahon, 1997; Agle et al., 1999; Berman et al., 1999; Greening and Turban, 2000; Hillman and Keim, 2001; Ruf et al., 2001; Rehbein et al., 2004), and recently have also been applied in accounting research (e.g. Cho, Patten and Roberts, 2005). Most importantly, these KLD data have been validated as the best currently available measurements of corporate social performance (Sharfman, 1996; Szwajkowski and Figlewicz, 1999). A complete and detailed description of the KLD rating system is available from Waddock and Graves (1997a, 1997b) and KLD's website (www.kld.com).

⁹ Socrates is a proprietary database program issued by Kinder, Lydenberg, Domini & CO. Inc. that provides access to KLD's ratings and other data pertaining to the social records of over 3,000 publicly traded U. S. companies.

KLD separately assigns strengths and concerns across eight social performance dimensions. These dimensions are community, corporate governance, diversity, employee relations, environment, human rights, product, and others (KLD, 2003). The sum of the concern scores of the eight dimensions are used to measure the sponsoring corporations' needs of legitimacy for the selected years.

Hypotheses 2a and 2b are tested by regression. The difference between the amount of total contributions (total grant monies plus administrative expenditures¹⁰) and the amount of minimum payout requirement is the dependent variable. KLD concern scores are the control variables. If the coefficient of the constant is significant with a negative sign, then hypothesis 2a is supported, which indicates that the annual amount of contributions given by a corporate foundation does not significantly exceed its minimum payout requirement after their parent company's legitimacy needs are accounted for. This result suggests that the giving behavior of corporate foundations is primarily guided by tax benefits. On the other hand, if the coefficient of the constant is significant with a positive sign, then hypothesis 2b prevails, which support that the annual amount of contribution given by corporate foundations significantly exceeds the minimum payout requirement after controlling for the legitimacy need of the parent company. Thus, the main motivation of corporate foundations' giving is to strategically manage firms' environment.

¹⁰ On average the amount of administrative expenditures is 4.19% of the total contributions with a range of 0% to 63.21%.

Analysis of the Results

Analytical procedures

The description of the sample corporate foundation is presented in Table 2. The average ending asset was \$49.43 million, with a range of 0 to \$441.25 million. The average age of the foundation at the end of 1998 or 1999 was 30.90, with a range of 1 to 82. The foundation donated, on average, \$9.52 million to various organizations, with the least amount donated being \$1.10, and the highest amount donated being \$67.89 million.

Table 2 Summary of Sample Corporate Foundations

	Min	Max	Mean	Standard Deviation
Assets ^a	0	441.25	49.43	76.93
Age	1	82	30.90	16.60
Total Grant given	1.10	67.89	9.52	10.56
Grants to Charities	0.92	63.27	8.10	9.02
Grants to research/public policy studies	0	11.21	1.42	2.10

^a in million except for age. $N=181$

Source: *Corporate Foundation Profiles* by The Foundation Center (2002).

Hypothesis one, the difference between the amount of grant money to traditional charities and to research and public policies studies, was tested by paired samples T-Test and is significant at the 0.000 level with a t score statistic of 11.61. A summary of corporate foundation grant money distribution by recipient and percentage is presented in Table 3. The corporate foundations gave, on average, approximately \$8.10 million to traditional charities, which accounted for 85.08 percentage of the total grant money;

followed by higher education \$1.21(12.71%), public policy studies \$0.09 (0.95%), medical research \$0.08 (0.84%), and other research \$0.04 million (0.42%).

Table 3
Summary of Corporate Foundation Payout Behaviors by Recipient and Percentage

	Charities	Higher Education	Public Policy	Medical Research	Research
Amount* (mean)	8.10	1.21	0.09	0.08	0.04
Percentage	85.08	12.71	0.95	0.84	0.42

* in millions

Hypothesis two was tested using Ordinary Least Squares (OLS) regression with group dummy variables, and Hausman tests indicate random model is appropriated for the data set. Table 4 presents the descriptive statistics of the variables, and the test results of the model are presented in Table 5.

Table 4
Descriptive Statistics

	Min	Max	Mean	S. D.
Amount above required pay-out*	-1,269.29	161,848.76	12,386.99	17,955.85
KLD	0	16	3.60	2.87

N=540 * in thousand (\$)

The difference between the amount of grant monies and the required payout, on average, is \$12,386.99 thousand with a range of \$ -1,269.29 to \$ 161,848.76 thousand. The sponsoring company's legitimacy needs, on average, is 3.60 with a range of 0 to 16, as measured by KLD rating scores. The correlation between the KLD scores and the

amount of grant monies above the required payout is 0.279, which is significant at the 0.01 level.

Table 5

Regression results for corporate foundation giving motivation test

Dependent variable = difference between the amount of total contributions and required payout for 1998-2002.

	Expected sign	OLS Random Model		
		Parameter estimates	Standard error	Sig. ^a
KLD	+	1498.47	268.95	0.000
Constant	+/-	6992.50	1789.67	0.000
<i>Model Statistics</i>				
Model		<i>F</i> -statistic = 20.22		
Sig.		Sig. at the 0.000 level		
<i>R</i> -squared		Adjusted <i>R</i> ² = 0.79		

N = 540. Mean KLD score is 3.60 with a range of 0 to 16.

The random model is significant at the 0.000 level with a *F* score statistic of 20.22, and the adjusted coefficient of correlation (*R*²) for the random model is 0.79. The control variable (KLD) and constant are both significant with a positive sign. The overall results support hypothesis 2b.

Discussion of research findings

The particular social functions of private foundations such as corporate sponsored foundations are theorized to provide alternative solutions to social issues by supporting research and public policy studies. However, the empirical results indicate that corporate foundations gave more than 85% of their grant monies to traditional charities, and less than 15% of their grant monies were used to carry out their social function. Whether the resources of foundations should be used primarily to substitute governmental

expenditures, to mitigate social inequality or to support research that may provide answers to challenging social problems are important public policy issues. The current tax laws do not appear to require that foundations fulfill their commonly agreed upon specific social function. Amendments to the current tax laws may be necessary if society agrees that the social function of foundations is different from that of charities and desire foundations to carry out their specific social roles.

The timing for corporations to donate (transfer) funds to their sponsored foundations, as suggested by many economic studies, may be primarily motivated by tax advantages. The research results, however, reveal that one primary motivation of corporate foundation giving, the resources outflow from foundations to society, is a strategic desire to manage their parent company's business environment. Corporate foundations gave more grant monies than the amount required by the tax laws. Moreover, corporate foundations donate even more monies when their parent company's social legitimacy need is high. After the influence of sponsoring corporation's legitimacy need is controlled, foundations still gave out more grant money than necessary. These research findings provide a strong support to hypothesis 2b that corporations use their foundation giving as the premium of social and political insurance to manage their business environment. In addition, the giving behavior of corporate foundation seems to be different from that of other private foundation. Sansing and Yetman (2002) document that private foundation in general have a tendency to minimize their payouts. The results of this current study concentrated only on corporate foundations, however, indicate that the annual amount of contribution given by corporate foundations extensively exceeds the minimum payout requirement.

According to the results of this current study, one may question the social value of corporate foundations in their current practices. As private foundations, they do not provide adequate funds to support research; as corporate foundations, they are used by their parent company as a strategic instrument to manage the sponsoring company's social legitimacy and business surroundings.

Conclusions and Limitations

There were two purposes in this study. The first one was to empirically test the relationship between the current tax laws and the fulfillment of corporate foundations' social roles. The second objective was to examine whether tax advantage or strategic management desire is the primary motivation of corporate foundation giving. The results indicate that the current tax laws do not provide incentives for foundations to support research and public policy studies. The research findings also reveal that corporate foundation giving is motivated more by a desire for strategic management than tax benefits. However, this study does not exclude tax advantage as one of the motivations of corporate foundation giving.

Several future research directions are suggested by the findings of this present study. First, the effects of tax laws on the selection of recipients or grant monies allocation between charities and research could be tested by experimental studies. Second, this study could be refined using direct measures of managers' understanding of their legitimacy needs as control variable. Finally, the social functions of foundations could be further identified by historical review.

As with any research, this study has certain limitations. This study has relied on the categorization scheme provided by *Corporate Foundation Profiles*; a detailed breakdown as to who were the recipients of corporate foundations giving was beyond the scope of this current study. The empirical tests were performed on large corporate foundations that may restrict the generalizability of the findings. The social roles of foundations adopted by this study may be subject to debate.

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