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Charitable Tax Credits: Boon or Bust for Nonprofits?

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As state governments dig out of the fiscal problems encountered in the past few years, budget allocations for human service programs remain tight. Spending on education and Medicaid dominates state budgets (National Governors Association 2004), making it difficult to sustain or expand spending for a broad range of human service programs that serve low-income people and residents in need of services. To address the needs of the poor, some members of Congress have proposed federal legislation to create tax credits to encourage private donations to organizations that serve the poor and fight poverty. Like the charitable tax deduction, the charitable tax credit assumes that donors will respond favorably to the tax incentive. A handful of states (Arizona, Colorado, Michigan, and North Carolina) have enacted state charity tax credits to stimulate giving, and these programs can be viewed as experimental models for proposed federal policy.

Charity tax credit programs typically share three common goals: (1) to increase charitable giving, (2) to allow taxpayers to determine directly the utility or effectiveness of charitable services, and (3) to support antipoverty programs. This approach assumes that individual donors know the needs of their local communities and can assess the capacity of local service providers and the quality of the services.

These assumptions raise a number of important policy questions for the nonprofit sector: Will a tax credit stimulate giving or merely provide tax relief to indi-

How Do Tax Credits and Tax Deductions Differ?

Both charitable tax credits and tax deductions have been promoted as methods to stimulate private giving by lowering the out-of-pocket cost to taxpayers who make charitable contributions. But these two approaches differ in their administrative mechanics and the potential benefits to individual taxpayers. Under the federal charitable tax deduction program, for example, taxpayers who itemize their returns can claim a charitable deduction against their adjusted gross income on their Form 1040, if they contribute cash or goods to a registered 501(c)(3) nonprofit or religious organization. The deduction lowers the amount of income on which the tax rate is based.

In contrast, the charitable tax credit is applied *after* the taxable income is calculated and reduces—dollar for dollar—the amount of taxes owed, up to the ceiling on the tax credit. But unlike the charitable tax deduction that is available for a contribution to any 501(c)(3) or religious organization, charitable tax credits typically are restricted to contributions to specific types of charities, such as those directly serving the poor. Donor choice under the charity tax credit programs is thereby limited to specific types of charities.

viduals who already contribute to charities? Which organizations are most likely to benefit from a charity tax credit? And what are the implications for the sector as a whole? Because the Arizona tax credit program contains some features that have been incorporated into pending federal legislation (HR 1672), an analysis of the Arizona model sheds light on the strengths and challenges of this approach.

The Arizona Model

The Arizona charitable tax credit (A.R.S.§43-1088) was enacted in 1997 as part of the state's welfare reform legislation. It gives taxpayers a credit on their state income taxes for cash donations to nonprofit 501(c)(3) organizations that spend at least 50 percent of their budgets on services to Arizona residents who receive welfare (TANF) or residents with household income below 150 percent of the federal poverty level. A service is defined as cash assistance, medical care, child care, food, clothing, shelter, job training, job placement, and other assistance that meets immediate basic needs. Community action agencies that receive community service block grant monies are also eligible. To qualify, nonprofits send a letter to the Arizona Department of Revenue self-certifying that they meet the eligibility criteria. The names of qualifying organizations are posted on the state's web site (www.revenue.state.az.us/welflist.htm). By 2004, more than 500 nonprofits in Arizona had self-certified as qualifying charitable organizations.

Because the policy is intended to attract new charitable contributions to the nonprofit sector, the Arizona program establishes a baseline year for determining a threshold of giving. To receive the credit, a taxpayer must contribute more than the baseline amount. The baseline year is the first year after 1995 in which the taxpayer itemized charitable contributions. For many taxpayers, this is the 1996 taxable year. Taxpayers are eligible to receive a maximum tax credit of $200 for donations that are above the charitable contributions paid in the baseline year.[1] For example, if a taxpayer claimed a $500 deduction in 1996 for cash contributions to charitable organizations, and then gave $700 in 1997 that includes $200 to a qualifying charity, the taxpayer can receive a $200 tax credit. Only taxpayers who have itemized their returns to create a baseline year are eligible for the credit. These contributions may go directly to a qualifying charity or through an umbrella organization, such as the United Way, which collects donations on behalf of member groups.

Initial Effects of the Tax Credit on Giving

The most recent data available from the Arizona Department of Revenue show that the tax credit seems to have added some new money to the nonprofit sector, although the downtrend in the economy confounds the picture (table 1). In 1998, 2,856 filers claimed $475,438 in tax credits. One year later, the numbers increased (6,712 filers claimed $1,161,162 in tax credits). By 2000, as the economy softened, both the number of filers claiming the tax credit and the tax credits used declined slightly (5,705 filers claimed $1,017,604 in credits). Total contributions to the nonprofit sector, however, grew almost threefold in this three-year period, from $1.1 million to $3.2 million. Whether this influx of new money can be sustained in lean economic times remains an open-ended question.

TABLE 1. Contributions and Arizona Charitable Tax Credits Claimed in 1998, 1999, and 2000

Filers and amounts	1998	1999	2000
Number of filers	2,856	6,712	5,705
Total tax credits	$475,438	$1,161,162	$1,017,604
Total contributions	$1,100,291	$2,374,600	$3,225,161

Source: Office of Economic Research and Analysis, Arizona Department of Revenue.
Note: Data are preliminary, subject to amended returns and updated information.

What is less clear is how this new funding has impacted nonprofit agencies. The literature on nonprofit human service organizations suggests that even if donor contributions rise as a result of a tax credit program, not all nonprofits will be affected equally. Some will win and others may lose financially, depending on their ability to market their programs to potential donors (Cordes et al. 1999). The ability to capitalize on new opportunities and to survive funding changes is tied to an organization's size (Twombly 2003), fiscal health (Chang and Tuckman 1993; Galaskiewicz and Bielefeld 1998), and diversity of funding sources (Gronbjerg 1993).

Which Nonprofits Gained from the Arizona Tax Credit Program?

The biggest recipient in 1998 and 1999 was the United Way. It received just over one-quarter (26 percent) of all reported contributions in both 1998 and 1999 (table 2). Other groups that gained in both years were the Salvation Army, St. Vincent de Paul, Habitat for Humanity, and St. Mary's Food Bank. Contributions to these five organizations, combined, represented between 45 and 50 percent of all donations in 1998 and 1999. (Detailed data for 2000 are not yet available.) Moreover, the list of the 12 largest recipients of contributions under the Arizona charitable tax credit program did not change appreciably during the first two years. Ten of the 12 largest recipients appeared on both the 1998 and 1999 lists. On average, these 12 organizations have budgets of over $10 million and are among the best-known charities both locally and nationally.

How Representative Are the Self-Certified Organizations?

Although the tax credit is available to all nonprofits that meet the eligibility criteria, it is not clear if self-certified groups are representative of all poverty-fighting organizations in the state. To address this question, we looked at IRS Form 990 financial data for fiscal year 2000. We compared the self-certified organizations with Arizona nonprofits that ostensibly meet the eligibility criteria (that is, they provide services such as food, shelter, employment and training, etc.), but were not self-certified (see "Creating Comparison Groups" sidebar for data and methods).

In general, the self-certified organizations are better structured to take advantage of the tax credit program. Four distinguishing features emerged:

TABLE 2. Nonprofits That Received the Largest Contributions under the Arizona Charitable Tax Credit Program, 1998 and 1999

1998		1999	
Charity	**Amount**	**Charity**	**Amount**
United Way	$288,947	United Way	$614,813
Habitat for Humanity	99,671	Salvation Army	174,596
Salvation Army	90,843	St. Vincent de Paul	140,594
St. Vincent de Paul	54,642	Habitat for Humanity	125,431
St. Mary's Food Bank	44,045	St. Mary's Food Bank	59,258
Westside Food Bank	32,686	Gospel Rescue Mission	56,615
Primavera	32,448	Community Food Bank	51,508
Goodwill	19,907	Westside Food Bank	43,563
Community Food Bank	19,886	Neighborhood Clinic	42,040
United Methodist Outreach Ministries	16,017	Phoenix Rescue	40,667
Gospel Rescue Mission	16,008	Goodwill	34,735
Interfaith Cooperative Ministries	12,863	Primavera	31,411
Other	372,328	Other	959,369
Total reported contributions	1,100,291	Total reported contributions	2,374,600

Source: Office of Economic Research and Analysis, Arizona Department of Revenue.
Note: Data are preliminary, subject to amended returns and updated information.

Creating Comparison Groups

Two sources of data were used in this analysis: (1) data from the Arizona Department of Revenue web site (downloaded October 2003) that lists eligible charities that participate in the state tax credit program to assist working but poor families, and (2) data from the Form 990 (an annual financial report) that nonprofits file with the Internal Revenue Service (IRS). The Form 990 data were obtained from the National Center for Charitable Statistics at the Urban Institute.

The list of self-certified organizations was matched with Form 990 records to obtain information on the finances of these organizations. Of the 513 self-certified organizations, 387 groups (75 percent of the list) had filed a Form 990 return with fiscal year 2000 data. Of these groups, 375 provided sufficient information on their return to be included in the analysis. Of the 126 groups that could not be located, about 30 percent were faith-based organizations that are not required to file Form 990; 20 percent were very new (that is, formed in 2001 or later) or very small (revenues of less than $25,000); 15 percent were foundations that typically file a Form 990PF; 10 percent were affiliates of national organizations or appeared to be government entities; and 10 percent simply had not filed during the four-year period examined (1998–2001). The status of the remaining groups (15 percent) could not be determined from the information available.

To generate a comparison group, we selected organizations whose primary purpose was to supply services such as job training and vocational rehabilitation, emergency food and shelter, and low-income housing; community health clinics; and most children, youth, and family providers. Using these criteria, we identified 354 Arizona nonprofits that provide the types of services likely to qualify for the charitable tax credit but had not self-certified for participation in the program.

- **Self-certified groups are bigger.** Nonprofits that are self-certified reported total revenues and expenses that were about 60 percent greater than those that had not self-certified. Self-certified groups reported total revenues in 2000 of $2.2 million compared with $1.3 million for noncertified groups. Similarly, total expenses in self-certified nonprofits were higher than for noncertified groups—$2.0 million versus $1.3 million.
- **Self-certified nonprofits are financially healthier.** Several measures show that self-certified groups are in a stronger financial position than those that are not self-certified. For example, 71 percent of the self-certified organizations ended the year 2000 with positive net income (that is, revenues exceeded expenses) compared with 63 percent of noncertified groups. Self-certified groups and noncertified nonprofits had about the same level of assets ($1.8 million versus $1.5 million), but self-certified organizations had net equity balances that were more than 2.5 times greater ($1.0 million versus $410,000), suggesting that they were less encumbered with debt.
- **Self-certified groups are more reliant on charitable contributions.** Self-certified organizations clearly have a stake in stimulating private giving. Ninety-seven percent of these organizations in 2000 reported that they received part of their income from private donations, compared with 72 percent of their noncertified counterparts. In fact, on average, charitable contributions are the largest source of funding for self-certified organizations. They comprise 38 percent of total revenue, followed by client fees and third party payments (27 percent) and government grants (25 percent). In contrast, noncertified groups reported that client fees and third party payments were their primary source of funding (36 percent), followed by charitable contributions (28 percent) and government grants (22 percent). The differences in reliance on private donations and fees are statistically significant, suggesting that self-certified organizations have a real stake in stimulating private giving.
- **Self-certified nonprofits spend more on fundraising.** Raising private charitable dollars requires time and effort, and self-certified organizations have built this expense into their budgets. Both self-certified and noncertified nonprofits spent about the same amount (82 percent) of their 2000 budgets on program costs, but self-certified organizations spent twice as much, on average, on fundraising (4 percent versus 2 percent). This difference suggests that self-certified groups place a higher priority on reaching potential donors and attracting charitable dollars to support their work.

Implications for Nonprofits

Nonprofit human service organizations have always been concerned about their ability to attract donors and raise funds. But with government support uncertain and public confidence in the nonprofit sector down, the current concern over generating sufficient income to meet needs is well grounded. Tax credits for charitable donations are one mechanism for inducing public support for nonprofits, but they may carry unintended consequences, such as increasing competition among charitable organizations for donor dollars and further emphasizing marketing and outreach activities to help an organization stand out in a field of competitors.

The Arizona charitable tax credit program appears to have been a boon to the United Way and several other large, well-known nonprofits in the state. At least during the first few years of the Arizona charitable tax credit program, name recognition and brand image seem to have been instrumental in leveraging charitable contributions from potential donors and taxpayers. Smaller and lesser-known groups, which abound in local communities, appear to be at a disadvantage under this policy. Building greater marketing capacity to compete for donor dollars, however, runs counter to public and donor expectations that nonprofits should spend more on programs and less on administrative and overhead functions, such as fundraising.

Although the Arizona tax credit for charitable contributions seems to have stimulated some additional giving, at least in good economic times, it is not a panacea for funding the nonprofit sector. It is not yet clear, for example, if taxpayers generated a "substitution effect" by redirecting their contributions from poverty-fighting organizations that are not self-certified to those that are. Potential donors are likely to overlook many well-run, medium- and small-sized organizations simply because these groups lack the marketing capacity to create name recognition and brand images to compete with the big-name players. It is also not clear how umbrella organizations redistribute these funds. Is the additional money that umbrella groups receive going to the poorest communities or to better-off neighborhoods with less need?

The Arizona tax credit program has created a two-tiered system of nonprofit organizations—namely those that are eligible for the tax credit and those that are not. Nonprofits that focus on the environment, animal rights, the arts, and a host of other programs serving the public good are shut out entirely. It is too early to determine, however, to what extent donors respond to the tax credit incentive, and whether ineligible groups receive less support from private donors.

Policymakers routinely use the tax code to affect public behavior, but the charitable tax credit raises important issues of equity and fairness. By giving an incentive to individuals to support particular types of organizations, it undermines the principle of donor choice in private giving and collectively weakens the broad array of organizations that create community cohesiveness and civil society. The jury is still out on whether a charitable tax credit program can sufficiently strengthen antipoverty organizations without jeopardizing other groups that provide important services to the community.

Endnote

1. The $200 limitation applies to all tax returns filed by individuals. The credit does not apply to charitable contributions made by corporations. The only provision related to marital status is if a husband and wife file separately, they may each claim one-half of the tax credit that would have been allowed for a joint return. If the allowable tax credit exceeds the taxes otherwise due, the taxpayer may carry the unused credit forward for the next five consecutive tax years.

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