


How Student Tuition Tax Credits Are Failing Arizona

Chris Thomas, General Counsel
Arizona School Boards Association



A.R.S. §43-1089 (HB2074, 1997 Session)

- Allows \$500 tax credit for claiming individual; \$1000 per married couple
- Can carry credit up to 5 years if credit would exceed liability
- Get credit in lieu of federal deduction
- Cannot direct funds to dependent of taxpayer

A.R.S. §43-1089 (HB2074, 1997 Session)

- Student Tuition Organizations
 - Must be non-profit (501c3 under I.R.S. Code)
 - Must give out at least 90% of received funds in form of scholarships to students
 - Can spend up to 10% on administrative expenses
 - Receiving schools cannot discriminate based on race, color, handicap, familial status or national origin
 - CAN discriminate based on religion
 - NO PENALTIES written into law for non-compliance (reporting requirements only)

A.R.S. §43-1089 (HB2074, 1997 Session)

- Policy Arguments In Support:
 - “Next step” in bringing free market principles to Arizona education, making both public and private schools better
 - Charter schools, 1994
 - Open enrollment, 1996
 - Will open up private schools to less fortunate
 - Will save state money - as less students use public system which costs taxpayers more

Law Tested

- ASBA, along with a number of education organizations, challenged constitutionality of law immediately upon Governor's signature
 - Claimed violation of:
 - Establishment Clause of First Amendment to U.S. Constitution
 - "Aid", "Religion," "Gift" and "General and Uniform" Clauses of Arizona Constitution

Arizona Supreme Court: STO Program Constitutional -- Kotterman v. Killian

- 3-2 decision with strong dissent
- Difference between a deduction and a tax credit “constitutionally insignificant,” regardless of difference in effect
- Constitutional under Establishment Clause
 - Law is “facially neutral” as to benefits of to private schools (religious vs. non-religious)
- Religion clause of Arizona Constitution is indistinguishable from Establishment Clause
- “Encouragement of private schools” does not violate General and Uniform Clause

Arizona Supreme Court: STO Program Constitutional -- Kotterman v. Killian

- Spent most of opinion looking at Aid Clause:
 - Art. IX, Sec. 10: No tax shall be laid or appropriation of public money made in aid of any church, or private or sectarian school, or any public service corporation.
 - So-called Blaine Amendment
 - Amendment never adopted to U.S. Constitution that had great influence in state constitutions in late 1800's, early 1900's; may have been motivated by anti-Catholic, anti-immigrant animus

Arizona Supreme Court: STO Program Constitutional -- Kotterman v. Killian

- Because state never receives money, and amount donated simply reduces the amount of tax owed, it isn't state money and isn't a "tax laid" in aid of religion in violation of AZ Constitution.
- Looked at anti-religious motivation of Blaine Amendment
- Dissent: STO program violates the plain language of the AZ Constitution

Growth of STO/ETC Tax Credits

- STO Growth

- 1998: \$1.8M
- 1999: \$13.7M
- 2000: \$17.7M
- 2001: \$24.9M
- 2002: \$26.4M
- 2003: \$29.4M
- 2004: \$31.8M
- 2005: \$42.1M
- 2006: \$51.0M
- 2007: \$54.3M
- 2008: \$55.2M

- ETC Growth:

- 2003: \$23.4M
- 2004: \$25.8M
- 2005: \$28.6M
- 2006: \$35.0M
- 2007: \$40.3M

Expansion of STO Tax Credits, '99-'09

- Originally set at \$500 per filing (individual or joint filer)
 - ETC set at \$200 per filer
- Education 2000 set at \$500 per individual or \$625 per joint filer (not sent to voters)
- Now \$500 per individual, \$1000 per joint filer



SB1499 (2006 Session): New corporate tax credit program

- Credit for corporations that owe Arizona corporate income tax
 - Capped at \$5 Million per year; can increase 20% per year
 - Must get pre-approval of ADOR
 - Cannot go to benefit any particular individual student
 - Must limit to students from low income households
 - Must transfer from public school to private school
 - Corporations can still be anonymous
 - No enforcement provisions
 - Program sunsets in at end of FY 2011

HB2001, Laws 2009, 49th Leg., 2nd Special Session

- Creates disabled and foster scholarship program
 - Corporate tax credit program;
 - Replaces voucher program ruled unconstitutional; no requirement that student have been in public school before
 - Also expands corporate tax credit program to allow insurance companies that pay insurance premium tax to get tax credit for contributions made to STO's

Tax Credits Still At Issue in Courts

- Green v. Garriott
 - Constitutionality of corporate tax credit program
 - ACLU, ASBA and others have challenged; lost at Superior Court and Court of Appeals; pending appeal before AZ SC
- Winn v. Hibbs
 - As applied challenge to STO program brought by ACLU; long procedural history; big win in 9th Circuit
 - Now can look at whether programs are unconstitutional the way they are run
 - Disproportionate benefit to religious schools?

Tax Credits: Investigative Journalism At Its Best

- Arizona Republic: 8/1/09, 9/5-7/09
 - www.azcentral.com/arizonarepublic
- East Valley Tribune: 8/1-8/4/09
 - <http://www.eastvalleytribune.com/page/taxcredits>
- Confirmation of many disturbing practices rumored or hidden; many new practices few knew about

Do Tax Credits Assist the Poor?

- Trent Franks, Architect of Program in 1997: “The focus on the program is entirely low-income students.”
- Most that benefit from program not from poor families
 - Only 7 out of 55 have means test for recipients of scholarships
- Most that take credit are wealthy
 - Of 51,322 who claimed tax credit in 2003, average annual income was \$141,000
 - One STO’s average donor income was \$729,000
 - Corp. Tax Donor on average took \$142K in credit




Do Tax Credits Assist the Poor?

- No change in make-up of schools
 - Most overwhelmingly still white, while state's Hispanic population has boomed (80% in 1996; 79% in 2008)
- Private school tuition has increased with every increase in the credit
 - Tuition increased 30% in four years



Do Tax Credits Move Students from Public Schools to Private Schools?

- 2005 Goldwater Institute study showed vast majority of scholarship recipients were already attending private school or would have without the credit
- Private schools have grown by 6800 students since 1999; in that time, public school enrollment has grown by 280,000



Is STO program neutral towards religion?

- 2008: 93% of schools benefiting from program faith-based schools
- Many STO's benefit one school only, a violation of law
- Other STO's give nominal amount to other schools to “comply” with multiple school requirement
- Largest STO in state requires schools be Christian to participate in STO

Are STO's following the intent and/or letter of the law?

- Most allow for earmarking of funds to a particular student, including some for the credit claimant's dependent, a clear violation of the law
 - Most teach "credit swapping"
 - One school allows banking of funds for fetuses
- Elaborate instructions by STO's to pool credits to cover the cost of tuition
 - One parent profiled got \$20K per year in tuition totally covered with money left over -- which was then earmarked for a friend's child

Are STO's following the intent and/or letter of the law?

- STO's allowed to take up to 10% for administrative/processing expenses
 - Nearly 2/3 spent more
 - Part of problem is in way funds are accounted for
 - Some holding back funds in anticipation of program being found unconstitutional
 - One has \$500,000 balance
 - Question why even 10% is allowed to be held back
 - Some STO's hold back as little as 2%
 - AZ administrative expenses: 9.5%

Some Getting Benefits that were not intended

- Maricopa County Schoolhouse Foundation
 - Supposed to benefit students that attended Pappas School for Homeless to go to private high school
 - After little accountability, money finally gifted to Children First Academy, a public charter school; money has been used for buses, computers and to pay school nurse's salary
- Many charters setting up before and after school programs through non-profits and using STO funds, including second-half of all day Kindergarten
 - While still getting state funding for all day Kindergarten!

I.R.S. Rules Being Violated?

- Cannot take deduction if there is a personal benefit
 - Many parents coached to take credit PLUS take the deduction, a clear violation of Arizona law
 - One says “YOU MAKE MONEY”
- Executive Compensation
 - Private inurement: can lose non-profit status if compensation out of line
 - Six-figure salaries of Execs; for-profit “side” businesses; luxury vehicles and use of credit; rent abuses beyond fair market value

Can We Afford Program?

- Not saving state money
 - Tuition being “bundled” means students are getting more than \$5000 that avg. AZ public school gets
 - Costs for private tuition up to \$20,000 per year
 - Students taking part in program would be in private schools anyway - even without the credit
 - Arizona public school funding: 49th out of 50 states
- Program has cost state \$350 Million since 1998; open-ended for future

Where's the Accountability?

- Arizona Department of Revenue readily admits they don't have personnel to oversee program
 - No jurisdiction by Attorney General and Auditor General
 - I.R.S. also has cut auditors (1% of non-profits audited)
- No enforcement provisions for wrong-doing
- Law vague in many places
- Scholarship recipients not public record - makes tracking impossible
- Corporate donors private
- No requirement that schools receiving students follow accountability of student progress or laws on OML, public records

To Fix or Not Fix?

- Democratic leaders in House of Representatives have set up bipartisan ad-hoc task force to look at reforming system
 - Goldwater Institute and others open to small reforms
- ASBA position: STO program is fundamentally flawed - it can't be fixed - it must be abolished!
 - If certain problems are fixed, others will pop up
 - We believe it is unconstitutional

Questions?

Cthomas@azsba.org