
Income Tax Deductions and Credits for Public and Nonpublic Education in Minnesota

Legislation enacted in Minnesota in the first special session of 1997 created an income tax credit for public and nonpublic education-related expenses and expanded the size and scope of the dependent education expense deduction that has been in effect since 1955. This information brief outlines the legislative and legal history of the deduction, both the current credit and a credit that was in effect from 1971-1973, their effects on tax liability, and education tax credit programs in five other states.

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Executive Summary

Dependent Education Expense Deduction

Minnesota has allowed an income tax deduction for dependent education expenses paid to others since 1955. Taxpayers may deduct up to \$1,625 for students in grades K-6, and up to \$2,500 for students in grades 7-12. Expenses qualifying for the deduction include tuition, transportation, textbooks, instructional materials, tutoring, academic summer school and camps, and up to \$200 of the cost of a computer or education-related software. All Minnesota taxpayers may claim the deduction, regardless of whether they claim itemized deductions or the standard deduction at the federal level. The U.S. Supreme Court upheld Minnesota's deduction in 1983.

A deduction reduces the amount of income subject to tax; the benefit a taxpayer receives equals the taxpayer's marginal tax rate times the amount of the deduction. Most Minnesota taxpayers are in the 7.05 percent bracket, where a \$2,500 deduction decreases taxes by \$176.25.

Education Tax Credits: 1997-present and 1971-1973

Minnesota allows a refundable education tax credit, equal to 75 percent of qualifying expenses. If the credit exceeds a taxpayer's liability, the excess is paid to the taxpayer as a refund. Taxpayers may claim the credit for all expenses allowed under the deduction, with the exception of nonpublic school tuition. The maximum credit is \$1,000 per child. The credit was enacted in the 1997 first special session,¹ and was initially equal to 100 percent of qualifying expenses. In tax year 1998, the credit was available only to families with incomes under \$33,500;² the 1999 Legislature provided for the credit to phase out for families with incomes between \$33,500 and \$37,500.³ The 2001 Legislature limited the credit to 75 percent of qualifying expenses, effective in tax year 2002.⁴ The 2005 Legislature eliminated the so-called "family cap" and allowed families to claim the \$1,000 credit for an unlimited number of children in grades K-12.⁵ Prior to tax year 2005 the maximum credit per family was \$2,000, effectively limiting the credit to two children per family.

Minnesota allowed a refundable tax credit for nonpublic school tuition from 1971 to 1973. Pupil unit weighting made the \$100 credit worth \$50 for kindergarten students, \$100 for students in grades 1 to 6, and \$140 for students in grades 7 to 12. Because credits directly offset tax liability, a \$100 credit decreased a taxpayer's liability by \$100. In 1973, the U.S. Supreme Court struck down similar New York tax provisions, including a tuition credit. The Court found the New York credit had the effect of providing financial support to nonpublic sectarian institutions, and neither restricted the uses of public funds, nor offered ways to ensure that schools complied

¹ Laws 1997, 1st spec. sess., ch. 4, art. 13.

² The income measure used is the same as for determining the property tax refund and the child care credit; it is a broad measure that includes welfare benefits, tax-exempt interest, and nontaxable Social Security.

³ Laws 1999, ch. 243, art. 2, § 14.

⁴ Laws 2001, 1st spec. sess., ch. 5, art. 9.

⁵ Laws 2005, 1st spec. sess., ch. 3, art. 3.

with any restrictions. The Minnesota Supreme Court, following the U.S. Supreme Court decision, struck down the Minnesota credit in 1974.

Table 1 shows the number of taxpayers claiming the deduction and credit in tax year 2004.

Table 1
**Fiscal Impact of Dependent Education Expense
Deduction and Education Credit, Tax Year 2004**

| | Cost (millions) | Number of Taxpayers Affected |
|-----------|------------------------|---|
| Deduction | \$13.8 | 186,000 |
| Credit | \$15.0 | 58,593 |

Source: Minnesota Department of Revenue, Tax Expenditure Budget, Fiscal Years 2004-2007; and report on refundable income tax credits.

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Other States' Programs

Five other states offer income tax credits for educational expenses or for contributions to scholarship-funding organizations. Table 2 lists the states and programs, lists the number of claimants and costs for the most recent year data available, and indicates the result of any legal challenges filed.

Table 2
Tax Credits and Deductions for K-12 Education in Other States

| State and program | Number of claimants and cost | Legal challenge |
|--|---|--|
| Arizona Credit for contributions to school tuition organizations (individuals) | 63,830 claimants \$31.9 million Tax year 2004 | Yes; credit upheld by Arizona Supreme Court; challenge pending in U.S. Supreme Court |
| Arizona Credit for contributions to school tuition organizations (corporations) | Takes effect in 2007; Credit limited to \$5 million per year | No |
| Arizona Credit for extracurricular public school fees | 143,697 claimants \$22.5 million Tax year 2002 | No |
| Florida Credit for contributions to scholarship-funding organizations | 102 claimants \$47.6 million Tax year 2004* | No |
| Illinois Credit for qualified education expenses | 207,275 claimants \$67.9 million Tax year 2004 | Yes; credit upheld by state appellate courts |
| Iowa Credit for tuition, textbooks, and extracurricular activities | 166,700 claimants \$13.8 million Tax year 2003 | Yes; credit upheld by federal district court |
| Iowa Credit for contributions to school tuition organizations | Takes effect in 2006; Credit limited to \$2.5 million in 2006 and \$5 million in following years | No |
| Pennsylvania Credit for corporate contributions to scholarship-funding organizations | 1,470 claimants \$41.8 million Fiscal year 2005 | No |
| * Tax year 2005 data through January 2006 show 113 claimants of \$74.1 million; the tax year 2005 allocation remains open through December 2006. | | |

Dependent Education Deduction

Description

Minnesota allows a deduction⁶ for education-related expenses of up to \$2,500 for each dependent in grades 7 to 12, and up to \$1,625 for each dependent in grades K to 6. The dollar limits for the deduction were increased from \$1,000 and \$650 to the current levels in 1998.⁷ When first enacted in 1955, the deduction was limited to \$200 per dependent, regardless of grade.⁸ The accompanying box shows the history of the deduction.

The deduction applies to the following categories of expenses:

- tuition, including tutoring and academic summer school and camps
- textbooks, including instructional materials, supplies, and equipment
- transportation

Tuition. Taxpayers may claim the deduction for tuition paid for instruction at nonpublic schools. The 1997 legislation added tutoring and academic summer school and camps to the list of items qualifying as “tuition.” Tutoring and academic summer school and camps must help to improve knowledge of academic standards required to graduate, including world languages, in order to qualify for the deduction.

Timeline: Dependent Education Expense Deduction

| | |
|-------|---|
| 1955* | \$200 per dependent, for tuition and transportation expenses paid to others |
| 1975 | Amount increased to \$500 for grades K-6 and \$700 for dependents in grades 7-12. Deduction allowed for nonreligious textbooks, instructional materials, and equipment |
| 1978 | Deduction not allowed for extracurricular activities Federal district court in Minnesota upholds deduction in <i>Minnesota Civil Liberties Union v. Roemer</i> 452 F. Supp. 1316 (D. Minn. 1978) |
| 1983 | U.S. Supreme Court upholds deduction in <i>Mueller v. Allen</i> 463 U.S. 388 (1983) |
| 1985 | Amount increased to \$650 for grades K-6 and \$1,000 for grades 7-12 |
| 1998 | Amount increased to \$1,625 for grades K-6 and \$2,500 for grades 7-12. Deduction allowed for tutoring, academic summer school and camp, and computers |
| 2005 | \$2,000 maximum credit per family eliminated, allowing families to claim up to \$1,000 per child for all children in family in grades K-12 |

* Years shown are effective years

⁶ A deduction reduces tax liability by an amount equal to the taxpayer’s marginal tax rate times the amount of the deduction. The greatest tax decrease possible for the maximum \$2,500 deduction is \$196.25, which goes to higher income taxpayers in the 7.85 percent bracket. Taxpayers in the 5.35 percent bracket receive a tax decrease of \$133.75 for a \$2,500 deduction. Those with no tax liability receive no benefit from a deduction. The tax rate reductions enacted in the 1999 and 2000 sessions reduced the maximum value of the deduction.

⁷ [Laws 1997, first special session, chapter 4](#), article 13, made the expanded deduction contingent on adequate revenue being available in the November 1997 economic forecast for the expanded deduction, the new education credit, and an increase in the working family credit. Adequate revenue was available so the three items took effect in tax year 1998.

⁸ Laws 1955, ch. 741, § 1.

Textbooks. Textbooks include instructional materials and equipment. The law excludes books and materials used to teach religious tenets, doctrines, and worship. The 1997 legislation added computers and education-related software to the definition. However, only \$200 per year per family may be deducted for computer equipment and software.

Transportation. This includes the cost of transporting children to school during the regular school year, but not to summer school or camps.

Extracurricular activities, such as sporting events, music, and drama and speech activities, do not qualify.

The list of expenses qualifying for the deduction has expanded in recent years. Tutoring, academic summer school and camps, and up to \$200 of computer hardware and educational software first qualified in 1998. Beginning in 1999, parents could deduct tuition paid to teachers who are members of the Minnesota Music Teachers Association. Rental of musical instruments has long qualified for the deduction; purchase of instruments first qualified in tax year 2001. Each year the Department of Revenue provides information on what expenses qualify for the deduction. The information in Table 3 is from the 2005 income tax instructions and gives examples of expenses that do and do not qualify for the deduction.

Table 3
Qualifying Educational Expenses: Dependent Education Deduction and Credit

| Educational expense | Qualifies for: | |
|---|----------------|-----------|
| | Credit | Deduction |
| Private school tuition | | X |
| Tuition for college courses used to meet high school graduation requirements | | X |
| Fees for after-school enrichment programs | X | X |
| Tuition for academic summer camps | X | X |
| Instructor fees for driver's education if offered as part of school curriculum | X | X |
| Tutoring | X | X |
| Music lessons | X | X |
| Purchase of required educational material for use during regular public, private, or homeschool day | X | X |
| Purchase or rental of equipment used during regular school day, such as musical instruments or graphing calculators | X | X |
| Fees paid to others for transportation to/from school or for field trips during the normal school day | X | X |
| Home computer hardware and educational software (up to \$200 for credit and \$200 for deduction) | X | X |
| Expenses that do not qualify: <ul style="list-style-type: none"> • Costs to drive your child to/from school • Costs to transport your child to/from tutoring, enrichment programs, or camps that are not part of the school day • Travel expenses, lodging, and meals for overnight class trips • Fees paid for and materials and textbooks purchased for use in a program that teaches religious beliefs • Sport camps or lessons • Purchase of books and materials used for tutoring, enrichment programs, academic camps, or after-school activities • Tuition and expenses for preschool or post-high school classes • Costs of school lunches • Costs of uniforms used for school, band, or sports • Monthly Internet fees • Noneducational software | | |
| Source: Instructions for 2005 Form M-1, the standard Minnesota income tax form, Minnesota Department of Revenue | | |

Taxpayers are not required to claim itemized deductions at the federal level in order to claim the dependent education expense deduction. Taxpayers may claim either a standard deduction amount, which is indexed annually for inflation, or the sum of a list of itemized deductions, whichever benefits them most.⁹ Before 1998, only taxpayers who claimed itemized deductions were allowed to claim the dependent education expense deduction.¹⁰

The cost of the deduction is estimated at \$13.8 million in tax year 2004 (fiscal year 2005), and is expected to be claimed by about 186,000 filers. Table 4 shows the estimated cost of the deduction in 2004, and in 1998 before and after the expansion of qualifying expenses.

Table 4
**Fiscal Impact of Dependent Education Expense Deduction
Tax Years 1998 and 2004**

| | Cost (millions) | Number of taxpayers claiming deduction |
|---------------------------------|----------------------------|---|
| Tax year 1998, before expansion | \$3.8 | 73,000 |
| Tax year 1998, with expansion | \$11.7 | 144,000 |
| Tax year 2004 | \$13.8 | 186,000 |

Source: The cost of the deduction in 1998 before expansion was estimated by the Department of Revenue during the 1997 special session. The cost and number of taxpayers affected for 1998 was estimated from a sample of 1998 individual income tax returns, prepared by the Department of Revenue. The cost and number of taxpayers affected for 2004 are from the Department of Revenue's Tax Expenditure Budget, Fiscal Years 2004-2007.

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The substantial increase in both the number of taxpayers claiming deductions and the dollar value of deductions is due to the 1997 legislation that:

- increased the amount of the deduction;
- expanded the list of eligible expenses to include tutoring, academic summer schools and camps, and limited computer hardware and software purchases;
- allowed the deduction to parents who claimed the federal standard deduction.

⁹ Taxpayers who own their homes are more likely to itemize than those who rent, since deductions are allowed for property taxes and mortgage interest paid. Other itemized deductions include medical expenses and casualty/theft losses that exceed a percentage of income, state income taxes, charitable contributions, and certain business-related expenses.

¹⁰ When the deduction was enacted in 1955, Minnesota's income tax was not as closely tied to the federal income tax as it is today. For many years Minnesota allowed taxpayers to claim either a state standard deduction amount or state itemized deductions. The dependent education expense deduction was allowed as a state deduction, but was not allowed for taxpayers who claimed the Minnesota standard deduction amount. In the 1987 legislative session, Minnesota responded to the Federal Tax Reform Act of 1986 by conforming to the federal definition of income after deductions, but continued to allow the dependent education expense deduction in addition to itemized deductions allowed at the federal level.

Effect on Tax Liability

The tax reduction a taxpayer sees from claiming the deduction depends on the taxpayer's income and the total amount deducted.¹¹ The value of an income tax deduction equals the taxpayer's marginal income tax rate times the amount of the deduction. Minnesota has a progressive rate structure, with higher marginal rates for higher income taxpayers. Table 5 shows the income ranges, or brackets, and tax rates for tax year 2006 by filing status. The income ranges shown are Minnesota taxable income, which equals income after federal deductions and exemptions, and after Minnesota additions and subtractions. Taxable income is significantly lower than gross income. For example, in tax year 2006 a typical married couple with two dependents must have at least \$22,650 in gross income before having any Minnesota taxable income.

Table 5
Income Tax Rates and Brackets for Tax Year 2006

| Filing Status | 5.35 percent | 7.05 percent | 7.85 percent |
|---|-----------------|-----------------------|----------------|
| Married joint* | \$0 to \$29,980 | \$29,981 to \$119,100 | over \$119,100 |
| Single | 0 to 20,510 | 20,511 to 67,360 | over 67,360 |
| Head of household** | 0 to 25,250 | 25,251 to 101,450 | over 101,450 |
| * Brackets for married separate filers are half the brackets for married joint filers. ** Head of household filers are typically single parents. | | | |

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Tax deductions under a progressive income tax provide greater benefits to taxpayers in higher tax brackets than to those in lower tax brackets, and no benefits to taxpayers who do not have taxable income. A taxpayer who claims a \$1,000 dependent education expense deduction and whose top tax bracket is 5.35 percent will see a tax decrease of \$53.50, or 5.35 percent of \$1,000. If the taxpayer's income is high enough to reach the 7.85 percent bracket, the tax decrease will be \$78.50.¹² If the taxpayer's income is low enough to be totally offset by the standard deduction and exemptions (\$22,650 for a family of four in 2006), a deduction provides no benefit at all.

¹¹ For more information on tax deductions, see the House Research Department publication *Income Tax Terms: Deductions and Credits*, July 2005.

¹² Until tax year 1998, the deduction was available only to taxpayers who claim itemized deductions at the federal level. Beginning in tax year 1998, taxpayers who claim the standard deduction are also allowed to claim the dependent education expense deduction; however, many of those claiming the deduction will be itemizers. For itemizers, the tax decrease realized at the state level is offset in part in the following year by a tax increase at the federal level. This is because itemizers also deduct state income taxes in computing federal tax. The amount of the federal offset will equal the tax value of the state deduction, multiplied by the taxpayer's federal marginal tax rate. Federal marginal rates for tax year 2006 range from 10 percent to 35 percent, depending on income.

Legal History

Several Minnesota taxpayers challenged the constitutionality of the dependent education expense deduction in *Mueller v. Allen* in 1983.¹³ These taxpayers claimed that the deduction amounted to an establishment of religion in violation of the First Amendment because almost all of the taxpayers using the deduction had children in parochial schools.¹⁴ They argued that this fact, in addition to the fact that Minnesota public schools were largely tuition-free to most residents, showed that the statute advanced religion by providing tax relief for tuition expenditures for religiously affiliated education.

In a five-to-four decision, the U.S. Supreme Court upheld the Minnesota statute giving tax deductions to parents for tuition and other costs they incurred in educating their children at public and nonpublic schools. The Court's majority found that the deduction met all three parts of the *Lemon* test (see box to right).¹⁵ Justice Marshall dissented, arguing that the tuition deduction had the effect of advancing religion.

Under the three-part test the U.S. Supreme Court announced in *Lemon v. Kurtzman*, 403 U.S. 602 (1971), a government action violates the First Amendment establishment clause, which forbids laws that establish religion, if it:

- (1) has a nonsecular purpose;
- (2) has a primary effect of advancing religion; or
- (3) creates excessive church-state entanglement.

The Court found several valid secular purposes for the law under the first part of the *Lemon* test. First, by offsetting parents' educational expenses, the deduction helped ensure an educated populace and protected the community's political and economic health. Second, ensuring the continued financial health of private schools helped relieve the financial burden on public schools. The Court wrote that any statutory benefit sectarian schools received could be seen as a "rough return" for the benefits these schools conferred upon the state and its taxpayers. Third, promoting "wholesome competition" between public and nonpublic schools promoted the state's interest in providing all children with the highest quality education.

¹³ 463 U.S. 388 (1983). The tax deduction statute was first challenged in *Minnesota Civil Liberties Union v. Roemer* in 1978. The federal district court in Minnesota upheld the statute because it was designed to benefit public and nonpublic school children.

¹⁴ The plaintiffs showed that more than 95 percent of Minnesota's 91,000 nonpublic school students attended parochial schools during the 1979-1980 school year. Plaintiffs also showed that while the 87,000 parochial school students represented about 10 percent of the state's total elementary and secondary school population, 71 percent of the \$2.4 million state revenue lost through the tuition deduction was due to taxpayers with children in parochial schools; 820,000 students attended the state's public schools at the time.

¹⁵ Some Supreme Court justices have questioned the *Lemon* test and suggested alternative establishment clause tests, including a coercion test and an endorsement test. In *Lee v. Weisman*, 505 U.S. 577 (1992), the U.S. Supreme Court held that a nonsectarian prayer at a public school graduation ceremony violated the establishment clause by coercing students to participate in the prayer. The majority opinion defined coercion to include social and psychological pressure. The dissent defined coercion as that which is supported by the force of law. In *Lynch v. Donnelly*, 465 U.S. 668 (1984), Justice O'Connor suggested modifying the *Lemon* test to say that the establishment clause is violated when government endorses or disapproves of a religion. In *Agostini v. Felton*, 521 U.S. 203 (1997), the U.S. Supreme Court made *Lemon* a two-part test by combining the primary effect and excessive entanglement inquiries, which require similar evidence.

The Supreme Court looked at several important features of the deduction statute in deciding whether it had the primary effect of advancing the sectarian aims of nonpublic schools under the second part of the *Lemon* test. The court appeared to consider relevant the following factors in upholding the constitutionality of the deduction:

- the deduction was one of many deductions available to Minnesota taxpayers
- the legislature had considerable discretion in making tax classifications and distinctions
- the deduction was available to parents of both public and nonpublic school children
- public funds became available only as a result of “numerous, private choices of individual parents”
- the financial benefits to parochial schools were minor

The Court found that the statute’s potential for excessive government entanglement under the third part of the *Lemon* test might come only from state officials’ need to decide whether or not a textbook qualified for the deduction.¹⁶ The Court observed that the administrative involvement implicated in the statute was like the government’s involvement in other programs the Court had already approved¹⁷ and that the Minnesota statute would not excessively entangle the state in religion.

In dissent, Justice Marshall argued that the tuition deduction had the primary effect of advancing religion. He reasoned that “any generally available financial assistance for elementary and secondary school tuition expenses mainly will further religious education because the majority of schools charging tuition are sectarian.” Marshall charged that the textbooks and instructional materials subsidized under the textbook deduction could be used to inculcate religious values and beliefs, since the statute permitted a deduction for books the parochial schools chose. He found the majority’s opinion “flatly at odds with the fundamental principle that a state may provide no financial support whatsoever to promote religion.” He wrote that the statute provided no effective means for restricting state aid to the secular functions of private schools.

¹⁶ Instructional books and materials used in teaching religious tenets, doctrines, or worship do not qualify for a deduction.

¹⁷ The Supreme Court had already authorized the government to loan textbooks to public and private school students.

Education Tax Credit

Description of the Current Education Credit

Minnesota enacted an education tax credit in the first special session of 1997, with the credit first available in tax year 1998. Parents can claim the credit for all education-related expenses that qualify for the dependent education expense deduction, except nonpublic school tuition. Thus, the credit is allowed for transportation; tuition for academic summer school and summer camps; tutoring; textbooks, defined to include instructional materials and equipment, including the purchase of musical instruments; and up to \$200 per family of computer hardware and educational software.

The maximum credit per family is \$1,000 multiplied by the number of children in the household in grades K-12. The credit is refundable. Any amount that exceeds tax liability is paid to the claimant as a refund. The credit equals 75 percent of qualifying expenses up to the maximum per child.¹⁸ Thus, a family with one child and \$1,333 of expenses will qualify for the maximum \$1,000 credit in tax year 2006 (\$1,000 is 75 percent of \$1,333). A family with two children will need to spend \$2,667 on qualifying purchases in order to receive the maximum \$2,000 credit. Before 2005, the maximum credit per family was \$2,000, effectively limiting families to claiming the maximum \$1,000 per child for only two children. Beginning in 2005 families may claim up to the maximum \$1,000 per child for each child in kindergarten through grade 12, and families are also allowed to allocate qualifying expenses among children in grade K-12 as they choose. For example, a family with two children in grades K-12 may claim the entire \$2,000 credit (\$1,000 times two children) for expenses related to one child.¹⁹

The credit phases out for taxpayers with incomes over \$33,500. The \$1,000 maximum for one child phases out at a rate of \$1 for each \$4 of income over \$33,500, and the maximum for more than one child (\$1,000 times the number of qualifying children) phases out at a rate of \$2 for each \$4 of income over \$33,500. The credit phaseout took effect in tax year 1999;²⁰ in tax year 1998 the credit was limited to claimants with incomes under \$33,500. 2005 legislation that eliminated the two-child “family cap” effectively extended the phaseout by \$2,000 for each additional child eligible for the credit. Thus, the credit is fully phased out when income reaches \$37,500 for families with two qualifying children, when income reaches \$39,500 for families with three qualifying children, at \$41,500 for families with four qualifying children, and so on. The income measure used to determine eligibility for the credit is a broad measure that includes nontaxable interest, Social Security, and public welfare benefits; the same income measure is used under the property tax refund and the dependent care credit.

¹⁸ [Laws 2001, First Special Session, chapter 5](#), article 9, reduced the credit from 100 to 75 percent of qualifying expenses. This change was enacted in 2001 but did not take effect until tax year 2002, so as not to reduce the expected credits of families who had already made qualifying expenditures in tax year 2001.

¹⁹ [Laws 2005, 1st spec. sess., ch. 3](#), art. 3, § 10.

²⁰ [Laws 1999, ch. 243](#), art. 2, § 14.

A total of 58,593 families claimed the education credit in tax year 2004, at an estimated average benefit of \$256 each, for a total cost of \$15.0 million. Table 6 shows the cost of the credit and number of recipients as estimated in the 1997 special session, and the actual cost and number of recipients in tax years 1998 through 2004.

Table 6
**Fiscal Impact of K-12 Education Credit
 Tax Years 1998 to 2004**

| | Cost (millions) | Number of taxpayers claiming credit |
|--|----------------------------|--|
| Tax year 1998, as estimated in 1997 special session | \$38.5 | 192,500 |
| Tax year 1998, actual cost | \$14.2 | 38,500 |
| Tax year 1999, actual cost | \$21.4 | 57,962 |
| Tax year 2000, actual cost | \$21.3 | 55,941 |
| Tax year 2001, actual cost | \$19.4 | 56,414 |
| Tax year 2002, actual cost | \$16.0 | 60,996 |
| Tax year 2003, actual cost | \$15.9 | 61,253 |
| Tax year 2004, actual cost | \$15.0 | 58,593 |
| Source: The 1997 special session estimates of the cost and number of taxpayers affected were prepared by the Department of Revenue. The actual cost and number of taxpayers affected for 1998 through 2004 are from the Department of Revenue's income tax processing file or summary reports. | | |

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The total cost and number of claimants has been substantially lower than the Department of Revenue's estimates from the 1997 special session. The average amount claimed per family, \$369 in both 1998 and 1999, is higher than the department's expected average of \$200, but the number claiming credits was substantially lower than the department's estimate. The data shows the number of families claiming the credit initially increasing as taxpayers become more aware of the credit's availability, and then leveling off at between \$55,000 and \$60,000. The total dollar amount claimed dropped from 2001 to 2002, reflecting the reduction in the credit percentage from 100 to 75 percent of qualifying expenses.

Families eligible for the credit may assign their anticipated refunds to participating financial institutions and tax-exempt foundations. The organizations accepting assignment of refunds will make loans to families, with the loan amount paid directly to a third-party vendor for providing education-related products and services. Low-income families with perhaps only small amounts of disposable income and savings will use the loans to obtain education-related products and services in anticipation of qualifying for the tax credit when they file their tax returns in the following year. The Department of Education must certify that the products and services qualify for the credit, in order for the assignment to be valid. The third-party vendor must disclose to the taxpayer the cost of products and services to be provided and information on how to obtain repair or replacement of defective products. Taxpayers may not assign more than

the maximum credit of \$1,000 per child or \$2,000 per family. Refund assignment first became available on a temporary basis in tax year 2002,²¹ and has since been made permanent.²²

Assignments have last claim on income tax refunds, after claims for delinquent taxes, child support, restitution, and revenue recapture. The Commissioner of Revenue may disclose the aggregate amount of outstanding claims to participating organizations before the organization decides to accept an assignment. Once an assignment exists, the Department of Revenue will subtract delinquent taxes, child support, restitution, and revenue recapture claims from any income tax refund amount due the taxpayer, and pay the remaining amount to the organization that accepted the assignment, up to the amount of the assignment. Any refund amount in excess of the assignment will be paid directly to the taxpayer.

Effect on Tax Liability of the Current Education Credit

Tax credits directly offset tax liability, unlike deductions, which reduce taxable income. In the case of refundable credits, the benefit to the taxpayer exactly equals the amount of the credit claimed. If a refundable credit exceeds a taxpayer's income tax liability, the excess is refunded to the taxpayer. This is accomplished by providing an open appropriation to the Commissioner of Revenue to pay refunds allowed under the credit.

A refundable credit provides the same benefit to all claimants, regardless of income. As a result, filers who claim an education tax credit of \$1,000 receive a \$1,000 benefit. For those with tax liability, the benefit comes in the form of reduced taxes. Filers without tax liability receive a \$1,000 refund check. Since the credit equals 75 percent of qualifying expenses, a taxpayer must purchase \$1,333 of qualifying products and services in order to claim the maximum \$1,000 credit.

Taxpayers may not claim the deduction and credit for the same expenses. Parents who qualify for both the deduction and credit will receive the greatest benefit by first claiming up to the maximum allowable under the credit, and then claiming any remaining expenses under the deduction. Table 7 shows how the deduction and credit interact for a married couple with two children who purchase a \$1,000 computer and have \$500 of tutoring expenses.

²¹ [Laws 2001, 1st spec. sess., ch. 5](#), art. 9, sec. 12.

²² [Laws 2003, ch. 127](#), art. 3, sec. 23.

Table 7
Education Deduction and Credit Example
Married Couple with Two Children, Tax Year 2006

| | |
|-----------------------------|--|
| Gross income | \$30,000 |
| Taxable income | \$6,500 |
| Education-related expenses | \$500 for tutoring \$1,000 for computer |
| Tax deduction | \$200 for computer |
| Tax decrease from deduction | \$11 (\$200 x 5.35% tax rate) |
| Tax credit | \$500 for tutoring \$200 for computer |
| Credit rate | 75% |
| Tax decrease from credit | \$525 (\$700 x 75% credit rate) |
| Total tax decrease | \$536 |

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Claimants are limited to \$200 in computer-related expenses for both the deduction and the credit. Because this couple has \$1,000 of computer expenses, they can claim \$200 as a deduction and 75 percent of \$200 as a credit. Combined with their \$500 of tutoring expenses, which qualifies for the credit at the 75 percent rate, the couple experiences a total tax decrease of \$536.

Description of the 1971-1973 Education Credit

Minnesota enacted a nonpublic education tax credit in 1971.²³ The credit was allowed for “education costs,” defined to include tuition, classroom instructional fees, and textbooks. The statute used the same language as the deduction, specifying that the credit was not allowed for purchase of textbooks used in the teaching of religious tenets, doctrines, or worship.

The credit was set at \$100 per pupil unit for 1971 and 1972. The way Minnesota weighted pupil units made the credit worth \$50 for kindergarten students, \$100 for students in grades 1 to 6, and \$140 for students in grades 7 to 12. For 1973 and following years, the credit was adjusted by the percentage growth in school foundation aid.

Taxpayers claiming the credit had to document their eligibility. Their income tax returns had to include nonpublic school receipts listing the following:

- the name and location of the nonpublic school
- the amount paid for education costs and textbooks and the date of payment
- the grade in which the student was enrolled
- the student’s name and name of the person who paid for tuition and textbooks

²³ Laws 1971, ch. 944.

The legislation also required taxpayers to include certification from the nonpublic school indicating the following:

- that the school satisfied the requirements of compulsory attendance
- the restricted maintenance cost of education per pupil²⁴
- the total amount paid by the taxpayer for education costs
- the maximum allowable tax credit for each month of enrollment²⁵
- the student's name and the number of months the student was enrolled

The tax credit was refundable, with any amount in excess of tax liability refunded to the taxpayer. In addition, there was no limit on the number of students for whom a taxpayer could claim the credit. However, only one credit could be claimed for each student, and taxpayers had to choose between claiming the credit and claiming the already existing dependent education expense deduction.

Department of Revenue records show that between 44,000 and 45,000 taxpayers claimed the credit in each of the three years it was available. Taxpayers claimed \$7.4 million in credits in 1971; \$8.6 million in 1972; and \$10.6 million in 1973. The average credit claimed increased from about \$170 in 1971 to about \$240 in 1973.²⁶

Legal History

In 1974, the Minnesota Supreme Court ruled the state's education tax credit impermissible on federal constitutional grounds. The state court relied on a 1973 U.S. Supreme Court decision finding New York's tuition reimbursement program unconstitutional under the federal establishment clause because it had the effect of promoting religion.

In the early 1970s, New York state provided programs to children similar to the Minnesota tax credit. The programs

Timeline: Education Tax Credit (in effect from 1971 to 1973)

| | |
|------|---|
| 1971 | \$100 per pupil unit tax credit enacted |
| 1972 | Ramsey County District Court finds state tax credit permissible under then-existing law Plaintiffs appeal district court judgment |
| 1973 | Legislation restricts credit to Minnesota residents U.S. Supreme Court finds similar New York credit unconstitutional in <i>Nyquist</i> |
| 1974 | Minnesota Supreme Court follows precedent set in <i>Nyquist</i> and strikes down the Minnesota credit State Department of Revenue disallows the credit for tax year 1974 and following years |
| 1980 | Repeal of credit included in Department of Revenue technical legislation |

²⁴ The statute defined "restricted maintenance cost" as 80 percent of the levy portion of school expenses.

²⁵ The statute based the total claim for the credit on a ten-month school year, so that a taxpayer could claim 10 percent of the full credit amount for each month of student enrollment.

²⁶ Available data on tuition costs suggest that the increase in the amount claimed per family resulted from increased tuition at nonpublic schools.

provided partial tuition reimbursement and tax credits to low-income parents who sent their children to nonpublic schools, including sectarian schools, by:

- reimbursing low-income parents for private school tuition,²⁷ and
- allowing a private school tuition deduction for parents who were not entitled to the tuition reimbursement.²⁸

A third program provided direct money grants to private schools for maintaining and repairing school facilities and equipment. Several New York taxpayers challenged the constitutionality of the programs.

In the 1973 case *Committee for Public Education and Religious Liberty v. Nyquist*,²⁹ the U.S. Supreme Court found that New York’s tuition reimbursement and tax deduction programs violated the establishment clause of the First Amendment. The state argued that the tax programs removed the state’s ability to directly fund nonpublic schools because it was only through parents’ individual choices, and not state action, that state money flowed to nonpublic schools. The Court rejected the argument, finding that the programs advanced religion because the programs neither restricted the uses of public funds to nonsectarian programs, nor offered ways to ensure that schools complied with any restrictions. The Court indicated that parental choice was just one of many factors in deciding whether state funds had the effect of promoting religion.³⁰

In a six-to-three decision,³¹ the Court found that all three programs were unconstitutional under the second part of the *Lemon* test, i.e., they had the effect of promoting religion.³² The Court held that the effect of the tuition reimbursement was “unmistakably to provide financial support for nonpublic sectarian institutions” because the payments gave parents a financial incentive to send their children to religious schools and the financial ability to do so.

²⁷ The New York tuition reimbursement statute allowed a parent who had an annual taxable income of less than \$5,000 to receive a tuition reimbursement of up to \$50 for each elementary school child and up to \$100 for each secondary school child.

²⁸ The New York tax deduction statute allowed taxpayers who had dependent children attending nonpublic elementary or secondary school to subtract from their gross income a defined amount for up to three children. The amount that taxpayers could subtract was based on taxpayers’ income and not actual tuition expenses. For example, if a taxpayer’s income was less than \$9,000, he or she could subtract \$1,000; once income reached \$15,000, the deduction decreased to \$400; and once income reached \$25,000 or more, no deduction was allowed.

²⁹ 413 U.S. 756 (1973).

³⁰ The Court has permitted aid to parents with parochial school children in those instances where there was no threat that the funds could be used for sectarian purposes. For example, in *Everson v. Board of Education*, 330 U.S. 1 (1946), the Court upheld a New Jersey statute permitting parochial school children to use state-funded buses to reach their schools safely. In *Board of Education v. Allen*, 392 U.S. 236 (1968), the Court upheld a New York statute that lent secular textbooks to children in public and private school. In such cases, state benefits had no sectarian characteristics and could not be put to nonsecular uses.

³¹ Chief Justice Burger and Justice Rehnquist both dissented in part, and Justice White dissented from the entire opinion.

³² The Court concluded that the statutes had a secular purpose, which satisfied the first part of the *Lemon* test, and stated in dicta that it was unlikely the statutes would pass the excessive entanglement test, the third part of the *Lemon* test.

The Court struck down the tax deduction because it rewarded parents for sending their children to nonpublic schools and operated, in effect, as a tax credit by allowing a fixed amount of “tax forgiveness” to those parents who did what the state encouraged without regard to the taxpayer’s actual tuition expenses.³³ The Court used a similar analysis for the program directing money grants to private schools for maintenance and repairs, concluding that the state could not ensure that direct money grants to private schools went for secular purposes.³⁴

In 1974, following the *Nyquist* ruling, the Minnesota Supreme Court found Minnesota’s tax credit unconstitutional in *Minnesota Civil Liberties Union v. State*.³⁵ In 1971, the Minnesota Civil Liberties Union, Americans United for Separation of Church and State, and seven Minnesota taxpayers challenged the Minnesota tax credit on the grounds that it violated the U.S. Constitution and the Minnesota Constitution. In 1972, before *Nyquist* was decided, the trial court found the statute to be constitutional. The trial court reasoned that the statute had a valid secular purpose, that it survived entanglement challenges, and that the primary effect of the statute was not to promote the establishment of religion. The plaintiffs appealed to the Minnesota Supreme Court.

While the appeal was pending, the U.S. Supreme Court announced a series of decisions, including *Committee for Public Education v. Nyquist*, that, according to the Minnesota Supreme Court, “effectively changed the course and standard of measurement of establishment questions.” The state supreme court discussed the *Nyquist* opinion at length and declared its intent to follow the precedent set in *Nyquist* in evaluating the tax credit statute before it. In applying the three-part *Lemon* test, the court had no difficulty in finding a secular purpose for the statute. The court found the “primary effects” part of the test problematic because it believed that the result in *Nyquist* obligated it to use an “any effects” test instead. Under such a standard, where the First Amendment establishment clause received clear preference over the free exercise clause,³⁶ the court found that the tax credit statute could not pass constitutional muster under federal law.³⁷ The court rejected the argument that Minnesota’s tax credit statute could be distinguished from *Nyquist*.

Taxpayers were allowed to keep credits issued from 1971 to 1973. The court did not consider the constitutionality of 1974 state legislation that prohibited the Commissioner of Revenue from

³³ The Court reserved its right to decide the constitutionality of a genuine tax deduction. It did so later in upholding the Minnesota deduction. See discussion on pages 8 and 9.

³⁴ The statute limited grants to nonpublic schools to 50 percent of the amount expended for comparable services in public schools. The Court observed that “a mere statistical judgment will not suffice as a guarantee that state funds will not be used to finance religious education.”

³⁵ 302 Minn. 216, 224 N.W.2d 344 (1974), *cert. denied*, 421 U.S. 988 (1975).

³⁶ The establishment clause forbids laws that establish religion, and the free exercise clause forbids laws that prohibit the free exercise of religion.

³⁷ Although the Minnesota Supreme Court disposed of the constitutional challenge on federal constitutional grounds, it specifically commented on the validity of the statute in the context of the state constitution. The court quoted those sections of the state constitution providing for “a thorough and efficient system of public schools” and prohibiting the use of public moneys for the support of religious schools. The court also commented upon the failure of the courts and the litigants in the case to recognize that the major problem at issue was “society’s concern for the children involved.”

recovering credits paid in previous years.³⁸ The credit was not allowed for 1974 and following years because it was found unconstitutional before the end of the 1974 tax year. The tax credit remained in statute until 1980, when it was repealed in a Department of Revenue technical bill.

³⁸ Laws 1974, ch. 556, § 20.

Other States' Programs

Arizona, Florida, Illinois, Iowa, and Pennsylvania also provide income tax credits for education-related expenses. To date, courts in Arizona, Illinois, and Iowa have upheld the permissibility of these credits in their respective states.

Arizona

Arizona provides its individual income taxpayers with two education-related credit programs: a tax credit for contributions to school tuition organizations (STOs) that operate like charities; and a tax credit for extracurricular public school fees. Both credits are nonrefundable but may be carried forward for up to five tax years if the credit exceeds the taxpayer's liability. Taxpayers may claim both credits in the same tax year.

Arizona also provides corporate taxpayers with an education-related credit program, beginning in tax year 2007, that is similar to the individual tax credit for donations to STOs. The individual and corporate programs that provide credits for donations to STOs are expected to operate in tandem and all organizations registered as STOs are eligible for donations from either program.

Credit for individual income taxpayer contributions to school tuition organizations.

Arizona taxpayers may claim a credit for contributions to school tuition organizations that assist students with the cost of tuition at a qualified school. In tax year 2005, the maximum credit was \$500 for single filers and \$825 for married couples filing joint returns; the maximum for married couples increases to \$1,000 in tax year 2006 and following years. Arizona statute, section 43-1089, paragraph E, defines "qualified school" as a nongovernmental primary or secondary school in Arizona that does not discriminate on the basis of race, color, handicap, familial status, or national origin and that satisfies state requirements for private schools; this definition allows schools to limit admission based on religious adherence, preference, or observance. The same paragraph defines "school tuition organization" as a section 501(c)(3) charitable organization that allocates at least 90 percent of its annual revenue for educational scholarships or tuition grants to children to allow them to attend any qualified school of their parents' choice.

Under this tax credit law, parents may not designate the credit to benefit their own children and nonprofit organizations may not designate the credit to benefit students of only one school. If a taxpayer's allowable tax credit for a given year exceeds the taxes due, the taxpayer may carry the credit forward for up to five years.

In tax year 2004 more than 63,000 Arizona filers claimed the school tuition credit, with donations qualifying for the credit equaling \$31.9 million and funding \$28.2 million in scholarships for 21,160 students. The number of filers claiming the credit and the total amount of qualifying donations have increased steadily since the program began. From 1998 to 2004, the program raised \$146 million in donations and awarded 98,300 scholarships.

Table 8
Arizona School Tuition Credit

| | Number of claimants | Amount donated (millions) | Amount of scholarships awarded (millions) | Number of scholarships | Average scholarship |
|------|----------------------------|----------------------------------|--|-------------------------------|----------------------------|
| 1998 | 4,248 | \$1.8 | \$0.1 | 244 | \$554 |
| 1999 | 32,023 | \$13.8 | \$2.4 | 3,713 | \$650 |
| 2000 | 38,249 | \$17.7 | \$13.7 | 15,377 | \$888 |
| 2001 | 46,755 | \$24.9 | \$16.3 | 18,100 | \$900 |
| 2002 | 52,161 | \$26.2 | \$22.4 | 19,568 | \$1,143 |
| 2003 | 58,122 | \$29.4 | \$24.5 | 20,138 | \$1,219 |
| 2004 | 63,830 | \$31.9 | \$28.2 | 21,160 | \$1,334 |

Source: "Individual Income Tax Credit for Donations to Private School Tuition Organizations: Reporting for 2004," Arizona Department of Revenue, November 25, 2005.

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Because scholarships are generally awarded before the start of the school year while qualifying donations are made throughout the calendar year, there may be a one-year lag between an increase in the amount donated and the corresponding increase in the number of scholarships awarded.

Credit for contributions to public schools and for extracurricular public school fees.

Arizona individual income taxpayers may claim a credit for any fees the taxpayer pays for extracurricular activities and for any amounts the taxpayer contributes to character education programs at a public school. In tax year 2005, the maximum credit per family is \$200 for single parents and \$350 for married couples; the maximum for married couples increases to \$400 in tax year 2006 and following years. Under Arizona Statutes, section 43-1089.01, "extracurricular activities" means the equipment, uniforms, and materials that students must have in order to participate in school-sponsored activities and for which the school charges a fee. Under Arizona Statutes, section 15-719, "character education program" is defined as instruction in understanding and use of at least six of the following traits: truthfulness, responsibility, compassion, diligence, sincerity, trustworthiness, respect, attentiveness, obedience, orderliness, forgiveness, and virtue. If a taxpayer's allowable tax credit for a given year exceeds the taxes due, the taxpayer may carry the credit forward for up to five years.

Table 9
Arizona Credit for Public School Contributions and Fees

| | Number of claimants | Credit amount (millions) | Average credit |
|--|----------------------------|---------------------------------|-----------------------|
| 1998 | 74,242 | \$9.0 | \$121 |
| 1999 | 109,748 | \$14.8 | \$135 |
| 2000 | 149,215 | \$17.5 | \$117 |
| 2001 | 166,468 | \$20.0 | \$120 |
| 2002 | 143,697 | \$22.5 | \$156 |
| Source: "Arizona Department of Revenue 2004 Annual Report;" "Arizona Department of Revenue 2003 Annual Report;" "Arizona Department of Revenue 2002 Annual Report;" Department of Revenue, State of Arizona. | | | |

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In tax year 2002, more than 143,000 Arizona filers claimed the credit for contributions and fees, for a total of over \$22 million in credits and an average credit of \$156.

The average credit increased from 2001 to 2002; 2002 is the first year in which contributions to character education programs were eligible for the credit.

Credit for corporate contributions to school tuition organizations (STOs). Beginning in fiscal year 2007, corporations that are pre-approved by the Arizona Department of Revenue, under Arizona Statute, section 43-1183, may donate funds to STOs on a first-come, first-served basis for student scholarships and receive a dollar-for-dollar credit against the corporation's income taxes. The credit program is limited to a total of \$5 million in each fiscal year between July 1, 2006, and June 30, 2011. Corporate donors may carry forward unused credits for up to five years. For students to be eligible for program scholarships, their family income must not exceed 185 percent of the federal poverty level, which was \$37,553 for a family of four in the 2006-2007 school year, and they either must have attended a public school in the previous year or be entering kindergarten. Scholarships for students in kindergarten through grade 8 are capped at \$4,200 per school year and scholarships for students in grades 9 through 12 are capped at \$5,500 per school year, with both caps automatically increasing by \$100 annually. For STOs to qualify to participate in this program, they must be nonprofit organizations that allocate at least 90 percent of their revenue to private school scholarships and file periodic fiscal reports with the state revenue department. Participating STOs must not restrict scholarship donations to one school. A qualified STO that receives corporate contributions may establish additional student eligibility criteria, which often are based on students' financial need and sometimes target a particular residential area or school system. Private schools that receive scholarship donations must not discriminate based on students' race, color, disability, familial status, or national origin.

Legal challenge. When the Arizona Legislature enacted both the tax credits in 1997, state taxpayers and education groups filed a lawsuit in the Arizona Supreme Court, rather than a trial court, to gain an expedited ruling on whether the credit for school tuition organization

contributions, which benefited students attending private religious schools, violated federal and state constitutional prohibitions against government aid to religion. According to critics, the law did not:

- require school tuition organizations to give priority to poor children when granting scholarships;
- cap scholarship amounts in order to benefit the maximum number of students;
- explicitly prevent taxpayers from designating their contributions to benefit specific students who are not their own children; or
- preclude nonprofit groups from targeting donors interested in supporting scholarships to specific schools such as evangelical Christian schools.

In a three-to-two decision, the court upheld the law, concluding that the tuition tax credit does not prefer one religion over another, aids a broad spectrum of citizens, allows a wide range of private choices, and does not have the effect of advancing or inhibiting religion. The court based its conclusions on a variety of factors, including the following:

- there are no constitutionally significant distinctions between credits and deductions
- the school tuition tax credit is only one of an extensive assortment of tax saving mechanisms available to all state taxpayers, and not just to parents of school children
- student tuition organizations may not limit grants to students of only one institution
- the tax credit law achieves a higher degree of parity among families by making private schools more accessible and providing alternatives to public education
- the primary beneficiaries of the credit are taxpayers who contribute to student tuition organizations, whereas private religious schools are only incidental beneficiaries
- the tax credit is not an appropriation of public money and no money ever enters the state's control as a result of this credit

The two dissenting judges vigorously disagreed with the majority, arguing that the school tuition organization contribution credit represented government action designed to induce taxpayers to give direct financial support to predominantly religious schools, thereby violating both federal and state constitutional prohibitions against government aid to religion. The dissent observed that the law did not offer the same or even similar benefits to all taxpayers; it provides a \$500 credit for private school tuition contributions and a \$200 credit for reimbursement of extracurricular activity fees charged at public schools. The dissent also was troubled by the ability of a group of taxpayers under the law to form a school tuition organization to support schools affiliated with a particular religion. This decision is legally binding only in Arizona. The U.S. Supreme Court in 1999 declined to review the Arizona Supreme Court decision in *Kotterman v. Killian*, 528 U.S. 921 (1999).

On September 30, 2003, the U.S. Supreme Court agreed to review *Hibbs v. Winn*, a lawsuit brought by a group of taxpayers challenging Arizona's tax credit for private school tuition. Plaintiffs argued that the tuition tax credit, which allows contributions that benefit private schools, violates the establishment clause of the U.S. Constitution. The Ninth Circuit Court of Appeals reinstated the suit after it was dismissed by a federal district court on the basis that federal authorities cannot interfere with the collecting of state taxes. The Ninth Circuit ruled that because the taxpayers wanted to block the granting of a tax credit, and not the collecting of state

taxes, the federal Tax Injunction Act (TIA) and principles of comity and federalism that prevent federal courts from interfering with state tax collection do not apply. The director of Arizona's Department of Revenue wanted the U.S. Supreme Court to decide whether TIA and principles of comity required a federal court to dismiss a constitutional challenge to a state tax credit that directly affected how a state's tax system is administered. The director also argued that the Ninth Circuit Court of Appeals opinion conflicted with the holdings of other circuit courts and that the Arizona Supreme Court already decided the issue of constitutionality of the tax credit in *Kotterman v. Killian*.

In June 2004, the U.S. Supreme Court ruled that the tax credit could be challenged in federal court and returned the case to the federal district court. Unlike the first challenge that argued the law was unconstitutional as written, the second challenge argued that the credit was unconstitutional as implemented because contributions went to particular religions or religious schools. In March 2005, a federal district court judge granted a motion by the Arizona chapter of the Institute for Justice to dismiss the case and uphold the tax credits as constitutional. The Arizona Civil Liberties Union appealed the district court decision to the U.S. Circuit Court of Appeals, where the case is pending and may be subsequently appealed to the U.S. Supreme Court.

To date, there have been no legal challenges to the credit for corporate contributions to STOs.

Florida

Florida allows individual and corporate taxpayers to claim a nonrefundable credit for contributions to nonprofit scholarship-funding organizations (SFOs). The credit is limited to 75 percent of the claimant's tax liability. Taxpayers are allowed to carry forward unused credit amounts for up to three years. The overall credit amount statewide was limited to \$50 million in 2002 and originally scheduled to increase to \$88 million per year starting in 2003. The limit was reduced to \$50 million for 2003 in response to concerns about program administration, remained at \$50 million in 2004, and increased to \$88 million per year in 2005 and following years. The maximum per claimant is \$5 million. If claims exceed the limit for the year, the credit is to be allocated on a first-come, first-served basis, with 5 percent of the total reserved for small businesses.

Amounts contributed to nonprofit scholarship funding organizations must be awarded to students who qualify for free or reduced price school lunch, with priority given to students who qualified for a scholarship in the preceding school year. The maximum scholarship is \$3,500 for a student attending a nonpublic school, and \$500 for a student attending a public school located outside the district in which the student lives. Scholarships may be used for paying tuition, textbook, and transportation expenses; if the scholarship is to a nonpublic school, 75 percent must be used for tuition. Unlike the Arizona program, all contributions must be used to provide scholarships in the same state fiscal year in which the contribution is received.

Table 10
Florida Corporate Tax Credit Scholarship Program

| | Number of claimants | Credit amount (millions) | Number of private school scholarships awarded | Private school scholarship per student |
|--|----------------------------|---------------------------------|--|---|
| 2002 | 77 | \$47.7 | 15,585 | \$3,500 |
| 2003 | 114 | \$47.6 | 11,550 | \$3,500 |
| 2004 | 102 | \$47.6 | 10,473 | \$3,500 |
| 2005* | 113 | \$74.1 | 13,497 | \$3,500 |
| * Credit data as of January 2006; private school scholarship data as of November 1, 2005. Source: "Program Statistics" Florida Department of Education, http://www.floridaschoolchoice.org/Information/CTC/program_statistics.asp ; Florida Department of Revenue; e-mail correspondence with Christian Weiss, Florida Chief Economist. | | | | |

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In tax year 2004, 102 companies made donations that qualified for \$47.6 million in credits, \$2.4 million under the limit for 2004. These contributions funded scholarships for 10,473 students in the 2004-2005 school year.

Illinois

Illinois enacted legislation in June 1999 to provide its taxpayers with a tax credit of up to \$500 per family for qualified educational expenses for tuition, books, and lab fees. The credit equals 25 percent of qualified educational expenses above \$250, up to the maximum of \$500; a family must spend at least \$2,250 to qualify for the full \$500 credit. The credit is nonrefundable; that is, taxpayers' liability cannot be reduced to less than zero under this credit. To be eligible for the credit, the student generating the qualified educational expenses must be:

- an Illinois resident;
- under age 21 at the end of the school year for which the taxpayer claims the credit; and
- enrolled full-time in a kindergarten through grade 12 education program at any public or accredited nondiscriminatory nonpublic school that provides instruction in English.

Table 11
Illinois Education Tax Credit

| | Number of claimants | Credit amount (millions) | Average credit |
|------|----------------------------|---------------------------------|-----------------------|
| 2000 | 165,781 | \$61.2 | \$369 |
| 2001 | 189,055 | \$68.4 | \$362 |
| 2002 | 185,005 | \$66.5 | \$360 |
| 2003 | 194,923 | \$67.1 | \$344 |
| 2004 | 207,275 | \$67.9 | \$328 |

Source: Illinois Department of Revenue 2003 Annual Report; telephone communication with Illinois Department of Revenue, February 2006.

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Data from the Illinois Department of Revenue indicate that 207,275 returns claimed a total of \$67.9 million in credits in tax year 2004, for an average credit of \$328.

Legal challenge. Two Illinois circuit courts and the Fourth and Fifth District Appellate Courts of Illinois have held the Illinois educational expense tax credit constitutional.

In *Toney v. Bower*, a group of parents sued the director of the Illinois Department of Revenue, charging that Illinois' Income Tax Act violated the state and federal constitutions by:

- allocating the benefit of the credit primarily to taxpayers whose children attend private school;
- discriminating against low-income parents who earn insufficient income to claim the credit;
- allowing money that would otherwise be paid to the state in income taxes to be used to pay private school expenses;
- expending at private schools virtually all money diverted from the state treasury as a result of the credit;
- giving a preference in law to a religious denomination or mode of worship;
- using public funds for religious education and activities, which are not public purposes; and
- distinguishing between low-income and high-income taxpayers in terms of who can take full advantage of the credit, which bears no reasonable relationship to the credit's stated objective.

The trial court dismissed the plaintiffs' complaint, finding that:

- the statute's secular purpose includes assisting parents in meeting the rising costs of educating their children, ensuring that Illinois children are well-educated, and maintaining the financial health of private schools because such schools relieve taxpayers of the burden of educating private school students;
- the credit is one of many credits allowed by tax laws;

- the credit is facially neutral in its availability to all parents of public and private sectarian and nonsectarian school children;
- public funds become available to schools only as a result of private choices made by individual parents;
- disallowing deductions for materials used in teaching religious tenets does not foster excessive government entanglement with religion; and
- differences that exist in the deductions granted various classes of taxpayers satisfy the state's constitutional requirement for reasonableness.

Plaintiffs appealed and a three-judge panel of the Illinois Fourth District Appellate Court unanimously affirmed the trial court's decision in *Toney v. Bower*, 744 N.E. 2d 351 (Ill. App. Ct. 2001). The Illinois Supreme Court refused to grant an appeal and let the appellate court decision stand.

In *Griffith v. Bower*, the plaintiffs raised arguments almost identical to those raised and addressed in *Toney*. In upholding a trial court decision, a unanimous three-judge panel of the Illinois Fifth District Appellate Court in *Griffith v. Bower*, 747 N.E. 2d 423 (Ill. App. Ct. 2001), found the reasoning in *Toney* persuasive and gave similar answers to plaintiffs' charges, finding the act constitutionally permissible because:

- the credit under the act does not involve any appropriation or use of public funds and no money enters the state's control as a result of the tax credit;
- the act allows Illinois parents to keep more of their own money to spend on educating their children as they see fit and assists parents in meeting rising education costs;
- the act has the secular purpose of ensuring that Illinois children are well-educated;
- maintaining the financial health of private schools relieves taxpayers of the burden of educating private school students;
- the credit is equally available to all parents of public or nonpublic school children; and
- funds become available to schools only as the result of private choices made by individual parents.

Iowa

Tax credit for education expenses. Iowa provides its taxpayers with a tuition tax credit equal to 25 percent of the first \$1,000 the taxpayer pays to others for tuition, nonreligious textbooks, and extracurricular activities for each dependent in kindergarten through grade 12 who attends an accredited not-for-profit nondiscriminatory elementary or secondary school in Iowa. The credit percentage was increased from 10 percent to 25 percent in tax year 1998. There is no income limit on eligibility for the credit; before 1998 the credit was limited to taxpayers with household incomes under \$40,000.

Under Iowa Statute, section 422.12, subsection 2, "textbook" means books and other instructional materials and equipment used in teaching subjects commonly taught in the state's public elementary and secondary schools. The definition of "textbook" excludes religious textbooks and materials. Beginning in 1998, the definition was amended to include books and materials used for extracurricular activities such as sporting events, musical or dramatic events,

speech activities, driver’s education, and similar programs; these books and materials were excluded before 1998.

Subsection 2 defines “tuition” to mean charges for personnel, buildings, equipment, materials, and other expenses of elementary and secondary schools related to teaching subjects commonly taught in the state’s public elementary and secondary schools. The definition of “tuition” excludes charges related to teaching religious subjects. The definition of “tuition” was expanded beginning in tax year 1998 to include charges for providing extracurricular activities; before 1998 charges for extracurricular activities were explicitly excluded from “tuition.”

Table 12
Iowa Tuition Tax Credit

| | Number of claimants | Credit amount (millions) | Average credit |
|------|----------------------------|---------------------------------|-----------------------|
| 1997 | 89,110 | \$3.0 | \$33 |
| 1998 | 71,500 | \$8.7 | \$122 |
| 1999 | 127,100 | \$10.3 | \$81 |
| 2000 | 141,500 | \$11.5 | \$81 |
| 2001 | 152,400 | \$12.4 | \$81 |
| 2002 | 161,500 | \$13.1 | \$81 |
| 2003 | 166,700 | \$13.8 | \$83 |

Source: “Iowa Individual Income Tax Annual Statistical Report,” 2000 to 2003, and correspondence with Iowa Department of Revenue and Finance.

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In tax year 1997, when the credit was still at 10 percent of the first \$1,000 of expenses, and when the definition of expenses excluded books, materials, and charges for extracurricular activities, about 89,000 taxpayers claimed the credit for a total tax expenditure of about \$3 million. In tax year 1998, after the credit rate increased to 25 percent, the definition of allowable expenses was expanded to include extracurricular activities, and the household income limit was removed, the number of taxpayers claiming the credit decreased to 71,500, and the total tax expenditure increased to \$8.7 million. Since then the number of claimants has continued to grow, reaching 166,700 in tax year 2003, while the average credit has leveled off at just over \$80.

Tax credits for contributions to school tuition organizations (STOs). Beginning in 2006, taxpayers who voluntarily contribute under section 422.11M of the Iowa Code to a qualified STO to support private school scholarships are eligible to receive an individual income tax credit of up to 65 percent of the value of their contribution. A qualified STO must be a private nonprofit organization that supports private school scholarships. The statewide tax program is limited to \$2.5 million in 2006 and \$5 million in subsequent years. The tax credit amount that each qualified STO can give to its contributors in the form of a tax certificate is restricted to the STO’s share of the total statewide value of the program, and is based on student enrollment in those schools where the STO distributes its scholarships. An STO must:

- be a federally tax-exempt organization;
- be governed by a seven-member board of directors;
- use 90 percent of contributions to provide scholarships to nonpublic school children from families whose household income does not exceed 300 percent of federal poverty guidelines;
- annually certify its student enrollment to the Iowa education department; and
- direct a CPA to conduct an annual financial review.

STOs may not restrict scholarships to a single school although students who receive scholarships from an STO may all elect to attend the same school. Contributing taxpayers may not identify particular students as scholarship recipients. Participating schools must be state accredited and comply with federal and state civil rights laws.

Legal challenge. The Iowa Legislature first enacted legislation providing taxpayers with tuition and textbook deductions or credits on personal income tax returns in 1987. Iowa taxpayers brought suit in federal district court claiming that the income tax law violated the establishment clause of the First Amendment of the U.S. Constitution that prohibits Congress and the states, through the Fourteenth Amendment, from making laws establishing religion. The federal district court determined that the case was substantially similar to *Mueller v. Allen*, in which the U.S. Supreme Court upheld the constitutionality of Minnesota's education tax deduction statute. The court in *Luthens v. Bair*, 788 F. Supp. 1032 (S.D. Ia. 1992), found the Iowa tax law constitutional because, among other things, it:

- assured that taxpayers using the standard deduction gained the same type of tax benefit based on actual tuition and textbook payments that itemizing taxpayers gained;
- encouraged students to attend accredited schools, which served an important state interest
- provided direct financial benefits to the parents of school children, and only attenuated benefits to schools;
- excluded expenses related to the teaching of religion;
- avoided the need for on-site monitoring by prorating the financial benefit based on the time a student spent in classes for religious instruction and for subjects commonly taught in public schools; and
- created a relationship between the state and its taxpayers and, because it did not provide any kind of direct aid to parochial schools, did not create an impermissible relationship between the state and parochial schools.

There have been no legal challenges to the program providing tax credits for donations to STOs.

Pennsylvania

Beginning midyear in 2001, Pennsylvania allowed corporations to claim a nonrefundable credit based on contributions to nonprofit scholarship-funding organizations (SFOs), or contributions to educational improvement organizations (EIOs) for innovative public school programs. In 2005 the Educational Improvement Tax Credit was expanded to pre-kindergarten scholarship organizations. The credit equals 75 percent of contributions for one-time contributions, and 90 percent of contributions for two-year commitments by corporations. The maximum credit per

corporation is \$200,000 and may not be carried forward to future tax years. The overall credit amount statewide in 2002 and 2003 was limited to \$30 million, with \$20 million directed toward SFOs and \$10 million toward innovative public school programs. The limit increased to \$40 million in 2004, with two-thirds of the total allocated to SFOs and one-third to innovative programs. In 2005, the limit remained at \$40 million for SFOs and innovative programs, with an additional \$5 million allowed for pre-kindergarten scholarship organizations. In 2006, the total allocated to SFOs and innovative programs will increase to \$44 million (still allocated two-thirds to SFOs and one-third to innovative programs), with an additional \$5 million for pre-K scholarship programs.

Table 13
Pennsylvania Educational Improvement Tax Credit

| | Number of claimants | Contributions (millions) | Credit amount (millions) |
|---|----------------------------|---------------------------------|---------------------------------|
| 2002 | 1,135 | \$29.6 | \$26.0 |
| 2003 | 1,356 | \$33.3 | \$29.7 |
| 2004 | 1,566 | \$43.5 | \$38.3 |
| 2005 | 1,470 | \$46.7 | \$41.8 |
| Source: Pennsylvania Department of Community and Economic Development, e-mail correspondence, Sept. 26, 2005. | | | |

House Research Department

In fiscal year 2005, 1,470 businesses made \$46.7 million in qualifying contributions, resulting in \$41.8 million in tax credits.

Scholarships are targeted to students in families with household incomes of \$50,000 or less. The household income limit of \$50,000 is adjusted upward by \$10,000 for each dependent in the household. SFOs and prekindergarten scholarship organizations must apply at least 80 percent of their annual receipts toward scholarships, and educational improvement organizations must apply at least 80 percent of their annual receipts towards grants to public schools.

For more information about income tax deductions and credits, visit the income tax area of our web site, www.house.mn/hrd/issinfo/tx_inc.htm.