Joint Legislative Budget Committee
Staff Memorandum

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DATE: November 30, 2006

TO: Members, Joint Legislative Income Tax Credit Review Committee

FROM: Tim Everill, Revenue Section Chief

SUBJECT: 2006 INCOME TAX CREDIT REVIEW

This memo transmits background materials for the December 7**,** 2006 meeting of the Joint Legislative Income Tax Credit Review Committee.

Background

Laws 2002, Chapter 238 established the Joint Legislative Income Tax Credit Review Committee, and specified a schedule for review of corporate and individual income tax credits. The credits scheduled for review in 2006 include:

- Family Income Tax Credit
  A.R.S. § 43-1073 (Individual)
- Private School Tuition Organization Credit
  A.R.S. § 43-1089 (Individual)
- Public School Extra Curricular Activity Fee Credit
  A.R.S. § 43-1089.01 (Individual)
- School Site Donation Credit
  A.R.S. § 43-1089.02 (Individual)
  A.R.S. § 43-1181 (Corporate)
- Solar Hot Water Heater Plumbing Stub Outs and Electric Vehicle Recharge Outlets Credit
  A.R.S. § 43-1090 (Individual)
  A.R.S. § 43-1176 (Corporate)

The Committee is charged with determining the original purpose of each of the existing income tax credits, and establishing a standard for evaluating the success or failure of the credit. Based on statute (A.R.S. § 43-221), the standard for evaluation of the credits may include: 1) the history, rationale and revenue impact; 2) the benefit to the state in various economic terms; and 3) the complexity in the use and administration of the credit.

Limitations

There are several limitations that affect the evaluation of income tax credits. For example, based on Department of Revenue (DOR) interpretation of Arizona law (A.R.S. § 43-2001), the department is generally prohibited from releasing company-specific tax credit data. While DOR provides tax credit information in aggregate form, in some cases so few companies take a particular credit, there is no financial data available related to the credit.

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A second limitation is the timeliness of data that is available. Because tax credit data must be compiled manually from actual hard-copy tax returns, corporate tax credit data is currently available only through tax year 2004 and individual tax credit data through tax year 2005.

And finally, there is generally a lack of performance measures for tax credits. Some credits have stated performance measures or goals, but most of the credits do not have objectives included in statute. It should be noted that Chapter 238 requires any new credit to include a clause that explains the rationale and objective of the credit (A. R. S. § 43-223).

2006 Review

Attached are summaries for each of the income tax credit categories that are included in the 2006 review. The following information is provided (where applicable) for each of the credit categories:

Description – the definition of the tax credit, and how the credit is calculated.

Refundable – whether or not the credit is refundable. A nonrefundable credit is one in which, when the credit exceeds the taxpayer's tax liability, the amount of credit that is greater than the liability may be carried forward to future tax years (as provided in statute). If a credit is refundable, the amount of credit that exceeds the taxpayer's liability is refunded to the taxpayer in each tax year. All of the credits included in the current review are nonrefundable.

Carry Forward – whether or not any unused nonrefundable credit may be carried forward into subsequent tax years, and if so, for how many years.

History and Rationale – the year the tax credit was implemented, revisions to the credit since it was implemented, and relevant information regarding the intended purpose of the credit.

Revenue Impact – based on information from DOR, information for each tax year on the number of claimants, the amount of new credit identified, total credit identified, credit used, and credit carried forward to a subsequent tax year. In addition, we provide data specific to each tax credit (where applicable), and more detailed definitions of the above terms.

Economic Benefits – a summary of information available related to any economic benefits associated with each tax credit, including economic development, new investments, job creation or retention of existing jobs, and any other economic benefits that may be specific to each credit.

Complexity – information related to the complexity of administration and application of each tax credit, including the perspective of the state agency administering the credit (generally DOR), trade associations, and representatives of the businesses and/or individuals that claim the credits.

Potential Performance Measures – a listing of potential measures that might be used to evaluate each of the income tax credits.

Information under the above headings from each income tax credit category was obtained from a variety of sources. JLBC Staff reviewed the statutes establishing each of the credits, as well as the tax forms and instructions used by businesses and individuals to claim the credits. Staff also had discussions with current and former legislative staff.

Staff also reviewed summaries and minutes of committee and subcommittee hearings that were held prior to adoption of the credits. In addition, research conducted by the Governor's Citizens Finance Review

Committee was reviewed. Various state agencies were contacted, including DOR, Arizona Department of Education, the Charter Schools Board, and the School Facilities Board.

And finally, in order to get a perspective on the credits from those who actually claim the credit, various business and non-profit organizations, as well as industry and government representatives were contacted.

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Family Income Credit

Family Income Tax Credit

Summary

- The cost of the credit was $7.5 million in tax year 2005, the last year for which data is available.
- The credit was claimed by 417,990 taxpayers at an average of $18 per claim.
- The 417,990 taxpayers claimed 339,310 dependents, or on average less than 1 dependent per taxpayer.
- While labeled as a family tax credit, single households with no dependents may take the credit. Of the 417,990 credit claimants, about 179,000 fell into this category.
- While family status is not a necessary requirement to receive the credit, the taxpayer must be a low-income earner. Single tax-filers with incomes above $10,000 do not qualify.
- The average credit is declining as other tax law changes have assisted low-income taxpayers.

Statute

A.R.S. § 43-1073 (Individual Income Tax)

Description

This credit is provided to taxpayers below certain income levels. A taxpayer's income limit depends on both their filing status and the number of dependents claimed on their tax return.

The credit is currently $40 for each member of a household for whom a personal or dependent exemption is allowed. However, the total amount of credit claimed cannot exceed $240 for married taxpayers filing joint returns or for single persons filing as head of household. The credit is limited to $120 for singles and married couples filing separate returns.

For taxpayers whose filing status is single or married filing separately, their Arizona adjusted gross income, plus any amounts subtracted for non-personal exemptions, must be less than or equal to $10,000 to qualify for the credit. For most taxpayers, this amount is the same as their federal adjusted gross income. The income thresholds for other taxpayers are shown in the table below.

Filing Status	# of Dependents	Income Limit
MFJ[1/]	< 2	$20,000
MFJ	2	$23,600
MFJ	3	$27,300
MFJ	≥ 4	$31,000
HOH[2/]	< 2	$20,000
HOH	2	$20,135
HOH	3	$23,800
HOH	4	$25,200
HOH	≥ 5	$26,575

[1/] Married couples filing joint returns.
[2/] Single persons filing as head of household.

Refundable

The credit is not refundable.

Carry Forward

No carry-forward of unused credits is allowed.

History and Rationale

This credit was created by Laws 1995, 1st Special Session, Chapter 9 (SB 1009) and became effective retroactively from January 1, 1995. The credit was one of several tax provisions in SB 1009 that were designed to reduce both property and individual income taxes by $(200) million annually. According to both House Ways and Means and Senate Finance Committee Minutes from March 15, 1995, the credit was intended to help low-income households by effectively removing them from the state income tax rolls. In other words, the credit was designed to remove any tax liability remaining after basic exemptions and deductions. More specifically, the bill provided that no family earning $20,000 or less ($10,000 or less for single households) would have to pay any state income taxes.

To meet the aforementioned objective, SB 1009 provided a credit of $30 per household member but limited the total credit claimed to $120 for married couples filing joint returns and single persons filing as head of household and $60 for all other taxpayers.

Laws 1998, 4th Special Session, Chapter 3 (SB 1007) increased the per-person credit from $30 to $40 and expanded the application of the credit from 4 to 6 household members, as reflected in the table on the previous page. As noted earlier, the maximum credit per taxpayer was increased from $120 to $240 for married couples filing joint returns and for single persons filing as head of household, and from $60 to $120 for all other taxpayers. The expansion of the family income tax credit was one of several provisions contained in the "Tax Relief Act of 1998" that were designed to reduce individual income taxes by $(50) million annually. (Note that both Laws 1995, Chapter 256 and Laws 1998, 5th Special Session, Chapter 2 provided minor technical changes to the family income tax credit.)

Revenue Impact

The cost of the credit has increased from $5,150,000 in 1995 to $7,503,304 in 2005. Over the same period, the number of taxpayers claiming the credit increased from 340,844 to 417,990. It is estimated that these figures represent 21.4% and 20.6% of all residential tax-filers, respectively. The share of tax-filers claiming the credit has varied between a low of 17.6% in 1998 and a high of 21.4% in 1995. The data in the table below, which was furnished by the Department of Revenue (DOR), provides more detail of the 417,990 tax-filers that claimed the family income tax credit in tax year 2005.

Filing Status	# of Returns	% of Total	# of Dependents	% of Total	Avg. # of Dependents
Married Filing Jointly	119,127	28.5%	141,492	41.7%	1.19
Head of Household	109,931	26.3%	189,980	56.0%	1.73
Married Filing Separately	2,926	0.7%	543	0.2%	0.19
Single	186,006	44.5%	7,295	2.2%	0.04
Total	**417,990**	**100.0%**	**339,310**	**100.0%**	**0.81**

The table above indicates that almost half (44.5%) of all the tax-filers that claimed the family income tax credit in 2005 filed as single individuals. These individuals claimed 2.2% of the 339,310 dependents for which the $40 per-person credit was applied. The same data set shows that most dependents (56%) were claimed by individuals who filed as head of household. Such tax-filers claimed on average 1.73 dependents compared to 0.81 for all taxpayers.

The average amount of credits identified per taxpayer increased from $60 in 1995 to $84 in 2005. This increase is mainly attributable to a 1998 tax law change, which raised the per-person family income tax credit from $30 to $40. The average credit used increased from $15 in 1995 to $18 in 2005. The data in the table below, which was provided by the Department of Revenue (DOR), shows the annual impact of the family income tax credit.

Tax Year	# of Claimants	Total Credit	Avg. Credit Identified	Used	Avg. Credit Used
1995	340,844	$20,600,000	$60	$5,150,000	$15
1996	340,790	$20,526,564	$60	$5,071,340	$15
1997	345,223	$20,483,252	$59	$4,637,593	$13
1998 [1/]	312,768	$27,669,951	$88	$7,390,406	$24
1999	327,974	$28,374,663	$87	$7,925,721	$24
2000	335,253	$28,924,670	$86	$7,799,840	$23
2001	402,094	$33,377,585	$83	$7,356,939	$18
2002	427,798	$36,064,781	$84	$7,382,178	$17
2003	417,451	$35,068,208	$84	$7,445,937	$18
2004	425,484	$35,617,953	$84	$7,709,270	$18
2005	417,996	$35,051,721	$84	$7,467,680	$18

[1/] Laws 1998, 4th Special Session, Chapter 3 increased the per-person credit from $30 to $40.
# of Claimants – the number of taxpayers who claimed the credit in each year.
Total Credit – the total tax credits identified in each tax year.
Used – the total value of credits claimed in each year.

The table above suggests that while the average per-person credit identified has remained fairly stable over time (approximately 2 persons claimed per taxpayer), the average credit used has declined significantly. For example, in the period between 1998 and 2005, the average credit used decreased from $24 to $18 in comparison to a reduction from $88 to $84 for the average credit identified. The reduction of the average credit used is believed to be primarily attributable to a (3.3)% reduction of the lowest marginal tax rate in 1997 and a 12.5% increase of the standard deduction in 2001. Both of these tax law changes have reduced the tax liability for low-income earners.

Two recent tax law changes can be expected to further reduce the average amount of the credit claimed: (1) Laws 2005, Chapter 334, which restored inflation-indexing of the standard deduction, and (2) Laws 2006, Chapter 354, which provided across-the-board tax rate reductions of 5% in 2006 and 10% in 2007. For example, the combined effect of both these tax law changes for a 2-parent family of 4 with an annual income of $23,000 (and thus a total credit of $160) would be to reduce their estimated tax liability and hence credit used from $100 in 2005 to $88 in 2006 and $79 in 2007.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

This credit is not directly designed to promote economic development or spur new investments that would result in new jobs. Instead, according to DOR's August 2000 report "Income Tax Credits in Arizona," the family income tax credit is intended to alleviate the tax burden on low-income individuals. Two other income tax credits provided by Arizona law – earned credit for property taxes (A.R.S. §43-1072) and credit for increased excise taxes paid (A.R.S. §43-1072.01) – have the same objective. The property tax credit is limited to senior citizens and recipients of Supplemental Security Income with a household income below $5,501. The excise or sales tax credit provides a $25 per-person credit for households with a federal adjusted gross income of up to $25,000. Unlike the family income tax credit, both the property tax and excise tax credit are refundable.

The information above suggests that one and the same taxpayer may be eligible for more than one of the 3 low-income tax credits provided in statutes. For example, a single mother with two dependent children and an annual income of $20,000 would qualify for a family income credit of $120 (of which about $70 would be used to fully offset her tax liability) and a refundable excise tax credit of $75.

Although this credit was not directly intended to promote economic growth, it may still provide some economic benefits to society since it effectively increases the disposable income of low-income households. A higher disposable income, all else equal, should have the effect of increasing economic activity in the state somewhat. For the individual taxpayer, the credit may have the effect of marginally increasing his spending on goods and services, which in the aggregate could result in the creation of new jobs and increased investments in the state.

According to a recent study by the Center on Budget and Policy Priorities ("The Impact of State Income Taxes on Low-Income Families in 2005"), two-parent families of four with incomes below the federal poverty line ($19,806) are liable for state income taxes in 19 of the 42 states that levy such tax. The lowest income level at which such families begin incurring state income tax liability ("threshold") varies between $4,600 (Alabama) and $42,700 (California). With a threshold of $23,600, the report ranks Arizona 28th in the nation. (Note: the higher the rank, the higher the income threshold.)

Complexity

Unlike most other credits, the family income tax credit does not require a separate form to be appended to the individual income tax return filed by the taxpayer. Instead, the book of instructions that accompanies the income tax form includes a worksheet for the taxpayer to determine whether he is eligible for the credit or not, and if so, to calculate the amount of the credit he is allowed to claim. According to DOR, this worksheet is relatively easy to use since all the information that is necessary for the credit calculation is included on the invidual's income tax form. For this reason, the credit requires no separate administration or approval process by DOR.

Potential Performance Measures

Since the income limit to qualify for the family income tax credit is not adjusted for inflation, one potential performance measure could be to express the income threshold as a percent of the federal poverty line. For example, for 2-parent families of 4, this percentage has declined from 143% in 1998 to 119% in 2005.

Private School Tuition Organization Credit

Private School Tuition Organization (STO) Credit

Summary

- In 2005, statewide contributions to school tuition organizations (STO's) were reported to be $42.2 million – The actual revenue impact of the credit, however, may be lower.
  - Only information on contributions is available – Actual data on the number of claims, and the total amount claimed, has not yet been compiled.
- While the credit reduces state revenues, it may also reduce state K-12 education costs.
  - The revenue loss from the credit could be offset if it results in students attending private school who would otherwise attend public school. The state currently saves about $5,300 for each student that would have otherwise attended public school.
- Eight STO's received more than $1 million each and accounted for $31.4 million of the total.
- A total of 69,234 taxpayers contributed, with an average contribution of $609.
- Of the $42.2 million in 2005 contributions, STO's distributed $30.9 million in scholarships and grants. The remaining monies were either allocated for administration or retained for future awards.
- A total of 22,522 scholarships and grants were distributed, with an average award of $1,370. However, some students are likely receiving more than one scholarship. Using data from a Goldwater Institute survey of private schools, JLBC Staff estimates that 20,030 students actually received a state-supported scholarship in 2005, with the average recipient getting $1,540.
- Enrollment in private schools was 46,366 in FY 2004, or about 5% of the total statewide K-12 population. Looking at enrollment since FY 1996, growth in the private school population has been low compared to public schools – Over the past few years, however, private school growth has more closely resembled that of public schools.
- In its survey, the Goldwater Institute found the average tuition of a private K-8 school to be $3,700, and the average tuition of a private high school to be $5,500. On average, state-supported scholarship funding covers 40.5% of the cost of K-8 tuition and 27.3% of the cost of high school tuition.

Statutes

A.R.S. § 43-1089 (Individual Income Tax)

Description

This credit is provided to taxpayers for any voluntary contributions made to a school tuition organization (STO). An STO is defined as a charitable organization that is exempt from federal taxation and that allocates at least 90% of its revenue for educational scholarships or tuition grants to children to attend a non-governmental elementary or secondary school, or a non-governmental preschool for handicapped students. The organization may use the remaining 10% of revenue for its administrative costs. In addition, an STO must allocate its awards without limiting availability to students of one school. While this requirement does not mean that an STO actually has to award monies to more than one school in any particular year, the organization must have a qualifying list of schools students could attend to receive an award.

A contribution that is made for the direct benefit of any dependent of the taxpayer does not qualify for the credit.

Refundable

The credit is not refundable.

Carry Forward

The unused portion of the credit may be carried forward for a maximum of 5 consecutive years.

History and Rationale

The private STO tax credit was created by Laws 1997, Chapter 48 and became effective January 1, 1998. Chapter 48 also established the public school extracurricular activity fee tax credit.

In *Kotterman v. Killian*, opponents of the tax credit challenged its constitutionality in state court, claiming it violated both federal and state prohibitions against using public monies to support a religious establishment, and a state prohibition against using public monies for private or sectarian schools. The Arizona Supreme Court voted 3-2 to uphold the constitutionality of the tax credit. In *Winn v. Hibbs*, opponents of the credit filed a challenge to it in federal court. That case is on-going.

As originally enacted, the maximum credit allowed was $500. Laws 2000, Chapter 1, 5th Special Session increased the cap to $625 for married taxpayers filing a joint return. Laws 2005, Chapter 334 increased the maximum credit for married couples filing jointly from $625 to $825 for taxable year 2005 and to $1,000 for taxable year 2006 and thereafter. The maximum credit for single individuals and heads of households was left unchanged at $500.

The statute creating the tax credit does not include a specific statement of purpose or a rationale. Minutes from committee meetings indicate supporters were seeking to provide more educational opportunities for children from low-income families.

In addition to the existing individual income tax credit, a corporate income tax credit was created with the passage of Laws 2006, Chapter 14 (later amended by Laws 2006, Chapter 325). The corporate credit, which is effective from July 1, 2006 through June 30, 2011, also allows corporations to claim a credit for contributions to an STO. Unlike the individual credit, corporate contributions must be used to provide an educational scholarship or tuition grant to a child whose family income does not exceed 185% of the level required to qualify for a free or reduced price lunch. The corporate credit is capped in the aggregate at $10 million, an amount which increases by 20% annually beginning in FY 2008. The corporate credit is not subject to the Committee's review this year.

Revenue Impact

The Arizona Department of Revenue (DOR) has not yet compiled data on the actual number of claimants, or the actual dollar amount claimed, for this credit since its establishment. The department has indicated that it is currently compiling this information for tax year 2003.

Instead of tax form credit claims, DOR does report on contributions made to STO's. The statutory language establishing the credit requires that an STO receiving contributions report annually to DOR on the total number and dollar amount of contributions received in the prior year, the total number of students awarded scholarships or grants, and the total amount awarded.

Historical data on contributions are summarized in the table below.

Private School Tuition Organization Tax Credit Contributions

	1998	1999	2000	2001	2002	2003	2004	2005
# of Contributions	4,248	32,023	38,249	46,755	52,161	58,122	63,830	69,234
$ Received (in millions)	$1.8	$13.8	$17.7	$24.9	$26.2	$29.4	$31.9	$42.2
Avg Contribution	$427	$430	$463	$533	$502	$507	$499	$609

As indicated in the table, the total amount of contributions has increased from $1.8 million in 1998, the first year the credit was offered, to $42.2 million in 2005. (According to DOR, contributions were low in 1998 due to the legal challenge to the credit.) The average contribution has also increased, from $427 in 1998 to $609 in 2005.

Both 2001 and 2005 witnessed large growth in both the total amount of contributions received and the average contribution. This was likely a result of the changes to the law that increased the cap on the allowable amount of the credit for married couples. Since the allowable cap was again raised for married couples in 2006, there may be another jump in contributions in the current year.

Given that DOR has not reported actual claims data, the revenue impact of this credit can not be determined with certainty; however, the annual impact may be less than the amounts cited in the table above. For any particular taxpayer, actual contributions may exceed the maximum allowable credit, or a low tax liability might limit the amount of the credit that could be used. On the other hand, the unused portion of the credit can be carried forward for 5 years, allowing the taxpayer the opportunity to generate some portion of the credit over multiple years.

In addition to its effect on state revenues, the tax credit may also have an impact on state K-12 education costs. Since the credit results in additional contributions made to student tuition organizations, these organizations may be able to offer additional scholarships to new students or increase existing awards to current students. Any loss in state revenues from taxpayers claiming the credit, therefore, could be offset if it results in new private school students or students remaining in private school who otherwise would have transferred to public school. It is difficult, however, to quantify all the incentives that factor into private school attendance, as there are both monetary and non-monetary ones.

Currently each pupil added to the statewide K-12 Average Daily Membership (ADM) count costs the state General Fund on average about $5,300. The state General Fund, therefore, saves an average of about $5,300 for each pupil that would have otherwise attended public school.

Beyond its impact on K-12 operating costs, the credit could result in lower School Facilities Board (SFB) costs for new school construction and building renewal. New school construction costs would be reduced if the SFB approved fewer new schools because of lower public school enrollment growth from the credit. This would reduce SFB building renewal costs as well because fewer school buildings would require funding under that formula.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

This credit is not directly designed to promote economic development or spur new investments that would result in new jobs. Instead, according to DOR's August 2000 report "Income Tax Credits in Arizona," this credit is one of several tax credits in statute that are primarily intended to encourage cash contributions to certain target groups in society, such as the working poor or students in private or public schools.

Appendix A provides information on contributions received by each STO in 2005. In that year, a total of $42.2 million was received. Eight STO's, who generated over $1 million each, accounted for $31.4 million, or about 75%, of total revenues.

Of the $42.2 million received in donations in 2005, STO's distributed $30.9 million. Remaining donation revenues were either allocated for administrative costs or retained for future year awards. Historical data on scholarships and grants are summarized in the table on the following page.

Private School Tuition Organization Grants and Scholarships

	1998	1999	2000	2001	2002	2003	2004	2005
# of Scholarships/Grants	128	3,365	15,081	18,049	19,559	20,134	21,146	22,522
$ Distributed (in millions)	$0.1	$2.2	$13.6	$16.1	$22.3	$24.4	$28.2	$30.9
Avg Scholarship/Grant	$811	$653	$899	$893	$1,142	$1,214	$1,334	$1,370

As isndicated in the table on the prior page, the total number of awards distributed has increased from 128 in 1998, the first year the credit was offered, to 22,522 in 2005. The average award has also increased, from $811 in 1998 to $1,370 in 2005.

As DOR notes in its annual report, a student may receive more than one scholarship. The Goldwater Institute, which produced a 2004 survey of Arizona private schools, found that the average amount received per student, whether through one or more scholarships, was $1,500. Since the average 2004 award ($1,334) was less than the average amount scholarship recipients actually received ($1,500), this indicates that some students are being awarded more than one scholarship. Conversations with STO's confirmed this.

From FY 2004 to FY 2005, the average distribution grew from $1,334 to $1,370, an increase of 2.7%. Applying this growth rate to the Goldwater data, JLBC Staff estimates the average scholarship recipient actually received $1,540 in 2005. With total scholarship distributions running at $30.9 million in that year, the total number of students who actually received an award in 2005 is estimated to be 20,030.

According to the most recent available data, the total population of Arizona's private schools was 46,366 in FY 2004. This represents 4.7% of the total K-12 population. With 20,030 private school students receiving an award, JLBC Staff estimates 43.2% of the private school population is on a state-supported scholarship.

Historical data on private and public school enrollment is summarized in the table below.

Private and Public School Enrollment

	FY 1996	FY 1998	FY 2000	FY 2002	FY 2004	Total Growth	FY 02 – 04 Growth
Private School Enrollment [1/]	44,134	44,991	44,060	44,360	46,366	5.1%	4.5%
Public School Enrollment [2/]	723,794	772,332	840,130	879,106	933,734	29.0%	6.2%

1/ Data from the National Center for Education Statistics: Private School Universe Survey
2/ Data from the Arizona Department of Education: Annual Report

As indicated in the table, Arizona's private school enrollment has grown from 44,134 in FY 1996 to 46,366 in FY 2004, an increase of 5.1%. Most of this growth occurred from FY 2002 to FY 2004, when the private school population increased 4.5%. Public school enrollment increased 29.0% from FY 1996 to FY 2004, and 6.2% from FY 2002 to FY 2004. Over the long term, therefore, private school levels of growth have lagged significantly behind public school growth rates. As evidenced by the FY 2004 enrollment figures, however, private schools have recently experienced growth that is closer to that of the public schools.

In its 2004 survey of private schools, the Goldwater Institute found that the average tuition for a private K-8 school was about $3,700, while the average tuition was $5,500 at a private high school. With the average scholarship recipient receiving $1,500 in 2004, this would cover 40.5% of the cost of a K-8 school and 27.3% of the cost of a high school. Based on discussions with certain STO's, however, it appears that many of these organizations take tuition levels into consideration when distributing need-based awards. Goldwater also found that 89% of private schools offer financial aid, and that 80% of those schools work with STO's.

Complexity

The private STO tax credit does not appear to be unusually complex in its description, calculation or application.

Potential Performance Measures

Performance measures could include:

1. Percentage of scholarships and grants distributed to children whose family income is less than 185% of the level to become eligible for a free or reduced price lunch.

   It would appear that some, but perhaps not all, STO's would have this information available since financial need forms at least part of the basis for determining many scholarships. This measure, however, would require STO's to compile and report additional data.

2. Percentage of private school tuition paid for with award funding.

   This information would appear to be collected by STO's who distribute need-based scholarships, but would also require additional reporting.

3. Percentage of STO revenues retained for administrative costs.

   The STO's would have this information readily available.

Public School Extracurricular Activity Fee Credit

Public School Extracurricular Activity Fee Credit

Summary

- In 2005, statewide fees and contributions in support of public school extracurricular activities or character education programs were reported to be $35.3 million – The actual revenue impact of the credit, however, may be lower.
  - School districts – $32.0 million
  - Charter schools – $3.3 million
  - Only information on fees and contributions is available – Actual data on the number of claims, and the total amount claimed, has not yet been compiled.
- Ten districts received more than $1 million each and accounted for $18.3 million of the total.
- For school districts, the average contribution per student was $36. For charters, it was $60.
- A total of 214,664 taxpayers contributed, with an average contribution of $164.
- School districts with higher family income levels received more contributions, while districts with lower family income levels generated fewer contributions – Other factors to impact contributions could include:
  - District administration
  - Community involvement

Statutes

A.R.S. § 43-1089.01 (Individual Income Tax)

Description

This credit is provided to taxpayers for any fees or contributions made to a K-12 public school in support of extracurricular activities or character education programs. School districts are not allowed to use any portion of contribution revenues for program administration.

Extracurricular activities are defined in statute as "school sponsored activities that require enrolled students to pay a fee in order to participate." The definition includes, but is not limited to, the following list of items:

- Band uniforms;
- Equipment or uniforms for varsity athletics;
- Scientific laboratory materials; and
- In-state or out-of-state trips that are solely for competitive events.

Excluded from the definition of extracurricular activities are senior trips or events that are recreational, amusement or tourist activities.

Regarding character education, A.R.S. § 15-719 specifies that a character education program must include the following components:

- Instruction in the definition and application of at least 6 character traits;
- Activities, discussions and presentations on the application of the character traits; and
- Presentations by teachers or mentors who demonstrate the character traits.

Refundable

The credit is not refundable.

Carry Forward

The unused portion of the credit may be carried forward for a maximum of 5 consecutive years.

History and Rationale

The public school extracurricular activity fee tax credit was created by Laws 1997, Chapter 48 and became effective January 1, 1998. The credit was added as an amendment in the Senate Education Committee to a bill (HB 2074) which already contained provisions to establish a private school tuition organization tax credit. In its final form, therefore, Chapter 48 created both the public school extracurricular activity fee tax credit and the private school tuition organization tax credit.

As originally enacted, the maximum credit allowed was $200. Laws 2000, Chapter 1, 5th Special Session increased the cap to $250 for married taxpayers filing a joint return. Laws 2005, Chapter 334 increased the maximum credit for married couples filing jointly from $250 to $300 for taxable year 2005 and to $400 for taxable year 2006 and thereafter. The maximum credit for single individuals and heads of households was left unchanged at $200.

The credit did not initially contain a provision allowing a claim for contributions to character education programs. These programs were added with the passage of Laws 2000, Chapter 313.

The statute creating the tax credit does not include a specific statement of purpose or a rationale. According to a March 2002 Arizona State University Education Policy Studies Laboratory Report, the credit was added to HB 2074 as a compromise to opponents of the original legislation. The likely intent is to assist parents with the cost of extracurricular activities.

Revenue Impact

The Arizona Department of Revenue (DOR) has not yet compiled data on the actual number of claimants, or the actual dollar amount claimed, for this credit since its establishment. The department has indicated that it is currently compiling this information for tax year 2003.

Instead of tax form credit claims, DOR does report on contributions made to schools. The statutory language establishing the credit requires that a public school receiving fees or cash contributions report annually to DOR on the total number and dollar amount of fees and contributions received by the school, as well as the total dollar amount spent by the school, during the prior year.

Historical data on contributions are summarized in the table below.

Public School Extracurricular Activity Fee Tax Credit Contributions

	1998	1999	2000	2001	2002	2003	2004	2005
# of Fees/Contributions	74,242	109,748	149,215	166,468	143,697	201,407	213,987	214,664
$ Received (in millions)	$9.0	$14.8	$17.5	$20.0	$22.5	$27.8	$31.0	$35.3
Avg Fee/Contribution	$121	$135	$117	$120	$156	$138	$145	$164

As indicated in the table, the total amount of fees and contributions has increased from $9.0 million in 1998, the first year the credit was offered, to $35.3 million in 2005. The average contribution has also increased, from $121 in 1998 to $164 in 2005.

Although the number of contributions changed little from 2004 to 2005, the total amount of contributions and the average contribution each increased by over 10%. This was likely a result of the changes to the law that increased the cap on the allowable amount of the credit for married couples. Since the allowable cap was again raised for married couples in 2006, there may be another jump in contributions in the current year.

Given that DOR has not reported actual claims data, the revenue impact of this credit can not be determined with certainty; however, the annual impact may be less than the amounts cited in the table above. For any particular taxpayer, actual fees and contributions may exceed the maximum allowable credit, or a low tax liability might limit the amount of the credit that could be used. On the other hand, the unused portion of the credit can be carried forward for 5 years, allowing the taxpayer the opportunity to generate some portion of the credit over multiple years.

As noted earlier, school districts are not allowed to use revenues generated from contributions for program administration. The Arizona Association of School Business Officials (AASBO) has indicated that authorizing districts to use 5-10% of revenues for administration might benefit some districts with the costs of running these programs.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

This credit is not directly designed to promote economic development or spur new investments that would result in new jobs. Instead, according to DOR's August 2000 report "Income Tax Credits in Arizona," this credit is one of several tax credits in statute that are primarily intended to encourage cash contributions to certain target groups in society, such as the working poor or students in private or public schools.

In 2005, a total of $35.3 million in contributions was received by the districts and charters. Of that amount, the districts generated $32.0 million, while the charters collected $3.3 million. Ten districts, who generated over $1 million each, accounted for $18.3 million of total revenues. Three charter schools collected over $100,000 each. Ten districts and 26 charters reported receiving no contributions.

On a per pupil basis, contributions to school districts ranged from $0 to $398 per student, with an average per pupil contribution of $36. Charter contributions ranged from $0 to $1,135 per student, with an average contribution of $60 per student. (The charter amounts are based on only a portion of the data reported by DOR – In many cases it was difficult to match charter data provided by DOR with attendance data from the Arizona Department of Education.)

Comparing contributions per student with data on the percent of students eligible for a free or reduced price lunch, a statistical analysis of the data revealed that school districts with a lower percentage of free or reduced price lunch students generated a higher level of contributions per student. For example, the average percentage of students eligible for a free or reduced price lunch in all school districts was 61%. In districts that exceeded this level, the average contribution per student was $25, while districts that were below the 61% average yielded $46 per student. (Charter schools were not analyzed in a similar manner as free or reduced price lunch eligibility data was only available for a limited number of charters.)

School district free or reduced price lunch data is often used as an indicator of community family income levels. For example, a child from a family of 4 with an annual family income of $26,000 or less would qualify for a free lunch. A child from a family of 4 with an annual family income of $37,000 or less would qualify for a reduced price lunch. Consequently, districts with better than average family income levels received more contributions per student, while districts with lower than average family income levels generated less per student.

While the above analysis demonstrated that a relationship between family income and contribution levels exists, a further examination of the data established that the size of the district impacted the strength of this relationship. In larger school districts with over 1,000 students, the relationship was much more pronounced, meaning that income levels played a greater role in determining contributions in those

districts. The relationship was weaker in smaller school districts with 1,000 students or less, indicating that income levels only had a slight impact on contribution rates in those districts.

Since family income levels only minimally affected contribution rates in smaller districts, and accounted for some, but not all, of the difference in contributions in larger districts, there must be other factors that impact contribution levels. Although there is no data available to evaluate the impact of other factors, one such factor could include the ability of the school district administration to advertise the credit and make it accessible to potential contributors. For example, a quick survey of certain school districts showed that while most districts appear to advertise the credit on their web site and include a printable contribution form, some districts do not. Another factor that might impact contribution levels is the community's involvement in its school system. Community involvement could include volunteer organizations, such as the Parent Teacher Association.

Complexity

The public school extracurricular activity fee credit does not appear to be unusually complex in its description, calculation or application.

Potential Performance Measures

Performance measures could include:

1. Student participation rates in extracurricular activities and character education programs. While the school districts would have this information available, this measure would require them to compile and report additional data.

School Site Donation Credit

School Site Donation Tax Credit

Summary

- The first eligible year for the school site donation tax credit was 2001. Data has been compiled for individual tax credits through tax year 2003 and through tax year 2004 for corporate tax credits.
- More individual taxpayers have used the credit than corporate taxpayers. The corporate credit was claimed by a total of 3 taxpayers in 2004 while the individual credit was claimed by 31 taxpayers in 2003.
- The number of individuals claiming the credit decreased from 51 in 2001 to 31 in 2003.

Statutes

A.R.S. § 43-1089.02 (Individual) and A.R.S. § 43-1181 (Corporate)

Description

The statutes provide corporations and individuals an income tax credit for donating real property and improvements to a school district or a charter school for use as a school or as a site for the construction of a school. To qualify for the credit, a few conditions must be met, including the following:

- The value of the donated property must be determined by a certified appraisal as defined in A.R.S. § 32-3601that is conducted by an independent party and is paid for by the donee.
- An Arizona school district shall not accept the donation unless the School Facilities Board (SFB) has determined that the real property and improvements are suitable as a school site or as a school. SFB does not approve donations for charter schools.

The credit is equal to:

- Thirty percent of the value of the real property and improvements.
- In addition, if a site is donated to a school district, SFB will distribute a dollar amount equal to 20% of the fair market value of the land to the district as a reward for getting the donation. If a district does not use all of these monies on capital related projects within a year, the money will revert back to SFB.

Refundable

The credit is not refundable.

Carry Forward

The unused portion of the credit may be carried forward for a maximum of 5 consecutive years.

History and Rationale

This tax credit was created by Laws 2000, Chapter 334 and became effective on January 1, 2001. The purpose behind the credit is to provide encouragement for developers and/or landowners to make a real property donation for a school. The credit was first introduced in HB 2451. There have not been any substantive changes to the tax credit since its creation.

SFB is responsible for providing Arizona school districts with funding for new school construction, building renewal, and the correction of emergency deficiencies. SFB purchases land and approves new construction projects in order for districts to build new public schools throughout the state. When land or improvements are donated to districts, it results in cost savings for SFB and in turn the state since new school construction is funded through General Fund monies.

Revenue Impact

The cost of the individual credit has decreased from $2,869,400 in 2001 to $561,900 in 2003. The number of individual taxpayers claiming the credit has also decreased from 51 in 2001 to 31 in 2003. The average credit claimed decreased from $56,300 in 2001 to $18,100 in 2003.

The table below, which was provided by DOR, contains information on the individual income tax impact of the credit. The impact due to the corporate tax credit is not included in the table because corporate data was only available in 2004, since there were not enough corporate taxpayers that made donations to release information for the other years. It is unclear what size the donated sites and/or improvements are and how many individuals are donating each site and therefore claiming a credit.

School Site Donation Tax Credits from DOR

	2001	2002	2003	2004	2005
# of Claimants	51	66	31	NA	NA
Total Credit	$4,380,699	$3,711,546	$1,136,287	NA	NA
Credit Used	$2,869,356	$2,380,444	$561,908	NA	NA
Carry Forward	$1,518,242	$1,697,036	$386,963	NA	NA

# of Claimants – the number of taxpayers who claimed the credit in each year.
Total Credit – the total tax credits identified in each tax year, including any new credits and any credits carried over from a previous year and identified in that year.
Used – the total value of credits claimed in each year.
Carry Forward – the total credit identified but not used in each year. The full carry forward may not be reflected in the following year's estimate. For example, a taxpayer could have $200 of the credit identified in tax year 2001, use $100 of it in 2001 (leaving $100 as a carry forward). If that taxpayer did not identify or claim the credit in 2002, that $100 carry forward would not be included in the carry forward total for 2002.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

This credit is not directly designed to promote economic development or spur new investments that would result in new jobs. Instead, according to DOR's August 2000 report "Income Tax Credits in Arizona," this credit is behavioral in nature. It was designed to encourage the donation of real property to school districts and charter schools.

Although this credit was not directly intended to promote economic growth, it may still provide some economic benefits to Arizona districts and charter schools insofar as it provides less of a financial burden to SFB and charter schools in terms of financing new capital projects.

Since SFB must approve school site donations for Arizona school districts, they track all land donations their districts receive. When comparing this data on the following page with the table above, please be aware that the tax credit claimed by individuals and corporations is equal to 30% of the appraised value of the land. This data from SFB only includes land donations. SFB has not received real property donations other than land. Donations made to charter schools are not tracked.

School District Land Donations from SFB					
	2001	**2002**	**2003**	**2004**	**2005**
# of Donations	19	18	12	10	18
Total Acres Donated	247	274	155	149	313
Donation Value	$3,489,852	$4,386,411	$2,492,356	$2,050,223	$8,352,108
Average Donation	$183,676	$243,690	$207,696	$205,022	$464,006

Complexity

The credit does not seem to be unnecessarily complex in terms of its administration and approval process, as evidenced by the SFB approval process before a district can accept a land donation.

Potential Performance Measures

Performance measures could include:

1. For all qualifying school districts and charter schools to report on the number of acres (for a school site) and square feet (for an improvement) donated each year. SFB already tracks their land donations in terms of acres but charter schools do not track their donations.

Solar Hot Water Heater Stub Out and Electrical Vehicle Recharge Outlet Credit

Solar Hot Water Heater Plumbing Stub Outs And Electric Vehicle Recharge Outlets Credit

Summary

- The cost of the credit was $5,348 in tax year 2004, the latest year for which data is available.
- The credit was claimed by 12 taxpayers in tax year 2004 with an average claim of $445.
- After peaking in tax year 2000, usage of these tax credits trended downward.
- Recent trends have favored other technologies than those promoted by these tax credits.

Statutes

A.R.S. § 43-1090 (Individual)
A.R.S. § 43-1176 (Corporate)

Description

The statutes provide individuals or corporations with an income tax credit for installing residential 1) solar water heater plumbing stub outs, or 2) electric vehicle recharge outlets. A "stub out" is a fixture that is designed to accommodate additions to the original plumbing. The statute defines the specific types of pipes and wires that are required for the stub out to qualify for the tax credit. The recharge outlets must be connected to the utility system by a dedicated line that meets various codes and industry standards.

The credit cannot exceed $75 for each installation for each separate dwelling unit. The credit may be transferred from the builder to the purchaser of the dwelling.

Refundable

The credit is not refundable.

Carry Forward

The unused portion of the credit may be carried forward for a maximum of five consecutive years.

History and Rationale

The federal government first introduced individual solar energy tax credits with the Energy Tax Act of 1978. Arizona created its first solar energy tax credit in 1979. The federal tax credit expired in 1985 and Arizona's tax credit expired in 1987.

Arizona's current solar energy device tax credit was first passed and signed into law in June 1994 (Laws 1994, Chapter 117) and became effective for the 1995 tax year. Laws 1997, Chapter 218 amended the list of qualifying solar energy devices and created a separate tax credit for plumbing stub outs and electric vehicle recharge outlets. Laws 2006, Chapter 333 established a corporate income tax credit for solar energy devices and capped the total amount of credit available at $1 million per year. While the 1994 and 1997 laws were limited to devices installed at residences, the 2006 legislation provided credits for commercial and industrial purposes and established a maximum credit of $5,000 for a single residence and $25,000 for a commercial building. Taxpayers who claim the tax credits for solar water heater stub outs and electric recharge outlets may also claim the tax credits for other qualifying solar energy devices.

The statutes creating the tax credits for solar stub outs and electric vehicle recharge outlets do not include a specific statement of purpose or a rationale. The credits were included in a floor amendment to SB 1523 that was passed by the House Committee of the Whole. An earlier bill, HB 2440, which included provisions for the solar energy device tax credit, was heard by the House Ways and Means Committee. At

that time, the bill's sponsor stated the purpose of the solar energy tax incentives was to restore Arizona to a position of leadership in the solar energy field and to promote energy efficiency.

Revenue Impact

The cost of the individual tax credit was $5,348 in 2004, the last year for which reasonably complete data is available. While claims for the corporate credit were recorded for tax year 2000, they were too few to meet the Department of Revenue's confidentiality standards for releasing the data.

The following table summarizing the individual income tax impact of this credit was provided by the Arizona Department of Revenue.

	1998	1999	2000	2001	2002	2003	2004
# of claimants	23	35	35	18	15	2	12
Total credit	$12,352	$16,589	$21,308	$16,951	$4,920	*	$14,646
Used	$8,874	$7,944	$11,566	$7,804	$3,312	*	$5,348
Carry forward	$3,478	$8,915	$9,742	$9,147	$1,608	*	$9,298

# of claimants – the number of taxpayers who claimed the credit in each year.
Total credit – the total tax credits identified in each tax year, including any new credits and any credits carried over from a previous year and identified in that year.
Used – the total value of credits claimed in each year.
Carry forward – the total credit identified but not used in each year. The full carry forward may not be reflected in the following year's estimate. For example, an individual could have $500 in credit identified in tax year 2003 and use $400 of it in 2003 (leaving $100 as a carry forward). If that individual didn't identify or claim that credit in 2004, that $100 carry forward would not be included in the carry forward total for 2004.
* – Data for tax year 2003 cannot be disclosed due to laws protecting taxpayer confidentiality.

Solar Energy Industry Trends

When the solar stub out credit was created in the late 1990s, water heaters were the primary focus of solar energy technology and public policy. In spite of federal and state tax incentives and public utility rebate programs, solar water heaters did not prove to be widely popular among consumers and businesses. In spite of the credit, there was little interest from home builders and buyers in plumbing modifications for solar water heater installations.

In recent years, solar energy technology has evolved, and tax incentives and regulatory policies have emerged to encourage investment in photovoltaic systems that generate electricity rather than merely heat water. At the same time, growing interest in other forms of renewable energy, such as wind, biomass, and biodiesel fuels, has diverted some energy investments away from solar energy technologies.

Electric Vehicle Industry Trends

The federal government established a tax credit for the purchase of qualified electric vehicles with the Energy Policy Act of 1992. It was extended by the Working Families Tax Relief Act of 2004. The credit is for 10% of the cost of the vehicle up to a maximum of $4,000. However, this tax credit was reduced by 75% for 2006 and is scheduled to expire in 2007. The federal government also provided subsidies to manufacturers to promote the development of electric vehicles.

In late 1996, General Motors (GM) introduced its rechargeable electric vehicle, the EV1. GM manufactured about 1,100 EV1s and leased approximately 800 of them to customers in California and Arizona. The cars were able to maintain highway speeds and performed much like conventional vehicles but were relatively expensive and had limited range between charges. GM cancelled the EV1 program in 2003.

Since then, the automotive industry has focused on hybrid vehicles that combine internal combustion engines with electric motors to achieve reduced emissions and improved fuel economy. These vehicles are more popular among consumers than the all-electric vehicles were and do not need to be plugged in to recharge their batteries.

The Neighborhood Electric Vehicle (NEV) is another class of vehicle that continues to be sold by several manufacturers. Some of these vehicles can attain speeds up to 25 miles per hour and are allowed in some jurisdictions to share the road with conventional vehicles. However, NEVs can be recharged with a conventional electric outlet and do not require a special dedicated line.

Economic Benefits

Measurable Economic Development
New Investments
Creation of New Jobs or Retention of Existing Jobs

We cannot measure the economic development, new investment, or the creation or retention of jobs related to this credit with the data available. We do know that investment in solar energy equipment has increased in recent years, while the market for plug-in electric vehicles has declined as the hybrid electric vehicle industry has evolved. We are unable to establish a direct link between the credit and subsequent economic development or a specific number of jobs.

Complexity

The credit does not appear to be unusually complex in its description, calculation and application. However, the low usage of this tax credit does not appear to warrant the related administrative costs.