



# Arizona State Senate Issue Brief

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## Note to Reader:

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## **PRIVATE SCHOOL TAX CREDITS IN ARIZONA**

### **INTRODUCTION**

Arizona law allows several types of income tax credits for voluntary cash contributions made by a taxpayer to a school tuition organization (STO) of their choice.<sup>1</sup> An STO is a 501(c)(3) nonprofit organization that allocates at least 90 percent of its annual revenue (contributions) in the form of scholarships and tuition grants for students to attend a K-12 private school of their 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.<sup>2</sup>

An individual taxpayer, or a married couple that files a joint return, can claim two separate tax credits for contributions to a qualified STO that is certified by the Arizona Department of Revenue (ADOR).<sup>3</sup> Two separate tax credits are also available for corporate contributions to a qualified STO to support scholarships for low-income, disabled and displaced students to attend qualified private schools.<sup>4</sup> Additionally, two separate tax credits are available to an individual shareholder of an S corporation for contributions made by the S corporation to a qualified STO, provided the S corporation qualifies for a corporate tax credit and elects to pass that credit through to its individual shareholders.<sup>5</sup>

### **INDIVIDUAL TAX CREDITS**

In 1997, a nonrefundable individual tax credit of up to \$500 was established for voluntary cash contributions made by a taxpayer to a qualified STO. The tax credit is not allowed if the taxpayer designates that the contribution directly benefits his or her own dependent. Since the tax credit's enactment, 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

<sup>1</sup> Title 43, Chapters 10, 11, 15 and 16

<sup>2</sup> Title 43, Chapter 15, Article 1 and Chapter 16, Article 1

<sup>3</sup> A.R.S. § 43-1089 and A.R.S. § 43-1089.03

<sup>4</sup> A.R.S. § 43-1183/A.R.S. § 20-224.06 and A.R.S. § 43-1184/A.R.S. § 20-224.07

<sup>5</sup> A.R.S. § 43-1089.04

schools to qualify for a scholarship or tuition grant.<sup>6</sup> In early 2000, the individual tax credit was extended to allow scholarships to preschool students with special education needs attending private schools.<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

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.<sup>10</sup> In 2010, a requirement for ADOR to adjust the dollar amounts of the credit for inflation was added, beginning January 1, 2011. The adjusted dollar amounts must be raised to the nearest whole dollar and may not be adjusted below the levels allowed in the prior tax year.<sup>11</sup> According to ADOR, the maximum credit amount that may be taken for tax year 2018 is \$555 for a single filer and a married couple filing separate returns, and \$1,110 for a married couple filing a joint return. The credit is claimed by the individual taxpayer using Arizona Form 323 (Form 323).

In 2012, the law was amended to allow a second tax credit for individuals or married couples who make an additional donation to a qualified STO, provided they have already donated the maximum amount allowed under the individual tax credit claimed on Form 323. This credit is statutorily set at \$500 and \$1,000 for individuals and married couples, respectively, and is subject to inflation adjustment by ADOR.<sup>12</sup>

According to ADOR, the maximum amount that may be taken for this credit in tax year 2018 is \$552 for single filers or married couples filing separately and \$1,103 for married couples filing jointly. The credit is claimed by the individual taxpayer using Arizona Form 348.

The individual tax credit program was challenged in *Kotterman v. Killian*, in which plaintiffs argued that the individual tax credit program violated the Establishment Clause of the U.S. Constitution, which prohibits public funds in the aid of religion, and the Arizona Constitution's version of the "Blaine Amendment,"<sup>13</sup> which prohibits the use of tax dollars for private or sectarian schools. The Arizona Supreme Court upheld the tax credit 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 (SCOTUS) declined to take action on the appeal.<sup>14</sup>

In February 2000, the Arizona Chapter of the American Civil Liberties Union (ACLU) 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 SCOTUS 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.<sup>15</sup> The Ninth Circuit Court of Appeals held oral arguments on January 2008.

In April 2009, the Ninth Circuit Court of Appeals reversed the District Court's ruling,

<sup>6</sup> Laws 1998, Chapter 102

<sup>7</sup> Laws 2000, Chapter 394

<sup>8</sup> Laws 2000, 5<sup>th</sup> Special Session, Chapter 1

<sup>9</sup> Laws 2003, Chapter 169

<sup>10</sup> Laws 2005, Chapter 334

<sup>11</sup> Laws 2010, Chapter 293

<sup>12</sup> Laws 2012, Chapter 4

<sup>13</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.

<sup>14</sup> See *Kotterman v. Killian*, 972 P.2d 606 (Ariz. 1999)

<sup>15</sup> See *Winn v. Hibbs*, 361 F. Supp. 2d 1117 (D. Ariz. 2005)

holding that the plaintiffs had standing to bring their suit, having alleged a viable claim that the tax credit law violated the Establishment Clause.<sup>16</sup> However, in April 2011, SCOTUS overturned the Ninth Circuit Court of Appeals' ruling, holding that plaintiffs lacked standing under Article III of the U.S. Constitution, challenging a tax credit as opposed to an appropriation or expenditure of state funds.<sup>17</sup>

Individual Tax Credit Donations to School Tuition Organizations			
Reporting Year	# of STOs	# of Donations	Total Donations
CY 1998	16	4,248	\$1,816,798
CY 1999	33	32,023	\$13,781,341
CY 2000	36	38,249	\$17,701,284
CY 2001	43	46,696	\$24,897,444
CY 2002	43	52,203	\$26,512,683
CY 2003	51	58,122	\$29,444,972
CY 2004	53	63,830	\$31,846,494
CY 2005	53	69,239	\$42,196,206
CY 2006	56	73,617	\$51,012,326
CY 2007	55	76,065	\$54,304,968
CY 2008	55	78,434	\$55,260,728
CY 2009	54	73,430	\$50,916,897
CY 2010	53	62,940	\$43,163,214
FY 2011 <sup>18</sup>	50	74,681	\$51,408,122
FY 2012	49	76,739	\$51,918,033
FY 2013	48	76,098	\$54,794,058
FY 2014	49	80,893	\$58,129,582
FY 2015	52	80,930	\$61,740,333
FY 2016	55	86,513	\$65,436,399

Source: ADOR, Office of Economic Research and Analysis

<sup>16</sup> See *Winn v. Garriott*, 05-15754 (9th Cir. 2009)

<sup>17</sup> See *Arizona School Tuition Organization v. Winn*, 563 U.S. 125 (2011)

<sup>18</sup> Pursuant to Laws 2010, Chapter 292, beginning with FY 2011, STOs are to report on the income tax credit programs on a fiscal year, rather than a calendar year, basis.

**CORPORATE TAX CREDITS**

**Corporate Donations for Low-Income Scholarships**

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 STOs. Subject to ADOR preapproval and verification, the aggregate amount of the tax credit was capped at \$5 million, beginning in FY 2007 through 2011.<sup>19</sup> 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 FY 2007, with an annual increase of 20 percent in FY 2008, and every subsequent year thereafter.<sup>20</sup> According to ADOR, the maximum aggregate amount of tax credits allowed in FY 2019 is \$89.2 million.<sup>21</sup>

In 2009, the law was amended to: 1) allow insurance companies to take a credit against their insurance premium tax liability for voluntary tax contributions made to STOs; and 2) eliminate the June 30, 2011 sunset date for the corporate income tax credit program.<sup>22</sup>

Unlike the individual tax credit, the STOs are required to allocate 90 percent of the annual contributions to low-income students who qualify for free and reduced lunch under the federal school lunch program.<sup>23</sup> Students receiving scholarships or tuition grants must have either:

- attended a public school as a full-time student or a preschool program that offers services to students with disabilities at a public school for at least 90 days of the prior fiscal year or one full semester and transferred to a qualified private school;
- enrolled in a qualified private school in a kindergarten program or a preschool program

<sup>19</sup> Laws 2006, Chapter 14

<sup>20</sup> Laws 2006, Chapter 325

<sup>21</sup> DOR. *Corporate Income Tax Credits for Donations to School Tuition Organizations*. <https://azdor.gov/TaxCredits/CorporateTuitionTaxCredits.aspx>

<sup>22</sup> Laws 2009, Chapter 168

<sup>23</sup> To qualify for free and reduced lunch, the family income must not exceed 185 percent of federal poverty level.

that offers services to students with disabilities;

- been the dependent of a member of the U.S. Armed Forces stationed in Arizona pursuant to military orders; or
- received a scholarship or tuition grant in the prior year through the individual income tax credit program.<sup>24</sup>

The amount of the scholarship or tuition grant is capped at \$5,400 for grades K-8 and preschool students with disabilities, and at \$6,700 for grades 9-12 in Academic Year 2018-2019 and increases by \$100 each subsequent year.

In September 2006, the Arizona School Boards Association and the Arizona Chapter of the ACLU 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 appealed the decision. In March 2009, the Arizona Court of Appeals upheld the corporate tax credit program. The Arizona Supreme Court subsequently declined to review the lower court’s decision.<sup>25</sup>

## *Corporate Donations for Displaced Students and Students with Disabilities*

Arizona law also allows a corporate income tax credit and an insurance premium tax credit for contributions made to STOs to provide scholarships for disabled and displaced students. To qualify for a scholarship from contributions made under this program, a student must have either:

- been placed in the Arizona foster care system at any time before graduating from high school or obtaining a GED; or
- been identified as having a disability under Section 504 of the federal Rehabilitation Act of 1973 (29 U.S.C. § 794) or identified at any time by a school district as a child with a disability or a child with a disability who is eligible to receive school district services. The amount of the scholarship or tuition grant that an STO can award to a qualified student is limited to the cost of tuition or 90 percent of state aid that otherwise would have been computed for the student, whichever is less. The Arizona Department of Education is required to provide an STO with the state aid amount computed for a student representing the 90 percent prescribed limitation in a timely manner, upon request.<sup>26</sup> The maximum aggregate amount of tax credits allowed in a fiscal year is \$5 million.<sup>27</sup>

## *S Corporation Private School Tuition Credits*

In 2015, the law was amended to establish a pro rata tax credit for an S corporation that donates to an STO. To qualify for the tax credit, an S corporation must donate at least \$5,000 during a tax year. For tax years beginning after December 31, 2014, an S corporation that qualifies for a corporate private school tuition credit is allowed the option to pass through the credit to its individual shareholders. However, the

<sup>24</sup> A.R.S. § 43-1504

<sup>25</sup> See *Green v. Garriott*, 221 Ariz. 404, 417, ¶ 51, 212 P.3d 96, 109 (App. 2009)

<sup>26</sup> A.R.S. § 43-1505

<sup>27</sup> DOR, Corporate Income Tax Credits for Donations to School Tuition Organizations.  
<https://azdor.gov/TaxCredits/CorporateTuitionTaxCredits.aspx>

tax credit is not allowed if either the S corporation or a shareholder:

- designate the STO contribution for the direct benefit of a shareholder’s dependent;
- designate a student beneficiary as a condition of the STO contribution; or
- with the intent to benefit a shareholder’s dependent, agrees with one or more other taxpayers to designate reciprocal STO contributions for the direct benefit of the other taxpayer’s dependent.<sup>28</sup>

**SCHOLARSHIP APPLICATION PROCESS**

Currently, there are over 70 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 Constitution, Article IX, § 10, relating to the prohibition of public funds to private or parochial schools
- Arizona Department of Revenue
  - ◇ *Brochure #707: Private and Public School Tax Credit Information Publication*  
<https://www.azdor.gov/Portals/0/Brochure/707.pdf>
  - ◇ *Corporate Tuition Tax Credits:*  
<https://www.azdor.gov/TaxCredits/CorporateTuitionTaxCredits.aspx>
  - ◇ *Disabled/Displaced Scholarships:*  
<https://www.azdor.gov/TaxCredits/CorporateTuitionTaxCredits/DisabledDisplacedScholarships.aspx>
  - ◇ *Private School Tax Credit Reports*  
<https://www.azdor.gov/ReportsResearch/SchoolTaxCredit.aspx#private>
  - ◇ *School Tax Credits for Individuals:*  
<https://www.azdor.gov/TaxCredits/SchoolTaxCreditsforIndividuals.aspx#private>

<sup>28</sup> A.R.S. § 43-1089.04

<sup>5</sup> A.R.S. § 15-393 (A)  
<sup>6</sup> A.R.S. § 15-393 (B)  
<sup>7</sup> A.R.S. § 15-391 (3), (5)  
<sup>8</sup> A.R.S. § 15-393 (Q)