TAX CREDIT PROGRAM GUIDELINES FOR
QUALIFYING CHARITABLE ORGANIZATIONS (QCOs)
(A.R.S. § 43-1088)

rev. 01/26/24

Prepared by: Arizona Department of Revenue

TAX CREDIT PROGRAM GUIDELINES FOR QUALIFYING CHARITABLE ORGANIZATIONS (QCOs)

(A.R.S. § 43-1088)

Section 1. Overview **1**

Section 2. Requirements for a Qualified Charitable Organization **1**

A. Eligible Populations 2

B. Qualifying Services 2

1. Cash Assistance 3
2. Medical Care 3
3. Childcare 3
4. Food 4
5. Clothing 4
6. Shelter 4
7. Job Training 4
8. Job Placement 5
9. Immediate Basic Needs Services 5
10. Services That Do Not Qualify 5
11. Financials 6

Section 3. Umbrella Charitable Organizations **7**

Section 4: Pass-through Services **7**

Section 5: The Application Review Process **8**

A. Application Evaluation Process 8

B. Common Pitfalls 10

1. General/Operational 10
2. Services 11
3. Financials 11

Section 6: Provisional Certification **11**

Section 7: Following Approval **12**

Section 8. Appeal Process **12**

Section 9: Periodic Updates **12**

A. Law Changes 12

B. Scheduled Recertifications 12

C. Changes in Qualification 13

Section 10: QCO Contact Information 13

Section 11: Department Contact Information **13**

Section 1. Overview

Pursuant to Arizona Revised Statutes (**A.R.S.**) § 43-1088(A), Arizona provides an income tax credit to an individual who makes a contribution to a charitable organization that is classified as a Qualifying Charitable Organization (**QCO**).

Before a charitable organization can be classified as a QCO and therefore receive contributions eligible for these tax credits, it must first be certified by the Arizona Department of Revenue (**the Department**) as a QCO. The Department's certification pertains solely to an organization's qualification for the Arizona tax credit program, as required by state statute, and is *not* a determination or assessment of the organization's value and benefit to the public good. Moreover, this program is wholly independent of general licensing or operational requirements applicable to such organizations.

Being recognized by the Internal Revenue Service (**IRS**) as a charitable organization under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (26 U.S.C. § 501(c)(3)), is *not* the same as being a QCO for the purposes of this Arizona tax credit. The requirements to become a QCO are in addition to the IRS requirements for charitable organizations. To request certification or recertification as a QCO, a charitable organization must complete the Department's application form and submit it along with required documentation to the agency's QCO program staff.

An individual who makes a cash donation to a QCO may claim a corresponding tax credit on his or her Arizona individual income tax return.

Section 2. Requirements for a Qualified Charitable Organization

A charitable organization must meet *all* of the following criteria to qualify as a QCO:

1. The organization is a nonprofit 501(c)(3) or is a designated community action agency that receives community services block grant program monies pursuant to 42 United States Code (U.S.C.) § 9901.
2. The organization spends over 50% of its budget to provide *qualifying services* to *eligible populations*.
    a. <u>Qualifying services</u>: By statute, there are 8 categories of services that qualify for purposes of meeting the 50% spending threshold, as long as they are provided and used in Arizona: (i) cash assistance, (ii) medical care, (iii) childcare, (iv) food, (v) clothing, (vi) shelter, (vii) job placement and job training services, or (viii) any other support that is reasonably necessary to meet immediate basic needs. These services will be referred to collectively in this document as either "**qualifying services**" or "**basic needs services**."
    b. <u>Eligible populations</u>: To be counted toward the 50% spending threshold, the organization's services must be furnished to one of three categories of Arizona residents: (i) Temporary Assistance for Needy Families (**TANF**) benefit recipients,

(ii) low-income residents, or (iii) individuals who have a chronic illness or physical disability. As defined in statute,

i. "Low-income residents" means persons whose household income is less than 150% of the federal poverty level.

ii. "Individuals who have a chronic illness or physical disability" means individuals whose primary diagnosis is a severe physical condition that may require ongoing, medical or surgical intervention.

All individuals meeting the criteria of any one of these three categories of benefit recipients are referred to interchangeably as "**qualifying individuals**," "**eligible populations**," or "**eligible recipients**."

3. The organization provides a statement indicating plans to continue spending at least 50% of its budget on services to Arizona residents who fall within one or more of the three eligible populations.
4. The organization provides a statement indicating it does not offer, pay for, or provide coverage for abortions, and does not financially support any other entity that provides, pays for, or provides coverage of abortions.

A. Eligible Populations

As listed above, there are three categories of individuals who are considered to be eligible recipients of basic needs services for the purposes of this tax credit.

Low-income residents are defined as individuals living at or under 150% of the federal poverty level. Organizations claiming that their clients meet this criteria are required to explain the verification process used to determine this criteria has been met.

Individuals who receive TANF benefits are also considered part of an eligible population.

For the purposes of this program, "individuals who have a chronic illness or physical disability" means individuals who have a diagnosis of a severe physical condition that may require ongoing medical or surgical intervention. The definition does not include intellectual and developmental disabilities without such a diagnosis of a severe physical condition. Consequently, individuals who are diagnosed only with disabilities that are *not* physical in nature do not qualify. Organizations will be expected to describe the illnesses and physical disabilities from which their clients suffer.

Although individuals are not part of the eligible population based on their intellectual and developmental disabilities alone, they may still qualify under other criteria such as low-income or also having a diagnosis that is physical in nature.

Note that all individuals who otherwise meet the qualifying population criteria must also be Arizona residents.

B. Qualifying Services

With few exceptions, the services provided by the organization need to be provided directly to the eligible recipients. These exceptions will be noted in greater detail below.

Providing access to or paying for immediate basic needs services is accepted as a basic needs service. For example, some organizations employ case workers who match eligible clients with providers of basic needs services, even when the provision of those basic needs services isnot one of the main purposes of the organization itself. The Department considers such matching services to be basic needs services.

1. <u>Cash Assistance</u>

Cash assistance (including the provision of gift cards) must be provided directly to the client. For a cash payment to be considered qualified, the organization cannot demand that the money be spent on anything specific (*e.g.*, food, clothing, gas).

Payments/scholarships to schools, camps, activities, or team sports do not constitute cash assistance. Payments to a service provider that provides basic needs services (e.g., utility, apartment complex, doctor, hospital) does not constitute cash assistance, but instead should be treated for application purposes as expenditures by the organization for providing access to the services directly.

2. <u>Medical Care</u>

For medical care to be considered qualifying services, the care must be provided by the applicant organization directly, or indirectly by providing access to medical care (e.g., by paying for it, providing transportation to it, or connecting the eligible client with the medical care).

Medical care is often (though not always) provided by an individual certified under A.R.S. Title 32 or Title 36 to provide such care. This includes but is not limited to doctors, nurses, physicians assistants, midwives, optometrists, ophthalmologists, dentists, chiropractors, psychologists, psychiatrists, licensed therapists, and acupuncturists.

A variety of therapeutic services qualify as basic needs services, provided that they are provided by professionals. This may include doulas and other caregivers and therapists who are not certified under A.R.S. Title 32 or Title 36.

Payment for medical care by the applicant organization is allowed as a basic needs service.

Transportation to medical appointments is considered a qualifying service because it provides access to medical care.

Care coordination services are considered qualifying services, as such services foster and facilitate access to and the provision of medical services.

3. <u>Childcare</u>

As defined in and informed by A.R.S. Title 46, "child" means a person who is under 13 years of age., while "childcare" means the compensated service that is provided to a child who is unaccompanied by a parent or guardian during a portion of a twenty-four-hour day.

Childcare must be *regular and predictable* to be considered a basic needs service. Any programming provided to children in the course of offering childcare is not relevant to the determination.

It is not necessary for the care to be provided by a licensed day care center in order for it to be considered a basic needs service.

For care of persons 13 years of age or over, refer to "Immediate Basic Needs Services" below.

4. Food

Food is intended to include food products for home preparation as well as the provision of prepared meal(s). Food can include snacks or refreshments at an event, provided that the event itself is considered a basic needs service.

The distribution or donation of perishable food items to another organization that then provides the food to the eligible population is a qualifying service.

5. Clothing

Qualified clothing includes, but is not limited to, baby clothes, shirts, pants, skirts, school uniforms, socks, underwear, shoes, boots, coats, and interview attire.

The provision of clothing does not qualify as a basic needs service if it consists of a single item of clothing per client. For example, a t-shirt provided as part of participation in an event does not constitute the provision of clothing as a basic needs service.

The provision of sports team uniforms does not qualify as a basic needs service.

6. Shelter

Expenditures by an organization toward the following are considered spending for qualifying services:

- Direct provision of permanent or temporary housing.
- Payment of rent.
- Provision of furnishings for a home.
- Provision of or payment for the maintenance of a home.
- Payment of utility bills.
- Transportation to a shelter.

Depreciation is not considered a qualifying service.

7. Job Training

Job training is expected to be teaching, instruction, or similar activities directed to a specific paid position of regular employment. General education (e.g., GED or college prep classes) is not considered job training, even though it may be part of workplace development programs, secondary education student retention programs, and housing or financial literary services. These broader concepts are not captured within the current QCO tax credit statute.

In an apprenticeship or similar scenario, the employment of an employee who is employed as part of job training is not considered an eligible service. However, the employment of the trainer performing the job training is considered an eligible service. Thus, the wages of the employee being trained do not count toward the 50% spending threshold, whereas the wages of the trainer *do* count toward the 50% spending threshold.

The provision of transportation to job training or job interviews is considered a basic needs service.

For English acquisition learning services, refer to "Immediate Basic Needs Services" below.

8. Job Placement

Job placement activities are those undertaken to post individuals into a workplace for work experience. Specific examples include interview training, resume building, and assistance with job applications.

9. Immediate Basic Needs Services

Activities that provide or promote safety (both emotional and physical) are considered immediate basic needs services. Examples of providing immediate basic needs services include providing:

- Immediate support to crime victims;
- Crisis training to individuals with disabilities and law enforcement;
- Day care or adult day care for chronically ill or physically disabled individuals, if it provides respite for a caregiver;
- Hygiene products; and
- English language acquisition services for English language learners (see guidance document on English Language Acquisition Services).

10. Services That Do Not Qualify

As a general principle, when determining whether a particular service qualifies, it is necessary to consider both the activity and the context or particular application in which it is offered to an eligible population. This analysis helps inform whether the service is being provided to meet a recipient's immediate basic needs. Examples of services that are not considered to meet immediate basic needs include but are not limited to:

- Training for life skills, parenting skills or empowerment or character education;
- General education;
- Recreation, including sports, wellness, and exercise;

- Non-therapy pets/animal encounters, sanctuary groups, and animal rescue;
- Furnishing items that are useful but not essential to daily living, such as items (computers, school backpacks and school supplies) intended for recipients to use for school;*
- Toys and gifts (birthday or holiday), although the provision of gifts of (significant) clothing may qualify as basic needs services;
- Holiday parties; and
- Fundraising and/or donations to organizations (even to organizations that are qualified for the credits).

The distribution to eligible populations of goods and services that have been donated to the organization does *not* qualify as an immediate basic needs service.

11. Financials

As reminders, when preparing financial documentation for the Department's review:

- At least 50% of the organization's expenses in the most recently completed fiscal year must have been used to provide qualifying services to an eligible population.
- The financials provided and considered need to be for the entire organization named in the IRS 501(c)(3) determination letter, unless the organization has a group exemption letter.
- The Department does not accept the financials for programs that are part of a larger organization.
- We consider expenses as a representation of the "budget" referenced in A.R.S. § 43-1088. We do not consider sources of income or revenue.
- Expenses related to fundraising, advertising, or marketing do not count toward the 50% spending threshold, although they are included within the calculation.
- Depreciation is entirely excluded from the 50% spending threshold calculation.

The value of donated items (including food) or in-kind services is entirely excluded from the 50% threshold calculation. The Department recognizes that the collection and distribution of in-kind goods or services are an efficient method for charitable organizations to serve their clients, and note that its treatment for purposes of evaluating financials is not intended to discourage its use. The exclusion of the value of the in-kind goods or services entirely from the 50% calculation, should neither harm nor help an organization under consideration as a QCO. For example, for an organization that collects food or goods and distributes them to the eligible population, the cost of collecting, storing, or distributing those goods would be included in the 50% calculation, but the value of the goods would not be. If the organization includes the value of those goods in their financials, the Department staff will remove the value from the Total Expenses as well as from

* These items are illustrative of items intended for use by recipients for school. However, the same items *could* qualify if intended for use by recipients for purposes essential for daily living.

the Eligible Expenses before calculating whether the eligible expenses were at least 50% of the total expenses.

The Department does not accept the IRS Form 990 as an example of acceptable financials because the Form 990 does not provide sufficient detail relevant to the application of the state tax credit. The preferred statement of financials is the Statement of Functional Expenses.

Supplemental material matching the qualifying services provided to the eligible population with the expenses is expected. For example, if only some of the population served is an eligible population, then the financials and supplemental information should reflect the portion of the expenses that support the eligible population. If only some of the services provided are qualifying services, then the financials and supplemental information need to reflect the portion of the expenses that support the qualifying services.

Section 3. Umbrella Charitable Organizations

Umbrella organizations are not certified by the Department. As long as the umbrella organization meets all of the following requirements, donations made through the umbrella organization can qualify for the tax credit :

1. The umbrella organization is an IRC § 501(c)(3) organization.
2. The umbrella organization simply acts as a conduit for the funds and does not place requirements on the use of the funds.
3. The funds collected are designated by the donor for a specified charity that is either a QCO or a QFCO found on one of the Department's lists.
4. 100% of the donation is passed through to the designated charity.
5. The receipt provided to the donor specifies the name of the charity and states that 100% of the donation is passed through to the specified charity.

The umbrella organization may charge a charity a fee for its services, but the fee may not be deducted from the amount distributed to the charity. The charity must receive the entire donation and then pay any fee. The fee counts towards the portion of the charity's budget that is not used for the required services.

Section 4: Pass-through Services

Organizations that do not perform qualifying services themselves but, rather, use their expertise or provide funds to other providers to perform the qualifying services, are referred to as providers of *pass-through services*. From a statutory perspective, the issue with such charities is that such services are not being provided directly by the organization, but are instead being outsourced to other organizations and/or individuals. Charities with a focus on pass-through services are thus acting as a *facilitator* of services rather than a *provider* of services.

While the Department will consider expenditures for pass-through services involving the transfer of perishable food to be qualifying services, expenditures for other pass-through services are generally *not* considered to be for qualifying services toward meeting the 50% threshold.

Section 5: The Application Review Process

Once received, the Department will enter the organization name and contact information into its QCO database. A QCO Code will be assigned at that time. The QCO Code is the code that a taxpayer uses to claim the tax credit on their tax return.

When reviewing the application, the Department will follow the evaluation process described below. The goal of the applicant organization should be to be as responsive as possible with the materials it submits, thereby minimizing the need to provide additional clarification or supplementation later.

Incomplete applications and inadequate explanations will delay the approval process and may result in denial.

The Department will contact applicant organizations as needed by email and/or previously scheduled phone calls.

If, at any time during the process, it is clear that the organization will not qualify, the Department staff may suggest that the organization withdraw its application.

The Department staff is unable to make recommendations or provide counseling to the applicant organization as to how it could modify its operations to make it more likely for the organization to meet the QCO criteria.

A. Application Evaluation Process

- Does the application contain all of the required components? Is each section of the application completed?
    - Is the application signed?
    - If the application is handwritten, can the Department read the handwriting? (Please PRINT, if completing the application by hand. If the application is not clear and legible, the review of the application may be delayed.)
    - Was an IRS 501(c)(3) determination letter included?
    - Was a narrative included? Does it name and describe specific programs?
    - Was financial information included?
    - Is the material provided understandable? (Please note that undefined abbreviations and jargon are not helpful to evaluators who may not know what they mean.)
- If anything is missing, the Department will ask the organization to correct, supplement, or withdraw its application.

- Once the Department has received the required components, the substantive review will commence.
- Based on the narrative, has the organization shown that it serves an eligible population?
  - If **No**, the Department will ask the organization to correct, supplement, or withdraw the application.
  - If **Yes**, has the organization shown what portion of its client population qualifies as an eligible population?
    - If **No**, the Department will ask the organization to correct, supplement, or withdraw the application.
    - If **Yes**, has the organization shown how it knows that its clients qualify as an eligible population?
      - If **No**, the Department will ask the organization to correct, supplement, or withdraw the application.
      - If **Yes**, proceed to the next step.
- Based on the narrative, has the organization shown that the services it provides constitute qualifying services?
  - If **No**, the Department will ask the organization to correct, supplement, or withdraw the application.
  - If **Yes**, has the organization shown what portion of its services constitute qualifying services?
    - If No, the Department will ask the organization to correct, supplement, or withdraw the application.
    - If Yes, proceed to the next step.
- Based on the financials provided, has the organization shown that the expenses related to the qualifying services for the eligible population constitute at least 50% of the total expenses for the most recently completed fiscal year?
  - If **No**, the Department will ask the organization to correct, supplement, or withdraw the application.
  - If **Yes**, proceed to the next step.
- The Department will evaluate all three components: eligible population, qualifying services, and the 50% spending threshold.
  - Has the organization demonstrated how the eligible population served by the organization is represented in its expenses?
    - If **No**, the Department will ask the organization to clarify.
    - If **Yes**, proceed to the next step.

- Has the organization demonstrated how the qualifying services are represented in the expenses?
    - If **No**, the Department will ask the organization to clarify.
    - If **Yes**, proceed to the next step.
- Has the organization tied its narrative to its expenses? (That is, are the terms the organization uses in its narrative represented also in its expenses? Is it clear which program in the expenses is considered to be qualified, as explained in the narrative?)
    - If **No**, the Department will ask the organization to clarify.
    - If **Yes**, proceed to the next step.
- Do the expenses the organization shows as attributable to qualifying services provided to the eligible population equal or exceed 50% of the total expenses?
    - If **No**, the Department will ask the organization to clarify.
        - If **Yes**, the Department will ask the organization to supplement or withdraw its application.
        - If **No**, the Department will deny the application.
    - If **Yes**, the Department will approve the application.

The Department requests that applicant organizations *not* send the following items as part of their applications:

- Brochures,
- Bank statements,
- Check registers,
- IRS Forms 990 (Return of Organization Exempt From Income Tax),
- Entire copies of financial audits, or
- Excessively technical narratives that use abbreviations and jargon that individuals outside of the industry would not understand.

B. Common Pitfalls

The following list provides common scenarios the Department has encountered under which a charitable organization has failed to meet the criteria for certification or recertification as a QCO:

1. General/Operational

- The applicant is a program within a larger organization and lacks both standalone 501(c)(3) status *and* standalone financials.
- The organization exists to pool money to be passed along to other charitable organizations.

- The organization cannot provide data sufficient to verify that its service recipients meet the qualifying population criteria.
- The organization does not provide direct services and only collects items to be passed along to other charitable organizations.

2. Services

- Organizations that provide many different services, some which do not qualify, have found it difficult to meet the statutory 50% spending threshold for providing qualifying services to an eligible population.
- The organization provides direct services to pets or animals belonging to individuals who may meet the eligible population criteria but who are not themselves receiving basic needs services from the organization.
- An organization provides social or emotional need services that do not meet the qualifying services criteria.
- A significant portion of an organization's services and expenses are provided to individuals who are not Arizona residents.

3. Financials

- The organization engages in a high level of spending on advertising or fundraising.
- The organization spends a significant amount on staff who do not actively contribute to the provision of qualifying services.
- The organization makes a one-time large, non-qualified expenditure, making the 50% spending threshold difficult to meet. (Example: Organization received a grant to provide services to clients located outside of the United States. For the year being evaluated, Organization's income was higher than normal and its expenses were also higher than normal as compared to other years. The out-of-the-ordinary expense made it impossible for the organization to meet the 50% spending threshold for providing qualifying services to an eligible population.)
- The value of in-kind donations received by the organization and distributed to clients is included as part of expenses, but the actual monetary outlay does not meet the 50% spending threshold.
- An organization has such variable expenses that it cannot attest it will continue being able to meet the 50% spending threshold on future qualifying services.

Please note that this list is provided for illustrative purposes only and is not exhaustive in scenarios under which the Department may find that an organization fails to meet the criteria requisite for QCO status.

Section 6: Provisional Certification

When a new organization wishes to receive QCO certification, but does not have a full year of actual services and expenses, it can apply for a one-year provisional certification.

At the end of the provisional year, the organization will be asked to provide a Statement of Functional Expenses for a full year of operation so that the Department can determine whether the actual expenses satisfy the 50% spending threshold. If financials cannot be provided, or if the financials do not support that at least 50% of expenses were for qualified services for an eligible population, the organization will no longer be considered a QCO. That said, the provisional certification will be respected through the end of the provisional year, thus providing certainty to taxpayers claiming the credit for donations made during the provisional year.

Section 7: Following Approval

Once approved, the Department will notify the organization by sending the organization an email with a letter and the certification attached. In the future, the certificates issued will have an expiration date.

The Department updates the QCO list each week. Changes established by Wednesday morning will be included on the published QCO list by Friday evening.

In addition to the revised list being published on the the Department website, the revised information is made available to tax preparation vendors as well.

Section 8. Appeal Process

If the Department does not approve the QCO application for certification, the applicant may appeal the decision in accordance with A.R.S. Title 41, Chapter 6, Article 10. An appeals form will be included with a denial letter.

Section 9: Periodic Updates

A. Law Changes

If legislation is passed that alters the criteria for approval, it may be necessary for the Department to contact a QCO to determine whether the organization still qualifies. Such a change could become effective at any time designated by the legislation. If a law change occurs, and if an organization fails to provide the supplemental information that the Department requests, the Department may need to remove the organization from the QCO list.

B. Scheduled Recertifications

The Department is committed to performing periodic recertifications of existing QCOs. The recertifications are important to maintain the integrity of the QCO list and the tax credit program as a whole, given that an organization may:

- Close operations;
- Change the nature and scope of the services provided;
- Change the client populations served;

- Change how it spends its money;
- Change how much money it spends providing qualifying services to an eligible population; or
- Change how much money it spends on services and populations that do not meet the QCO criteria.

Even a seemingly minor change may cause an organization to no longer meet the criteria of a QCO. A recertification requires the organization to reapply as if it were a new organization. The current schedule requires that each organization be recertified once every 5-6 years.

C. Changes in Qualification

What if my QCO no longer qualifies?

1. An organization informs QCO staff that the organization is no longer operating
    - If the organization has not taken any donations in the current year, the organization can be removed from the current year QCO list.
    - If the organization has taken donations during the year, the organization would be removed from the QCO list for the following year.
2. An organization informs QCO staff that it can no longer represent that the organization plans to continue spending at least 50% of its budget on services to residents of this state who receive temporary assistance for needy families benefits, who are low-income residents, or who are individuals who have a chronic illness or physical disability.
    - If the organization has not taken any donations in the current year, the organization can be removed from the current year QCO list.
    - If the organization has taken donations during the year, the organization would be removed from the QCO list the following year.
3. An organization could also be removed from the QCO list during a recertification process, though such removal will be prospective only.

Section 10: QCO Contact Information

It is critical that each QCO provides the Department with updated contact information when there is a change in organization name, address, or relevant staff.

In addition, if an organization's 501(c)(3) status terminates or it ceases operations, it is necessary for the organization to notify the Department so that the published QCO list can be updated accordingly.

Section 11: Department Contact Information

Applications, questions, and communications should be directed to the QCO program. Applications must be submitted electronically to QCO@azdor.gov.

Questions can be directed to Alejandra Garcia, QCO Program Manager, at (602) 716-6372, ext.2.