AZ TAX CREDITS FAQ

Tax Credits vs. Tax Deductions

It's important to draw a distinction between tax credits and tax deductions. Credits and deductions differ in how they impact an individual's tax obligations.

A **tax credit** reduces an individual's tax liability (or the total amount of tax debt owed to the government) on a dollar-for-dollar basis. For every dollar an individual claims as a tax credit, her tax obligation is reduced by a dollar. In contrast, a **tax deduction** reduces an individual's taxable income. For every dollar an individual claims as a tax deduction, her taxable income is reduced by a dollar. Based on the calculation from her income bracket, the individual pays a tax on the amount left over after deductions are subtracted.

Consider the example of a single taxpayer with $40,000 in taxable income and an effective Arizona State tax rate of 3 % (this rate is just used for the purposes of an example; current Arizona state income tax rates can be found on the IRS website). In this case, the taxpayer's Arizona state tax liability is $1,200 (3 % of $40,000).

Now let's assume this individual has donated $400 to a Qualifying Charitable Organization and $500 to a Qualifying Foster Care Charitable Organization; then she takes the $400 maximum allowable tax credit for a gift to a QCO, and the $500 maximum allowable tax credit for a gift to a QFCO. In this scenario, these two tax **credits** would reduce the individual taxpayer's liability by $900 ($400 + $500), from $1,200 to $300. The individual would end up paying **$300** to the State of Arizona.

Now let's consider the implications of two equivalent tax **deductions** for the same taxpayer. In this example, assume the individual makes the same two donations of $400 and $500, except in this case the gifts are made to two charities that have not been certified as either Qualifying Charitable Organizations or Qualifying Foster Care Charitable Organizations by the State of Arizona. In this scenario, these two tax deductible gifts would reduce the individual's taxable income by $900 ($400 + $500), from $40,000 to $39,100. After applying the 3% effective tax rate to the individual's $39,100 of taxable income, the individual taxpayer's liability would be **$1 173**, resulting in a higher payment to the state of Arizona.

Minimum Dollar Requirements for the Arizona Charitable Tax Credit

Donors often wonder whether they can receive tax credits under the Arizona Charitable Tax Credit for smaller gifts, especially when they want to support a charity but are not able to donate hundreds of dollars. To clarify, there is no minimum dollar requirement for the Arizona Charitable Tax Credit.

Charitable contributions to QCOs and QFCOs do not have to exceed a minimum dollar threshold. A single taxpayer who wants to contribute $400 to a QCO and claim the maximum allowable credit may do so; likewise, a taxpayer can make a $5 donation, record this gift on Arizona Form 321, and receive a tax credit in the amount of $5 from the state of Arizona.

Five Year Carry Forward Period

The Arizona Charitable Tax Credit permits any credits for contributions to QCOs and QFCOs that are not applied against tax obligations for the most recent taxable year to be carried forward for a period of five consecutive years. However, the instructions for Arizona Form 321 and Arizona Form 352 both contain an important, identical caveat: “You may carry over only that portion of the credit that you do not apply to tax. You cannot carry over any amount that you gave that was more than the maximum amount allowed as a credit.”

Let’s clarify this limitation with an example. Consider the case of a single taxpayer with an Arizona state liability of $700, who had contributed $500 to a QFCO and $1000 to a QCO in the most recent taxable year. In order to offset their $700 tax liability, this individual may claim the $500 maximum allowable tax credit for a gift to a QFCO and a $200 tax credit for the QCO gift (remember, the maximum allowable tax credit for a gift to a QCO is $400, so this is within the limit). Since these two credits completely offset the $700 tax owed, the taxpayer now owes the state of Arizona nothing ($0).

But what about the remaining $800 from the QCO gift ($1000 minus the $200 tax credit that was applied)? In this case, the individual has an available credit carryover of $200, since only $200 of the $400 maximum allowable tax credit for a QCO donation was applied against her current tax liability. This remaining $200 tax credit may be used for the next tax year. The remaining $600 of the original $1000 gift ($1000 – $200 tax credit – $200 credit carryover) may not be used as a tax credit for the most recent tax year, nor may it be used as a tax credit in any future years.

Arizona State Tax Credits Cannot Exceed a Taxpayer’s Current Tax Liability

You may have noticed from the example above that the taxpayer did not use the $200 tax credit carryover to generate a tax refund for the most recent tax year. This is due to another limitation that is spelled out in the instructions for both Arizona Form 321 and Arizona Form 352, which state, “Because this is a **nonrefundable** credit, the total amount of available credit [current year plus any valid carryover amount(s)] that a taxpayer may use for the taxable year cannot be greater than the tax liability shown.”

Put simply, this means that tax credits from the Arizona Charitable Tax Credit can only be applied up to a taxpayer's current Arizona state tax liability. The tax credits cannot be used to receive money back from the State of Arizona. Of course, based on your specific tax situation, you may still be eligible for a State tax refund, so be sure to consult with your tax advisor for advice on your specific tax circumstances.

By comparison, "a **refundable** tax credit can reduce a taxpayer's tax liability to below zero, which means if the amount of a refundable tax credit is more than the amount of taxes due, the difference will be paid to the taxpayer as a tax refund," according to the Arizona Department of Revenue's Ed Greenberg.

Arizona Standard Deduction Adjustments

In 2019, the passage of Arizona HB 2757 introduced adjustments to Arizona's standard deduction amounts, aligning them with the federal standard deduction. For single and married (filing separately) taxpayers, Arizona's standard deduction was increased to $12,200, from $5,312 — a 130% increase. For head of household filers, Arizona's standard deduction was raised to $18,350, from $10,336 (up 78%). And for married (filing jointly) taxpayers, Arizona's standard deduction was boosted to $24,400, from $10,336, a whopping 136% hike.

To allay fears that increasing Arizona's standard deductions could curb charitable giving, Arizona HB 2757 also stipulates that "the Arizona standard deduction can be increased by 25 percent of the charitable deductions the taxpayer would have claimed if they had itemized their deductions," according to Ed Greenberg of the Arizona Department of Revenue. This increase ensures that taxpayers who would have otherwise donated and claimed those gifts while itemizing their tax deductions will still be incentivized to make charitable contributions.

The IRS Deadline for Federal Credits and Deductions Differs from State Deadlines

IRS deadlines are different from Arizona's state deadlines, however. The IRS specifies that, in order for contributions to be deductible on federal tax returns, contributions must be made "by the end of your tax year." Keep this in mind when planning your charitable contributions and estimating your state and federal tax credits and deductions, and be sure to consult with your tax advisor regarding the optimal timing of your charitable gifts.