Joint Legislative Budget Committee
Staff Memorandum

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DATE: December 2, 2011

TO: Members, Joint Legislative Income Tax Credit Review Committee

FROM: Hans Olofsson, Chief Economist

SUBJECT: 2011 INCOME TAX CREDIT REVIEW

This memo transmits background materials for the December 7**,** 2011 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 provided a schedule for review of corporate and individual income tax credits. The credits scheduled for review in 2011 include:

- Credit for Investment in Qualified Small Businesses ("Angel Tax Credit")
  A.R.S. § 43-1074.02 (Individual)
- Credit for Residential Solar Energy Devices
  A.R.S. § 43-1083 (Individual)
- Credit for Corporate Contributions to School Tuition Organizations
  A.R.S. § 43-1183 (Corporate)

As a result of a law enacted by the Legislature in 2010 (Laws 2010, Chapter 225), the Department of Revenue (DOR) is now authorized to disclose confidential statistical information gathered from taxpayers. Prior to Chapter 225, DOR did not disclose credit information unless a certain minimum number of taxpayers had claimed the credit. The non-disclosure of credit information in such cases was intended to protect taxpayer confidentiality. The credits reviewed in 2011 have been claimed by a sufficient number of taxpayers to allow DOR to disclose all relevant credit information.

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.

The Committee last reviewed the residential solar energy device tax credit in 2004. The angel investment and corporate school tuition organization credits will be reviewed for the first time in 2011.

Limitations

There are several limitations that affect the evaluation of income tax credits. For example, the timeliness of data is one such limitation. Because tax credit data must generally be compiled manually from actual hard-copy tax returns, corporate credit data is currently available only through tax year 2009. Both 2009 corporate tax credit data and 2010 individual tax credit data are preliminary and thus subject to revision.

A second limitation is the 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. Chapter 238, however, requires any new credit to include a clause that explains the rationale and objective of the credit (A. R. S. § 43-223).

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Finally, the evaluation of tax credits in terms of their economic benefits to the state is often difficult to conduct since the data required to do so is rarely available. For example, while the amount of certified angel investments is reported, there is no data on the number of new jobs associated with these investments.

2011 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.

Transferable - whether or not any unused portion of the credit can be sold or otherwise transferred to other taxpayers. None of the credits included in the current review is transferable.

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. The 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.

The Staff also reviewed summaries and minutes of committee and subcommittee hearings that were held prior to adoption of the credits. Various agencies were contacted, including DOR and the Arizona Commerce Authority.

HO:mt
Attachment
xc: Reed Spangler, Senior Policy Advisor, Senate
Jeff Winkler, Policy Advisor, Senate
Carolyn Speroni, Research Analyst, Senate
Lorenzo Romero, Director of Fiscal Policy, House
Mark Bogart, Senior Economist/Policy Advisor, House
Daniel Plumhoff, Research Analyst, House

Angel Investment Credit

Tax Credit for Investment in Qualified Small Businesses ("Angel Investment Credit")

Summary

- The credit is limited to individual income taxpayers and applies to investments of between $25,000 and $250,000.
- The credit is subject to an aggregate cap of $20 million over the life of program (July 1, 2006 to June 30, 2016).
- A total of $10.1 million in credits have been authorized to date, representing $31.1 million in qualified investments.
- Through tax year 2010, $1.75 million in credits have been used.
- The credit was claimed by 163 taxpayers in tax year 2010 at an average credit cost of $3,600.
- The 2011 "Arizona Jobs Bill" expanded the credit by eliminating the capital gains tax on income derived from qualified angel investments, beginning in 2014.

Statute

A.R.S. § 43-1074.02 (Individual Income Tax)

Description

This credit is provided to investors who make investments in targeted small businesses certified by the Arizona Commerce Authority (ACA). A qualified ("angel") investor must be either an individual, or a limited liability company, sub-chapter S corporation, or partnership. C corporations are not eligible for the credit.

An investor that wants to obtain tax credits under this program must submit an application for authorization to ACA for each investment in a qualified small business. To qualify for the credit, the investment in a qualified small business must be at least $25,000. Additionally, the angel investor, along with his affiliates, cannot possess more than 30% of the total voting power of all equity securities of the qualified small business.

The tax credit is equal to 30% of the qualified investment unless the investment is made in a rural or bioscience company, in which case the credit is 35%. The credits can be claimed over 3 years and cannot exceed the percentages (of the qualified investment amount) shown in the table below.

Qualified Investment in:	1st Year	2nd Year	3rd Year	Total Credit
Rural or Bioscience Company	12%	12%	11%	35%
Any Other Company	10%	10%	10%	30%

The tax credits, which are authorized by ACA on a first come, first served basis, are limited to a total of $20 million over the life of the program, from July 1, 2006 through June 30, 2016. Taxpayers are allowed to claim authorized credits through December 31, 2019. For an individual investor (and his affiliates), the credit is applied to investment amounts of up to $250,000 in a single calendar year for investments in one or more qualified small businesses. Investment amounts in excess of $250,000 do not generate tax credits.

Any firm that wants to receive qualified angel investments must submit a separate request for certification to ACA. To be a "qualified small business," the firm can be any type of business entity except a sole proprietor. Additionally, the business is required to maintain a portion of its operations in the state, and have at least two non-administrative full-time employees who are Arizona residents. The business is neither allowed to engage in activities involving human cloning or embryonic stem cell research, nor have assets exceeding $2 million ($10 million after December 31, 2011). Once a firm has received a total of $2 million in qualified investments, it is no longer allowed to receive credit-eligible angel investments.

Refundable

The credit is not refundable.

Carry Forward

The tax credit may be carried forward for 3 taxable years.

History and Rationale

This credit was created by Laws 2005, Chapter 316 and became effective January 1, 2007. The credit was originally scheduled to expire after December 31, 2014. The credit has since been extended by 5 years. The purpose of the credit is to "encourage taxpayers to invest capital in businesses that are in the early stages of development."

Based on a bill summary (SB 1335) issued by the House of Representatives on May 16, 2005, the angel investment credit was created based on a recommendation by the *Capital Formation Committee* within the *Governor's Council of Innovation and Technology*. Committee Minutes indicate that sponsors of the legislation argued that the credit would encourage investment in the high-tech sector by offering incentives to those who wish to invest in start-up companies in Arizona.

Laws 2011, 2nd Special Session, Chapter 1 ("Arizona Jobs Bill") amended the Angel Investment Program by: (1) extending ACA's credit authorization through June 30, 2016, (2) increasing the amount of assets a qualified small business is allowed to have from $2 million to $10 million, beginning in 2012, and (3) eliminating income taxes on capital gains from investments in qualified small businesses, beginning in 2014. The aggregate credit cap of $20 million was retained.

Revenue Impact

From the Angel Investment Program's inception in FY 2007 through the first months of FY 2012, ACA has authorized a total of $10.1 million in tax credits. These credits represented certified investments of $31.1 million by more than 450 qualified angel investors. With a total credit cap of $20 million and $10.1 million already authorized, there are a total of $9.9 million in credits currently remaining for angel investors.

It is important to note that not all of the credits authorized by ACA will necessarily be claimed by the taxpayers. In addition, there is also a delay between the time of the investment and the time the credit can be claimed. The first year an investor can claim a credit is the tax year following the calendar year in which the investment was made. For example, for an investment made in calendar year 2011, ACA would authorize the tax credit to be claimed over 3 consecutive years, beginning in tax year 2012. The investor would claim the first one-third of the credit for tax year 2012, which generally occurs during the tax filing season of calendar year 2013. The last one-third of the credit would not be claimed until calendar year 2015. Note that each authorized credit results in 3 annual tax credit claims.

The table below, which was provided by the Department of Revenue (DOR), shows actual credit claims by tax year since the inception of the program. There were a total of 163 credit claims in tax year 2010 (last year for which data is available), which resulted in a tax revenue loss of $580,849. Total credit use between tax years 2007 and 2010 was $1.75 million. Credit data for tax years 2009 and 2010 is preliminary.

Tax Year	# of Claimants	Total Credit Available	Credit Used	Carry Forward
2007	73	$395,916	$276,742	$119,174
2008	111	$796,219	$395,014	$401,205
2009	174	$1,660,973	$502,538	$1,158,435
2010	163	$2,329,055	$580,849	$1,748,206

# of Claimants - the number of taxpayers who claimed the credit in each year.
Total Credit Available - 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.
Credit 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 $10,000 of the credit identified in tax year 2007, use $5,000 of this amount in 2007 and leave $5,000 as a carry forward. If this taxpayer did not identify or claim the credit in 2008, the $5,000 carry forward would not be included in the credit carry forward total for 2008.

Between FY 2007 and FY 2011, ACA certified a total of 120 firms as qualified small businesses, of which 85 were certified more than once. Of these 120 certified small businesses, 76 received qualified investments. Among the 76 firms that received qualified angel investments, 13 companies received amounts exceeding $500,000. Two companies received the maximum allowable investment amount of $2 million.

Economic Benefits

New Investments
Creation of New Jobs or Retention of Existing Jobs
Commercial Infrastructure Development

The National Governors Association (NGA) issued a comprehensive report in 2008 on angel investments. This report ("State Strategies to Promote Angel Investment for Economic Growth") indicated that Arizona was one of 18 states nationwide that offered some type of angel investment incentive in 2008. The report identified angel investors as "wealthy individuals with business or technology backgrounds who provide entrepreneurs with capital, connections, and guidance." Angel investors typically provide early-stage financing of between $5,000 and $100,000 per investment in local and regional ventures, primarily in the high-tech sectors. According to the report, angel investors provide up to 90% of early-stage financing not obtained from the family and friends of entrepreneurs.

While the NGA report stressed the importance of developing metrics to monitor and evaluate the impact of state tax incentives on angel investments, it also conceded that thus far "the economic benefits of the investment tax credit to states are unknown." The report identified two reasons for this "gap in knowledge" related to angel investment credits: (1) lack of data and (2) difficulty of measuring or quantifying the economic impacts of such credits. Although the effectiveness of the credit remains unknown, the report noted that some industry representatives have opined that these credits are more likely to increase the amount rather than the number of angel investments. While a tax credit increases the effective benefit-cost ratio of an investment, it does necessarily improve the quality of the ventures available to investors.

To date, the Arizona Angel Investment Program has resulted in qualified investments totaling $31.1 million. There is no data, however, on the extent to which these tax-subsidized investments have resulted in successful "exits" such as acquisitions or initial public offerings. In economic development terms, "exit" refers to the strategy used by angel investors to recoup the capital that they have invested in start-up companies. Additionally, there is no data on the number of new jobs that the Angel Investment Program has created thus far.

While state-specific data on angel investments is unavailable, there are national statistics published by the Center for Venture Research (CVR) at the University of New Hampshire. CVR, which has been conducting research on the angel market since 1980, reports its findings on a regular basis. According to CVR's most recent annual report, angel investments contributed to the creation of an estimated 370,000 new jobs in the U.S. in 2010. For the U.S. as a whole, this figure translated into 6 new jobs per angel investment in 2010. The same report indicated that mergers and acquisitions represented two-thirds of angel exits in 2010 and that more than a quarter of all exits were bankruptcies. CVR estimated that about half of all angel exits in 2010 were profitable with annual returns of between 24% and 36%. Since the CVR report, which was based on survey responses by angel investors, did not provide state-specific information, it is not known to what extent Arizona's angel market is reflected in CVR's annual report.

Complexity

According to ACA, there has been no feedback from the industry to date that would indicate that the credit is unnecessarily complex in terms of its application, administration, and approval process.

Potential Performance Measures

Performance measures could include:
1. A requirement to report on the number of new jobs created by firms that have received qualified investments.
2. A requirement to report on the allocation of qualified investments by industry.
3. A requirement to report on the number of qualified small businesses that are associated with successful exits, such as initial public offerings or buyouts, within a stipulated period of time.

Prior Review

None.

Residential Solar Energy Device Credit

Residential Solar Energy Device Tax Credit

Summary

- The cost of the credit was $922,400 in tax year 2009, the last year for which data is available.
- The credit was claimed by 2,281 taxpayers in tax year 2009 at an average of $404 per claim.
- The credit is restricted to individual income taxpayers.

Statute

A.R.S. § 43-1083 (Individual)

Description

The statute provides an individual with an income tax credit for installing a solar energy device in the taxpayer's Arizona residence. Solar energy devices are defined in A.R.S. § 42-5001 as systems or mechanisms that provide heating, cooling, electrical and mechanical power, daylighting, and energy storage.

The solar energy credit is equal to 25% of the cost of the device, up to maximum of $1,000. The maximum credit in a taxable year cannot exceed $1,000, and the total solar energy credits allowed for a single residence cannot exceed $1,000. The maximum credit a taxpayer may take for all solar energy devices installed in the same residence cannot exceed $1,000.

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 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. The Energy Policy Act of 2005 established a federal tax credit of 30% of expenditures on qualified residential solar electric systems. The Energy Improvement and Extension Act of 2008 extended this credit for solar electric systems purchased before December 31, 2016 and removed the federal credit cap of $2,000.

Arizona's current solar energy device tax credit was signed into law in June 1994 (Laws 1994, Chapter 117) and became effective for the 1995 tax year. It has been substantively amended once. Laws 1997, Chapter 218 amended the list of qualifying solar energy devices to exclude "a solar hot water heater plumbing stub-out that was installed by the builder of a house or dwelling unit before title was conveyed to the taxpayer." This law also created a separate tax credit for these devices (A.R.S. § 43-1090).

The statute creating the tax credit does not include a specific statement of purpose or a rationale. The credit was included as 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 that 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.

The credit was intended to promote the growth of the solar energy industry and the development of sustainable solar technologies. A related goal would be to reduce the consumption of non-renewable fuels that would otherwise be used to generate electricity.

By itself, the credit creates an incentive to purchase solar energy systems by reducing the cost. Historically, the credit was used mostly to purchase solar water heaters and daylighting systems. However, in recent years the credit has increasingly been used in purchases of photovoltaic (PV) solar energy devices. Electric utility companies in the state also offer customer rebate programs in order to meet either regulatory or self-imposed standards for renewable energy generation. In combination with the state tax credit, the cost of a solar PV system which provides half of the power for a typical home can be reduced by approximately 25%. When also factoring in federal tax credits, the cost can be reduced by approximately 50%.

Revenue Impact

The cost of the credit was $922,400 in 2009, according to preliminary estimates. The following table summarizing the individual income tax impact of this credit was provided by the Arizona Department of Revenue.

Tax Year	# of Claimants	Total Credit Available	Credit Used	Carry Forward
1998	2,144	$783,799	$673,892	$109,420
1999	2,765	$1,065,616	$903,738	$152,877
2000	2,560	$1,032,948	$889,508	$143,012
2001	2,273	$1,021,789	$866,027	$155,194
2002	2,336	$1,131,895	$920,767	$210,656
2003	2,686	$1,314,084	$1,050,582	$250,263
2004	3,044	$1,483,235	$1,210,467	$272,768
2005	3,723	$1,942,747	$1,587,755	$354,155
2006	4,198	$2,544,690	$2,044,101	$499,708
2007*	2,509	$1,573,469	$1,209,393	$363,717
2008*	4,982	$3,110,811	$2,499,721	$610,709
2009*	2,281	$1,410,583	$922,376	$487,872

# of Claimants – the number of taxpayers who claimed the credit in each year.
Total Credit Available – 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.
Credit 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 2008, use $400 of it in 2008 (leaving $100 as a carry forward). If that individual did not identify or claim that credit in 2009, that $100 carry forward would not be included in the carry forward total for 2009.

*Data for these years are preliminary estimates.

Economic Benefits

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

We do not have a measure of the magnitude of 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 and that thousands of taxpayers have used the credit. According to the solar manufacturing and electric utility industries, the credit helped Arizona to remain active in encouraging energy conservation and the development of solar photovoltaic electricity generation technology. We are unaware of studies quantifying these impacts, though Solar Census studies show that Arizona's total solar-related employment increased from 3,800 in 2010 to 4,800 in 2011, or approximately 25%.

Complexity

The solar energy device credit does not appear to be unusually complex in terms of its application, administration, and approval process.

Potential Performance Measures

Performance measures could include:

1. Total megawatt hours of electricity generated from solar energy devices.

2. Total megawatt hours of electricity conserved from non-renewable energy sources.

3. Number of persons employed in businesses that manufacture, install or service residential solar energy devices.

The statute does not impose any requirements related to these measures. Arizona Public Service Co. (APS) and Unisource (TEP and Citizens Utilities) measure and report the amount of solar electricity generated in their service territories to the Arizona Corporation Commission on a regular basis. Salt River Project publicly reports similar information. However, the amount of energy saved by other solar energy devices, including water heaters, can only be estimated, and requiring this information would create an additional reporting burden. According to a 2011 study by the Solar Foundation, Arizona employs 4,786 people in a range of solar-related jobs, which is third most of any state.

Prior Review

The credit was last reviewed by the Joint Legislative Income Tax Credit Review Committee in 2004. The Committee recommended at that time that the credit be continued and placed on the 2009 review schedule. This date was later moved back to 2011 due to changes in the income tax credit review schedule enacted by Laws 2009, Chapter 32.

Credit for Corporate Contributions to School Tuition Organizations

Corporate Contributions to School Tuition Organizations

Summary

- Current law authorizes tax credits for 4 different types of corporate or insurer contributions to school tuition organizations (STOs). This review pertains only to corporate contributions to STOs awarding "low-income scholarships" (A.R.S § 43-1183).
- The Arizona Department of Revenue (DOR) essentially administers the corporate and insurer (A.R.S. § 20-224.06) programs as a single program. As a result, separate "corporate" versus "insurer" data for STO-related programs are not always available.
- Corporations and insurers made $11.3 million in contributions to STOs for "low-income scholarships" in FY 2011 (latest data for contributions, which are reported on a fiscal year basis). Contributions may not always result in a tax credit. In the latest year of available data (TY 2009), only $5.5 million of credits were used.
- To the extent that scholarships result in students not attending public school, the credit results in foregone General Fund costs. To offset the $5.5 million in tax credits, 1,100 students would have to be diverted from public school due to the scholarships.

Statute

A.R.S. § 43-1183

Description

Current law authorizes tax credits for 4 different types of corporate or insurer contributions to school tuition organizations (STOs):

1. Corporate contributions to STOs awarding "low-income scholarships" (A.R.S § 43-1183),
2. Insurer contributions to STOs awarding "low-income scholarships" (A.R.S. § 20-224.06),
3. Corporate contributions to STOs awarding scholarships to "displaced or disabled" pupils (A.R.S § 43-1184), and
4. Insurer contributions to STOs awarding scholarships to "displaced or disabled" pupils (A.R.S § 20-224.07).

This review pertains only to "corporate/low-income" contributions (A.R.S § 43-1183).

This credit is provided to corporations for voluntary contributions to STOs. A 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 non-governmental elementary or secondary schools. A STO may use up to 10% of corporate contributions for administration expenses.

Total corporate plus insurer contributions to STOs for "low-income scholarships" were capped at approximately $20.7 million for FY 2011 pursuant to A.R.S. § 43-1183C1, which increases the cap by 20% annually. Because of the cap, STO contributions from corporations and insurers must be pre-approved by DOR in order to be eligible for a tax credit. For FY 2011 (latest reported data for contributions), DOR pre-approved $11.4 million in combined corporate and insurer contributions to STOs for "low-income scholarships" and corporations and insurers made $11.3 million in related donations (*see Table 1 below*). Contributions, however, do not always result in the taxpayer using the credit. For example, the taxpayer may lack sufficient liability to take the credit *(see Table 2).*

Contributions from this credit must only be made available for scholarships or tuition grants to students whose family income does not exceed 185% of the income limit required for a student to qualify for reduced-price lunch under the National School Lunch and Nutrition Acts. In FY 2010, the maximum annual income for a family of four was $75,467. Students also must have attended public school in the prior school year, be entering kindergarten, or have received tuition assistance from a STO during the prior school year. The maximum scholarship amounts for FY 2012 are $4,700 for grades K-8 and $6,000 for grades 9-12. Those amounts increase $100 annually pursuant to A.R.S. § 43-1504C. Lastly, a corporation may not use a tax credit for any contribution if a corporation designates the scholarship for a particular student.

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.

Transferable

The credit is not transferable.

History and Rationale

The corporate STO "low-income scholarship" tax credit was created by Laws 2006, Chapter 14 and became effective starting in FY 2007. The purpose of the program is to encourage corporate contributions to STOs that award "low-income scholarships" that enable students to attend non-governmental elementary and secondary schools.

As originally enacted, total corporate tax credits to STOs for "low-income scholarships" was capped at $5 million pursuant to A.R.S § 43-1183C1. Laws 2006, Chapter 325 raised the cap to $10 million and by an additional 20% annually starting in FY 2008. As of FY 2011, the cap was $20.7 million for corporate and insurer contributions combined. As a result of the cap, corporations and insurers must receive preapproval from the Department of Revenue for any donation to STOs.

In September 2006, the Arizona School Boards Association and the Arizona Chapter of the American Civil Liberties Union filed suit against the state regarding this tax credit. In *Green v. Garriott*, plaintiffs alleged that corporate contribution "set asides" in the associated laws violated the "general and uniform" provision of the state's public education system. The Maricopa County Superior Court ruled in favor of the state in a ruling that was later upheld by the Arizona Court of Appeals. The plaintiffs appealed to the Arizona Supreme Court, but in 2009 it declined to review the case, making the Maricopa County Superior Court ruling stand.

The program was originally scheduled to sunset on June 30, 2011, but that date was repealed by Laws 2009, Chapter 168. The program's enabling statute (A.R.S § 43-1183) also has been amended in recent years to include references to the related insurer premium tax credit and to new STO administrative requirements enacted by Laws 2009, Chapter 292.

Revenue Impact

Table 1 summarizes corporate and insurer contributions to STOs for "low-income scholarships" since FY 2007. In FY 2011 (the most recent data year for contributions), 68 corporations and 11 insurance companies donated a total of $11.3 million to STOs.

Table 1

Corporate Contributions to School Tuition Organizations for "Low-Income Scholarships"

Fiscal Year 1/	Statutory Limitation 2/	# of Corporations	$ Approved by DOR	$ Received by STOs
2007	$10,000,000	108	$9,740,800	$9,535,800
2008	$12,000,000	73	$12,116,000	$11,996,000
2009	$14,400,000	98	$10,816,006	$10,494,506
2010	$17,280,000	63	$8,121,508	$8,100,008
2011	$20,736,000	68 3/	$11,365,351	$11,324,351

1/ DOR reports contributions on a fiscal year rather than tax year basis, since the statutory limitation on such contributions in A.R.S. § 43-1183C is on a fiscal year basis. DOR, however, reports corresponding tax credit and scholarship data on a tax year basis.
2/ The statutory limitation increases by 20% annually pursuant to A.R.S. § 43-1183C1.
3/ Plus 11 insurers.

The table above notes that the statutory limit on contributions increases by 20% each fiscal year. While that limit has increased by 107% from FY 2007 to FY 2011, contributions increased by a total of $1,788,551, or 18.8%, over this period. This trend of increasing donations counters the decrease in the number of corporations making donations, which fell from FY 2007 to FY 2011 by 40 corporations, or 37.0%. The average contribution made by corporations in FY 2007 was $88,294. This amount increased by 88.6% to $166,535 in FY 2011.

DOR also reports tax credits claimed for STO contributions, although on a tax year basis (January 1 - December 31) rather than a fiscal year basis (July 1 - June 30). *Table 2* summarizes tax credit data for the program since its inception (2009 data are preliminary):

Table 2

Corporate Contribution Credit Claims

Tax Year	# of Claims	Credits Claimed	Credits Used	Carry-Forward
2005	5	$530,000	$526,260	$3,740
2006	57	$9,925,940	$9,669,596	$256,394
2007	62	$11,625,278	$10,823,475	$801,803
2008	71	$6,825,214	$5,392,745	$1,432,469
2009 (preliminary)	54	$6,720,638	$5,538,024	$1,182,614

Not all corporate contributions result in tax credits. In Tax Year 2008, for example, corporations contributed $9.1 million to STOs (part during FY 2008 and part during FY 2009), but only claimed $6.8 million in credits, of which $5.4 million was used to offset actual tax liabilities *(see Table 2)*. A.R.S. § 43-1183E allows corporations to carry forward any claimed but unused credit for up to 5 years.

The tax credit may impact state K-12 education costs. Since students receiving the scholarships must have attended a government-funded school, be entering kindergarten, or have used the same scholarship in the previous year, at least some students who receive “low-income scholarships” from STOs probably otherwise would be in public schools. Currently each pupil added to the statewide K-12 Average Daily Membership (ADM) count costs the state General Fund on average about $5,000. The state General Fund, therefore, saves an average of about $5,000 for each STO “low-income scholarship” recipient who otherwise would attend public school. This implies that the program is currently “breaking even” if at least 1,100 students no longer attended public schools because of STO “low-income scholarships” ($5.5 million in credits used in TY 2009 ÷ $5,000 average state cost per public school student ≈ 1,100 students). The number of students receiving a STO “low-income scholarship” who otherwise would be attending state-funded public schools, however, is unknown. The “break even” number of public school “leavers” under the program varies from year to year depending on the total value of tax credits used.

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. The amount of SFB “foregone costs” due to the credit, however, is unknown. In addition, the SFB new school construction and building renewal formulas are not currently being funded.

Economic Benefits

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 statutes 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 TY 2010, STOs distributed $9.3 million in scholarships (4,215 scholarships to 187 schools) from corporate and insurance premium tax contributions (*see Table 3*). The $9.3 million scholarship total for TY 2010 does not correspond to the reported contribution total from a particular year, since scholarships are reported on a tax year basis but contributions are reported on a fiscal year basis (plus STOs can fund some current year scholarships with prior year carry forward balances).

Table 3

Scholarships for Tax Year 2010 by School Tuition Organization

School Tuition Organization	# of Recipients	# of Schools	Scholarship Amount	Average
Arizona Corporate Scholarship Fund	16	9	$ 30,066	$1,879
Arizona Episcopal Schools Foundation	48	3	137,277	2,860
Arizona Independent Schools Scholarship Foundation	49	2	242,200	4,943
Arizona Private Education Scholarship Fund	3	2	9,000	3,000
Arizona School Choice Trust	275	64	696,161	2,531
Brophy Community Foundation	566	24	1,397,995	2,470
Catholic Tuition Organization of the Diocese of Phoenix	1,442	40	2,021,176	1,402
Catholic Tuition Support Organization Diocese of Tucson	854	23	2,278,486	2,668
Christian Scholarship Foundation	12	2	21,401	1,783
Flagstaff Scholarship Fund	105	2	324,050	3,086
Institute for Better Education	265	57	487,074	1,838
Jewish Education Tax Credit Organization	34	1	159,800	4,700
Northern Arizona Christian School Scholarship Fund	5	1	3,208	642
Pappas Kids Schoolhouse Foundation	5	3	25,680	5,136
School Choice Arizona	379	46	1,060,231	2,797
School Tuition Association of Yuma	28	5	29,375	1,049
Tuition Organization for Private Schools	129	41	367,563	2,849
TOTAL	**4,215**	**187** 1/	**$9,322,243**	**$2,212**

1/ Unduplicated total, as some schools received scholarships from more than one STO.

Historically, the average scholarship has remained relatively constant, as shown in *Table 4*. Between FY 2007 and FY 2010, there was an increase of 2,268 scholarships distributed, or 116.5%. At the same time, the total amount of dollars distributed rose by $4,700,953, or 101.7%. DOR notes in its report for STO-related individual income tax credits that individual students may receive scholarships from more than one STO.

Table 4

School Tuition Organization Scholarships

Tax Year	# Scholarships	# Schools	$ Distributed	Avg. Scholarship
2007	1,947	156	$4,621,290	$2,374
2008	2,967	176	$7,516,750	$2,533
2009	3,652	169	$7,881,787	$2,158
2010	4,215	187	$9,322,243	$2,212

Complexity

DOR indicates that it is administratively simple for corporations to donate to STOs and claim the credit, and for STOs to receive pre-approval from DOR to receive corporate donations. DOR notes, however, that STOs can only award scholarships from this credit to "low income" students, which complicates the scholarship awarding process for STOs. DOR also notes that the annual reporting process for donations is time-consuming for both STOs and

DOR because of the sheer number of STOs and the fact that most STOs are staffed by volunteers, which leads to reporting inconsistencies and makes it difficult for DOR to educate STO staff on reporting requirements. Finally, DOR describes its oversight responsibilities over STOs as a "daunting task" that has not yet been fully accomplished and which has been affected by changing statutory requirements.

Potential Performance Measures

Performance measures could include:

1. Percentage of STO revenues retained for administrative costs.

   The STOs would have this information readily available.

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

   This information appears to be collected by STOs, but would require additional reporting.

Prior Review

None

2011 Income Tax Credit Review

Joint Legislative Income Tax
Credit Review Committee

December 7, 2011

JLBC

Joint Legislative Income Tax Credit Review Committee

- Annually reviews credits as determined in statute.
- This year's review includes:
  - Angel Investment Credit
  - Residential Solar Energy Device Credit
  - Corporate Private School Tuition Credit
- Solar energy device credit was last reviewed in 2004.

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Role of the Committee

- Determine original purpose of tax credit.
- Establish standards for evaluating and measuring success or failure.
- Recommend changes.

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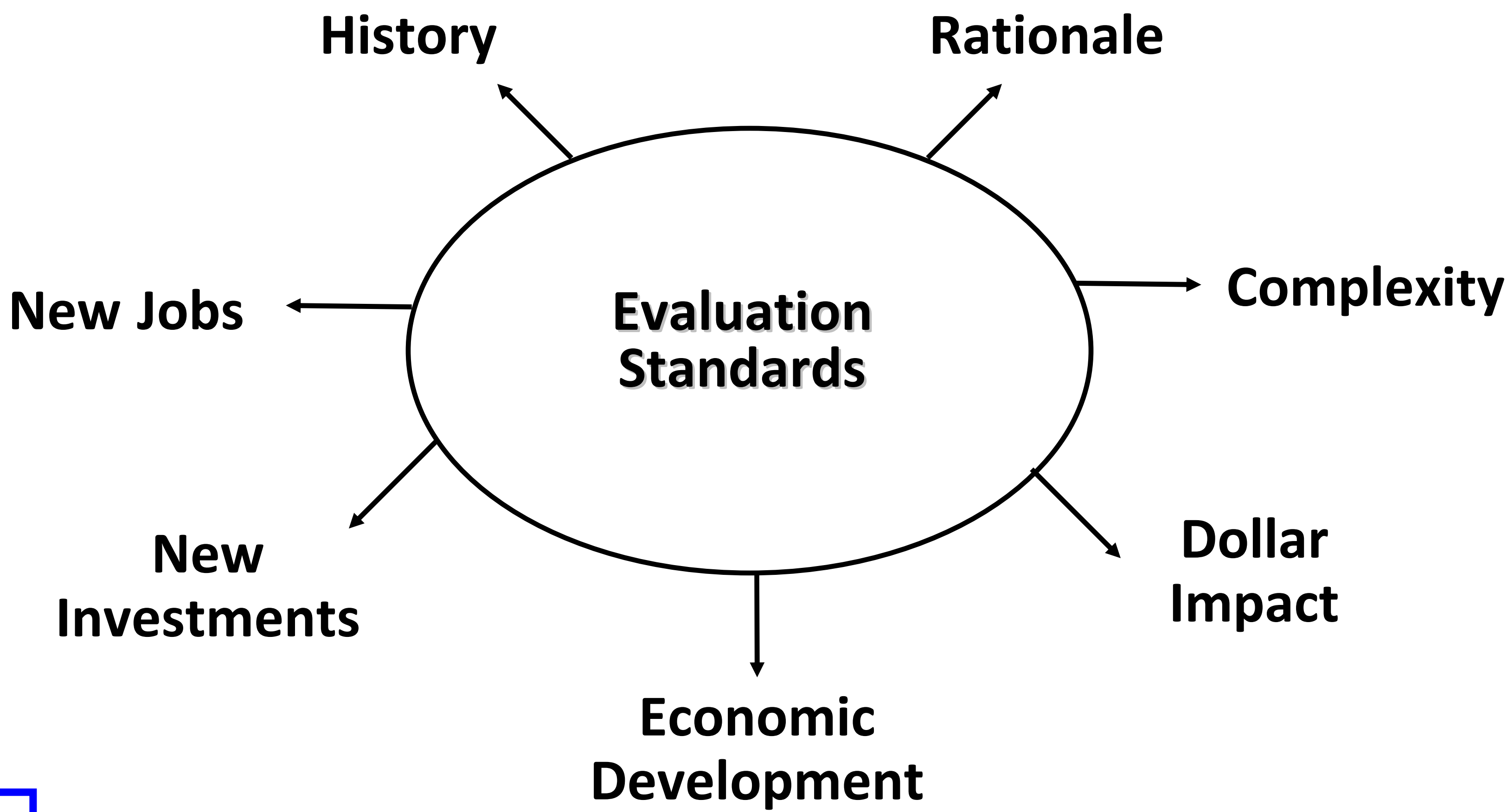
Statute Provides Possible Standards



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Issues Affecting Evaluation

- Timeliness of data.
- Lack of performance measures.
- Certain costs and benefits can be difficult to quantify.

Angel Investment Tax Credit
– Summary

- Cost – $581,000 in tax year 2010.
  - – 163 claims at an average of $3,600 per claim.
- Cap – credit is limited to $20 million over the life of the program. To date, $10.1 million has been authorized and $1.75 million has been used.
- Purpose – encourage investments in businesses that are in the early stages of development.
- Complexity – simple to use and administer.
- Performance Measures – none in statute.

Angel Investment Tax Credit

– Description of Credit

- Credit is only available to individual income tax-filers.
- Credit is limited to investments of between $25,000 and $250,000.
- Credit is claimed over 3 years and equals:
  - 35% of investment in rural or bioscience companies
  - 30% of investment in all other qualified businesses

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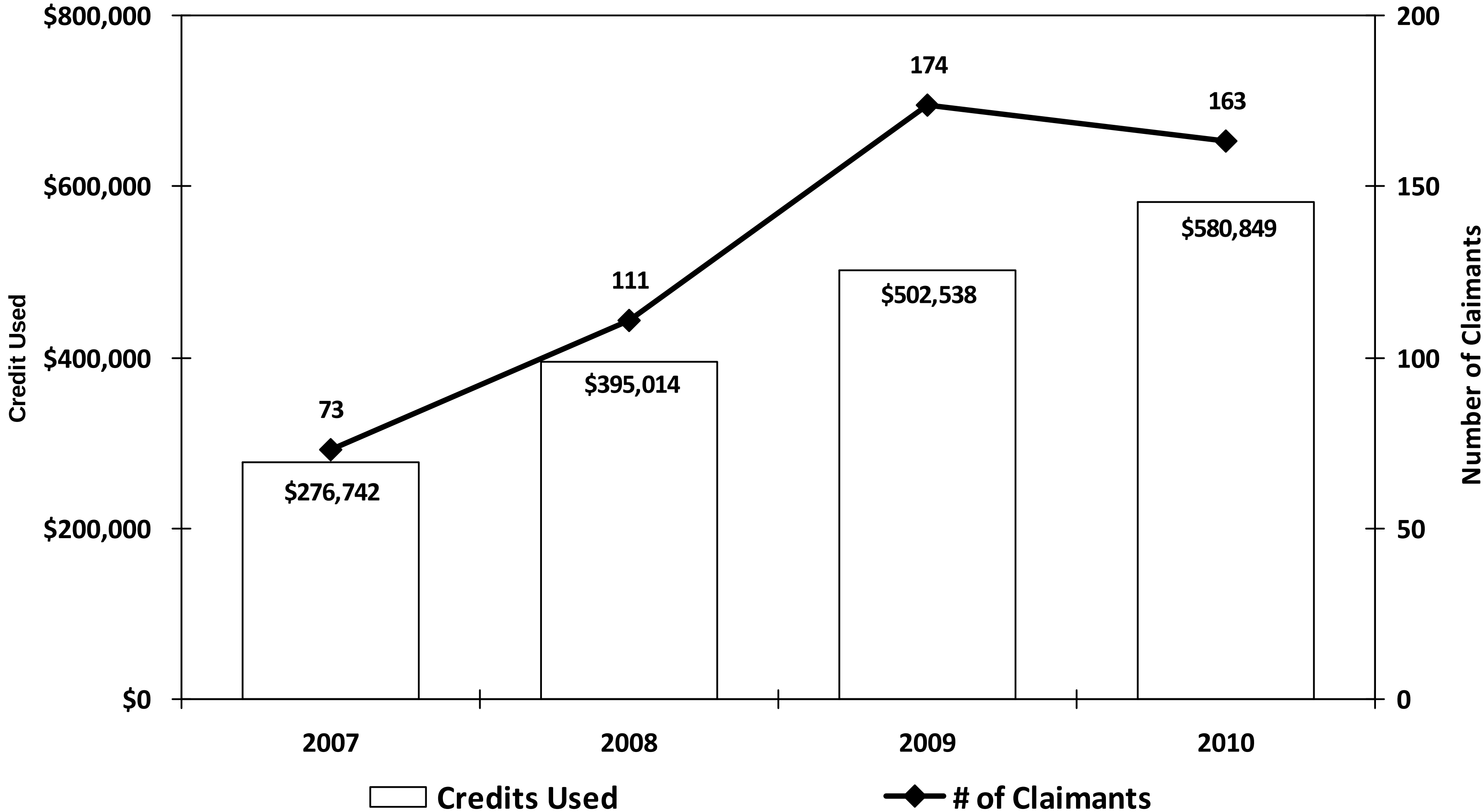
Angel Investment Tax Credit
– Description of Credit (cont.)

- Angel investor cannot possess more than 30% of the start-up company's voting power.
- Firms engaging in human cloning or embryonic stem cell research are excluded from receiving credit-eligible investments.
- To receive credit-eligible investments, a firm's total assets cannot exceed a certain amount.
- Credit is nonrefundable.
- Credit carry-forward is 3 years.

Angel Investment Tax Credit Credit
– Amount of Credits Used & Number of Claimants



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Angel Investment Tax Credit
– Benefits to the Arizona Economy

- To date, ACA has authorized qualified angel investments totaling $31.1 million.
- There is no data, however, on the number of new jobs that these investments have created.
- It is also unknown how many of the certified "angel businesses" that have been successful.
- 2010 national report estimates that each angel investment on average creates 6 new jobs.

Angel Investment Tax Credit
– Potential Performance Measures

- Number of new jobs created by the Angel Investment Program.
- Allocation of angel investments by industry.
- Number of businesses receiving angel investments that are associated with successful “exits” such as IPOs or buyouts.

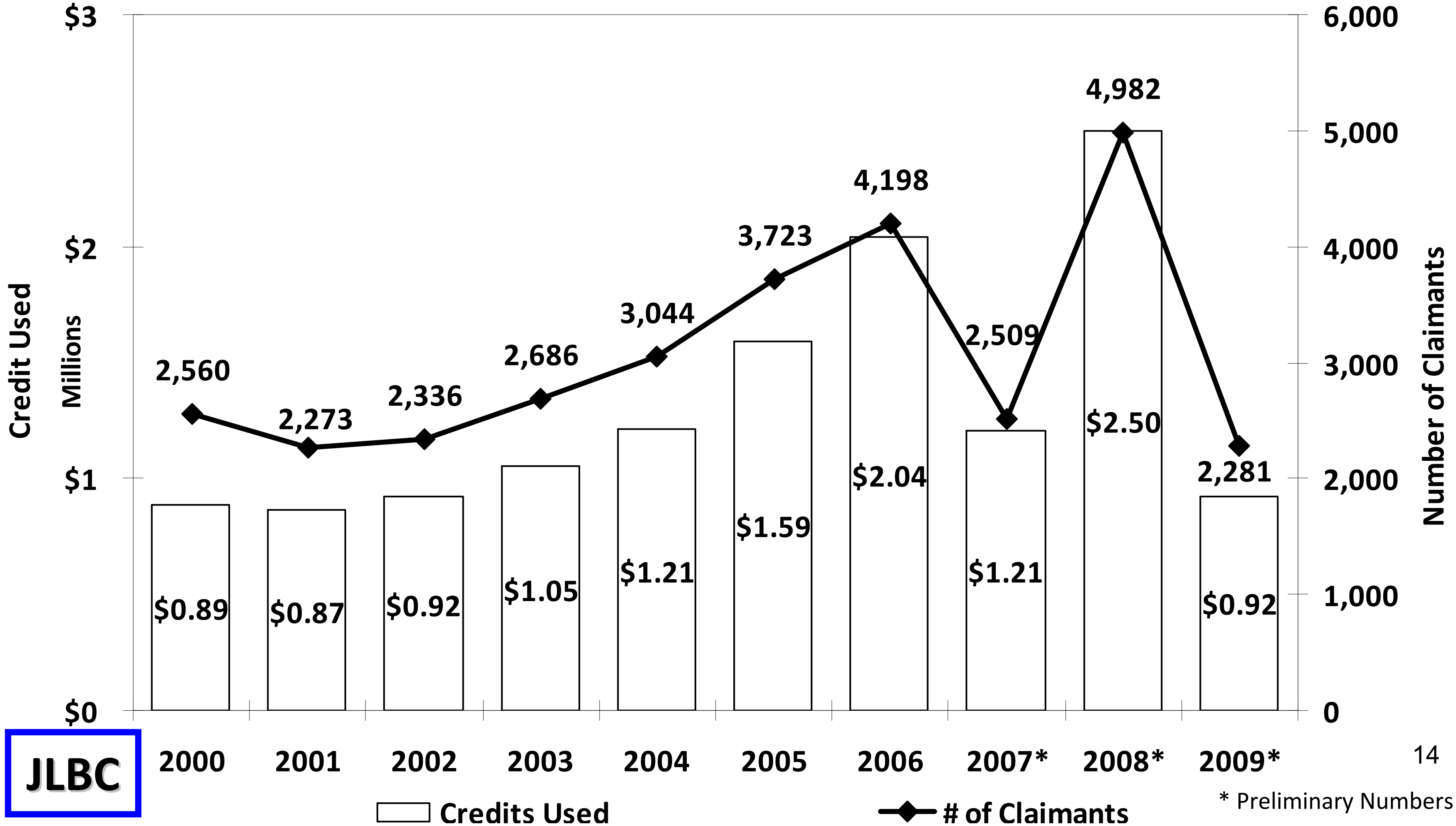
Residential Solar Energy Device Tax Credit
- Summary

- Cost - $922,400 in 2009.
- Purpose – to promote development of Arizona's solar energy industry, and to conserve non-renewable energy sources.
- Complexity - simple to use and administer.
- Performance Measures – none in statute.

Residential Solar Energy Device Tax Credit
– Description of the Credit

- Individual income tax credit for 25% of the cost of a solar energy device up to a maximum of $1,000 per residence.
- Solar devices include photovoltaic electricity generators, water heaters, and daylighting systems.
- 5-year carry-forward.
- Credit is non-refundable

Residential Solar Energy Device Tax Credit
– Amount of Credits Used & Number of Claimants



* Preliminary Numbers

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Residential Solar Energy Device Tax Credit
– Recent Trends

- Photovoltaic units are becoming less expensive and more efficient.
- Arizona instituted a Renewable Energy Standard (15% by 2025).
- Congress offering an individual solar energy credit of 30% through end of CY 2016.

Residential Solar Energy Device Tax Credit
– Benefits to the Arizona Economy

- There is no data on the number of new jobs that purchases related to this credit have created.
- However, studies show Arizona's total solar related employment has increased recently.
- Participants in the solar industry have indicated that the credit has helped Arizona remain active in encouraging energy conservation and the development of solar photovoltaic energy generation and technology.

Residential Solar Energy Device Tax Credit
– Potential Performance Measures

- Total megawatt hours of electricity generated from solar energy devices
- Total megawatt hours of electricity conserved from non-renewable energy sources
- Number of persons employed in businesses that manufacture, install, or service residential energy solar devices.

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Corporate STO "Low-Income Scholarship" Credit
– Summary

- Direct Cost – $5.5 million in tax year 2009
  - – also reduces state's K-12 costs
- Purpose – fund "low-income scholarships" for pupils attending private schools
- Complexity – DOR must pre-approve contributions; each School Tuition Organization (STO) must report contribution and scholarship data to DOR annually; "low-income" only
- Performance Measures – none in statute.

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Corporate STO "Low-Income Scholarship" Credit

– Description of Credit

- Credit capped at $20.7 M statewide (FY11)
  - -- cap increases 20% annually
  - -- no cap for individual corporations ("first come, first served")
  - -- cap also applies to insurers
- Credit is nonrefundable.
- Carry forward is 5 years.

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Corporate STO "Low-Income Scholarship" Credit

– Student Qualifications for Scholarships

- Family income cannot exceed 185% of "reduced price lunch" limit ($75 K for family of 4 for FY10)
- Student must meet one of the following requirements:
  - -- attended public school in prior year
  - -- enroll in private school Kindergarten
  - -- received "low-income scholarship" in prior year

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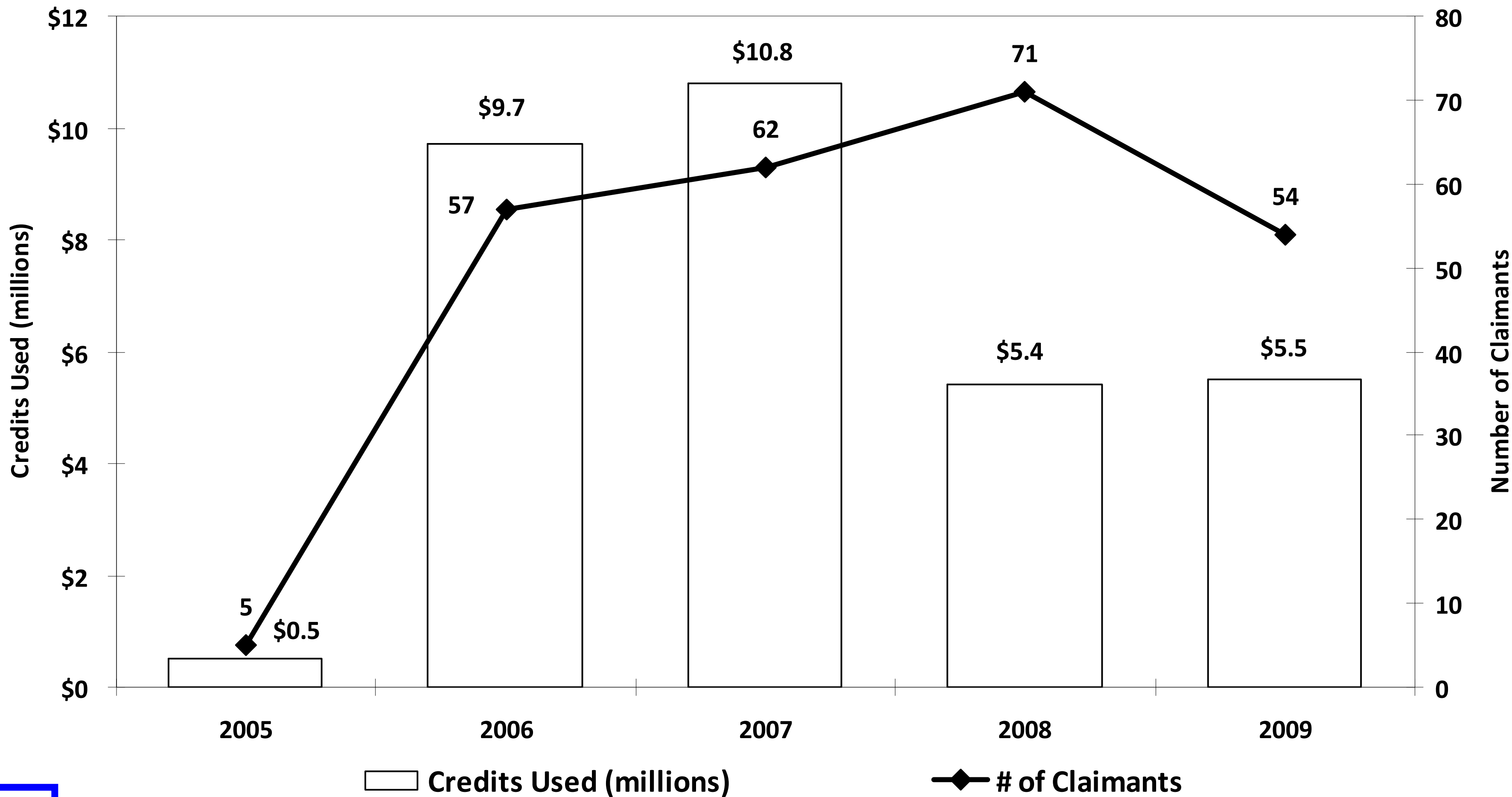
Corporate STO "Low-Income Scholarship" Credit
– Amount of Credits Used & Number of Claimants



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Corporate STO "Low-Income Scholarship" Credit

- Not directly designed to promote economic development or spur new investments
- Enables more students to attend private schools
  - -- 4,215 scholarships currently awarded (unsure of actual number of students)
- Current $5.5 M cost would be offset if 1,100+ students have left public schools (1,100 X $5,000 per student = $5.5 M)

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Corporate STO "Low-Income Scholarship" Credit
– Potential Performance Measures

- Percentage of STO revenues retained for administrative costs (at last 90% must be used for scholarships)
- Percentage of private school tuition paid for with award funding

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