APPLICATION OF THE ARIZONA DEPARTMENT OF EDUCATION,
Applicant.

Docket No. 93-154-I
Impact Aid Proceeding

ORDER OF REMAND

This is a proceeding initiated by Arizona Department of Education (Arizona) pursuant to 20 U.S.C. § 240(d)(2) and 34 C.F.R. § 222.69.See footnote 1 1/ Arizona requests a review of a determination by the Assistant Secretary for the Office of Elementary and Secondary Education of the United States Department of Education which concluded that Ariz. Stat. § 15-991.02(A) (hereinafter the "reversion provision") violated 20 U.S.C. § 240(d)(1) -- a provision that prohibits a State from taking into consideration Federal impact aid payments in determining the amount of State assistance to its local educational agencies (LEAs). The determination will require Arizona's LEAs to repay approximately $63 million of Federal impact aid received during the Federal fiscal year 1993 or, in the alternative, Arizona could provide assurances in accordance with 34 C.F.R. § 222.69(i)(2) (1992) that it will fully restore all reductions in State aid to these LEAs caused by the reversion provision.

For the reasons stated, infra, it is concluded that Arizona's reversion provision is compatible with the principles set forth in 20 U.S.C. § 240(d)(1)(A) (1992) to the extent discussed herein. This matter is remanded, however, to the Assistant Secretary to consider other arguments previously raised by the parties which should have been, but were not, addressed, and to address the applicability of 20 U.S.C. § 240(d)(1)(B).

I. OPINION

In 1974, Congress amended the Federal impact aid program regarding whether a State may consider Federal impact aid payments received by its LEAs in determining the amount of State aid provided to these agencies. Congress retained the general prohibition denying Federal impact aid payments to LEAs if the State took such payments into consideration in its contributions to the LEAs. It added, however, an exception that was set forth in 20 U.S.C. § 240(d)(2)(A) which permitted consideration of Federal impact aid payments "if a State has in effect a program of State aid for free public education . . . which is designed to equalize expenditures for free public education among the local educational agencies of that State."

Arizona, the Assistant Secretary (ED), and the intervenor LEAs agree that Arizona did not have an equalization program for fiscal year 1993 that qualified under the exception of Section 240(d)(2)(A). Therefore, Arizona is subject to the general rule of Section 240(d)(1) which prohibits, generally, a State from reducing its aid to LEAs due to their receipt of Federal impact aid--

(1) Except as provided in paragraph (2), no payments may be made under this subchapter for any fiscal year to any local educational agency in any State (A) if that State has taken into consideration payments under this subchapter in determining--

(i) the eligibility of any local educational agency in that State for State aid for free public education of children; or

(ii) the amount of such aid with respect to any such agency;

during that fiscal year or the preceding fiscal year, or (B) if such State makes such aid available to local educational agencies in such a manner as to result in less State aid to any local educational agency which is eligible for payments under this subchapter than such agency would receive if such agency were not so eligible.

The controversy between the parties concerns Arizona's newly enacted reversion statute which is a part of the financial assistance program for its LEAs. Under Arizona's funding formula, county and State governments share the responsibility of providing equalization assistance. Ariz. Stat. § 15-971. Beginning in Arizona's fiscal year 1993, the reversion provision required a LEA, under certain circumstances, to return a portion of the cash balances of its maintenance and operation fund and its capital outlay fund remaining at the end of the prior year. Ariz. Stat. § 15-991.02. This money was "reverted" by the county treasurer to a separate account and then added to the amount of the county's assistance in the succeeding year. Id. This increase in the county's assistance caused, in turn, a reduction in the amount of the State's financial assistance during the year.

The reversion provision combines a LEA's ending cash balances of the maintenance and operation fund account and the capital outlay account and then utilizes a ratio or proportional approach to exclude any Federal impact aid before the amount of reversion is determined. The Assistant Secretary determined that the proportional aspect of Arizona's reversion provision did not exclude all Federal impact aid assistance from the funds reverted and, therefore, that Federal impact aid was taken into consideration in determining the amount of State aid in contravention of Section 240(d)(1)(A)(ii).See footnote 2 2/

Arizona challenges this determination. Initially, it argues that none of the three independent criteria of Section 240(d)(1) are pertinent because this provision requires, at the onset, that a State must take "into consideration [the Federal impact aid] payments . . . in determining" the eligibility for or amount of State aid to a LEA. Arizona asserts, under a variety of arguments addressed below, that there are no Federal impact aid funds within the cash balances of the LEA's maintenance and operating account or its capital outlay account at the end of the State's fiscal year even though the LEA received Federal impact aid during the year. If this is correct, then the reversion provision cannot divert any Federal impact aid funds and, therefore, no Federal funds are "considered" in determining the amount of State assistance to its LEAs in contravention of Section 240(d)(1).

Arizona's primary position is that Federal impact aid loses its identity as Federal impact aid at the LEA level when it remains unexpended at the end of the State's fiscal year. The unexpended Federal impact aid loses its identity, according to Arizona, because it no longer satisfies the purpose for which it was given, namely, to remedy the shortfall in local revenues needed for current expenditures caused by Federal actions. Moreover, this loss of identification is justified

in Arizona's case because the combination of Federal impact aid and State assistance "overcompensates" these LEAs and permits them to accumulate substantial surpluses -- a matter which Arizona feels that Congress would deem undesirable. Finally, Arizona argues, by analogy to 20 U.S.C. § 238(d)(2)(E)(i), that Congress intended State law to govern the disposition of cash balances in accounts.

ED and the intervenor LEAs counter that impact aid represents money which was distributed as compensation to the LEAs. As such, it never loses its identity regardless of the period necessary to expend the assistance. In addition, ED argues that the effect of Arizona's position -- under which a reversion of some Federal impact aid from the LEAs then causes a reduction in the State's contribution in the same fiscal year -- transforms a Federal assistance program for LEAs into a State subsidy program, a matter which is clearly contrary to the purpose of the Federal impact aid program.

It is readily apparent that, as urged by Arizona, the primary purpose of the Federal impact assistance is to compensate the LEA for "the additional financial burden with respect to current expenditures placed on such agency by such acquisition of property." 20 U.S.C. § 237(a) (addressing the acquisition of real property by the United States).See footnote 3 3/ Similarly, 20 U.S.C. § 238 awards financial assistance to the LEA due to the presence of children of persons who reside and/or work on Federal property, and is based upon a local contribution rate reflecting the aggregate "current expenditures . . . of such comparable school districts derived from local sources." 20 U.S.C. § 238(d)(3)(A). Thus, the purpose of these provisions is to fund current expenditures of the LEA.

While this is its primary purpose, there is no support for Arizona's view that Federal impact aid assistance, which remains unexpended by a LEA at the end of its fiscal year, loses its identity and, therefore, may be claimed by the State.See footnote 4 4/ The entitlement statute does not provide that the impact aid loses its identity or that Arizona may claim any unexpended Federal impact aid assistance. Moreover, Arizona's position is contrary to the thrust of the general policy of Section 240 that a State may not use the LEA's financial assistance to reduce its assistance to the LEA. Shepheard v. Godwin, 280 F. Supp. 869, 874 (E.D. Va. 1968) ("the act was not intended to lessen the [financial] efforts of the State"); Carlsbad Union Sch. Dist. of San Diego County v. Rafferty, 300 F. Supp. 434, 440 (S.D. Cal. 1969) (the State's assertion "that the [impact aid] funds represent a windfall [to LEAs] is based on the faulty premise that [LEAs] were never entitled to such.").See footnote 5 5/

Arizona's next contention is that, assuming that cash balances at the end of the year contain unexpended Federal impact aid funds, the commingling of Federal funds with State and local funds in the absence of any Federal supervision or control over the accounts causes the Federal funds to lose their character as Federal funds. Such a concept is applied in an analogous context, according to Arizona, under 18 U.S.C. § 641 as interpreted by United States v. Gibbs, 794 F.2d 464, 466 (9th Cir. 1983) which maintains that "supervision and control over that money is the crucial factor in determining the federal character of fund, in a commingled account."

ED responds that 18 U.S.C. § 641 is a criminal statute which sets forth the elements necessary for the crime of embezzlement and is not a statute for determining whether impact aid funds are

contained in the cash balances of accounts at the end of the year. The Coalition argues that even if Arizona is correct regarding the criminal statute, ED does exercise sufficient supervision and control over the funds so that it retains its Federal character. The Coalition cites United States v. Long, 996 F.2d 731 (5th Cir. 1993) as support for its theory that oversight duties retained by the Federal agency constitutes supervision and control.

United States v. Long is dispositive of Arizona's argument. There, an associate professor at a state university was convicted of theft of Federal government property under 18 U.S.C. § 641 as a result of his misuse of funds that the university received from the Louisiana Department of Employment and Training which, in turn, had received these funds from the Federal government under the Job Training Partnership Act. On appeal, the associate professor contended that the funds lost their federal character when they were transferred to the State and commingled with other funds.

The Fifth Circuit held that the funds retained their Federal character within the context of 18 U.S.C. § 641 due to the extent of supervision and control retained by the Federal agency through its oversight duties. The oversight duties were, essentially, the right to monitor compliance with the Act through audits and investigations and to impose sanctions and seek repayments of funds for violations thereof.

The Federal government maintains somewhat similar oversight duties in the Federal impact assistance program. The supervision and control of the program is essentially front-loaded through the extensive requirements that determine eligibility and the amount of the entitlement. 34 C.F.R. Part 222, Subparts B-D. Audits may be conducted and ED may seek repayments due to adjustments or overpayments of the impact aid payments. 34 C.F.R. § 222.40-.42. Hence, ED maintains sufficient supervision and control over impact aid funds so that they retain their Federal character even for purposes of Federal embezzlement charges. Thus, Arizona's argument lacks merit.

Based upon the above, it is concluded that Federal impact aid assistance does not lose its identity upon its initial transfer into a LEA's maintenance and operations account and the capital outlay account. Therefore, the three independent criteria of Section 240(d)(1) may be applied to determine whether the operation of Arizona's reversion provision violates any of these standards.

The parties agree that Arizona's reversion provision does not violate the first standard set forth in Section 240(d)(1)(A)(i) which prohibits any limitation on a LEA's eligibility for State assistance due to the receipt of Federal impact aid assistance during the Federal fiscal year of its receipt or the preceding year.

The second criterion is Section 240(d)(1)(A)(ii) which prohibits Arizona from taking into consideration Federal impact aid payments received by a LEA in determining the amount of State aid to that agency during that fiscal year or the preceding fiscal year. As applied in the instant case, this standard prohibits, inter alia, the inclusion of any Federal impact aid within any of the funds reverted from the ending cash balances since those funds, in turn, reduce the amount of State aid.

It is stipulated that, with respect to the ending cash balance of an account in which it is impossible to determine the exact amount of Federal impact aid therein, ED's policy is to designate as Federal impact aid an amount equal to the proportion of the impact aid revenues in the account to total revenues in the account. Stip. of February 17, 1994 at ¶ 23; see also San Miguel Joint Union Sch. Dist. v. Ross, 173 Cal. Rptr. 292 (Ct. App. 1981).

Under the method of accounting employed by the LEAs, each LEA maintained a maintenance and operations account and a capital outlay account. Under the reversion provision, Arizona seeks to exclude any Federal impact aid received by a LEA from these accounts by employing ED's ratio policy. Arizona's reversion provision combines the ending cash balances of these two accounts (excluding certain adjustments not pertinent herein) and multiplies this sum by a ratio equal to the prior year's impact aid receipts over the prior year's total revenues in the accounts. This yields the total amount of Federal impact aid within the ending cash balances in these accounts. The sum of the ending cash balances of the two accounts is reduced by the revenues attributable to the Federal impact aid and the difference represents the total revenues remaining in the accounts whose sources were not the Federal impact aid payments. This difference is, then, multiplied by 27% and yields the amount of the reversion for the year. The amount of the reversion is then withdrawn from the ending cash balance of each account in a proportional manner unless the balance of one account is negative and then the full amount is withdrawn from the account with the positive balance. See Ariz. Stat. § 15-991.02.

The Assistant Secretary found that the reversion provision suffered from "a serious design flaw" which "prevents it from insulating all Impact Aid revenue from consideration." Determination at 8. The flaw was that the reversion provision combined the two funds in order to remove the Federal impact aid rather than treating each fund separately and, therefore, the funds reverted from one of the accounts may, in fact, contain Federal impact aid. As explained by the Assistant Secretary, the proportional approach--

> is effective in apportioning the Impact Aid revenues in a cash balance only where all Impact Aid revenues and all other revenues end up in a unified account. However, in Arizona[,] LEAs have complete latitude to deposit Impact Aid receipts and other revenues in either the maintenance and operations fund or the capital outlay fund as they see fit. If LEAs chose to deposit the bulk of Impact Aid funds in one account [footnote omitted] or the other such that the proportion of Impact Aid revenues in the account exceeds the proportion of Impact Aid revenues to total revenues, a violation of section 5(d)(1) can occur when the Impact Aid revenues in that account in excess of the reversion provision's proportion are subjected to the reversion.

Determination at 8.

The Assistant Secretary determined that, in two specific instances, Arizona's reversion provision caused the amount of State aid in the State fiscal year 1993 to be reduced due to the reversion of some Federal impact aid received during the State's fiscal year 1992. With respect to Indian Oasis United School

District, impact aid constituted 84% of the revenues deposited into its capital outlay account, yet impact aid represented only 38% of its overall revenues. As a result of this significant deposit

into the capital outlay account, a portion of the funds removed from this account after the close of the State fiscal year due to the reversion provision constituted Federal impact aid. The situation was similar with respect to San Carlos Unified School District where the Federal impact aid revenues represented 68% of its capital outlay account while the overall ratio of impact aid revenues to total revenues in both accounts was 34%.

Arizona responds that it is reasonable under the circumstances to employ one ratio to eliminate the Federal impact aid contained in the two accounts. It notes that almost all of the LEA intervenors were permitted to transfer funds between the two accounts after the initial allocation of impact aid funds. In addition, some LEAs have a negative balance in one fund and a positive balance in the other fund at the end of the year and Arizona law permits the "pooling" of the funds in the two accounts in order to satisfy an accrual in the deficit account. Thus, Arizona argues that there is no simple method to calculate separate reversions for each account and, therefore, it is appropriate to employ a single ratio.

It is apparent, based upon the affidavits submitted by Arizona (Ariz. Exs. 17-23), that a LEA has the discretion to allocate Federal impact aid payments between its maintenance and operations account and its capital outlay account at the time of their receipt and may also transfer these monies between the accounts during the fiscal year. It is equally apparent that, in fact, transfers are made during the year in the normal course of business. In some cases, funds from one account may be "pooled" in order to cover expenses incurred in the other account when the latter account had a negative balance.

Where, as here, a system of accounting permits the transfer of Federal impact aid funds between accounts and, therefore, permits the commingling of these accounts, each account loses its separate identity for purposes relevant here. Therefore, the two accounts may be treated as one. Arizona's reversion provision provides for such treatment and, consequently, it is apparent that no Federal impact aid funds were reverted by the LEAs to the county treasurer during State's fiscal year 1993. As such, Section 240(d)(1)(A)(ii) was not violated.

The third and last criterion, Section 240(d)(1)(B), precludes Federal impact aid payments to LEAs if their State makes its assistance available to LEAs in such a manner as to result in less State aid to any LEA which is eligible for Federal impact aid assistance than the LEA would receive if it were not so eligible.

The determination by the Assistant Secretary did not address this criterion. It also appears that ED's brief discussion of this criterion was based upon the premise that a portion of the amounts reverted under the Arizona statute contained Federal impact aid. As determined above, this premise is incorrect. In view of the above and the limited analysis proffered by Arizona in its brief, it is appropriate to remand this matter to Assistant Secretary for a determination.

II. ORDER

In view of the foregoing, the determination by the Assistant Secretary is reversed and the matter is remanded to the Assistant Secretary for additional consideration. On remand, the Assistant

Secretary shall consider all other arguments raised by the parties which were not addressed in the original determination and the applicability of 20 U.S.C. § 240(d)(1)(B). The tribunal will retain jurisdiction while the Assistant Secretary addresses these matters and, following the issuance of the determination, will establish a briefing schedule to afford the parties an opportunity to present their views to the tribunal. Thereafter, an initial decision will be issued.

Allan C. Lewis
Chief Administrative Law Judge

Issued: November 22, 1994
Washington, D.C.

SERVICE

A copy of the attached Order of Remand was sent on November 22, 1993, to the following:

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Footnote: 1 1/ Due to the nature of this proceeding and its impact upon the local school districts, the Arizona State Impact Aid Coalition (Coalition) and Chinle Unified School District No. 24 (Chinle) were permitted to participate fully in this proceeding. The Arizona State Impact Aid Coalition represents sixteen Arizona public school districts which receive Federal impact aid.

Footnote: 2 2/ There was a prior dispute among the parties regarding the qualification of Arizona's equalization program for the Federal fiscal years 1989 and 1990. This matter was ultimately settled by the parties. ED and the intervenors suggest that Arizona's reversion provision represents an effort to circumvent the terms of the settlement. Whether Arizona's action constitutes a breach of the settlement or some other improper act is not a matter within the jurisdiction of this tribunal and, therefore, will not be addressed herein.

Footnote: 3 3/ Current expenditures is this instance does not include capital outlays or debt service. 20 U.S.C. § 244(5).

Footnote: 4 4/ Indeed, Federal impact aid assistance is "unrestricted and may be used by the District for any educationally related purpose." San Miguel Joint Union Sch. Dist. v. Ross, 173 Cal. Rptr. 292, 293 (Ct. App. 1981). This would include current or capital expenditures.

Footnote: 5 5/ Lastly, Section 238(d)(2)(E)(1) offers no support for Arizona's view that the Federal impact aid funds lose their identity at the end of the year. This subsection is one aspect within a formula used by the Secretary to determine whether additional Federal assistance may be provided to a heavily impacted LEA which lacks sufficient funds to enable it to provide a level of education equivalent to that provided by generally comparable LEAs. 34 C.F.R. § 222.130(a).