

Non-cash charitable giving: Evidence of aggressive taxpayer reporting and a potential tax policy failure

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Abstract

Treasury Decision (TD) 8002 significantly relaxed the substantiation requirements for deducting non-cash charitable contributions under \$501 for tax years 1985 and after. We present evidence that TD 8002 caused a significant change in taxpayer behavior. Specifically, the relatively stable percentage of taxpayers who claimed zero non-cash charitable deductions in years prior to TD 8002 decreased consistently and significantly after TD 8002's implementation. This decrease in "zero non-cash" deductions was largely replaced by taxpayers who reported non-cash charitable deductions for amounts just under TD 8002's relaxed substantiation requirement (i.e., amounts just under \$501). We present a series of tests supporting the contention that the increase in reported non-cash charitable deductions is largely attributable to more aggressive reporting behavior rather than increased charitable giving.

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INTRODUCTION

Loosely speaking, aggressive tax reporting is an issue of crime and punishment. Indeed, a key factor in taxpayers' willingness to take aggressive positions is the perceived risk that such positions will ultimately be detected, corrected, and penalized by tax authorities (Fischer et al. 1992, Hite and McGill 1992, White et al. 1993, Dusenbury 1994, Carnes and Englebrecht 1995, and Christensen and Hite 1997). In this study, we provide evidence that a 1984 procedural change (i.e., Treasury Decision 8002; henceforth, TD 8002) that extensively relaxed the tax compliance requirements, and by implication, the perceived detection risk associated with non-cash charitable contributions, resulted in significant increases in non-cash charitable contribution deductions under \$501 for tax years subsequent to TD 8002 (i.e., post-1984).

As a result of TD 8002, for tax years 1985 and after, no ex-ante substantiation must be filed with a tax return claiming a non-cash charitable contribution unless the deduction exceeds \$500, at which point IRS Form 8283 (Non-Cash Charitable Contributions) is necessary. In contrast, prior to 1985, taxpayers claiming a non-cash charitable contribution of any amount were required to attach a statement to their return describing the property given, date of donation, and an estimate of its value. We posit that this compliance change created an environment with lower detection risk for non-cash charitable contributions under \$501 thereby providing taxpayers with an incentive to claim non-cash charitable deductions at levels slightly below the threshold triggering the filing requirement of Form 8283, regardless of their actual levels of property contributions.

Analyzing tax return data from 1979 to 1990, we find that reported deductions for non-cash charitable contributions increased significantly following the implementation of TD 8002 (i.e., in the period 1985-1990). This increase comes largely from taxpayers who, in tax years prior to TD 8002 (pre-1985), did not take deductions for non-cash charitable contributions. Moreover, we find that the largest increase in non-cash charitable deductions occurs at the \$400-\$500 level – in other words, at amounts just shy of the \$501 threshold triggering the Form 8283 requirement. This evidence suggests that the compliance changes enacted by TD 8002 contributed to dramatic changes in charitable contribution reporting behavior.

We further examine this change in taxpayer behavior by investigating the extent to which indicators of secondary evasion are present for those taxpayers who demonstrate potentially aggressive non-cash charitable contribution reporting behavior. Following the approach used by Christian and Gupta (1993) and by Slemrod (1985), we analyze the distribution of taxable incomes across the tax table brackets for non-cash contributors versus other taxpayers. We find that the taxable incomes of taxpayers reporting positive non-cash contributions tend to be disproportionately concentrated at the top of the tax table brackets compared to other taxpayers, a phenomenon consistent with secondary tax evasion (Christian and Gupta 1993). Further, this aggressive reporting behavior appears to be concentrated in that sub sample of tax returns that are self-prepared, suggesting that professional preparers have a moderating effect on this form of tax evasion. Having identified a potentially aggressive group of taxpayers (self-prepared returns with non-cash charitable contributions just under \$501), we provide evidence of a significant increase in this group's secondary evasion behavior following the implementation of TD

8002. In total, our results suggest that many taxpayers responded to TD 8002's relaxed reporting rules by overstating claimed deductions for non-cash charitable contributions.

The remainder of this study is organized as follows. We first develop formal hypotheses. Next, we describe our research method and present results related to these hypotheses. The final section discusses the policy implications of our findings.

HYPOTHESIS DEVELOPMENT

Background

The U.S. tax system affords many taxpayers the opportunity to take a deduction for charitable contributions. For individual taxpayers, the amount and extent of this tax benefit is a function of whether the taxpayer itemizes deductions¹. The Federal subsidy associated with the charitable contributions deduction is a function of both the level of giving and the marginal tax rate: the higher the tax rate, the more the subsidy reduces the net cost to the taxpayer of making the contribution.

The inherently elective nature of charitable giving implies that the after-tax cost of the contribution and the overall effect on after-tax income play an integral role in whether or not a contribution is made, and if so, in what amount. As such, a large body of research estimates the impact of tax policy on charitable contributions using elasticity analysis.² The sheer number of such studies implies that accurately assessing the relationship between tax policy and charitable contributions is an important issue; however, Slemrod (1989) and Joulfaian and Rider (2004) provide evidence that prior income and price elasticity estimates for charitable contributions are likely biased. Both studies suggest that the elasticity estimates of “real” charitable giving are likely higher

than those estimated in prior studies in part because total charitable contribution deductions can typically be bifurcated into an actual giving component and an overstatement component. Furthermore, the overstatement component of reported charitable deductions appears to be relatively insensitive to differences in tax rates across taxpayers. That is, taxpayers appear to consistently report excess contributions across all income levels, regardless of differences in tax rates. We believe that procedural compliance changes that affect the “crime and punishment” tradeoff made by taxpayers (i.e., TD 8002) may explain a portion of reported excess charitable contributions.

In addition, tax compliance changes may help explain some of the inconsistent results related to evasive behavior. Specifically, although one would expect a positive correlation between tax rates and evasive behavior (e.g., higher rates cause more evasion), prior research has produced significant, but inconsistent results (e.g., Clotfelter 1983, Graetz and Wilde 1985, Feinstein 1991, Joulfaian and Rider 1996 and 1998). Given that in some cases the correlation of tax rates and evasion are shown to be negative while in other cases a positive correlation is found, tax rates alone are not exclusively - and perhaps not even primarily - responsible for aggressive/evasive taxpayer compliance behaviors. Again, we believe that procedural compliance changes that affect the cost/benefit tradeoff made by taxpayers may help explain inconsistent results related to tax rates and evasive behavior.

Change in Compliance Requirements for Non-Cash Charitable Contributions

Treasury Decision 8002 (1985-1 CB 60) modified the substantiation requirements for non-cash charitable contributions made subsequent to December 31, 1984 that are

now part of the 1.170A-13 regulations.³ For tax years prior to 1985, taxpayers claiming a non-cash charitable contribution deduction, regardless of the amount, were required to report as part of their return the following information: 1) the date of the contribution along with the name and address of each organization to which a contribution was made, 2) a summary of the kind of property contributed, 3) the method used in determining the fair market value of the property, 4) the date and method of acquisition, and 5) the cost basis of the property. For tax years 1985 and after, the same information was required but only for non-cash contributions in excess of \$500. This information would now be reported on Form 8283, Non-cash Charitable Contributions, created for tax years 1985 and later.

TD 8002 also modified Reg. Sec. 1.170A-13(b)(1) to include the following verbiage related to obtaining a receipt for contributions of property other than money: “*A receipt is not required if the contribution is made in circumstances where it is impractical to obtain a receipt (e.g. by depositing property at a charity’s unattended drop site). In such cases, however, the taxpayer shall maintain reliable written records with respect to each item of donated property that include the information required by paragraph (b)(2)(ii) of this section.*” While the Pre-TD 8002 regulations afforded taxpayers similar flexibility regarding small non-cash contributions, such flexibility was not enumerated in the pre-amended regulations. Logically, the additional verbiage in TD 8002 may have inadvertently provided taxpayers with a reasonable explanation for reporting non-cash charitable deductions without a receipt.

While TD 8002 served, in part, to enhance the overall compliance requirements for high dollar non-cash charitable contributions, regulatory flexibility analysis (i.e., a

formal cost/benefit analysis) was not performed because the Commissioner of the Internal Revenue Service determined that the rule change encompassed therein did not constitute a major rule change as defined in Executive Order 12291. Thus, any potential revenue loss resulting from the relaxed reporting requirements associated with non-cash charitable contributions less than \$501 was likely considered *de minimis* in nature by the Commissioner.⁴

An ironic twist to TD 8002's implementation is that in 1984 (before TD 8002 was issued) the Treasury Department issued a report recommending that the charitable contribution deduction for non-itemizers not be extended. Part of the Treasury's concern was that a significant number of non-itemizing taxpayers taking the charitable contribution deduction claimed the maximum amount allowed of \$25. The Treasury was, in essence, questioning the legitimacy of the deduction. Thus, while the Treasury expressed concern that non-itemizing taxpayers were, perhaps, falsely claiming a \$25 deduction with no documentation, it simultaneously implemented rules enhancing the opportunity for itemizing taxpayers to claim a \$500 deduction with no documentation. On the surface, these two positions appear to be inconsistent.

It is fairly obvious that the changes enacted as part of TD 8002 provided taxpayers with substantial latitude in reporting non-cash charitable deductions in amounts up to \$500, perhaps signaling an environment of reduced detection risk. We posit that these regulatory changes provided an impetus to taxpayers to report non-cash charitable deductions at levels up to \$500, regardless of actual contributions made. These policy changes, in conjunction with Joulfaian and Rider's (2004) and Slemrod's (1989) findings

that the overstatement component of charitable contributions are less sensitive to tax rates and likely more a function of other stimuli lead us to the following hypotheses:

- H1: The use of non-cash charitable contributions by itemizing taxpayers will increase in years after the 1984 change in compliance requirements.**
- H2: The largest percentage increase of reported non-cash charitable contributions will be for amounts just under the \$501 documentation threshold.**

Secondary Evasion and Non-cash Charitable Giving

Slemrod (1985) and Christian and Gupta (1993) provide evidence that secondary evasion (i.e., “the phenomenon associated with the clustering of tax returns at the top of the \$50 tax table brackets”, Christian and Gupta, 72) is prevalent in the United States tax system. Secondary evasion suggests that taxpayers required to use the published tax tables to calculate their liability manipulate their tax deductions to reduce their respective taxable incomes from the bottom of the next higher table bracket to the top of the next lower table bracket resulting in a lower tax liability. Slemrod (1985) suggests that such secondary evasion is a clear indicator of primary evasion. Based on the nature, flexibility, and subjectivity of non-cash charitable contributions this deduction is relatively easy to manipulate. As such, we hypothesize the following:

- H3: The taxable incomes of taxpayers who claim deductions for non-cash contributions will be more heavily concentrated at the top of the tax table income brackets compared to other taxpayers in both the pre- and post-1984 periods.**

In addition, Christian and Gupta (1993) and Dunbar and Phillips (1997) suggest that secondary evasion is more prevalent among self-prepared returns than professionally prepared returns. Their explanation is that, although tax preparers are typically expected to act as client advocates in recommending sound tax minimization strategies that often

exploit the gray area of the tax law, in situations where the law is clear (i.e., application of the tax table to the calculated taxable income), tax practitioners are expected to demonstrate responsibility to the tax system. Thus we hypothesize:

H4: The taxable incomes of taxpayers who prepare their own tax returns and claim deductions for non-cash contributions will be more heavily concentrated at the top of the tax table brackets relative to those who use a professional preparer and claim deductions for non-cash charitable contributions.

To this point, we have outlined a fairly straightforward incentive for taxpayers to aggressively change their reporting behavior following enactment of TD 8002 (Hypothesis 1). In hypothesis 2, we identify a range of non-cash charitable deductions most likely subject to manipulation (i.e., deductions just under the \$501 documentation threshold). In hypotheses 3 and 4, we rely on prior literature to predict (1) non-cash charitable contributions are inherently prone to manipulation and (2) self-prepared returns are even more prone to manipulation. We conclude this section by forming a direct and targeted prediction of aggressive taxpayer behavior. Specifically, we rely on hypotheses 2 through 4 to identify a group of taxpayers most likely guilty of secondary evasion.

Formally:

H5: For self-prepared taxpayers who claim non-cash charitable deductions just under TD 8002's \$501 documentation threshold, taxable income will be more heavily concentrated at the top of the tax table brackets in the post TD 8002 period relative to the pre TD 8002 period.

RESEARCH METHOD AND EMPIRICAL RESULTS

Data Source

We obtain necessary tax return data from the Ernst and Young/University of Michigan Individual Taxpayer Panel (“the panel”) for tax years 1979 through 1990. Each year of the panel consists of a random sample of all tax returns filed for the tax year

represented, drawn by choosing all tax returns filed for that year with a primary taxpayer whose social security number ends with a pre-selected 4-digit number. The size of the data set varies from approximately 9,500 tax returns to over 45,000 tax returns. Because the panel data set is a random sample, rather than a stratified sample like the IRS Public Use Tax File, each return in the sample represents an equal number of returns in the population. Moreover, the distribution of returns present in the panel sample is distributionally representative of the distribution of returns in the population. Thus, the results observed from the panel data are directly generalizable to the population of tax returns filed for the years from which the samples are drawn.

Descriptive Results

Table 1 presents summary results examining hypothesis one. The data have been bifurcated into two groups: tax years before TD 8002 (1979 to 1984) and tax years after TD 8002 (1985 to 1990). We first present the average percentage of total tax returns that itemized deductions for the two groups of tax years (see Table 1). The percentage of itemizing tax returns remained fairly constant at 32.03% and 31.4% for the 1979-1984 and 1985-1990 years, respectively. These figures closely resemble the actual itemized tax return data published by the Statistics of Income division of the IRS for the same tax periods (i.e., 33.8% for 1979-84 and 32.7%, for 1985-1990 (IRS 2003-2004)).

Insert Table 1 about here

Of particular interest in Table 1 is the percentage increase in the number of tax returns claiming non-cash charitable deductions subsequent to the relaxation of the

compliance rules. The percentage of itemizing tax returns claiming non-cash charitable deductions increased from 21.97% during the six years preceding TD 8002 to 31.88% during the six years after TD 8002. Thus, although the percentage of itemizers in the population remained relatively constant (declining by less than 2%), the percentage of those itemizers claiming a deduction for non-cash contributions increased by 45%. These results support hypothesis 1. Figure 1 provides visual support that TD 8002 is the primary driver for this change. Specifically, the percentage of itemizing tax returns claiming a positive non-cash charitable deduction was quite consistent prior to 1985 (about 22%); however, this percentage increased rapidly and consistently after TD 8002.⁵ One possible explanation of this graph is that taxpayers quickly learned that a tax deduction that required no substantiation was “there for the taking”. Below, we further explore the possibility that the relaxed substantiation rules stimulated more aggressive reporting of non-cash charitable contributions.

Table 2 provides a more detailed analysis of non-cash charitable contributions for all itemized tax returns in our sample (during both the pre- and post- TD 8002 periods). Tax returns are divided into four categories: 1) itemized returns with zero non-cash contributions, 2) itemized returns with \$1-\$399 of non-cash contributions, 3) itemized returns with \$400-\$500 of non-cash contributions, and 4) itemized returns with greater than \$500 of non-cash contributions. Given the hypothesis described in H2, our focus is on category 3 (itemized returns with \$400 - \$500 of non-cash contributions) because this category offers a logical operationalization of being “slightly under” the \$501 documentation threshold.⁶ In layman’s terms, we suspect that many taxpayers viewed (view) the IRS’s relaxed substantiation requirement for non-cash charitable contributions

as an “opportunity.” Basic economic incentives suggest that taxpayers will take advantage of this opportunity.

Insert Table 2 about here

As shown in Table 2, although the majority of taxpayers with itemized deductions claim zero non-cash charitable contributions, this percentage has decreased markedly in the post TD 8002 period relative to the pre TD 8002 period (68.12% vs. 78.03%, respectively). Recall that TD 8002 established \$501 as the point at which taxpayers are required to file Form 8283 (Non-cash Charitable Contributions) to substantiate their deduction. Although unsurprising to an economic maximizer, the vast majority (90%) of the decrease in zero non-cash contributions is replaced by contributions at levels below the threshold triggering the requirement to file Form 8283. Consistent with H2, the majority of this shift occurs in itemized returns with \$400-\$500 of reported non-cash charitable contributions (i.e., amounts just under the substantiation requirement).

Figure 2 provides visual evidence that, over time, taxpayers learned to “take advantage of the opportunity” offered by TD 8002’s relaxed substantiation requirement. Additional support comes from linking individual taxpayers across the panel years in our sample. Specifically, we identified all taxpayers who (1) itemized deductions in each panel year of our sample (i.e., taxpayers who appear in each year of Table 2) and (2) reported non-cash charitable contributions in the \$400 - \$500 range at least three times during the post-TD 8002 period (i.e., taxpayers who potentially “learned to take advantage” of TD 8002). This selection process identified 70 unique taxpayers who, in

the six-year period 1979 through 1984 (i.e., prior to TD 8002) reported average non-cash charitable contributions of \$97.52. In contrast, during the six-year period 1985 through 1990 (i.e., after TD 8002) these same taxpayers reported average non-cash charitable contributions of \$412.13. While this dramatic difference in across-time reporting behavior offers some evidence that taxpayers “learned” to take advantage of TD 8002’s relaxed substantiation requirement,⁷ more compelling evidence comes from bifurcating the post-TD 8002 period. Specifically, in the three-year period 1985 through 1987, these 70 taxpayers reported average non-cash charitable contributions of \$343.81. In contrast, during the three-year period 1988 through 1990, the amount increased to \$480.46 ($t = 5.28 p < .01$). We next provide a more direct test of “taking advantage” of TD 8002 examining the issue of secondary tax evasion.

Secondary Tax Evasion

Hypotheses three through five examine the extent to which taxpayers who take non-cash charitable contributions may be engaged in secondary evasion. Following Christian and Gupta (1993) and Slemrod (1985), we analyze the distribution of reported taxable incomes relative to the tax table brackets as a proxy for secondary evasion. From 1981 until the end of our sample period, taxpayers with taxable income below \$50,001 were required to compute their taxable incomes by reference to the tax tables, rather than using the tax rate schedules. The tax tables are divided into \$50 increments from zero taxable income to \$50,000 taxable income. Every taxpayer with taxable income in a particular tax table bracket (e.g., income between \$41,151 and \$41,200) is assessed the same amount of tax. That amount is the tax that would be owed on taxable income at the midpoint of the bracket (e.g., \$41,175 in the above example).

All else equal, taxable incomes should be distributed evenly within tax table brackets. However, Christian and Gupta (1993) report that incomes tend to be disproportionately clustered at the upper end of each bracket, suggesting that taxpayers at the bottom of the next higher tax table bracket manipulate their reported incomes downward in order to fall into the next lower bracket. Christian and Gupta interpret this pattern of behavior as evidence of secondary tax evasion.

We employ Christian and Gupta's methodology to investigate the potential manipulation of non-cash charitable contributions. The flexibility and relative subjectivity in valuation of non-cash charitable contributions provides taxpayers with a relatively easy opportunity to manipulate these deductions to lower their taxable incomes to the upper part of the next lower tax table bracket. Thus, the deduction for non-cash contributions provides a simple and low-risk method for secondary evasion. Our results are summarized in Table 3.

Insert Table 3 about here

Table 3 compares taxpayers who claim zero non-cash contributions against those who claimed a deduction for non-cash contributions of \$500 or less.⁸ As in Christian and Gupta (1993), we compare the percentage of returns filed by taxpayers in the two groups with reported taxable incomes in the top \$15 of the tax table brackets. Consistent with hypothesis 3, the results indicate that taxpayers claiming a deduction for non-cash contributions are significantly more likely to report taxable income in the top part of the tax table brackets compared to those who claim zero non-cash charitable deductions.

Having established that taxpayers claiming non-cash charitable contributions are, in general, more aggressive than taxpayers who do not claim non-cash contributions, we next turn to the potentially moderating influence of professional tax preparers (cf. Dunbar and Phillips 1997). Table 4 summarizes results of an analysis investigating the effect of professional preparers on the reporting behavior of taxpayers claiming a deduction for non-cash contributions. In order to focus on taxpayers most likely to engage in secondary evasion as a result of TD 8002, we restrict this analysis to non-cash charitable contributions below the \$501 threshold amount at which Form 8283 must be filed. Because the professional return preparer variable is not available for panel years 1981 and 1985, these years are excluded from this analysis.

Insert Table 4 about here

The results reported in Table 4 provide support for hypothesis 4. Relative to professionally prepared returns, self-prepared returns claiming a deduction for non-cash contributions less than \$501 are significantly more likely to report taxable incomes in the top \$15 of the tax table brackets. Indeed, professionally-prepared returns are not disproportionately clustered in the top \$15 of the tax table brackets given that 30% of taxpayers in a uniform distribution would appear in the top of the brackets (top \$15 ÷ \$50 bracket = 30%). In contrast, a statistically significant portion of self-prepared returns claiming a deduction for non-cash contributions exhibit behavior consistent with secondary evasion.

We conclude by investigating our targeted prediction of aggressive taxpayer behavior associated with TD 8002. Specifically, we restrict our sample to self-prepared returns claiming non-cash contributions between \$400 and \$500 and investigate secondary evasion in the pre- and post-TD 8002 periods. Table 5 reports the percentage of these returns at the top of the tax table brackets in these periods, providing support for hypothesis 5.

Insert Table 5 about here

As indicated in Table 5, we find no evidence of “clustering” at the top of the tax table brackets prior to implementation of TD 8002. Specifically, we observe just under 30% of self-prepared returns claiming a non-cash charitable deduction between \$400 and \$500 in the top \$15 of the tax table brackets. All else equal, the reported 29.58% of taxpayers in the top of the tax table brackets is consistent with the 30% that would be expected in a uniform distribution. In contrast, we observe a large (49%) and significant ($p = 0.01$) increase in the percentage of these returns clustered at the top of the tax table brackets after implementation of TD 8002.

Alternative Explanation

The preceding results provide fairly direct evidence of aggressive taxpayer behavior following the Treasury Department’s decision to relax the reporting requirements for non-cash charitable deductions. However, one possible alternative explanation is that the increase in taxpayers reporting just under TD 8002’s \$501 threshold is, in part, attributable to taxpayers who actually give more than \$500 in non-

cash contributions, but wish to avoid filing Form 8283. In other words, it is possible that we have identified an over-reporting, rather than an under-reporting, phenomenon if taxpayers *reporting* in the \$400 - \$500 range actually gave more than \$500 in noncash gifts but wish to avoid filing Form 8283.

While a direct test of this possibility is not feasible (i.e., we have access to reported, but not actual non-cash charitable contributions), additional analyses suggest that the number of taxpayers “underreporting deductions to avoid Form 8283” is very small. Figure 3 shows no marked decrease in the percentage of itemized returns claiming non-cash charitable contributions just over TD 8002’s \$500 Form 8283 reporting threshold. Specifically, if a sizable number of taxpayers underreport charitable contributions in an effort to avoid filing Form 8283, then we would expect to see a decrease in the percentage of itemizers claiming between, say, \$501 and \$700 after TD 8002 was implemented. Throughout our sample period, the percentage remains a constant 1% (rounded) while the percentage of taxpayers reporting under \$501 increases substantially.⁹

Summary and Concluding Remarks

Our results indicate that the implementation of Treasury Decision 8002 was followed by a significant increase in the number of taxpayers who claimed a deduction for non-cash charitable contributions. The largest increase occurred in returns claiming a deduction just under TD 8002’s required reporting threshold. Viewed skeptically, this change in reporting behavior is consistent with taxpayer noncompliance rather than actual increases in the level of non-cash giving.

We further support this skeptical viewpoint by employing an analysis of secondary tax evasion. The reported taxable incomes of non-cash contributors are disproportionately clustered in the upper part of the tax table income brackets suggesting that taxpayers are using non-cash charitable deductions to manipulate their incomes downward (from the bottom of the next higher bracket to the top of the next lower bracket). Consistent with prior literature, this potential manipulation is mitigated by the presence of a professional tax preparer. Finally, we find a significant increase in secondary evasion for taxpayers most likely to engage in such behavior (i.e. self-prepared taxpayers claiming between \$400 and \$500 of non-cash charitable deductions) after the implementation of TD 8002.

We believe our results have implications for both tax research and tax policy. Regarding tax research, our results provide empirical evidence that characteristics of the tax system other than tax rates (in this case, compliance requirements) can have a significant impact on taxpayer reporting behavior. In addition, our results are consistent with and extend the observations of Slemrod (1989) and Joulfaian and Rider (2004) that charitable contributions are commonly overstated on taxpayer returns and that this overstatement is relatively insensitive to changes in tax rates. During our sample period, it is particularly interesting that we find a significant increase in non-cash charitable deductions during a period of falling tax rates. Finally, our results provide additional support for the secondary evasion literature. With its relaxed substantiation requirements, TD 8002 provided (provides) a straightforward mechanism for taxpayers to manipulate their taxable income in an effort to avoid taxation.

On the surface, results of this study suggest that the Treasury’s decision to issue TD 8002 may not have been well thought out. As noted previously, shortly before issuing TD 8002, the Treasury issued a report recommending that the deduction for charitable contributions for non-itemizing taxpayers be eliminated, due in large part to the government’s concern that many taxpayers were simply taking the maximum allowed deduction of \$25 without actually making the charitable donation. Yet in TD 8002, the Treasury not only eliminated the ex-ante reporting requirement for non-cash contributions up to \$500 (an amount 20 times the magnitude of the deduction for non-itemizers), it also highlighted in the regulations situations where a receipt was not required (e.g., a charitable organization drop-box).

We provide fairly compelling evidence that taxpayers quickly learned to take advantage of TD 8002 in amounts much larger than \$25 per taxpayer. That being said, we are not privy to the models used by the IRS to target tax returns for audit. If secondary evasion truly is indicative of primary evasion, it may be true that the Service “gave away” non-cash charitable contributions in an effort to obtain a useful audit flag (potentially used in conjunction with other flags such as “self-prepared return”). While we conservatively estimate lost tax revenues caused by TD 8002 to be in excess of \$250 million annually¹⁰, we struggle to assess potential benefits that may offset this cost.

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Table 1
Pre- and Post Treasury Decision 8002 Summary Statistics

	Tax Years 1979-84	Tax Years 1985-90	
			% Change
Total Tax Returns in Sample	176,142	118,204	
Returns with Itemized Deductions ^(a)	56,417	37,131	
Percentage of total returns that itemize	32.03%	31.41%	-1.93%
Itemizing Returns w/ positive Non-cash Contributions	12,392	11,837	
Percentage of Itemizing Returns w/ Non-cash Contributions	21.97%	31.88%	45.14%

^(a) Consistent with Christian and Gupta (1993), all “non current year” taxpayers were excluded from the sample. In other words, a taxpayer is excluded from our sample if he/she had a tax year other than 1980 in the 1980 panel file.

Table 2
Analysis of Itemized Tax Returns

	Tax Years 1979-84	% of Total Itemizing Returns	Tax Years 1985-90	% of Total Itemizing Returns	Raw Percentage Change
Itemizing Returns with Zero Non-cash Contributions	44,025	78.03%	25,294	68.12%	-9.91%
Itemizing returns with \$1-\$399 of Non-cash Contributions	10,026	17.77%	7,725	20.80%	3.03%
Itemizing returns with \$400-\$500 of Non-cash Contributions	658	1.17%	2,655	7.15%	5.98%
Itemizing returns with > \$500 of Non-cash Contributions	1,708	3.03%	1,457	3.92%	0.89%
Total Itemizing Returns in sample	56,417		37,131		

Table 3
Non-Cash Contributors and Secondary Evasion, 1981 through 1988 ^(a)

	Zero Non-Cash Contributions	\$1-\$500 Non-Cash Contributions	Z-statistic ^(b)	p-value
Top 30% of Tax Table (evidence of secondary evasion)	28,943	2,995		
Bottom 70% of Tax Table	82,377	6,506		
Proportion of potential secondary evasion	26.0%	31.52%	11.72	<.0001

^(a) Prior to 1981, tax tables were required for taxable incomes less than \$20,001. The 1981 through 1988 test period (1) consistently requires tax tables for taxable incomes less than \$50,001 and (2) maintains a symmetric number of tax years surrounding Treasury Decision 8002 (12/26/84). In total, there are 157,956 observations in the panel database during these years. The sub sample reported above excludes observations with over \$50,000 in taxable income, observations with over \$500 in non-cash charitable contributions, and all non-current year taxpayers (see Table 1 for a discussion of non-current year taxpayers).

^(b) The Z-statistic tests the null hypothesis of no difference in the percentage of returns in the top \$15 of the \$50 tax table brackets for taxpayers with \$0 of non-cash contributions vs. \$1-\$500 of non-cash contributions.

Table 4
The Effect of Professional Tax Preparers^(a)

	Self-Prepared Tax Return	Professionally Prepared Tax Return	Z-statistic ^a	p-value
Top 30% of Tax Table (evidence of secondary evasion)	813	1,026		
Bottom 70% of Tax Table	1,560	2,364		
Proportion of potential secondary evasion	34.26%	30.27%	3.20	0.0007

^(a) Consistent with Table 3, the time period 1981 through 1988 is investigated; however, the professional preparer variable is not available in panel data years 1981 and 1985. For the remaining panel years, 1982-1984 and 1986-1988, there are 91,084 observations in the panel database. Of this total, 7,085 observations have positive non-cash charitable contributions under \$501 and are current year taxpayers (see Table 1 for a discussion of non-current year taxpayers). Remaining sample reduction excludes taxpayers with reported income over \$50,000 (i.e., non tax table users).

^aThe Z-statistic tests the null hypothesis of no difference in the percentage of returns in the top \$15 of the \$50 tax table brackets for taxpayers with returns that are self-prepared vs. professionally-prepared.

Table 5
Potentially Aggressive Taxpayers: A Test of Secondary Evasion Before and
After Treasury Decision 8002 Using Self-Prepared Returns ^(a)

	PRIOR to TD8002 (documentation required)	AFTER TD8002 (no documentation required)	Z statistic^(b)	p-value
Top 30% of Tax Table (evidence of secondary evasion)	21	175		
Bottom 70% of Tax Table	50	222		
Proportion of potential secondary evasion	29.58%	44.08%	2.28	0.01

^(a) The current analysis is a sub-sample of data used in Table 4. Relative to Table 4, all taxpayers with reported non-cash charitable contributions less than \$400 have been excluded.

^(b) The Z-statistic tests the null hypothesis of no difference in the percentage of returns in the top \$15 of the \$50 tax table brackets for taxpayers with returns that are self-prepared and have between \$400-\$500 of non-cash charitable contributions.

Figure 1
Percentage of Itemizers Reporting a Non-cash Charitable Contribution

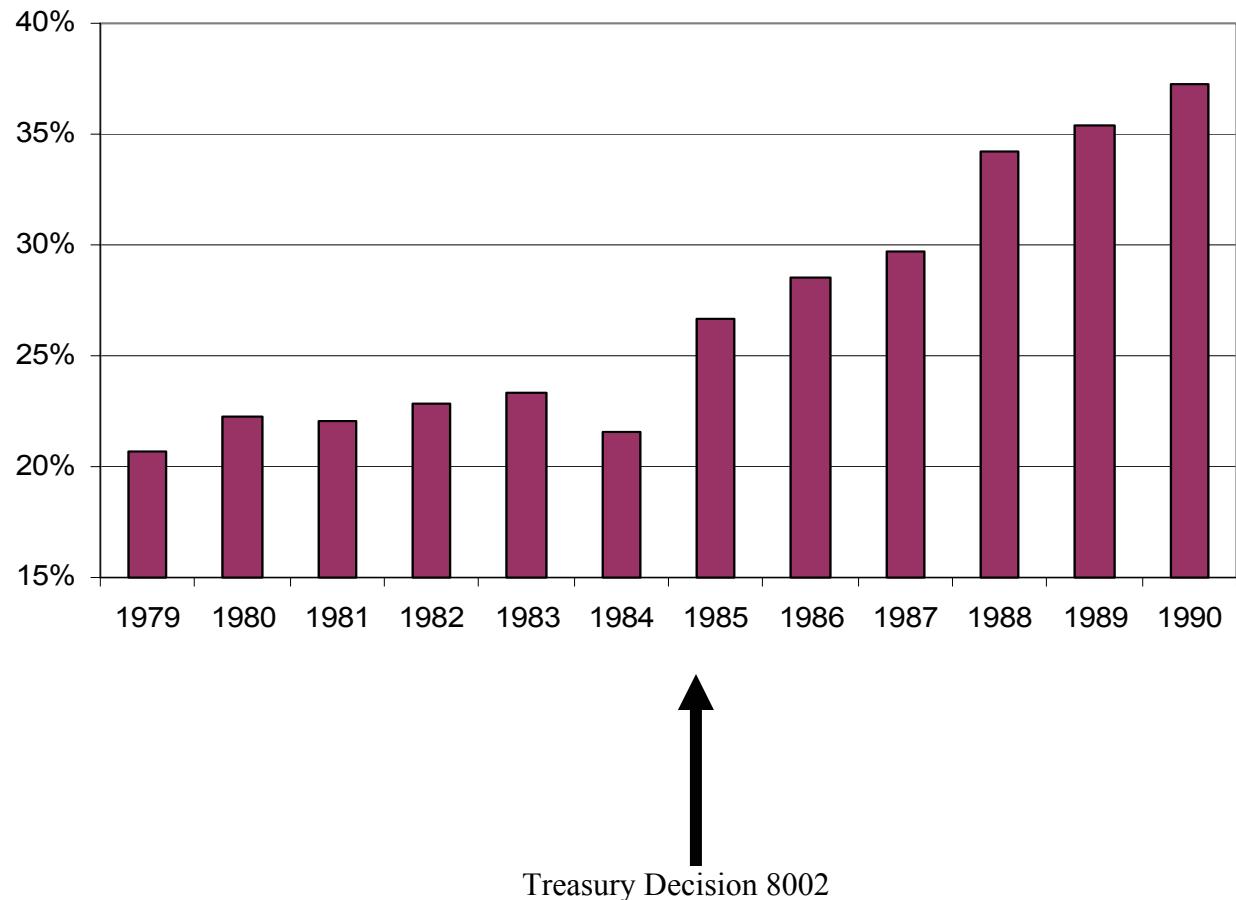
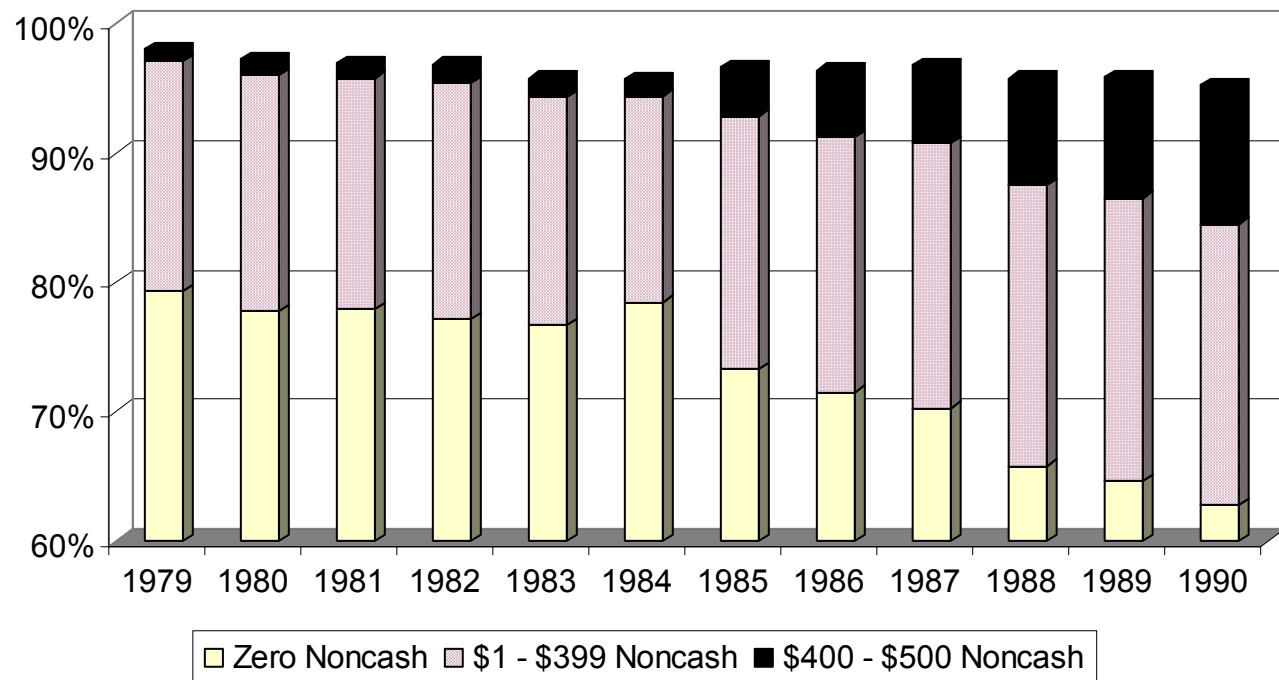
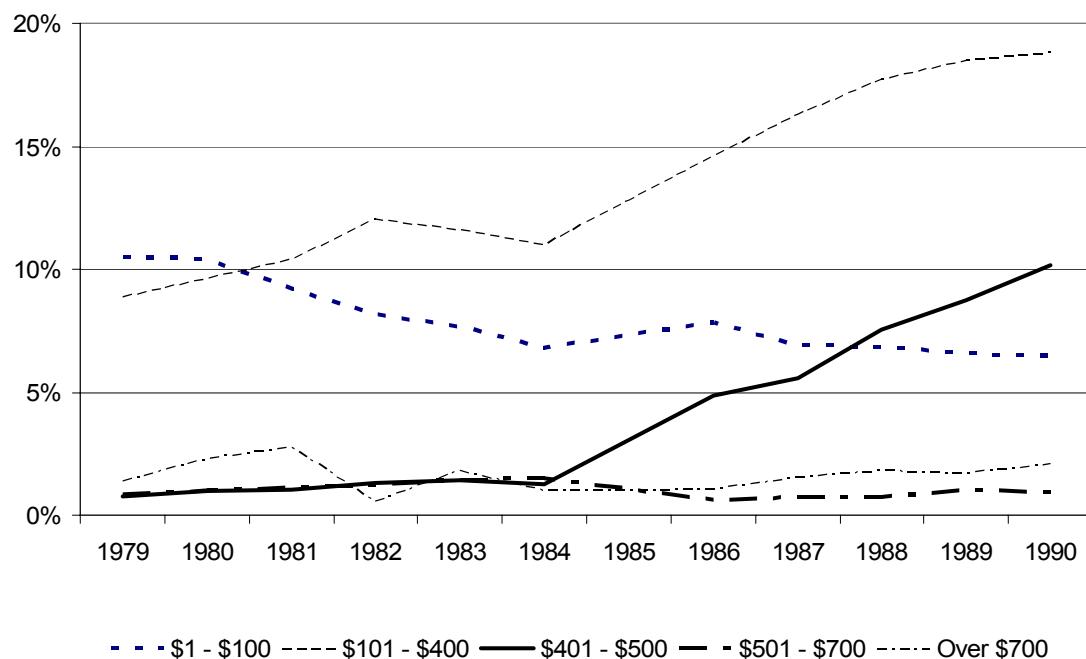


Figure 2
**Percentage of Itemizers Reporting Less Than \$501 in
Non-cash Charitable Contributions**



↑
Treasury Decision 8002

Figure 3
Percentage of Itemizers Reporting Positive Non-cash Charitable Contributions



Treasury Decision 8002



Endnotes

¹ Note that for tax years 1982-1986 taxpayers who did not itemize were allowed to deduct a small amount of charitable contributions in calculating their taxable income.

² Past research has calculated estimates of the price and income elasticities of charitable contributions for both itemizing taxpayers (e.g., Feldstein 1975, Feldstein and Clotfelter 1976, Feldstein and Taylor 1976, Boskin and Feldstein 1977, Lindsey 1986, Glenday et al. 1986, Feenber 1987, Broman 1989, Slemrod 1989, Christian et al. 1990, Barrett 1991, Auten et al. 1992, Ricketts and Westfall 1993, Randolph 1995, Auten and Carroll 1999, Greene and McClelland 2001, Tiehen 2001, Newsom et al. 2001, Auten et al 2002, Joulfaian and Rider 2004) and non-itemizing taxpayers (e.g. Robinson 1990, Dunbar and Phillips 1997, Duquette 1999, Cordes et al. 2000). The large number of studies investigating the impact of tax policy on charitable contributions via elasticity analysis is primarily a function of alternative estimation methods (e.g., OLS regression, first differences regression, difference-in-difference regression) and data sources (e.g., IRS Statistics of Income (SOI) public use data file, multiple year tax return panel data sets, TCMP audit data). The resulting price and income elasticity estimates from these studies vary, in some cases extensively, with price elasticity estimates ranging from zero to -1.34 and income elasticities ranging from 0.67 to 1.23 (Joulfaian and Rider 2004, p. 27). Higher income taxpayers maintain larger elasticities.

³ Note that Treasury Decision 8002 and the related changes to Regulations 1.170A-13 that were made on 12/26/1984 apply retroactively to all contributions made after December 31, 1982. However, because of the delay in issuing this Treasury Decision until 1984, the regulations allow taxpayers to only apply these provisions to post-1984 contributions. While most taxpayers theoretically had access to TD 8002 prior to filing their 1984 returns (e.g., before April 15th, 1985), we assume that the change in substantiation rules was not obvious until Form 8283 – Non-cash Charitable Contributions - was formulated by the Office of Management and Budget during 1985.

⁴ We estimate annual revenue loss associated with this rule change in the range of \$250 - \$300 million (2001 estimate, see footnote 10).

⁵ It is also noteworthy that these sizable increases in the level of non-cash giving occur in a period of declining marginal tax rates. If charitable contributions are price-elastic as hypothesized in a large number of prior studies, one would expect the level of giving to decline. Observing an increase in reported non-cash contributions during this period is therefore consistent both with our hypothesis that the relaxed reporting rules of TD 8002 encouraged more aggressive reporting behavior among taxpayers, and with the observations of Joulfaian and Rider (2004) and Slemrod (1989) that the overstatement component of charitable contributions is relatively insensitive to changes in tax rate.

⁶ All reported results are robust to other operationalizations of being “slightly under” the \$500 documentation threshold. Specifically, we examined all itemized returns with \$450 - \$500 of non-cash contributions and all itemized returns with \$300 - \$500 of non-cash contributions as alternatives. Results are similar using these alternative operationalizations.

⁷ Arguably, the only evidence offered by this portion of the analysis is that “there is no such thing as a consistent \$400 - \$500 non-cash contributor”. Specifically, our second selection criteria likely magnifies the difference in pre- versus post-TD 8002 non-cash charitable deductions because we sample only taxpayers who report between \$400 - \$500 in non-cash charitable contributions at least three times during the 1985-1990 timeframe (done in an attempt to identify taxpayers who “learned to take advantage” of TD 8002). The second portion of the analysis (i.e., bifurcating the 1985-1990 timeframe) offers more compelling evidence that taxpayers “learned” to tax advantage of TD 8002.

⁸ Prior to 1981, the tax tables were required for taxpayers with taxable incomes of \$20,000 or less. As such, the analysis in Table 3 excludes data for 1979 and 1980. Data for 1989 and 1990 were excluded in order to maintain equal time periods before and after the relaxation in reporting requirements (i.e., symmetric time periods surrounding TD 8002).

⁹ We also investigated the 48 taxpayers who reported non-cash contributions in the \$501 - \$700 range during 1984 (before TD 8002) who also appear as itemizers in the 1986 panel (after TD 8002). In 1986, 11 of these taxpayers reported over \$500 in non-cash contributions, 11 reported between \$350 and \$500, and 26 reported under \$350 in non-cash contributions.

¹⁰ Calculation: Post- minus Pre- TD 8002 percentage of all itemizers reporting \$400 - \$500 in non-cash charitable contributions = 6% change. Total 2001 itemized returns (from SOI) = 44.56 million. 44.56 million × 6% = 2.67 million taxpayers × \$450 (the “suspect” deduction midpoint) = \$1,201 billion in total “suspect” non-cash charitable contributions × 22% (avg. tax rate for 2001) = \$264 million.