



# Arizona State Senate Issue Brief

August 27, 2008

## Note to Reader:

The Senate Research Staff provides nonpartisan, objective legislative research, policy analysis and related assistance to the members of the Arizona State Senate. The *Research Briefs* series, which includes the *Issue Brief*, *Background Brief* and *Issue Paper*, is intended to introduce a reader to various legislatively related issues and provide useful resources to assist the reader in learning more on a given topic. Because of frequent legislative and executive activity, topics may undergo frequent changes. Additionally, nothing in the *Brief* should be used to draw conclusions on the legality of an issue.

## PRIVATE SCHOOL TAX CREDITS IN ARIZONA

### INDIVIDUAL TAX CREDIT

In 1997, a nonrefundable<sup>1</sup> individual tax credit of up to \$500 was established for voluntary cash contributions made by a taxpayer to a school tuition organization (STO). An STO serves as a nonprofit organization and allocates at least 90 percent of its annual revenue (donations) in the form of scholarships and tuition grants for children to attend a K-12 private school of the parent's choice. The STO must allocate monies to students in more than one private school. To qualify, the private school cannot discriminate on the basis of race, color, handicap, familial status or national origin. The tax credit is not allowed if the taxpayer designates that the contribution directly benefits his or her own dependent.

Since 1997, several modifications have been made to the individual tax credit program. In 1998, the definition of a private school was changed to allow students who attend same-sex only schools to qualify for a scholarship or tuition grant. In early 2000, the individual tax credit was extended to allow scholarships to preschool students with special education needs attending private schools. Later in the year, during a legislative special session related to Proposition 301, the individual tax credit was increased from up to \$500 to \$625 for a married couple. In 2003, annual reporting requirements were added for STOs to include the following information in aggregate as well as on a school-by-school basis: 1) total amount of contributions received; 2) total amount granted in scholarships or tuition grants; and 3) total number of children awarded scholarships or tuition grants. Finally, in 2005, the maximum tax credit for married couples was increased from up to \$625 to \$825 for tax year 2005, and \$1,000 for tax year 2006 and each subsequent tax year thereafter.

The individual tax credit program was challenged in *Kotterman v. Killian*, in which plaintiffs argued that the individual tax credit program violated the federal Establishment Clause, which prohibits public funds in the aid of religion, and

<sup>1</sup> A nonrefundable tax credit may only be used to reduce a tax liability to zero. Any unused amounts may be carried forward for not more than five consecutive taxable years.

the Arizona Constitution’s version of the “Blaine Amendment,”<sup>2</sup> which prohibits the use of tax dollars for private or sectarian schools. The Arizona Supreme Court upheld the tax credits law in January 1999, citing that the taxpayer contributions that are distributed to private schools by STOs are not state public funds, as they never enter into the state’s control nor do they ever reach the state treasury. The U.S. Supreme Court declined to take action on the appeal.

In February 2000, the Arizona Chapter of the American Civil Liberties Union filed a second legal challenge to the individual tax credit program. In *Winn v. Hibbs*, the United States District Court dismissed the case based on the Tax Injunction Act, which prohibits tax lawsuits in a federal court if a state tax jurisdiction is available. The Ninth Circuit Court of Appeals overturned the decision and the United States Supreme Court agreed with the appellate court opinion and remanded the case back to District Court.

In March 2005, the District Court dismissed the case and the plaintiffs again appealed the decision. The Ninth Circuit Court of Appeals held oral arguments on January 2008. The decision of the appellate court is pending. (Note: The case is now titled *Winn v. Garriott*, as the defendant in the case is the Director of the Arizona Department of Education. Elliot Hibbs was replaced by Gale Garriott in June 2005).

**Individual Tax Credit Donations to School Tuition Organizations**

Year	# of STOs	# of Donations	Total Donations
1998	16	4,248	\$ 1,816,799
1999	33	32,023	\$13,781,341
2000	36	38,249	\$17,701,284

<sup>2</sup> A Blaine amendment, named for James G. Blain, Speaker of the U.S. House of Representatives in 1875, is a provision in some state constitutions that prohibits the use of state funds to support private, religious or “sectarian” schools.

2001	43	46,755	\$24,924,656
2002	43	52,161	\$26,187,391
2003	51	58,122	\$29,445,494
2004	53	63,830	\$31,871,474
2005	53	69,239	\$42,194,898
2006	56	73,617	\$51,011,815
2007	55	76,066	\$54,304,282

Note: Data provided by Arizona Department of Revenue, Office of Economic Research and Analysis.

**CORPORATE TAX CREDIT**

During the 2006 legislative session, a new private school tax credit was created on a first-come, first-serve basis for corporations making voluntary cash contributions to the STOs. Subject to the Arizona Department of Revenue preapproval and verification, the aggregate amount of the tax credit was capped at \$5 million, beginning in tax year 2007 through 2011 (Laws 2006, Chapter 14).

However, prior to the end of the 2006 legislative session, the maximum aggregate amount of corporate income tax credits allowed increased from \$5 million to \$10 million in tax year 2007, with an annual increase of 20 percent in tax year 2008, and every subsequent year thereafter (Laws 2006, Chapter 325).

Unlike the individual tax credit, the STOs are required to allocate 90 percent of the annual contributions to students who qualify for free and reduced lunch under the federal school lunch program<sup>3</sup>. Students receiving scholarships or tuition grants must have either attended a public school in the prior year or a private school for kindergarten, or received a scholarship or tuition grant in the prior year through the individual income tax credit program. The amount of the scholarship or tuition grant is limited to \$4,200 for grades K-8 and \$5,500 for grades 9-12 in FY 2005-2006 and increases by \$100 each subsequent fiscal year.

<sup>3</sup> To qualify for free and reduced lunch, the family income must not exceed 185 percent of federal poverty level.

The reporting requirements for STOs are similar to the individual income tax credit. However, STOs receiving corporate cash contributions are required to submit their financial statements for compliance with generally accepted accounting principles for an independent review by a certified public accountant.

In contrast to the individual income tax credit program, private schools that enroll students receiving scholarships or tuition grants through corporate cash contributions eligible for a tax credit are required to annually administer and publish results from a nationally norm-referenced achievement test and must ensure that all staff with unsupervised contact with students be fingerprinted.

In September 2006, the Arizona School Boards Association and the Arizona Chapter of the American Civil Liberties Union filed a legal complaint against the state (*Green v. Garriott*) on behalf of parents challenging the constitutionality of the corporate tax credits on the same basis as the lawsuit filed in 1999. The complaint alleges that the inclusion of a \$10 million budget “set-aside” accounting for the potential fiscal impact of the program violates the state’s constitutional restriction on the use of funds for private and parochial schools and the “general and uniform” provision for the state’s public education system.

In March 2007, the Maricopa County Superior Court decided in favor of the state, citing the Arizona Supreme Court’s opinion in *Kotterman v. Killian* as a basis for its ruling. The Court did not make a legal distinction between the individual and corporate tax credit programs in Arizona. In *Kotterman*, the individual tax credit was held as constitutional, and, in the *Green* judgment, the Court applied the same constitutional standard. The plaintiffs have appealed this decision.

## **SCHOLARSHIP APPLICATION PROCESS**

Currently, there are 55 STOs operating in Arizona. To receive a scholarship, a student must apply to the STO that has a relationship with the private school that the student attends or wishes to attend. The application process for

each STO varies; however, generally, an application must include the student’s personal information (name, address, telephone number, date of birth), the private school that the student plans to attend and the school year for which the scholarship will apply. In addition, applicants are required to submit a copy of the parent’s federal tax return and a personal narrative of the student. In some cases, the STO may charge an application fee.

Each STO has a selection committee that reviews all applications and grants scholarship awards. In addition to the information provided as part of the application process, STOs may consider letters of recommendation or extenuating financial circumstances of the student’s family.

Application due dates vary by each STO, but, generally, applications are due in advance of the beginning of the school year to provide sufficient opportunity for review and notification to parents regarding scholarship awards. All awards are sent directly to the student’s school to be applied toward the student’s tuition costs.

• **ADDITIONAL RESOURCES** •

- Arizona Department of Revenue:  
<http://www.azdor.gov/ResearchStats/Schooltaxcredit.htm>
- *Kotterman v. Killian*, 193 Ariz. 273 972 P.2d 288 (Ariz. 1999)
- *Winn v. Hibbs*, 361 F. Supp. 2d 1117 (D. Ariz. 2005)
- Arizona Constitution, Article IX, § 10, relating to the prohibition of public funds to private or parochial schools
- Tax Credits Statutes: Arizona Revised Statutes, Title 43, Chapter 10, Article 5, and A.R.S. § 43-1183