Appendix A: How the Public Education Tax Credit Act Works

The Public Education Tax Credit Act allows all taxpayers, individual and corporate, to claim education tax credits for direct payment of educational expenses and for contributions to organizations that provide educational scholarships to lower-income families. Taxpayers can claim these credits against their state income, sales, and local property taxes where these are applicable.

All education providers—government, religious, or secular—constitute public education because all serve the public by educating children. Expanding the embrace of "public" education is an overdue recognition of educational reality, not political semantics. This model legislation presents a more effective way of fulfilling the ideals of public education, by ensuring that all families have the means to choose their children's schools from a diverse market of education providers.

The act is designed to provide universal access to the educational marketplace, not to create unnecessary dependence on third-party education funding or government programs. It therefore limits access of higher-income individuals to the scholarships funded by donation tax credits and phases out personal-use credits at the highest income levels. All individuals, regardless of income, can claim credits for education donations.

This proposal is the most comprehensive and broad-based tax credit model legislation yet developed. It offers the strongest prospects for creating a public education system that is dynamic, productive, and driven by freedom rather than coercion. Although this model tax credit legislation combines many aspects of previous proposals, it breaks new ground in the following five crucial respects.

1. Taxpayers are allowed to take credits against all three primary sources of non–federal government revenue: state income taxes, state sales taxes, and property taxes. This will ensure that the tax liabilities are sufficient to underwrite universal educational freedom.

2. The program is not capped at an arbitrary dollar amount. Each child is eligible to receive tax-credit-derived funds up to an amount that is less than current per pupil spending in government schools. Taxpayers may donate all of their tax liability for education; the total amount will be limited by the needs of each scholarship organization, which must use the funds for scholarships based on need and return any funds in excess of a 25 percent reserve. Therefore, money will be saved—as is the case in current choice programs—with each student's switch from the government system to the tax credit system.

3. Scholarship eligibility is not capped at an arbitrary income level. Families can secure scholarship assist-ance on a sliding scale relative to their tax liability. As family income increases, so does the tax liability against which it can claim personal-use credits. And as this personal-use credit increases, the amount of scholarship funds for which they are eligible decreases correspondingly.

Every family will have a "child credit cap" for each child, with the amount varying by family income. For example, say one family's child credit cap is $3,000 and they have one child. If that family pays enough taxes to claim $1,000 in personal-use credits, then it is eligible to use up to $2,000 in scholarship funds derived from donation tax credits. If it can claim $2,000 in personal-use credits, it can use only $1,000 in scholarship funds.

This formula will ensure that there is no coverage gap or unfair penalty for middle-class families who are able to pay for a significant portion of their education expenses but still need assistance.

4. The tax credits cover all education expenses, not just tuition. This aspect of the legislation ensures that parents have the greatest flexibility in choosing the best education possible for their child. It will enable the use and encourage the development of educational services such as distance learning, tutoring, and education support networks such as those for home schooling. It will produce the most dynamic education market choice for families possible.

5. Anyone can directly donate money for the education of a child. Grandparents, uncles and aunts, other relatives or friends, and even businesses can all pitch in together to help educate a child. This provision will ensure that friends and families take responsibility for a child's education before strangers do, helping to strengthen family and community bonds.

Although the concepts presented here are similar to ones contained in other model legislation and existing law, a number of innovations may require additional explanation. The extensive endnotes explain important provisions in the model legislation and are crucial to understanding the legislation.

The legislation can appear more complicated than it is, and the need to spell out in technical detail all provisions can make it difficult to see the big picture. The examples below show how the act would work for a variety of families and businesses. Two short scenarios and a few longer examples highlight the flexibility and comprehensive coverage of the Public Education Tax Credit Act.

Lower-income family—short example. Nancy Williams just moved to a new city to look for work. She found a job right away but isn't earning much money, doesn't have a partner, and has no family in the area. The biggest worry for Nancy is her son, John, who's in the sixth grade and not doing well. John is getting in trouble at school and falling behind academically.

Nancy knows she has to get John out of the failing school he's assigned to but can't imagine how she would pay for tuition, even at the Catholic school down the street which costs only $2,500. Luckily, Nancy's neighbor tells her about a scholarship organization that helps out with his daughter's tuition.

Nancy calls the school the next day at lunch, and they tell her that she clearly qualifies to get John a scholarship. The scholarship organization will cover $2,340—all but $160 for the year. She knows that saving even that small portion of the tuition will take an effort, but the scholarship organization promises to help her with financial planning. Nancy is relieved to know that John will be in a safe, disciplined environment next year with a solid academic reputation, and she's proud to be supporting her son's education as much as she can right now.

Middle-Income Family—Short Example. Mr. and Mrs. Jones have a four-year-old daughter, Emily, and an income of $45,000. They have been thinking about preschool and would love to send her to a great Montessori school down the street, but the $4,800 tuition is out of their price range.

The Joneses started asking some friends with older kids about preschool options, and one couple told them that they should take a look at the state education tax credit program, which lets them keep their money to spend on education instead of sending it to the state in taxes. It sounded too good to be true, but Mr. Jones looked at an information page online and saw that they could use the $3,100 they owed in combined state income and local property taxes to help pay for the Montessori school.

That weekend, the Joneses took a look at their budget and saw that they could pay the $1,700 left on the tuition after claiming their tax credits if they made some changes to their budget. The Joneses quickly signed Emily up for the next year and started telling all of their friends about the great tax credit program that let them control their own education funds.

Lower-Income Family. Mr. and Mrs. Smith have one child, Joe, and a family income of $27,000. They live in a state that spends $10,000 per student in the government system (the national average). Because they qualify for the Free or Reduced-Price Lunch Program, they can use Public Education Tax Credits worth 80 percent of government school per-student spending, which means $8,000 (that limit is called the "child credit cap").

During the summer, the Smiths aren't sure what they are going to do, but they know they need to get Joe into a better school. The one he's assigned to just isn't working for him. They've talked to friends and neighbors and have heard about a state program to help parents do exactly what they want to: choose another school for Joe. When they ask friends from their church, they discover that it actually runs a scholarship program to help parents choose a school. The church established its own scholarship organization a few years back by filing an application with the state, an easy process since it was already a registered nonprofit. The Smiths get some pamphlets the next Sunday and set up an appointment with an administrator to talk about their options.

At the meeting, Sue, from the church's scholarship organization, explains the program and gets them started. The Smiths have a small state sales tax credit that they can claim for education expenses. But that only comes to about $500 for the year. They are going to need a lot of help to get Joe into a better school.

Sue tells the Smiths that they can use up to $8,000 total under the tax credit program. Of that amount, they can get $7,500 in scholarships and claim the remaining $500 in credits from their own tax liability. Sue says that the church will be happy to give Joe scholarship money to go to a good school, but she reminds them to ask relatives if they can help out too. She explains that Joe's grandparents or uncle, or even a family friend or employer, can help pay and claim tax credits for Joe's education expenses (thanks to the credit, their contributions may cost them little or nothing).

Sue gives the Smiths a few forms and helps fill them out. She also gives them a list of schools in their area to ask around about. Then she sets up another meeting so they can see how much scholarship money Joe will need to go to the school his parents choose.

At their next meeting, the Smiths tell Sue that Apple Elementary looked great, and that Joe's grandparents filled out their form to claim $1,000 in tax credits on their taxes that year and write a check to the school. Since Apple Elementary costs $3,000, Sue files the church scholarship application for $1,500, along with a $500 loan that will let Mr. and Mrs. Smith pay their share up front, and tells them that they will have their confirmation letter in a week. The Smiths file their application with Apple Elementary and hear back in a few weeks that Joe has been accepted for the fall.

Middle-Income Family. Mr. and Mrs. Johnson have two children, Jack and Jill, and a family income of $58,000. They live in a state that spends $10,000 per student in the government system. Because their income is more than 1.5 times the Free or Reduced-Price Lunch Program but less than 3 times that limit, they can use Public Education Tax Credits worth 50 percent of government school per-student spending, which means $5,000 for Jack and $5,000 for Jill (the child credit cap).

During the summer, the Johnsons made a tough decision. Their daughter Jill is doing well at the government school she's assigned to, but Jack is really struggling. They know Jack needs to go to a school that has more structure and discipline but don't know how they can pay for tuition at Maple Middle School, a school they know has done wonders with a boy who used to play soccer with Jack.

Mrs. Johnson remembers reading something in the newspaper about a state program that gives parents a tax break to help pay for education expenses, just like their mortgage tax deduction helps them with house payments. Mrs. Johnson calls Maple Middle School to ask about applying to the school and to find out more about the education tax break. She sets up a meeting for the next week. In the meantime, Mrs. Johnson looks at the Public Education Tax Credit information website the man at the school recommended.

The Johnsons find that they can claim a sizeable amount of money in tax credits. Between their property taxes that fund local schools, sales taxes, and income taxes, they can claim $2,000. Mrs. Johnson also finds out that her employer has an employee donation policy and will pay $2,500 for each child of every employee—because they can adjust their tax payments and claim a tax credit for the donation, it only costs them a little paperwork. Also, Mr. and Mrs. Johnson discover they can adjust their state income tax withholding according to the state sales and income tax credits they will claim at the end of the year. That way they won't have to pay everything out-of-pocket before they file their return.

The Johnsons are excited but still a bit concerned because Maple Middle School costs $5,500 and they only have $4,500 in credits so far. They speak with the school admissions advisor, and he informs them that the school has a scholarship fund supported by former students and community businesses which can be used to help fill the gap. The Johnsons are eligible for up to $3,000 in scholarship funds, because their tax liability is only $2,000 and their child credit cap for each child is $5,000. Since Mrs. Johnson's employer gave them $2,500, they can use $500 in scholarship funds. The Johnsons and the admissions advisor work out a plan whereby the school scholarship fund will give Jack $500 and the Johnsons will pay the last $500 out of their own pocket without a credit.

The school advisor gives them a few papers to fill out, and the Johnsons rest easy knowing that Jack will be in a school that's a better fit this year. And they now know they can get more help for Jill if she needs to switch schools later on. Mrs. Johnson's employer would donate another $2,500 in credits if Jill needed to find another school, and they would be eligible to get Jill another $2,500 in scholarship funds since they used all of their personal tax credits on Jack. The school advisor assures them that they can work out a combination of scholarships and payments if they find that Maple Middle School or Oak High School is where Jill would do best.

Upper-Income Family. Mr. and Mrs. Garcia have one child, Isabel, and a family income of $200,000. They live in a state that spends $10,000 per student in the government system. Because their income is more than six times the Free or Reduced-Price Lunch Program, they can't use any Public Education Tax Credits for Isabel. But they can claim credits on 100 percent of their state tax liability for donating money directly to another family or to a scholarship fund.

Mr. Garcia heard about the state education tax credit program on a radio news program and talked about it with a friend and business colleague over lunch. His friend said he'd learned about it through his accountant and business manager, who recommended it as a good option for his business and for him personally—it's a great way to help people and donate money instead of letting it be wasted by the government school bureaucracy, he said.

Mr. and Mrs. Garcia spoke about it that night, and the next day Mr. Garcia met with his accountant. The Garcias can claim credits on $22,000 of sales taxes, property taxes that fund local schools, and income taxes. They decided they want to divide the credits among a few different scholarship organizations: $15,000 would go to a scholarship organization that works with schools that have tremendous success raising achievement levels of children from lower-income families in the city; $5,000 would go to a scholarship organization at a school that specializes in science and math (since Mr. Garcia is an architect and Mrs. Garcia is a biologist); and $2,000 would go to the scholarship organization to help families at the school where Isabel is enrolled.

The Garcias are excited to be able to spend their money directly on schools that work and the kinds of education that they personally find important. Finally, with the Public Education Tax Credit, they are able to see their money make a difference rather than send it to disappear in the bureaucratic maze of the government school system.

Business. The scenario for businesses is much the same as the example for a high-income family, because most businesses are S-Corps or LLCs, where business income is in many ways equivalent to individual income. All corporations are allowed to claim tax credits for donations to scholarship organizations and expenses incurred in support of a qualifying student's education expenses.

The Public Education Tax Credit Act is model legislation that doesn't address each state's specific taxes. Businesses should, however, be allowed to claim tax credits against any state business taxes in addition to property and income taxes. In addition, businesses could donate directly to employees or other parents needing aid for the education of their eligible children.

Appendix B: The Public Education Tax Credit Act (Donation and Family-Use Education Tax Credits)

Summary: This legislation creates an education tax credit for direct payment of educational expenses and for contributions to organizations that provide educational scholarships to eligible students in order to allow all parents to choose the best education for their children.

Section 1: Title

The Public Education Tax Credit Act[1]

Section 2: Definitions

A) "Program" means the program established by the Public Education Tax Credit Act.

B) "Department" means the state Department of Revenue.

C) "Educational expenses" means tuition at a qualifying school; transportation related to educational activities; tutoring services; educational association membership or testing fees; and educational materials such as books, school supplies, and academic lessons and curricula. Educational expenses for students taught in a nonpublic home-based program do not include expenses for tutoring or academic lessons if the parent conducts them. Educational expenses for a student who is enrolled in a public elementary and/or secondary school in our state, but who is not a resident of that school district include only transportation and out-of-district tuition expenses. Educational expenses do not include athletic fees or expenses.[2]

D) "Eligible student" means a student who:

1) is a resident of the state no less than age 5, is no more than age 18, and has not graduated from high school; and

2) was eligible to attend a government school in a preceding semester or is starting school for the first time, and is not enrolled in a public elementary or secondary school;[3] or

3) is not a resident of the school district of the public school in which the student is enrolled.

The eligible student must otherwise be in compliance with state education law.[4] Notwithstanding the above, the student for whom someone is claiming a credit against property taxes must be a resident of the school district in which that person is claiming the credit.[5]

E) "Scholarship organization" means an organization that receives donations from taxpayers and gives educational scholarships to eligible students.

F) "Parent" includes a guardian, custodian, or other person with authority to act on behalf of the student.

G) "Educational scholarships" means grants to students to cover part or all of the educational expenses of an eligible student.

H) "Funding benchmark" means the dollar amount equal to the average per-pupil expenditures for public schools from both state and local government sources during the year of enactment, with this amount adjusted each year in the same manner that brackets are adjusted in Section 1(f) of the Internal Revenue Code.

I) "Child credit cap" means the percentage of the funding benchmark a family is eligible to use for each eligible student as determined in Section 5.

J) "Government school" means a public government school as defined in Section x of state law.

Section 3: Basic Elements of the Public Education Tax Credit Act[6]

A) Individuals and corporations may claim a Public Education Tax Credit (donation) against relevant taxes detailed in Section 4 by contributing to scholarship organizations or by contributing directly to the payment of an eligible student's educational expenses.[7]

B) Parents may claim a separate Public Education Tax Credit (personal use) for the educational expenses of each child who is an eligible student.

C) Public Education Tax Credits are nonrefundable.[8]

D) Scholarship organizations may solicit contributions from individuals and corporations and provide educational scholarships to eligible students.

E) A corporate taxpayer, an individual taxpayer, or a married couple filing jointly may carry forward unused Public Education Tax Credits (for donation and personal use) for three years.[9]

F) For corporations, the amount of the Public Education Tax Credit (donation) shall equal any contributions to scholarship organizations during the taxable year for which the credit is claimed, up to 100 percent of the taxpayer's tax liability.[10]

G) For parents, the total amount of the Public Education Tax Credit (personal use) claimed for their eligible children shall equal no more than their total direct payments for educational expenses for all of their dependent eligible children, up to the child credit cap for each child or their total applicable tax liability, whichever is less, during the taxable year for which the credit is claimed.

H) For parents, the total amount of the funds used for their eligible children which is derived from scholarship organizations cannot exceed the total amount of their child credit caps minus their total tax liability against which a Public Education Tax Credit can apply (total amount available for personal use).

I) For an individual taxpayer or a married couple filing jointly, the amount of the Public Education Tax Credit claimed shall equal the total direct payments for educational expenses of eligible students (personal use credit) plus any contributions to scholarship organizations (donation credit) during the taxable year for which the credit is claimed, up to 100 percent of the taxpayer's tax liability.[11]

Section 4: Application of Tax Credits to Income, Sales, and Property Taxes[12]

A) Tax credits may be claimed against a taxpayer's full income tax liability in accordance with Sections 3 and 5.

B) Tax credits may be claimed against a person's full sales tax liability in accordance with Sections 3 and 5. The state sales tax liabilities against which individuals may claim credits will be determined according to tables produced by the Internal Revenue Service in accordance with the Tax Relief and Health Care Act of 2006, *Publication 600, State and Local General Sales Taxes* for the most recent year available.[13]

C) Tax credits may be claimed against a taxpayer's full property tax liability,[14] in accordance with Sections 3 and 5, to the extent that it derives from property taxes imposed for school operating purposes but not from property taxes levied for bonded indebtedness or payments pursuant to lease-purchase agreements for capital construction.[15] The eligible student for whom the person is claiming the credit must be a resident of the school district in which the person is claiming the credit.

1) The department shall develop forms for administering and claiming the credit for property tax purposes. The person or person's agent must use these forms to claim the credit. Tax collecting entities shall make the forms available at offices and locations where tax information is distributed.
2) The person shall claim the credit for

property tax purposes at the time payment is made and shall furnish the collecting entity a completed form, a copy of the receipt, and payment for the amount due, if any, after application of the credit.

Section 5: Determining the Child Credit Cap[16]

A) An eligible student's family can use a combination of Public Education Tax Credits up to the total amount of the child credit cap for each dependent eligible student.[17]

B) Notwithstanding the above, an eligible student's family can use educational scholarships derived from Public Education Tax Credit donations that amount to no more than the total of all child credit caps for all dependent eligible students minus the family's total tax liability for which a tax credit is available during the taxable year in which the scholarship is claimed.[18]

C) The child credit cap is:[19]

1) 80 percent of the funding benchmark for each dependent eligible student in a family with a current-year taxable income not exceeding the family size and income standards used to qualify for a reduced-price lunch under the national Free or Reduced-Price Lunch Program (42 USC Section 1751 et seq.).
2) 70 percent of the funding benchmark for each dependent eligible student in a family with a current-year taxable income not exceeding 1.5 times the family size and income standard used to qualify for a reduced-price lunch under the national Free or Reduced-Price Lunch Program (42 USC Section 1751 et seq.).
3) 50 percent of the funding benchmark for each dependent eligible student in a family with a current-year taxable income not exceeding *3.0 times* the family size and income standard used to qualify for a reduced-price lunch under the national Free or Reduced-Price Lunch Program (42 USC Section 1751 et seq.).[20]
4) 25 percent of the funding benchmark for each dependent eligible student in a family with a current-year taxable income not exceeding 6.0 times the family size and income standard used to qualify for a reduced-price lunch under the national Free or Reduced-Price Lunch Program (42 USC Section 1751 et seq.).
5) 0 percent of the funding benchmark for each dependent eligible student in a family with a current-year taxable income that is *more than 6.0 times* the family size and income standard used to qualify for a reduced-price lunch under the national Free or Reduced-Price Lunch Program (42 USC Section 1751 et seq.). These families *are* still able to claim credit for donations to scholarship organizations or direct payment of educational expenses for nondependent eligible children.[21]

D) Notwithstanding the above, each family that makes use of a combination of both donation and personal use credits must ensure that the total used does not exceed the total in child credit caps for which they are eligible according to the guidelines in section 5C above. If a family overestimates the scholarship funds for which they are eligible, the taxpayer must adjust downward the personal tax credit claimed on their income tax return for the current year.

Section 6: Responsibilities of Parents Claiming or Using Public Education Tax Credits[22]

A) Parents may claim the Public Education Tax Credit only for expenses they actually paid.

B) On a form prescribed by the department, parents will provide a detailed listing of the educational expenses for each child for whom they claim or have used a tax credit. They will attach to the form all receipts necessary to document these expenses.

C) On a form prescribed by the department, parents will provide a detailed listing of all taxpayers claiming tax credits for the educational expenses of the parents' dependent children and/or all scholarship organizations providing funds for the educational expenses for each dependent child. For each taxpayer and/or scholarship organization, parents will list the full name, address, total funds provided, and date of funding.[23]

Section 7: Responsibilities of Taxpayers Claiming Tax Credits

A) On a form prescribed by the department, taxpayers will provide a detailed listing of the scholarship organization(s), child or children, and family or families to which they provided funds. In each case, taxpayers will list the full name, address, total funds provided, and date of funding.

Section 8: Responsibilities of Scholarship Organizations[24]

A) Each scholarship organization shall:[25]

1) notify the department of its intent to provide educational scholarships to eligible students;
2) demonstrate to the department that it has been granted exemption from federal income tax as an organization described in Section 501(c)(3) of the Internal Revenue Code;
3) distribute periodic scholarship payments to parents or education providers serving specified parents for the specified educational expenses;
4) provide a department-approved receipt to taxpayers for contributions made to the organization;
5) ensure that at least 85 percent of revenue from donations is spent on educational scholarships, and that all revenue from interest or investments is spent on educational scholarships;
6) verify annually by written and signed statement from each family or guardian the total scholarship amount for which each child is eligible according to Section 5;
7) demonstrate its financial accountability by:

a. submitting a financial information report for the organization, conducted by the certified public accountant, that complies with uniform financial accounting standards established by the department; and
b. having the auditor certify that the report is free of material misstatements.

8) file with the department prior to the start of the school year financial information that demonstrates the financial viability of the scholarship organization if it is to receive donations of $50,000 or more during the school year.[26]

B) Notwithstanding the above, each scholarship organization may keep no more than 25 percent of total revenue from the previous fiscal year unused in a reserve fund. Any unused revenue in excess of this amount must be remitted to the taxpayer on or before a date one month prior to the tax filing deadline.[27]

Section 9: Responsibilities of the Department of Revenue[28]

A) The department shall develop a standardized form for education service providers to document the amount paid by a parent for qualified educational expenses.

B) The department shall ensure that parents are aware of the Public Education Tax Credit and that all procedures for claiming the credit are easy to follow.

C) The department shall establish guidelines for parents to easily assign their tax credit to their student's qualifying school and to easily adjust their state income tax withholding to reflect tax credit claims.[29]

D) The department shall require all scholarship organizations to register and annually report the information the department needs to carry out its responsibilities.

E) The department shall adopt rules and procedures consistent with this act as necessary to implement the Public Education Tax Credit Act.

F) The department shall annually report to the legislature on the number of parents claiming the tax credit, the dollar amount of the credits claimed by parents, the number of schools accepting eligible students who received a tax credit or educational scholarship, the number of scholarship organizations, the number and dollar amount of contributions to a scholarship organization, and the number and dollar amount of educational scholarships given to eligible students.

G) The department shall have the authority to conduct either a financial review or audit of a scholarship organization if possessing evidence of fraud.

H) The department may bar a scholarship organization from participating in the program if the department establishes that the organization has intentionally and substantially failed to comply with the requirements in Section 8.

I) If the department decides to bar a scholarship organization from the program, it shall notify affected scholarship students and their parents of this decision as quickly as possible.

J) The department shall allow a taxpayer to divert a prorated amount of state income tax withholdings to a scholarship organization of the taxpayer's choice up to the maximum credit allowed by law, including carry-over credits. The department shall have the authority to develop a procedure to facilitate this process.[30]

K) A qualifying school is autonomous and not an agent of the state or federal government. Neither the department nor any other state agency may regulate the educational program of a provider of educational services that accepts payments from eligible students under this program. The creation of the Public Education Tax Credit program does not expand the regulatory authority of the state, its officers, or any local school district to impose any additional regulation on education service providers.

Section 10: Effective Date

The Public Education Tax Credit may first be claimed in the next calendar year.[31]

Notes on the Public Education Tax Credit Act

These notes are intended to provide guidance to legislators on some of the key policy questions they will encounter in drafting and debating school choice tax credit legislation.

1. The model legislation has been drafted to make the tax credits for tuition and scholarship assistance immediately available in the next tax year. This may represent too great a transition for the state to make at one time. To increase competitive density and help maintain fiscal neutrality, both the personal use and donation credits can be phased in by age group, starting with the youngest children. It is important to use students' age rather than school grade as a phase-in metric, since some schools do not use a rigid age-based grading system.

2. The definition of "educational expenses" has been left intentionally broad. Parents should be allowed to choose the combination of educational products and services that best serves their children. Limiting education tax credits to tuition at a traditional brick-and-mortar school significantly compromises consumer freedom, inhibiting the use of alternative educational services and the development of a truly innovative education market. It is particularly important to allow room for, rather than to discourage, the further development of educational services such as distance learning, tutoring, and education support networks such as those for home schooling. Legislators should clearly define categories of expenses that they wish to allow because experience has shown that some hostile revenue agencies have disallowed legitimate homeschooling expenses such as music and language lessons. When enumerating such legitimate expenditure categories, the legislation should note that such lists are not meant to be exclusive, using language