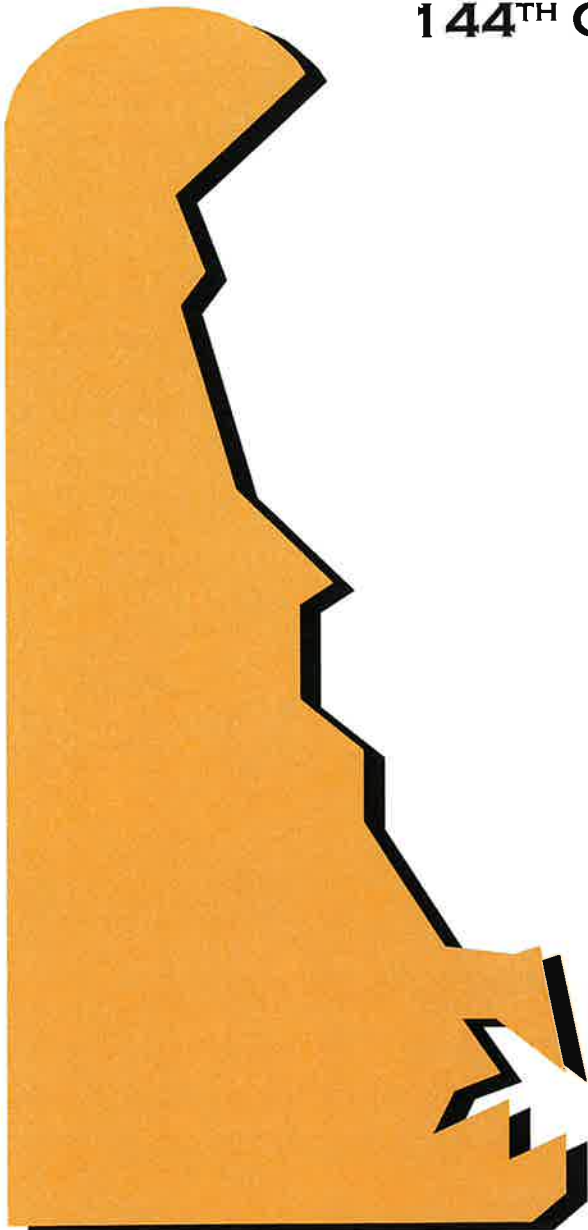


# **DELAWARE'S GENERAL FUND REVENUE PORTFOLIO**

**A REPORT SUBMITTED IN FULFILLMENT OF  
SENATE JOINT RESOLUTION No.5  
144<sup>TH</sup> GENERAL ASSEMBLY**



**DEPARTMENT OF FINANCE  
OFFICE OF MANAGEMENT AND BUDGET  
CONTROLLER GENERAL'S OFFICE  
FEBRUARY 2008**



STATE OF DELAWARE  
DEPARTMENT OF FINANCE  
OFFICE OF THE SECRETARY

February 28, 2008

RICHARD S. CORDREY  
SECRETARY OF FINANCE

The Honorable Ruth Ann Minner, Governor  
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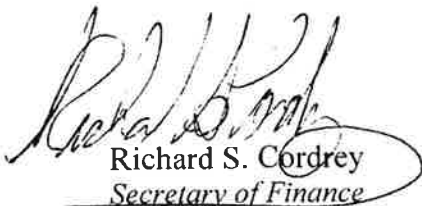
Governor and Legislators:

The Department of Finance, Office of Management and Budget and the Controller General's Office are pleased to submit our report on the analysis of the state's revenues pursuant to Senate Joint Resolution #5 of the 144<sup>th</sup> General Assembly. The report is an extensive review of our current revenues – risks and opportunities – while also performing an in-depth examination of potential revenue sources policy makers may want to consider.

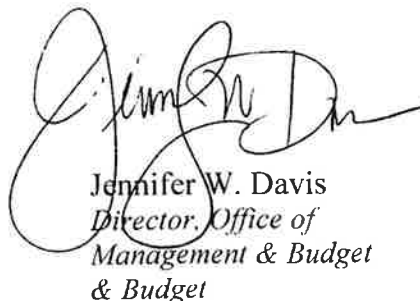
We would like to take this opportunity to thank David Gregor for his dedication and tireless efforts in spearheading this project. He along with Robert Scogletti, Mike Jackson, Steve Kubico, Jennifer Cohan, Robert Glen, Rick Geisenberger, James Craig and Tom Cook from our respective agencies have allowed us to produce a document that can not only be used by this General Assembly, but by future ones as well.

We look forward to discussing the report with you.

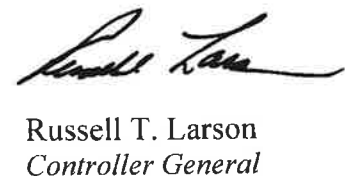
Sincerely,



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*Secretary of Finance*



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## EXECUTIVE SUMMARY

**The Report's Genesis:** In June of 2007, legislative leadership grappled with various policy options designed to raise revenues. Desiring a comprehensive review of the State's revenue system, the General Assembly passed Senate Joint Resolution No. 5 ("SJR No. 5"), which called for a report that addressed the following points:

1. A review of existing General Fund revenue sources, providing, in particular, an analysis of the various risks and opportunities associated with each source.
2. In recognition of changing demographic and economic conditions, a review of potential additional revenue sources that could potentially provide additional long term stable revenue for the state.

**Policy Focus:** Though tax analyses typically encompass a wide variety of policy criteria, SJR No. 5's focus is on a revenue system's most essential mission: its ability to raise the revenues required to meet the State's budgetary needs. While the Report touches on other policy concerns, it is focused almost exclusively on the existing system's and the various proposal's ability to raise adequate revenues in a reliable manner. It does not analyze other financial topics, such as the State's expenditure or debt policies.

**The Report's Context:** The report's analyses were prepared during the autumn of 2007. As such, all revenue and economic data referenced herein reflect information that was used in the preparation of DEFAC's September revenue estimates. In order for the reader to fully appreciate the policy choices confronting Delaware's policymakers regarding the State's revenue structure, it is important, too, that the reader understand the institutional factors and economic influences that affect the current revenue portfolio. A summary of the issues covered is offered below:

### Framework for Analysis:

- *Timeframe:* That SJR No. 5 was adopted during a period of slowing revenue growth is instructive and probably not a coincidence. With this in mind, the report is designed to both inform the reader about each revenue source's fundamental long-term characteristics and also to provide guidance regarding suitability in meeting more immediate fiscal needs under current economic conditions and forecasts.
- *Historic Context:* In the last twenty years, the timing of General Fund statutory revenue increases has generally been in response to economic downturns and not to fund the expansion of government programs during other stages of the business cycle. In recognition of this fact, the revenue options are evaluated with respect to their ability to meet an immediate budgetary shortfall.
- *Revenue Options Are Evaluated Independently:* The last two recession's saw Delaware respond with revenue packages designed to increase total General Fund revenues by 7% – 8% (roughly \$250 million in current budget terms). In each case, the packages increased tax rates in several revenue categories. For the reader to

understand each revenue source's strengths and weaknesses, however, it is necessary that options are assessed independently.

### **Elements of Delaware's Revenue System:**

- *Fiscally Centralized:* Delaware's overall state and local government finance system is highly centralized at the state level relative to other states.
- *Low Property Taxes:* Delaware's real property taxes are the second lowest in the nation, when measured as a percentage of personal income.
- *Unique Revenue Portfolio:* At the state level, Delaware's tax portfolio has effectively replaced the General Sales Tax employed in most other states with a combination of privilege taxes and fees on business charters and formations (e.g., the Corporate Franchise Tax) and a Gross Receipts Tax.
- *Unique Risks:* Many of the uncommon elements of Delaware's revenue portfolio have unique properties in terms of their cyclical and, especially, their structural risks.
- *High Tax Collections:* In terms of actual revenue receipts, the U.S. Census Bureau ranked Delaware as having the 6<sup>th</sup> highest state tax burden and the 13<sup>th</sup> highest combined state and local tax burden.<sup>1</sup>
- *Low Taxes and Exported Tax Burden:* Other studies show Delaware in a different light. According to the Tax Foundation, Delaware's tax burden is the 3rd lowest in the nation. Moody's Economy.com ranks Delaware's tax burden as the 8<sup>th</sup> lowest.<sup>2</sup> The State's high revenue collections, but low tax burden, are made possible because Delaware's General Fund contains large revenue sources, the true burden of which is significantly exported to citizens in other states. Most important among the "exported" revenues are:
  - √ The Corporate Franchise Tax and the Tax on Limited Liability Partnerships and Limited Liability Companies.
  - √ Abandoned Property
  - √ Video Lottery

### **Economic Conditions in the Period upon which the System's Evaluation is Based:**

- *Evaluation Period:* The Report evaluates the State's major General Fund revenue categories' performance over the period of FY 1997 to FY 2007. The period included two solid expansions, a recession, and more recently, what appears to be a soft landing characterized by slower growth.

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<sup>1</sup> The state tax ranking is based on FY 2004 figures. The state and local combined figures are for FY 2002.

<sup>2</sup> Tax Foundation: *Burden by State* (April, 2007). *Moody's Economy.com; State and Local Tax Index* (2005)

- *Atypical Events:* The period is also characterized by two asset bubbles: the tech boom of the late 1990's and, more recently, a real estate bubble that is in the process of deflating. These events influenced Delaware's revenues in ways that should not be expected to repeat anytime in the near future. When evaluating revenue sources, the Report isolates revenue performance that was likely driven by atypical events.

A synopsis of the potential additional revenue sources explored within the report is provided on the following page.

## SYNOPSIS OF POTENTIAL ADDITIONAL REVENUE SOURCES

Revenue Alternative	Issues	Revenue Potential (\$millions)
DOR in Banks' Abandoned Property Audits	<ul style="list-style-type: none"> <li>Revenue Uncertainty – until audits are complete, not possible to peg impact.</li> <li>Opportunity Cost – bank audits means other DOR audits are postponed.</li> <li>Examinations have already been conducted by State Bank Commissioner.</li> </ul>	Short-term: \$0 Long-term: Indeterminable
Increase the Multiplier on the Bank Franchise Tax	<ul style="list-style-type: none"> <li>Tax increase would apply only to smaller banks.</li> <li>Requires a large tax increase to generate significant revenues.</li> <li>Some banks may use alternative filing method to escape full impact of tax increase.</li> </ul>	Up to \$13 (Assuming Multiplier is raised from 0.56 to 0.75)
Escheat of Bottle Deposits	<ul style="list-style-type: none"> <li>Requires legislation stating the deposits are reportable property.</li> <li>In fairness to beverage industry, the effective date should recognize their need to prepare operationally and financially.</li> </ul>	Short-term: \$0 Long-term: \$1-2
Nonresident Personal Income Tax Provisions	<ul style="list-style-type: none"> <li><i>Pass-through Withholding at source:</i> Not a tax increase; merely a method by which DOR is better able to collect and administer the tax. <ul style="list-style-type: none"> <li>√ Met with some resistance in the past</li> <li>√ Employed successfully in other states</li> </ul> </li> <li><i>Nonresident Capital Gains on Interests in DE Pass-through entities:</i> Revenues difficult to pin down, could produce significant, if uneven, stream of revenues.</li> </ul>	<i>Pass-through WH:</i> \$4-6; <i>Nonresident capital gains on DE pass-through entities:</i> Indeterminable
Reintroduce the Estate Tax	<ul style="list-style-type: none"> <li>Would require some implementation time to allow taxpayers to plan for its return; may be of limited use in an immediate budget crisis.</li> <li>Inherently volatile.</li> </ul>	Short-term: \$0 Long-term: \$35-40
Public-Private Partnerships	<ul style="list-style-type: none"> <li>“Scaleable” – can be used for small or large assets.</li> <li>Large projects (e.g., highways) would be a big departure from current practices.</li> <li>Complex, significant risk vs. reward trade-offs.</li> <li>Tremendous revenue potential</li> </ul>	Short-term: \$0 Long-term: Depends on scale; conceivably \$100's of millions
Indexing Bank Franchise Tax Brackets for Inflation	<ul style="list-style-type: none"> <li>Regressive rate structure ensures that, over time as taxable income increases, banks pay progressively lower effective tax rates.</li> </ul>	Short-term: \$1-1.5 Long-term: Annual amts compound; e.g., 10 yrs = \$10-15
Abandoned Property Enforcement / Administration	<ul style="list-style-type: none"> <li>Abandoned Property has become a vital element supporting the State's Operating Budget.</li> <li>To the extent that future budget needs and growth are dependent on this source, it, too, must grow.</li> </ul>	Short-term: \$0 Long-term: Indeterminable
Lightering / Oil Transport on Delaware Waterways	<ul style="list-style-type: none"> <li>Significant legal challenges.</li> <li>Reaction to tax is difficult to anticipate.</li> <li>May elicit federal preemption.</li> </ul>	Short-term: \$0 Long-term: Indeterminable
Publicly-Traded Alternative Business Entities	<ul style="list-style-type: none"> <li>Reaction to tax is difficult to anticipate.</li> <li>Climate within industry must be suitable for tax to be considered</li> </ul>	\$5-10

## Section I: A Review of Existing General Fund Revenue Sources

- **Personal Income Tax (PIT)**  
*FY 2007 Revenues Net of Refunds*                      \$1,008.3 million  
*Share of FY 2007 General Fund*                      31%

Delaware's largest General Fund revenue source performed solidly the last ten years. Its growth and stability results were largely consistent with expectations, although revenues exhibited a somewhat elevated level of volatility on a year-over-year basis. Generally speaking, PIT's exposure to cyclical phenomena is balanced and manageable, although current conditions indicate that the most immediate cyclical risks are on the downside.

In terms of structural considerations, PIT faces the following issues:

- √ *An Aging Population's Growing Use of Non-means tested Tax Breaks:* As baby-boomers reach retirement age, the demographically-driven cost of several tax breaks will escalate.
- √ *Skewed Income Distribution:* Higher-income taxpayers' share of total payments has grown significantly in recent years. Their incomes' tend to be made up of more variable sources adding volatility to the revenue stream.
- √ *Federal Actions:* Delaware's PIT piggybacks on the Internal Revenue Code. Federal tax law changes, depending on their nature, they could either increase or decrease Delaware's PIT revenues.

Purely in terms of its ability to raise revenues in a stable and reliable fashion, an increase in the PIT's marginal tax rates is a viable option. As the State's largest revenue source, a small increase in effective tax rates would yield high revenues relative to other sources.

- **Corporate Franchise and Limited Partnership / Limited Liability Company Taxes (CFT – LP/LLC)**  
*FY 2007 Revenues Net of Refunds*                      \$622.5 million  
*Share of FY 2007 General Fund*                      19%

The State's second largest revenue source grew slowly and exhibited, on balance, a high level of stability from FY 1997 – FY 2007. Much of this performance is explained by the taxes' structures, but a significant amount is probably due to atypical economic events that occurred within this timeframe.

In terms of cyclical risk, this revenue source probably has less year-over-year downside and upside risks than most categories. It may, however, have more exposure to inflection points in multi-year trends, especially those in equity markets.



In terms of structural considerations, this revenue source faces the following issues:

- √ *An Inelastic Tax Structure:* In many respects, this revenue source's rate structures operate like a flat fee meaning that, unless they are increased, on an individual taxpayer basis the revenues they produce fails to keep pace with inflation.
- √ *Growing Preference for Alternative Entities:* Because Delaware's privilege tax rates are generally lower on alternative entities than they are on corporations, the trend toward the use of alternative entities has tended to reduce the overall growth rate.

Any proposal to increase this category must be carefully considered. This category is unlike other taxes because the State is not so much placing a levy on a reluctant "taxpayer" as it is charging a price on a desirable service that a customer, who has alternatives, is willing to pay. In other words, with respect to this revenue source, the State is actually operating an enterprise and, as a consequence, the revenues derived from this source should be evaluated accordingly.

Because these taxes are the State's second largest revenue source, increasing rates offers the potential to produce relatively large amounts of revenue. Nevertheless, it must be kept in mind, though, that it is a judgment call with respect to how the corporate community might react to a tax increase. Given that the last increase occurred relatively recently, this option may not be tenable for a number of years.

- **Corporate Income Tax (CIT)**

<i>FY 2007 Revenues Net of Refunds</i>	<i>\$140.3 million</i>
<i>Share of FY 2007 General Fund</i>	<i>4%</i>

CIT is a relatively small source of revenue. Its performance over the last ten years has been highly volatile around a fairly flat growth rate. CIT is subject to cyclical swings. Its structural limitations, however, often mean that these cyclical swings are not easy to anticipate and result in wide variations around the tax's cyclical trend. CIT's structural considerations include:

- √ *A Volatile Base:* Business profits exhibit wide swings that are difficult to forecast.
- √ *A Highly-Skewed Tax Base:* CIT's total tax collections are dominated by relatively few large taxpayers. As such, variations in the performance of just a few firms can have a major impact on revenues.
- √ *Growing Popularity of Pass-through Entities:* Firms are increasingly organized as pass-through entities, which mean that their members pay the PIT, and the entity does not pay the CIT.

√ *Federal Actions:* Like PIT, Delaware's CIT piggybacks on the Internal Revenue Code and may experience increases or decreases in receipts as a result of Congressional action.

CIT accounts for only about 4% the State's General Fund revenue. Without a hefty increase in the tax rate, relative to larger sources, CIT's revenue potential is somewhat limited. CIT is inherently unreliable. As a result, forecasting the revenue impact of a rate hike will be at least as unpredictable as the pattern of overall collections. Delaware's CIT tax rate is relatively high. Policymakers needing to balance a budget run the risk of being disappointed if they place too much emphasis on the CIT in solving an immediate fiscal shortfall.

- **Bank Franchise Tax (BFT)**

<i>FY 2007 Revenues</i>	<i>\$175.2 million</i>
<i>Share of FY 2007 General Fund</i>	<i>5%</i>

Over the past ten years the Bank Franchise Tax (BFT) has performed similarly to the CIT: a high degree of year-over-year volatility around relatively flat growth trend. This comes as no surprise, as they share some fundamental similarities. (Over a ten-year horizon, however, the BFT was measurably more stable than the CIT.)

Both taxes are levied on profits and, in both cases, a relative handful of taxpayers account for the lion's share of collections. Its cyclical and structural risk profiles are essentially the same as the CIT. The BFT is less exposed to the effects of changes in federal law. The BFT's regressive tax rates add another structural constraint to revenue growth.

BFT's revenue potential is somewhat limited. It accounts for about 5% of the State's General Fund revenue; thus, without a hefty rate increase, it would not be a source of large amounts of additional revenue. Moreover, the BFT is prone to substantial year-over-year revenue variations. Like the CIT, policymakers who need to balance a budget should probably resist placing too much emphasis on the BFT in solving an immediate fiscal shortfall.

- **Gross Receipts Tax (GRT)**

<i>FY 2007 Revenues</i>	<i>\$157.3 million</i>
<i>Share of FY 2007 General Fund</i>	<i>5%</i>

Typically, this is the State's most reliable major tax. Nevertheless, from FY 1997 to FY 2007 it demonstrated higher than normal rates of growth and variability. The GRT provides perhaps the best example of how some of the more unusual economic events of the past ten years have produced a revenue record that parts ways with some of a tax's fundamental qualities.

Cyclically, GRT revenues rise and fall with the fortunes of the broader economy, but do so in a more predictable manner than CIT or the BFT. In the near-term, most cyclical risks are on the downside as the economy is expected to cool over the next several quarters. With the exception of a tax base that is concentrated among a relatively small number of larger large taxpayers, the GRT has few structural risks.

The Gross Receipts Tax accounts for about 5% of General Fund revenues. Given its relatively small share, a hike in the GRT alone would likely be insufficient to bridge a significant budget gap. On balance, if it were needed to help meet an immediate budget shortfall, a rate increase in the GRT would provide policymakers with a fairly reliable revenue solution.

- **Abandoned Property**

<i>FY 2007 Revenues</i>	<i>\$364.9 million</i>
<i>Share of FY 2007 General Fund</i>	<i>11%</i>

In FY 1997 Delaware collected \$71.1 million in Abandoned Property. Abandoned Property accounted for about 4% of total General Fund revenues. By FY 2007, General Fund collections stood at \$364.9 million, or roughly 11% of total General Fund revenues. In the last ten years, Abandoned Property collections grew faster than any other revenue source. Collection patterns exhibited a high degree of volatility (almost exclusively in an upward direction, though).

Abandoned Property's risks are essentially structural and include:

- √ *Legal Underpinnings:* For the most part, Delaware's Abandoned Property collections are based on case law and specifically on the United States Supreme Court's ruling regarding owner unknown and address unknown property. The U.S. Congress has the power to change this ruling by legislation. Compared to a State-administered tax, the design of which Delaware's General Assembly directly controls, the State has less control over how this revenue source may evolve.
- √ *Inherently Volatile:* Because the vast majority of assets are tracked and accounted for without problems, "abandoned" property is by its very nature "the exception to the rule." More so than any other revenue source, its collections are based on enforcement actions, which, until they are essentially complete cannot be accurately gauged in terms of their individual revenue potential.
- √ *Owner Unknown Property:* A significant portion of collections are from owner unknown property. To the extent that improved record keeping systems could reduce the level of owner unknown property, Delaware could see its revenues reduced.

Because Abandoned Property is not a tax, the State cannot simply pass a law and expect to increase revenues. The ability to increase revenues under the current business model is limited, especially in the short-run. While adding resources to DOR's Abandoned Property enforcement efforts may be sensible long-term revenue policy, it is not likely to produce an immediate return.

- **Realty Transfer Tax (RTT)**

<i>FY 2007 Revenues</i>	<i>\$90.9 million</i>
<i>Share of FY 2007 General Fund</i>	<i>3%</i>

The Realty Transfer Tax's recent performance is probably the most influenced by the unique economic phenomena of the last ten years. Adjusted revenues grew at an annual rate of 14.7%, second after Abandoned Property. RTT was also among the most volatile revenues source examined. The RTT fell in only a single year, FY 2007, by 19% (gross collections). RTT's main risk is cyclical and, given the current outlook for housing, in the near-term it is decidedly negative.

Despite its position among the highest realty transfer tax rates in the nation, in terms of revenue raising potential, increasing Delaware's RTT could be used to address an immediate budget shortfall. The cyclical nature of the tax, however, means that the reliability of a revenue estimate on a tax hike would carry a larger confidence interval than would most other options.

- **Cigarette and Tobacco Products Tax**

<i>FY 2007 Revenues</i>	<i>\$88.3 million</i>
<i>Share of FY 2007 General Fund</i>	<i>3%</i>

It is not surprising that, overall, the Cigarette Tax's stability over the last ten years ranked among the highest of the State's revenue sources. In terms of growth, the Cigarette Tax provided a somewhat surprising performance, growing at rates that exceeded those typically associated with this tax.

The rate of use of cigarettes and tobacco within the population has fallen in recent decades, although these declines have moderated in recent years. Tax increases in neighboring states in the last ten years, which made Delaware the regional price leader, accounted for Delaware's strong revenue performance. Looking ahead, this category's risks are almost entirely structural. Even with no change in smoking rates, at best, one might expect Delaware's Cigarette Tax revenues to grow more in line with population growth rates. Given that Delaware just raised its tax in August 2007, in the near-term, raising the Cigarette Tax is probably not a viable revenue option.

- **Lottery**  
*FY 2007 Revenues* *\$256.7 million*  
*Share of FY 2007 General Fund* *8%*

Delaware's lottery is a mature revenue source with annual growth in recent years averaging about 5% and exhibiting little volatility. Structurally, competition from neighboring states is a threat to this revenue stream. The State successfully responded to Pennsylvania's nearby venues by expanding Delaware operations within the existing business model. Looking ahead, however, it appears that this tactic is largely exhausted. Delaware can no longer, for example, expand gaming hours as a response to competition, as the facilities already operate 24 hours per day.

Within the existing business model, the most obvious means of increasing Delaware revenues is to increase the State's share of video lottery net proceeds to a level commensurate with other states. Delaware's share of video lottery profits is well below other states' shares. Based on a video lottery base of roughly \$220 million, each additional percentage point added to the State's share could be expected to add roughly \$6.4 million.

## **Section II: A Review of Potential Additional Revenue Sources**

- **Division of Revenue Participation in Banks' Abandoned Property Audits:** This option is unlikely to provide additional revenues within the first two years of its implementation. After that time, any revenues that are provided will likely come at the expense of deferring other audits. By definition, only after an audit is complete does one understand if noncompliance exists. It is, therefore, impossible to predict how much revenue this option may produce.

Clearly, this option could not be counted on to help plug an immediate or near-term budget deficit. It also comes up short according to SJR No. 5's provision that places a priority on additional revenue that is long term and stable. Enforcement collections are neither long term nor stable. In the near-term, the crux of this proposal is less about its revenue potential and more a question of the uniformity and effectiveness of the State's abandoned property enforcement approach.

- **Increase the Multiplier on the Bank Franchise Tax:** Purely in terms of helping to plug a near-term budget gap, increasing the multiplier is a reasonably functional policy alternative. While there is a chance that a limited number of institutions may migrate to the alternative tax structure, the revenue estimates, under most scenarios, would be relatively reliable. Raising significant funds on a base of \$48 million would, however, require very large effective tax rate increases on the state's smallest banks. Moreover, higher revenue targets would obviously require higher tax rate increases, increasing the incentive for banks to switch filing methods, which, in turn, decreases

the reliability of the proposal's revenue estimate. In sum, this proposal offers limited revenue potential and carries distinct policy obstacles.

- **Escheat of Bottle Deposits:** Practically speaking, this option's only reliable variant is a change to the statute that would explicitly include bottle deposits within the definition of escheatable abandoned property. The change needs to be prospectively applied. This option's revenue potential is somewhat limited at \$1-2 million annually and, in fairness to the industry, probably would require a year or two to implement, meaning that the first Abandoned Property annual filing remittances might not be received by the Division of Revenue until three years after the statute's adoption.

Given its practical limitations, this option would be of little use in helping to meet an immediate fiscal gap. Nevertheless, once implemented, despite its relatively small fiscal impact, escheat of bottle deposits is consistent with SJR No. 5's pursuit of potential long term and stable revenue sources.

- **Nonresident Personal Income Tax Provisions:**

- √ *Pass-through Withholding at source:* Extending withholding at source to nonresidents partner/owner's distributive income shares is not a tax increase; it is merely a method by which the Division of Revenue is better able to collect and administer the Personal Income Tax. While the idea has been met in Delaware with some resistance in the past, it has been employed successfully in other states. It has a somewhat limited revenue potential (\$4-6 million annually), but would allow the Division of Revenue to better allocate its resources.

- √ *Nonresident Capital Gains on Interests in Delaware Pass-through entities:* Based on a judicial interpretation of the Personal Income Tax Statute, a nonresident owner of a pass-through entity (e.g., an S corporation or LP/LLC) who sells his/her interest in that entity is not required to pay Delaware income tax on the capital gain generated by the sale, even if the entity in question consists entirely of Delaware real estate holdings or is a business that operates solely in Delaware. This proposal would source nonresidents' gains on the sale their ownership interests in "Delaware" pass-through entities to Delaware. This proposal's revenue potential is difficult to pin down, but it is clear that it could produce a considerable, if somewhat uneven, stream of revenues.

- **Reintroduce the Estate Tax:** Given the uncertain political climate around the status of the federal Estate Tax and, by extension, Delaware's Estate Tax, this proposal would add a measure of certainty to Delaware's fiscal picture by mandating the Estate Tax's return to the revenue portfolio. Bringing the Estate Tax back would, however, require some implementation time to allow taxpayers to plan for its return. As such, this proposal may be of limited use in an immediate budget crisis. Nevertheless,

despite its inherent volatility, over the longer-run, adding the Estate Tax could be expected to add in the neighborhood of \$35 to \$45 million annually to the State's revenue stream.

- **Public-Private Partnerships:** Broadly speaking, this idea requires that the State allow a private entity to earn a profit while operating a State enterprise in exchange for a stream of contractually determined payments. A municipally-owned golf course that is run by a private operator that specializes in golf operations is a common example of such an arrangement. Contrary to a popular misconception, the government asset is not "sold" to the private management company.

It appears that the idea of large scale use of public-private partnerships in the operation of State enterprises has been deferred for the time being. Public-private partnerships have been used successfully in other states and are very common around the globe. When considered in 2005, however, the idea was new to Delaware and, as one might expect when encountering a new idea, the reaction among policymakers was mixed.

Admittedly, employing public-private partnerships on a large scale would be a fairly large departure from current practices within Delaware. That it would represent significant change and probably require a continued education effort on their operation are not reasons to permanently abandon the concept. Given this Report's focus is on uncovering potential sources of new revenues, the magnitude of funds that may be available under this option is difficult to ignore. The Chicago Skyway partnership, for example, reportedly yielded \$1.83 billion in proceeds. In light of this potential, public-private partnerships remain a viable option worth considering for a number of State assets.

- **Indexing Bank Franchise Tax Brackets for Inflation:** Assuming 2-3% annual inflation adjustments, the Bank Commissioner's Office estimates that indexing the tax's brackets could bring in an additional \$1.0 to \$1.5 million annually. The idea behind indexing the brackets is not that it would result in a large and immediate increase in revenues. The concept embraced by indexing is that it prevents the erosion of Bank Franchise Tax over a number of years. For example, in ten years time assuming relatively constant inflation of 2-3%, employing this option could mean revenues would be \$10-15 million higher than they would be under the current statute.
- **Long-term Commitment to Abandoned Property Enforcement and Administration:** It is difficult to determine how much revenue this proposal would ultimately produce. If faced with an immediate budget shortfall, it is clear that this option would do little, if anything, to address an imminent fiscal crisis. It is clear, though, that the additional resources that this proposal would bring to bear would

ultimately improve compliance and add revenues. Moreover, they would insure against Abandoned Property revenues “hitting an air pocket” in the event of staff turnover.

The State’s efforts to improve Abandoned Property compliance have thus far proven to be a resounding success. With revenues growing from \$71.1 million in FY 1997 to \$364.9 million in FY 2007, Abandoned Property now represents 11% of Delaware’s General Fund revenues. Moreover, these revenues can no longer be exclusively characterized as annual “windfalls” that are largely directed to the State’s Capital Budget in the form of “cash to the bond bill.” Abandoned Property revenues are now a vital element supporting the State’s Operating Budget. This reality, of course, also means that, to a significant extent, the State’s ability to meet growing needs in the Operating Budget is contingent upon the continued growth of Abandoned Property revenues.

In this respect, the State’s third largest revenue source has become a victim of its own success. Unless policymakers are willing to limit the Operating Budget’s reliance on Abandoned Property by, perhaps, capping its contributions to the General Fund and using any surpluses to fund “one-time” items, finding ways to ensure that revenues keep pace with expenditure pressures becomes imperative. Unlike a traditional tax, the General Assembly cannot simply mandate higher revenues through a statutory change. Abandoned Property, like the Lottery, requires active management. Given the current staffing levels and the need for specialized training, this proposal would represent another proactive step to actively manage this revenue source’s long-term viability.

- **Taxation of Lightering / Oil Transport on Delaware Waterways:** The taxation of lightering and/or the transport of crude oil in the Delaware Bay and River is an intriguing source of potential revenue. The proposal, however, is fraught with complex issues and potential pitfalls. If they choose to pursue this option, policymakers need to do so with their eyes wide open.

This proposal’s revenue potential is extremely difficult to estimate and, in the short-run, is practically impossible anticipate. In practice, it appears that there are viable alternatives to lightering at Big Stone Anchorage. This means that oil companies and shippers could change their behaviors to legally avoid a tax. In addition, given this proposal’s originality coupled with the myriad of complex legal issues it raises, there is a very significant probability that, if enacted, such a statute would be challenged, perhaps immediately. This complicating factor, coupled with the practical ability to legally avoid the tax, further diminish the certainty of the proposal’s revenue potential.

Even more concerning is the possibility that Congress could act to preempt the proposal altogether. The oil industry and perhaps elected officials and their constituents in other states are likely to view the State’s adoption of this proposal as



an example of Delaware aggressively attempting to export its tax burden. Given the importance of the refining industry to the region and the fact that gasoline and heating oil are necessities with price levels hovering around their historic highs, it seems clear that Congressional action that would specifically prohibit Delaware from levying such a tax would be a possibility that needs to be considered.

In sum, while it is conceivable that one day this proposal could become a viable source of State revenue, taken by itself it is not a panacea, especially for an immediate budget shortfall.

- **Apply the Corporate Franchise Tax Structure to Publicly-Traded Alternative Business Entities:** It is possible for alternative business entities, such as limited partnerships and limited liability companies (LP/LLC), to be listed on the major stock exchanges. Rather than offering shares, such entities may issue limited partnership units, membership units, or units of beneficial interest. Like corporations, publicly-traded LP/LCC's can possess substantial financial wherewithal. For example, the largest such limited partnership recently reported book assets in excess of \$9 billion and more than 115 million common units. Like other alternative entities, however, publicly-traded LC/LCC's pay a flat annual tax of \$200 to the State. This proposal would create a separate tax classification for publicly-traded alternative entities and employ a tax structure based on the Corporate Franchise Tax model, which ranges from \$35 to \$165,000, depending upon the size of the corporation.

The proposal raises several policy and analytic considerations. Among these are:

- √ It is likely that at least some of the smaller publicly-traded alternative entities would seriously consider merging to another State if they were subject to a substantial increase in annual taxes.
- √ The State lacks access to information that would directly determine how many affected entities might elect to take advantage of the Assumed Par Value Capital Tax Method. Lack of concrete information regarding this election translates into a somewhat "softer" estimate of the proposal's likely financial effect.
- √ Because many publicly-traded LPs and LLCs are affiliated with other publicly-traded corporations (many of which are maximum taxpayers), policymakers would need to decide whether to exempt related parties from having to pay the maximum franchise tax multiple times. Such an exemption would also reduce the revenue potential of this idea.

In terms of helping to plug a near-term budget gap, applying the CFT structure to publicly-traded alternative entities is an option – although one that is likely to be opposed by some as unwarranted in light of ongoing and relatively strong growth in aggregate CFT and LP/LLC taxes and the relatively short time since the last increase in 2003. There is a chance that some or perhaps many publicly-traded LPs/LLCs

would migrate elsewhere, taking related subsidiaries with them. It seems likely that any such shift out of Delaware would be limited to firms with smaller capitalizations. Revenue generated from such a change would likely be in the range of \$5 to \$10 million.

## INTRODUCTION

As the leaders of Delaware's General Assembly considered the components of the FY 2008 financial package, the central revenue item in the debate was a proposal to hike the State's Cigarette Tax. It soon became clear, however, that legislative leadership also wanted to consider other means of raising State revenue. While ultimately the General Assembly did, in fact, act to increase the Cigarette Tax, it also passed Senate Joint Resolution No. 5 ("SJR No. 5"), which calls on the Director of the Office of Management and Budget, the Secretary of Finance and the Controller General to provide the following:

- A review of existing General Fund revenue sources, providing, in particular, an analysis of the various risks and opportunities associated with each source.
- In recognition of changing demographic and economic conditions, a review of potential additional revenue sources that could potentially provide additional long term stable revenue for the state.

The Resolution further stipulated that results of this review are to be provided to the Governor and the General Assembly. (See Appendix I for a copy of Senate Joint Resolution No. 5.) This report is submitted in fulfillment of SJR No. 5's requirements.

Beneath SJR No. 5 requirements rests an important subtext. Some observers have interpreted the Resolution as a suggestion that Delaware is overdue in developing the "next big thing." Given Delaware's track record over the last thirty years, which has included the Financial Center Development Act in the 1980's, the advent of the video lottery in the 1990's and, more recently, the rapid increase in Abandoned Property revenues, it is understandable that this expectation exists in many quarters. Given this subtext, this report will also examine the potential advantages and pitfalls of managing the State's revenue policy while searching for and, possibly, counting on the "next big thing."

As mentioned above, this report is divided into two sections. The first section covers the strengths and weaknesses of the State's major General Fund revenue sources. The second section covers ideas for new sources of revenue. Ultimately, this report's purpose is to provide policymakers with a useful guide to managing the State's revenue requirements under a variety of conditions.

## FRAMEWORK FOR ANALYSIS

Tax systems are typically evaluated using several criteria. Among these are: equity or fairness, simplicity, and economic efficiency or neutrality. SJR No. 5, however, is concerned with the most basic and important criterion for measuring an effective tax system: revenue adequacy. Adequacy is the ability of a tax system to raise revenue in a stable and reliable manner throughout the business cycle. While effective fiscal management is equally dependent on responsible budgets and expenditure policies, SJR No. 5's mandate is to examine the adequacy of the State's major General Fund revenue sources. Before exploring the quantitative measures of the growth and stability of Delaware's revenue structures, it is important to understand that the State's revenue structure is

unique among the states. As a consequence, Delaware has very distinct positive attributes as well as some distinct potential shortcomings.

In evaluating the revenue potential of Delaware's "existing" General Fund Sources and those presented by "potential additional revenues sources," there is the possibility of overlap between what is considered an existing revenue source and what is an "additional" or a new revenue source. In the interest of avoiding confusion, this report makes the following distinctions when evaluating revenue potential:

- **Existing General Fund Sources** – Revenue potential in this regard will be limited to straightforward increases in tax rates, in the case of taxes, or the application of additional resources (e.g., funding & staffing) to the current business model, primarily in the case of non-tax revenues.
- **Additional Revenue Sources** – Revenue potential in this regard will include:
  - √ Entirely new taxes or revenue sources (e.g., adopting a retail sales tax)
  - √ Base-broadening or other reforms within existing tax structures (e.g., eliminating tax breaks or fundamentally changing a tax rate structure, for example, from a flat fee to tax brackets with progressive rates)
  - √ Significant modifications to revenue administration or enforcement (e.g., outsourcing / privatization)

Readers who are particularly interested in the revenue potential of base-broadening through the elimination or modification of targeted exemptions, deductions and credits are encouraged to read Delaware's *Tax Preference Report*, which quantifies and evaluates all such provisions contained within the State's Personal Income, Corporate Income, Public Utility and Motor Fuel Taxes.

In addition, the report attempts to be responsive to the environment in which SJR No. 5 was created by addressing the following practical considerations:

- *Timeframe:* That SJR No. 5 was adopted during a period of slowing revenue growth is instructive and probably not a coincidence. With this in mind, the report is designed to both inform the reader about each revenue source's fundamental long-term characteristics and also to provide guidance regarding suitability in meeting more immediate fiscal needs under current economic conditions and forecasts.
- *Historic Context:* In the last twenty years, the timing of General Fund statutory revenue increases has generally been in response to economic downturns and not to fund the expansion of government programs during other stages of the business cycle. In recognition of this fact, the revenue options are evaluated with respect to their ability to meet an immediate budgetary shortfall.
- *Revenue Options Are Evaluated Independently:* The last two recession's saw Delaware respond with revenue packages designed to increase total General Fund

revenues by 7% – 8% (roughly \$250 million in current budget terms). In each case, the packages increased tax rates in several revenue categories. For the reader to understand each revenue source’s strengths and weaknesses, however, it is necessary that options are assessed independently.

Revenue options are evaluated according to the following criteria:

- **Each option’s revenue potential.**
- **The reliability of the estimates themselves.** All other things being equal, options having tight confidence intervals around their revenue estimates are preferable to those that do not. It is important to bear in mind that any “solution” to a significant budgetary shortfall is likely to include several revenue planks. The options, however, are discussed in isolation.
- **Administrative and compliance ease, including the time needed for implementation.**
- **Other tax policy considerations, if significant.** If an option under consideration would in a significant manner either enhance or detract for another policy objective (equity, for example), then that attribute should be considered.
- **Legal and political considerations.** This criterion is not included to evaluate how controversial an option might appear to elected officials or how likely it might be to be adopted by the General Assembly. Instead, it is included to help gauge those issues that could potentially derail a revenue option after it was adopted. In other words, this criterion seeks to answer questions, such as:
  - √ What is the likelihood that the option under consideration would trigger a legal challenge?
  - √ Would the option survive such a challenge?
  - √ What is the likelihood that an option, if adopted, would trigger a federal response – i.e., preemption?

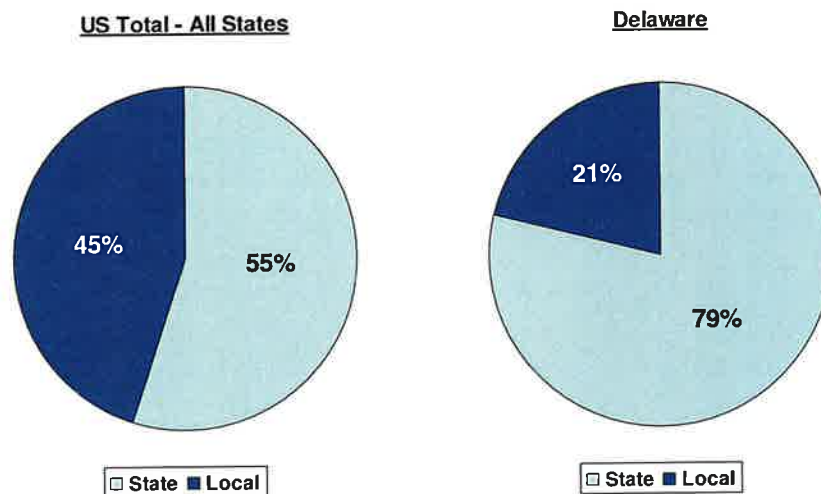
## **DELAWARE’S UNIQUE REVENUE SYSTEM**

To begin, it is useful to examine Delaware’s entire state and local revenue system. As can be seen in Chart 1 below, Delaware is much more fiscally centralized than other states. Its split of total state and local revenue is much more concentrated at the state level than is typically the case.

Chart 1.

## Delaware is Fiscally Centralized

### Shares of Total Own-source State and Local Revenues



Source: US Bureau of the Census: 2004-2005

Property taxes are one of the principle revenue sources funding government operations because they constitute 21% of total state and local government “own source” revenues nationally. In Delaware, however, property tax revenues account for only about 9% of total state and local government own source revenues.<sup>3</sup> In fact, Delaware’s property tax burden, measured as a percentage of personal income is the second lowest in the nation and is approximately one-half the level registered in the median state.<sup>4</sup>

Property taxes are typically a much more important source for local governments than they are for states. In Delaware’s case, it is unclear whether low property taxes are the reason for or an effect of fiscal centralization at the state level. Nevertheless, whatever the reason, Delaware has chosen to place far less reliance on this typically important state and local government funding element. In Delaware’s case, this translates into increased reliance on state funding sources.

Moving beyond the question of the relative responsibilities of the State vis-à-vis its localities and examining Delaware’s state revenue portfolio compared to other states yields more striking

<sup>3</sup> Source: U.S. Census Bureau: State and Local Government Finances by Level of Government and by State: 2004-05. Web Address: [http://www.census.gov/govs/estimate/0500ussl\\_1.html](http://www.census.gov/govs/estimate/0500ussl_1.html) (Note: The concept of “own source” revenues means all revenues other than revenues received from another level of government. Federal aid to a state or locality would not, for example, be included among “own source” revenues.)

<sup>4</sup> Source: AARP Public Policy Institute: “State and Local Property Tax Burdens in 2005,” Appendix Table A-1. Web Address: [http://assets.aarp.org/rgcenter/econ/2007\\_09\\_tax.pdf](http://assets.aarp.org/rgcenter/econ/2007_09_tax.pdf) (Note: Among 50 states and DC, Delaware’s property tax is 1.6% of personal income; the median state is 3.2%.)

contrasts. Most noticeable, of course, is Delaware's lack of a general sales tax. According the U.S. Census Bureau, in the typical state, the general sales tax makes up about one-third of total state tax revenues.<sup>5</sup>

A complete listing of the Census Bureau's break down of Delaware's state revenue sources vs. the total for all states is found in Table 1 on the following page. Table 1 includes revenues from General and special funds and is organized according to the Census Bureau's classification system. As a result, it does not match up neatly with the presentation of Delaware's General Fund revenues that the reader may be accustomed to seeing. Even so, upon examination, Table 1 is instructive in that it presents a clear picture of just how different Delaware's revenue structure is from those of other states.

Delaware's share (42%) of its total tax collections attributable to income taxes (both personal and corporate) is roughly on par with the U.S. total for all states (40%). Similarly, Delaware's share of selective sales taxes (e.g., alcoholic beverage, tobacco, and utility taxes) equals the U.S. total of 15%.

The largest sources of deviation between Delaware and U.S. in Table 1 are in the Corporate License and Occupational and Business License categories. The Census Bureau's Corporate License category primarily encompasses Delaware's Corporate Franchise and Limited Partnership/Limited Liability Company Taxes. Delaware captures 26% of its total tax revenue from this category while the U.S. total is only 1%. Occupational and Business Licenses includes, among other items, Delaware's Gross Receipts Tax. It constitutes 9% of Delaware's tax revenues and 2% nationwide.

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<sup>5</sup> US Census Bureau: "2005 State Government Tax Collections" Web Address:  
<http://www.census.gov/govs/www/statetax05.html>

**Table 1.**

**State Government Tax Collections: 2005**  
**Includes General and Special Fund Revenues**

(Amounts in thousands.)

Item	United States		Delaware	
	Amount	Pct of Total	Amount	Pct of Total
Population (thousands, 2005)	295,860		844	
Total taxes	647,886,410		2,725,095	
Property taxes	11,349,052	2%	X	0%
Sales and gross receipts	311,074,039	48%	397,264	15%
General sales and gross receipts	212,246,900	33%	X	0%
Selective sales taxes	98,827,139	15%	397,264	15%
Alcoholic beverages	4,731,621	1%	13,777	1%
Amusements	5,241,621	1%	X	0%
Insurance premiums	14,842,349	2%	69,369	3%
Motor fuels	34,570,428	5%	113,663	4%
Pari-mutuels	309,789	0%	169	0%
Public utilities	11,022,793	2%	38,070	1%
Tobacco products	13,216,670	2%	80,433	3%
Other selective sales	14,891,868	2%	81,783	3%
Licenses	42,702,918	7%	1,063,543	39%
Alcoholic beverages	389,263	0%	846	0%
Amusements	242,023	0%	330	0%
Corporation	7,280,358	1%	703,418	26%
Hunting and fishing	1,263,309	0%	911	0%
Motor vehicle	18,220,765	3%	35,140	1%
Motor vehicle operators	2,110,390	0%	2,293	0%
Public utility	473,972	0%	4,439	0%
Occupation and business, NEC	12,068,439	2%	250,289	9%
Other licenses	654,399	0%	65,877	2%
Income taxes	258,945,643	40%	1,131,341	42%
Individual income	220,254,617	34%	882,472	32%
Corporation net income	38,691,026	6%	248,869	9%
Other taxes	23,814,758	4%	132,947	5%
Death and gift	5,341,720	1%	6,180	0%
Documentary and stock transfer	10,049,250	2%	123,560	5%
Severance	8,131,446	1%	X	0%
Other	292,342	0%	3,207	0%

Abbreviations and symbols: - zero or rounds to zero; X not applicable

Source: US Census Bureau - 2005 State Government Tax Collections

Web Site: <http://www.census.gov/govs/www/statetax05.html>

2005 Population source: Table NST-EST2005-01 - Annual State Population Estimates: July 1, 2005, Population Division, U.S. Census Bureau, released December 22, 2005.



In the broadest sense, Delaware's state tax portfolio has effectively replaced the General Sales Tax employed in most other states with a combination of privilege taxes and fees on business charters and formations (e.g., the Corporate Franchise Tax) and a Gross Receipts Tax. The factors that influence the performance of a general sales tax are, of course, different from those that affect these more unique elements of Delaware's revenue system. These differences and their implications for policymakers are discussed, in depth, below.

An equally important difference between Delaware and other states is the nature of and our reliance on non-tax revenues. In FY 1990, Abandoned Property and Lottery revenues together totaled \$60.8 million or roughly one out of every twenty General Fund dollars. By FY 2007, the combined revenues exceeded \$620 million and represented nearly one dollar in five of General Fund revenues.

In other words, in relative terms, Delaware is now nearly four times as dependent on these revenue sources as it was in FY 1990. The importance of this trend is difficult to overstate. At its essence, Delaware's increased reliance on these two sources has, in effect, enabled a significant portion of the budgetary and fiscal milestones recorded over the past fifteen years. Program expansions, cash funding of capital projects and tax cuts have all, to some degree, resulted from the tremendous growth in Abandoned Property and Lottery revenues. The upshot of this reality is that, with such a high degree of reliance on these revenue items, it is critical that budget writers understand their limitations as well as their strengths when developing the State's financial blueprint.

#### **EXPORTING DELAWARE'S REVENUE BURDEN**

Delaware's revenue system is distinctive in another respect. In Delaware an uncommonly high share of the cost of government is actually paid by residents of other states. In terms of actual revenue receipts, the U.S. Census Bureau ranked Delaware as having the 6<sup>th</sup> highest state tax burden and the 13<sup>th</sup> highest combined state and local tax burden.<sup>6</sup> Based on these figures, one might conclude that Delaware is a relatively high-tax, high-spending state.

Other studies, however, show Delaware in a different light. According to the Tax Foundation, Delaware's tax burden is the 3<sup>rd</sup> lowest in the nation. Similarly, Moody's Economy.com ranks Delaware's tax burden as the 8<sup>th</sup> lowest.<sup>7</sup>

The seemingly unbridgeable gap between the Census figures and the other reports is attributable to the Census numbers' only reflecting the tax's legal incidence and making no attempt to take into account the economic incidence of each state's taxes. A tax's legal incidence is perhaps best thought of as falling on the person who writes the check to the taxing authority. The economic incidence, on the other hand, is best thought of as falling on the person who actually bears the burden of the tax. Consider the following example. If a state, assume Alaska, levies a tax on crude oil production, Alaska's revenue department would receive a check from the oil company producing that oil (legal incidence). If the demand for oil is sufficiently high and inelastic, however, the oil company will simply raise its prices and pass that tax along to consumers, the vast majority of whom live outside of Alaska (economic incidence).

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<sup>6</sup> The state tax ranking is based on FY 2004 figures. The state and local combined figures are for FY 2002.

<sup>7</sup> Tax Foundation: *Burden by State* (April, 2007). *Moody's Economy.com*; *State and Local Tax Index* (2005)

Expanding upon the example above is the idea that “businesses don’t pay taxes.” This is not a commentary on tax avoidance within the business community. Instead it reflects the reality that, once the business “writes the check,” the true cost of the tax is eventually borne by people. Businesses can pass a tax along to either:

- The consumer in the form of higher prices,
- Owners / shareholders in the form of lower returns on investment,
- Employees in the form of lower wages or fewer jobs, or
- Factor markets (suppliers) in the form of lower payments for inputs

Delaware’s General Fund contains many large revenue sources that are either nearly entirely or significantly exported. The most important of these, the Corporate Franchise – LP/LLC taxes and Abandoned Property, are tied to Delaware’s position as the preferred state of incorporation for corporate America. Most of the companies which call Delaware their legal home have few concrete ties to the State. For example, most firms chartered in Delaware have few, if any, employees in the state. Delaware’s population constitutes about 0.3% of the U.S. total meaning that its share of a national firm’s sales or shareholders is probably not too far from 0.3%.

When a large corporation writes its Franchise Tax check to Delaware, the State obviously gets 100% of the proceeds. Chances are, however, that when that cost is shifted to their customers, shareholders or employees more than 99% of them reside outside the State of Delaware. And, because the vast majority of Abandoned Property revenues are collected as a result of businesses being chartered in Delaware, it too is almost entirely exported.

Other revenue sources, like the Lottery with its high degree of nonresident video lottery play, are also significantly exported. In fact, using fairly conservative assumptions, the Department of Finance concluded that at least of 35% of the State’s General Fund was exported to other states. The fact that this allows Delaware to provide relatively high levels of state and local government spending and services without burdening its citizens with relatively high taxes perhaps explains the desire to find “the next big thing” in terms of revenues (discussed in the report’s Introduction) and what appears to be a lack of discomfort regarding the State’s increasing reliance on Abandoned Property and Lottery revenues.

#### **SENATE JOINT RESOLUTION NO. 5’S EVALUATION CRITERIA**

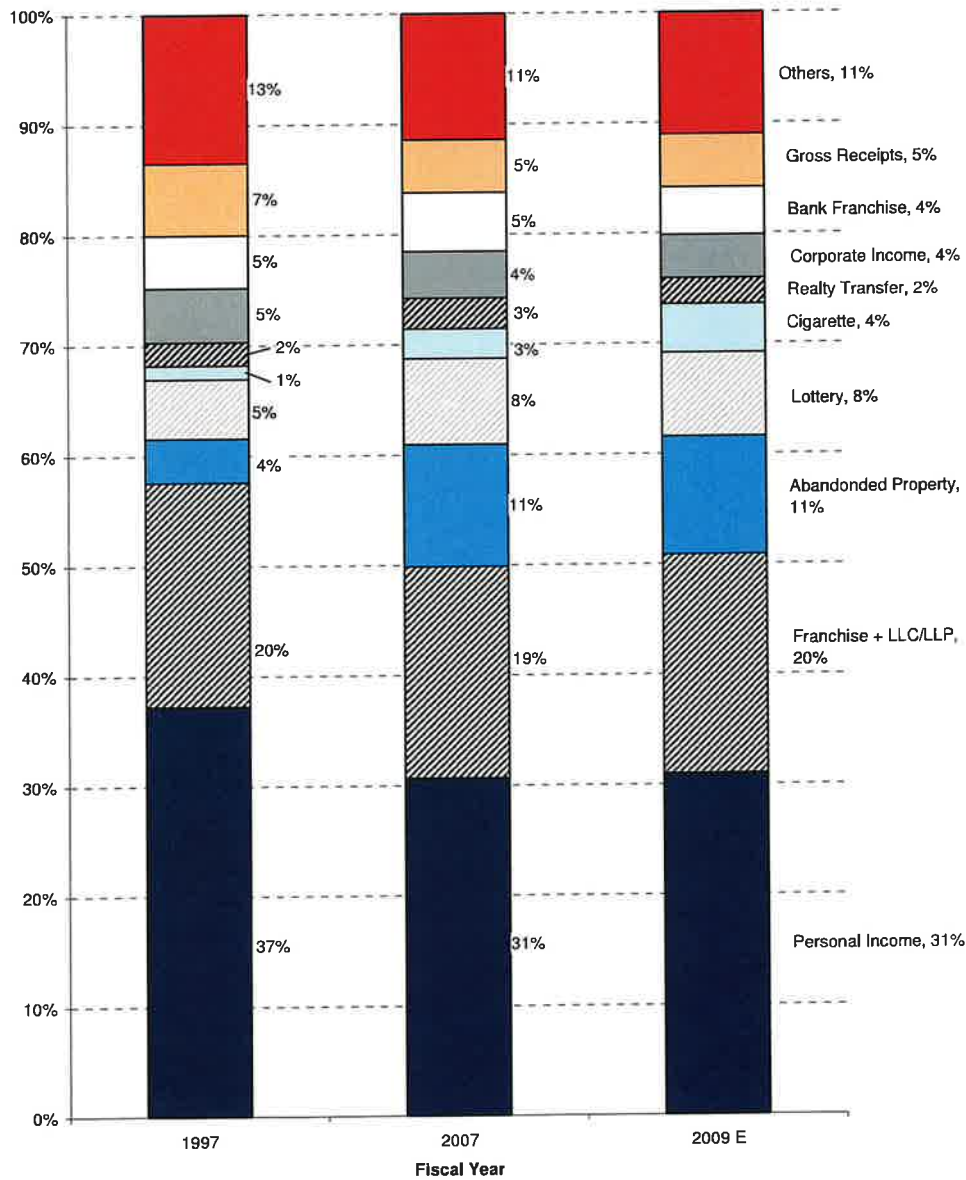
As mentioned above, this report evaluates Delaware’s General Fund revenue sources according to their ability to produce “adequate” revenues over the course of the business cycle. Long-term adequacy is a function of two sub-criteria: 1) stability and 2) growth. In evaluating these items, it is important to be mindful of a revenue system’s basic purpose – that being the provision of resources needed to fund government programs.

Revenue sources need to be evaluated with the budget’s requirements in mind. Because a budget is, at its core, a plan, it is not enough that the State’s revenue streams should be capable of growth. They must also demonstrate that they are sufficiently predictable and reliable to ensure the consistent delivery of services. On the other hand, revenue sources that are static and, thereby, stable and

predictable are of limited use if they fail to provide the growth required to fund the increasing costs of providing services. In practice, for state governments, there is no single source of revenue that will embody the desired combination of stability and growth while simultaneously raising sufficient funds to meet budgetary requirements. Revenue adequacy demands a “portfolio approach” with a state relying on a diversified mix of revenues allowing for the proper balance between growth and stability. Delaware’s revenue portfolio is presented in Chart 2.

**Chart 2.**

**Composition of General Fund by Source**



## REVENUE PERFORMANCE: FY 1997 – FY 2007

When evaluating a revenue source's performance, the first and most obvious step is to take into account any legislative changes that may have affected collections of the period examined. If these adjustments fail to occur, a tax, like Delaware's Personal Income Tax, that has had its rates cut several times will appear to under-perform. Conversely, the performance of a tax like Delaware's Cigarette and Tobacco Products Tax, which has been increased more than once during the period examined, will be exaggerated.

This analysis makes adjustments only for Delaware legislative actions. It does not, for example, make adjustments for federal tax law changes that may have affected Delaware revenues as a result of the State "piggybacking" on the Internal Revenue Code. Delaware's conformity to the Internal Revenue Code is considered an inherent feature of the State's tax system and, as a consequence, variability in State revenue streams due to federal changes is as much a part of the growth/stability equation as the variability of economic phenomena, such as employment growth or capital gains realizations.

The adjustments made to revenues were based on the fiscal impact estimates made at the time the legislation was enacted. Admittedly, this is an imperfect methodology as at the time they were made the estimates themselves embodied a degree of variability. Additionally, the fiscal impact estimates were based on the best available assumptions regarding underlying rates of economic growth in Delaware. To the extent that the actual performance of Delaware's economy has differed from that which was embodied in the fiscal impact estimates at the time they were made, those estimates may not reflect the true revenue effect of the legislated change.

Even accounting for some level of imprecision due to the adjustments made for legislative changes, very clear patterns emerge when Delaware's major revenue sources are evaluated quantitatively. For each revenue source examined, the following measures were catalogued:

### Stability

- Negative Growth Years – a simple measure of the number years out of the ten examined in which revenues fell below the level of the prior year.
- Standard Deviation – used to measure to revenue variability in absolute terms.
- Coefficient of Variation – used to measure revenue variability relative to the size of the revenue source in question.

### Growth

- Estimated Annual Growth Rate – value derived from "slope" calculation of adjusted revenue plot.
- Elasticity – revenue responsiveness to underlying economic activity as measured by personal income.

Table 2.

**Performance of Major Revenue Categories: FY 1997 - FY 2007**  
**(General Fund Revenues Adjusted for Delaware Legislative Changes)**

Revenue Source*	Share of FY 2007 Revenues	Years with Negative Growth in Last Ten Fiscal Years		Standard Deviation (1)		Coefficient of Variation (2)		Estimated Annual Growth Rate (3)		Elasticity vs. Delaware Personal Income (4)	
		Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank
Personal Income Tax	31%	3	5	165.8	8	22.3	4	6.5%	4	1.22	4
Corporate Franchise & LLC/LLP's	19%	3	5	69.3	6	12.4	1	2.9%	8	0.57	8
Corporate Income Tax	4%	4	7	31.9	4	31.0	6	4.6%	6	0.88	6
Bank Franchise Tax	5%	5	8	23.5	2	18.7	2	4.2%	7	0.76	7
Gross Receipts Tax	5%	1	1	26.3	3	23.3	5	7.0%	3	1.31	3
Abandoned Property	11%	2	3	101.9	7	48.0	7	15.5%	1	2.88	1
Really Transfer Tax	3%	1	1	37.2	5	50.0	8	14.7%	2	2.72	2
Cigarette & Tobacco Products Tax	3%	2	3	14.9	1	21.1	3	6.2%	5	1.14	5

\* Lottery Revenues are not included. See separate discussion on the Lottery in the body of the report.

(1) Standard deviation revenues in millions adjusted for Delaware legislative changes.

(2) Coefficient of Variation is defined as the (standard deviation / mean) x 100.

(3) Natural log of revenues in millions adjusted for Delaware legislative changes.

(4) Natural log of revenues in millions adjusted for Delaware legislative changes vs. natural log of Delaware Personal Income.

**INTERPRETING STABILITY AND GROWTH MEASURES:** By presenting the quantitative results for the bulk of Delaware's General Fund revenue sources in a single convenient format, Table 2 allows the reader understand and evaluate the State's revenue adequacy in its totality. Table 2 should help the reader determine:

- To what extent a trade-off between stability and growth is present in Delaware's portfolio. For example, in the last decade the Realty Transfer Tax has been among the least stable revenue sources, but has grown faster than all but one other revenue source.
- Whether the stability / growth trade-off is adequately balanced among the various revenue sources. For example, the State's largest source of revenue, the Personal Income Tax, when its size is taken into account has average stability and growth ratings. The State's second largest revenue source, the Corporate Franchise and LP/LLC taxes exhibit a more dramatic trade-off characterized by high stability at the expense of growth.
- To what extent there are revenue sources that underperformed. The Corporate Income Tax, for example, grew relatively slowly and was among the most volatile revenue streams.
- The manner in which proposed revenue policies may affect the overall balance and performance of Delaware's revenue portfolio.

#### **THE SPECIAL CASE OF THE STATE LOTTERY**

The State Lottery's revenue performance was not included in Table 2 because its evolution as an enterprise was so dramatic that making adjustments for statutory changes does not produce an adjusted revenue series that is amenable to the type of evaluation presented in the table. The video lottery, in particular, changed so profoundly in ten years that, in many respects, current operations bear little resemblance to the FY 1997 operation.

Consider, for example, how the video lottery business in Delaware has changed. In terms of hours of operations, in a typical week in FY 1997 each machine operated 121 hours out of a total of 168 hours, or 72% of the time. Today, each machine operates 162 hours, or 96% of the time. See Table 3, below:

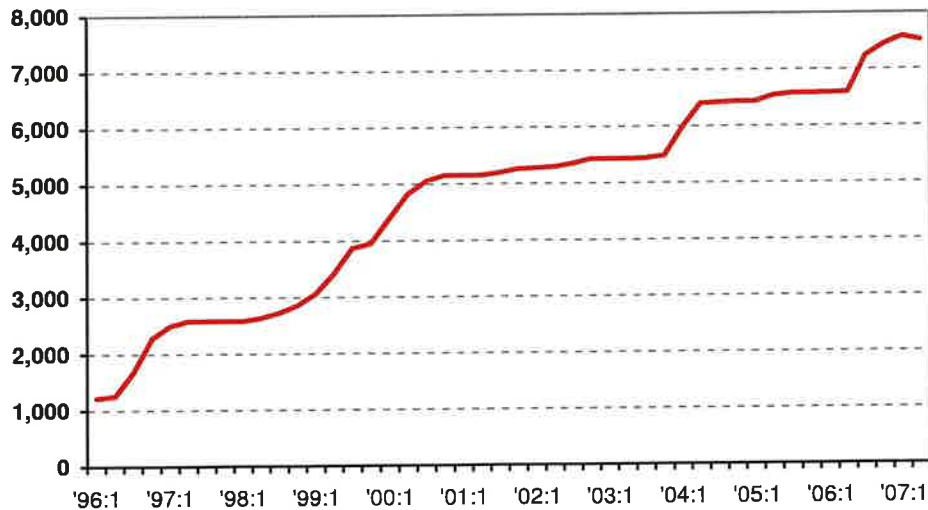
**Table 3.**  
**Changes in Video Lottery Operating Hours**

		<u>Day of the Week</u>	<u>Excluded hours</u>		Hours	Hours	<u>Days</u>	
			<u>From</u>	<u>To</u>	<u>Excluded</u>	<u>In Play</u>		
Original Legislation	69 Del. Laws c 446	Sunday	2:00 AM	1:00 PM	11	13	1	13
Effective 7/16/1994		Monday - Saturday	2:00 AM	8:00 AM	6	18	6	<u>108</u> 121
Pct Time in Play, typical week								72%
<hr/>								
		<u>Day of the Week</u>	<u>Excluded hours</u>		Hours	Hours	<u>Days</u>	
			<u>From</u>	<u>To</u>	<u>Excluded</u>	<u>In Play</u>		
HB 269	74 Del. Laws c 53	Sunday	4:00 AM	12:00 PM	8	16	1	16
Effective 6/19/2003		Monday - Saturday	4:00 AM	8:00 AM	4	20	6	<u>120</u> 136
Pct Time in Play, typical week								81%
<hr/>								
		<u>Day of the Week</u>	<u>Excluded hours</u>		Hours	Hours	<u>Days</u>	
			<u>From</u>	<u>To</u>	<u>Excluded</u>	<u>In Play</u>		
HB 332	75 Del. Laws c 229	Sunday	6:00 AM	12:00 PM	6	18	1	18
Effective 2/1/2006		Monday - Saturday	12:00 AM	12:00 AM	0	24	6	<u>144</u> 162
Pct Time in Play, typical week								96%

In terms of the number of video lottery machines operating, the transformation is even more dramatic. At the conclusion of the FY 1997 (the first full fiscal year of operations), there were roughly 2,600 video lottery terminals operating in Delaware. FY 2007 ended with over 7,500 video lottery terminals operating and, by the end of FY 2008, the number is expected to top 8,000. See Chart 3.

**Chart 3.**

### Delaware Video Lottery Terminals



In addition to the increases in operating hours and machines, the video lottery now employs multi-player games, progressive jackpots, and promotional credits that did not exist when the video lottery first came on line.

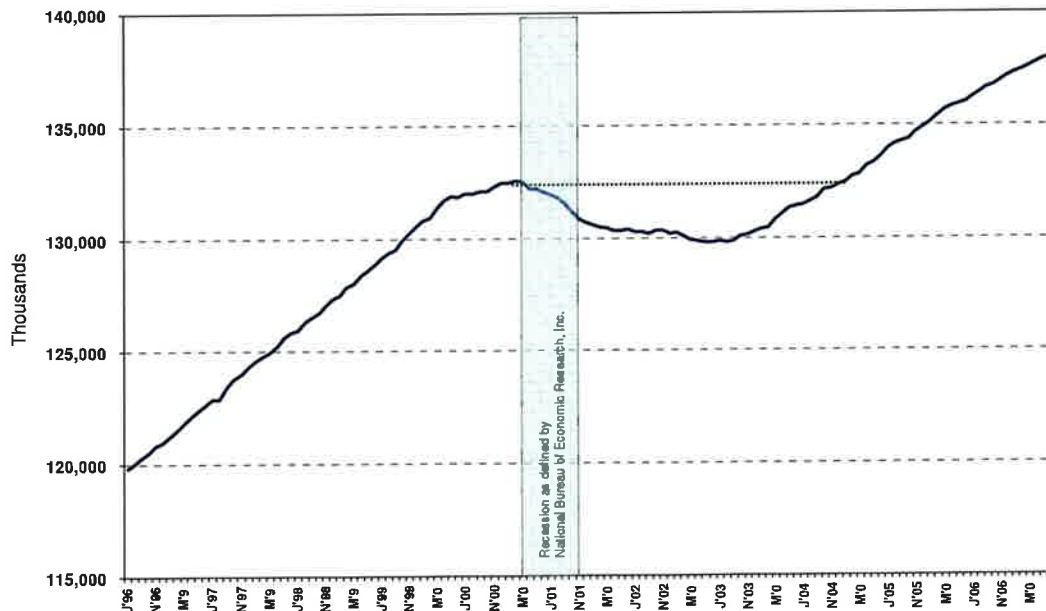
As a result of the Lottery's transformation, its revenue performance will be evaluated using slightly different criteria. Additionally, given that the General Assembly has issued a separate resolution to study the viability in Delaware of sports betting, the discussion in the Lottery section within this report will be confined to current operations.

#### DISCUSSION OF ECONOMIC TRENDS DURING COMPARISON PERIOD

Before coming to conclusions regarding the data included in Table 2, it is useful and instructive to review the economic conditions that were in place during the period covered in the analysis: FY 1997 to FY 2007. In some respects this period is a perfectly fitting basis for comparison and analysis. The period included two solid expansions, a recession, and more recently, what appears to be a soft landing characterized by slower growth. (See Chart 4, below.)

Chart 4.

## U.S. Employment





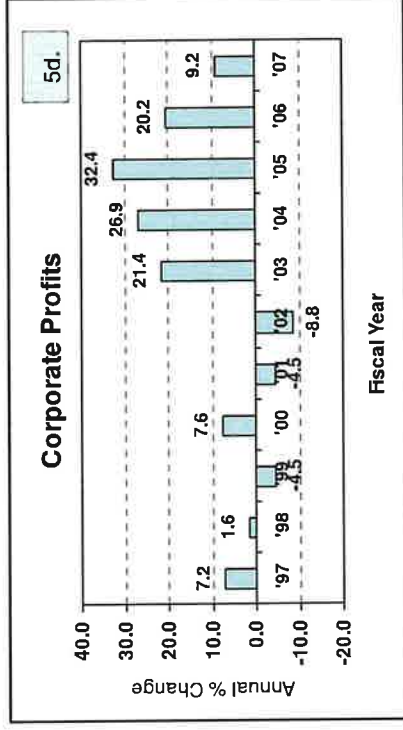
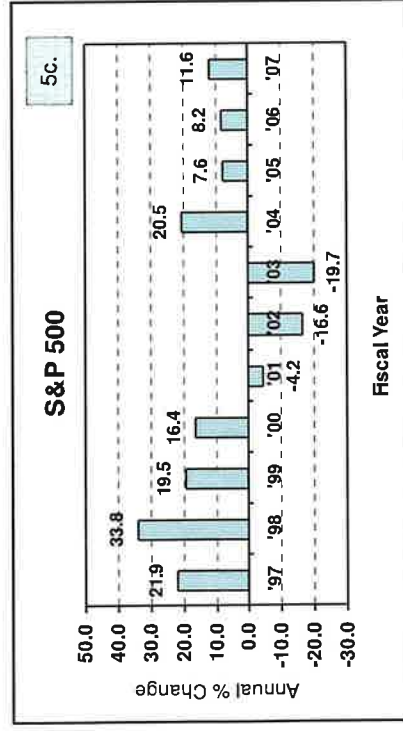
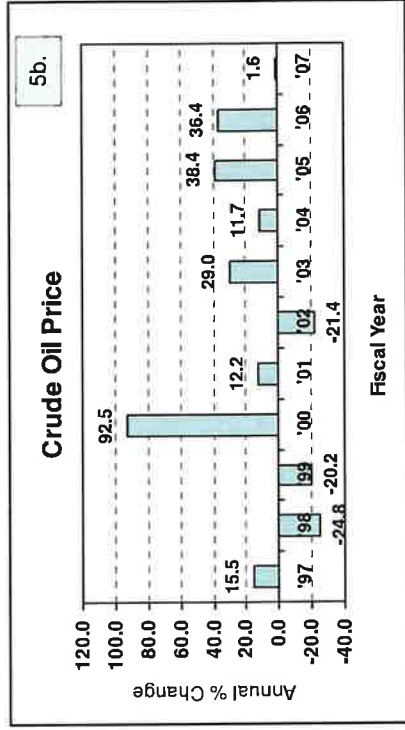
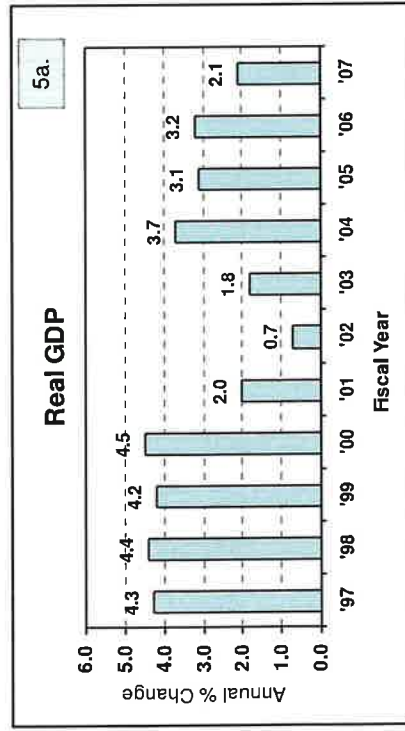
On the other hand, the period is also characterized by two asset bubbles: the tech boom of the late 1990's and, more recently, a real estate bubble that is in the process of deflating. In each case, these asset bubbles saw speculation that was unmatched in the post-war period. Clearly, these events influenced Delaware's revenues in ways that should not be expected to repeat anytime in the foreseeable future. Thus, when evaluating the results contained in Table 2, it is important, where possible, to identify that which was driven by atypical events. The charts on the following pages provide guidance in making this distinction.

The report's analyses were prepared during the autumn of 2007. As such, all revenue and economic data referenced herein reflect information that was used in the preparation of DEFAC's September revenue estimates.

Charts 5a – 5d

# Economic Indicators

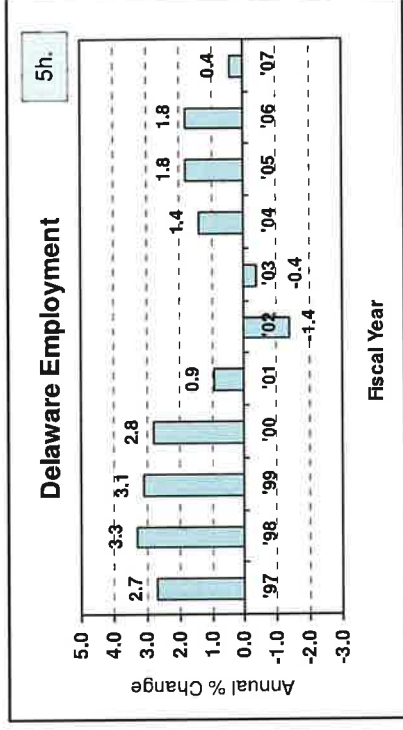
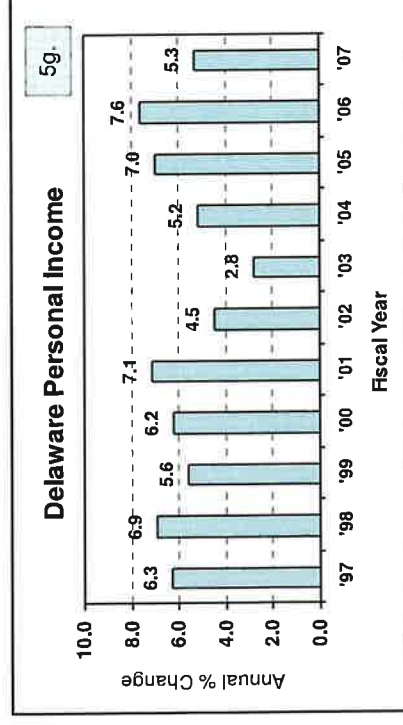
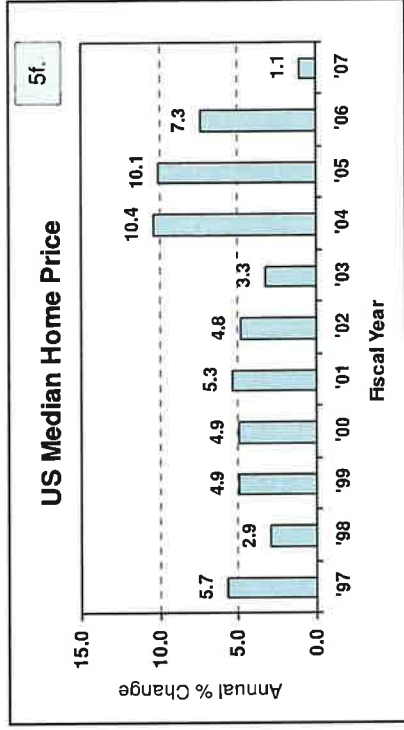
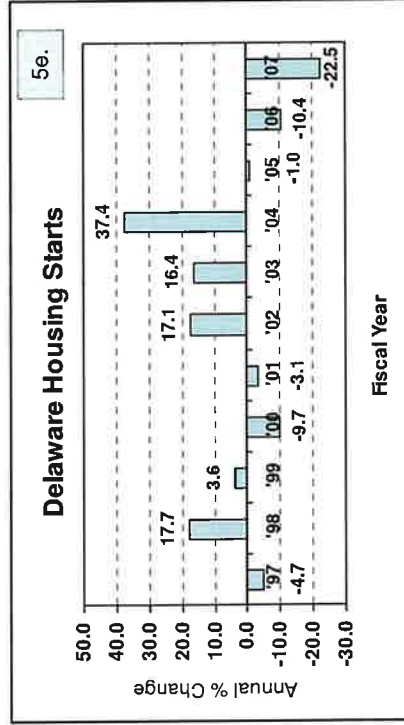
FY 1997 – FY 2007



Charts 5e – 5h

# Economic Indicators

FY 1997 – FY 2007



**SECTION I. REVIEW OF MAJOR GENERAL FUND REVENUE SOURCES**

**PERSONAL INCOME TAX**

*FY 2007 Revenues Net of Refunds*                      *\$1,008.3 million*  
*Share of FY 2007 General Fund*                      *31%*

**TAX CONFIGURATION:** As mentioned above, Delaware’s Personal Income Tax conforms to or “piggybacks” on the Internal Revenue Code. Delaware’s tax base begins with Federal Adjusted Gross Income (AGI), which consists of income from all sources (e.g., wages, dividends, business income, and capital gains) less certain federal adjustments. Federal adjustments reduce the amount of income that will ultimately be subject to tax, but unlike itemized deductions which are not available to individuals using the standard deduction, federal adjustments are available to all taxpayers.

In addition to starting with Federal AGI, Delaware recognizes most federal itemized deductions (e.g., mortgage interest, local government taxes, and charitable contributions). For obvious reasons, Delaware does not allow a deduction for taxes paid to state governments.

In arriving at Delaware AGI, the State’s tax code provides for various modifications (additions and subtractions). Taxpayers must add back interest income received from non-Delaware state and local bonds. They are afforded subtractions including interest received on U.S. obligations and up to \$12,500 in pension or other qualified retirement income.

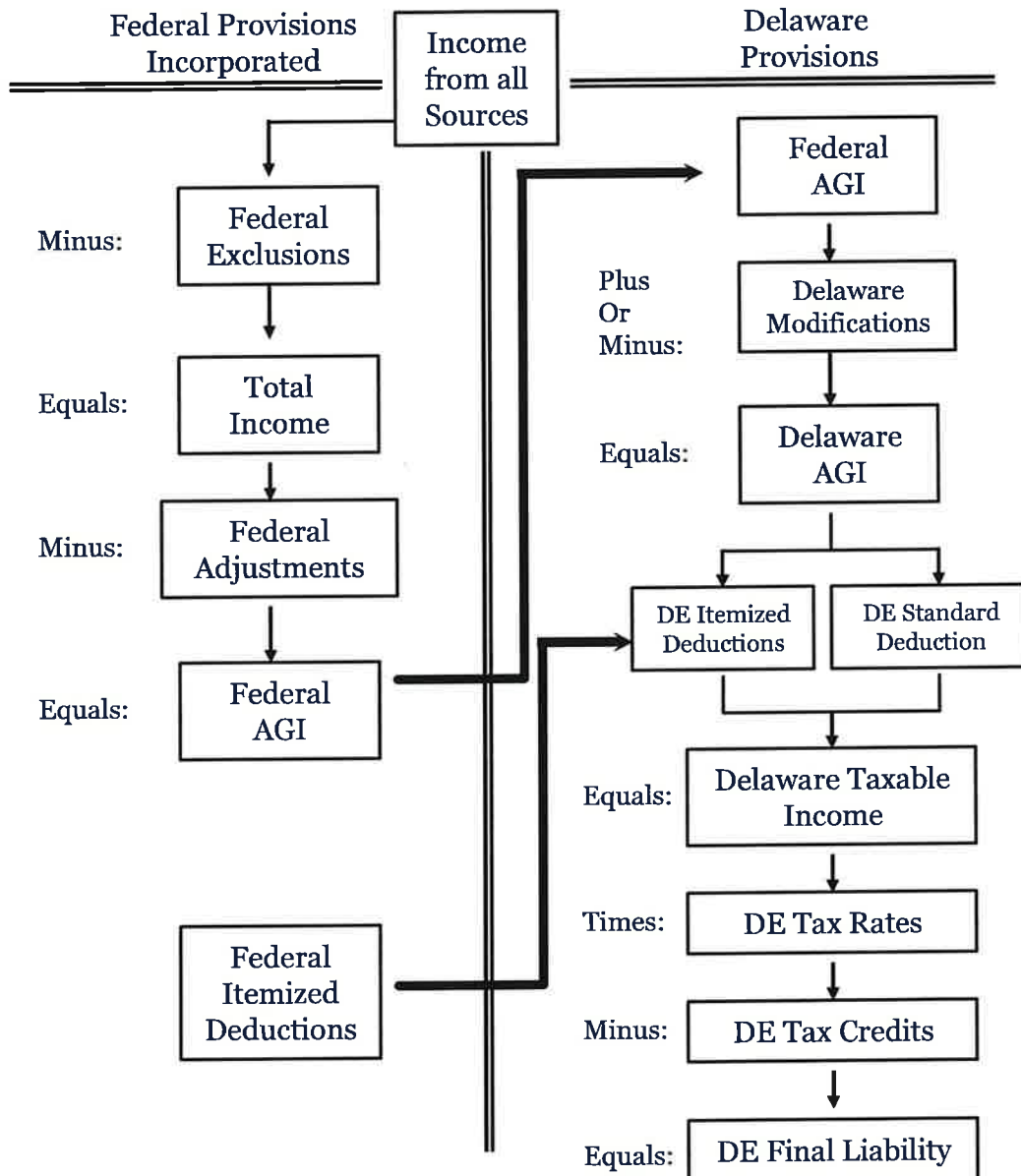
In arriving at Taxable Income, taxpayers reduce Delaware AGI by either the amount of their standard or itemized deductions. Taxpayers age 65 and older are entitled to a standard deduction that is \$2,500 higher than the basic standard deduction. Taxable Income is then subject to the following rate schedule:

<b>IF TAXABLE INCOME IS GREATER THAN:</b>	<b>BUT LESS THAN:</b>	<b>TAX LIABILITY IS CALCULATED AS:</b>	<b>PLUS:</b>	<b>ON TAXABLE INCOME OVER:</b>
\$0	\$2,000	\$0.00	0.00%	\$0
\$2,000	\$5,000	\$0.00	2.20%	\$2,000
\$5,000	\$10,000	\$66.00	3.90%	\$5,000
\$10,000	\$20,000	\$261.50	4.80%	\$10,000
\$20,000	\$25,000	\$741.50	5.20%	\$20,000
\$25,000	\$60,000	\$1,001.00	5.55%	\$25,000
\$60,000		\$2,943.50	5.95%	\$60,000

The resulting liability provided by this calculation is then further reduced by applicable tax credits. All taxpayers are entitled to a \$110 personal credit for the number of personal

exemptions claimed on their federal return. Taxpayers age 60 and over are entitled to an extra personal credit. Delaware has chosen to recognize, in part, two federal credits. Taxpayers may take nonrefundable credits equal to 50% of the federal child care credit and 20% of the federal earned income tax credit. A diagram of Delaware's Personal Income Tax structure is found in Figure 1.

**Figure 1.**  
**The Structure of Delaware's Personal Income Tax**



**RECENT PERFORMANCE:** From FY 1997 to FY 2007, Delaware's Personal Income Tax (PIT) was, on balance, among the State's more stable revenue sources. Revenues fell only in the during the recession affected years of FY 2002 -03 and in FY 2007, reflecting restructuring in the State's financial sector and the beginning of a major correction in the housing market. PIT is the State's largest revenue source, and as might be expected, its standard deviation ranked eighth out of the eight revenue sources examined (most volatility in absolute terms). When it is variability is considered in light of its size (Coefficient of Variation), however, PIT becomes the State's fourth most stable revenue source over the period.

In terms of growth, Delaware's PIT performed in line with long-term trends. An estimated annual growth rate of 6.5% and an elasticity of 1.22 are in line with expectations. Both of these figures ranked fourth among the eight revenue sources examined. (Please refer to Table 2.) Given that it is the State's largest revenue source, this middle of the road performance is somewhat reassuring. Delaware's PIT appears to have demonstrated that it is reasonably stable while providing a rate of growth that is fairly consistent with the rate of growth in the underlying economy.

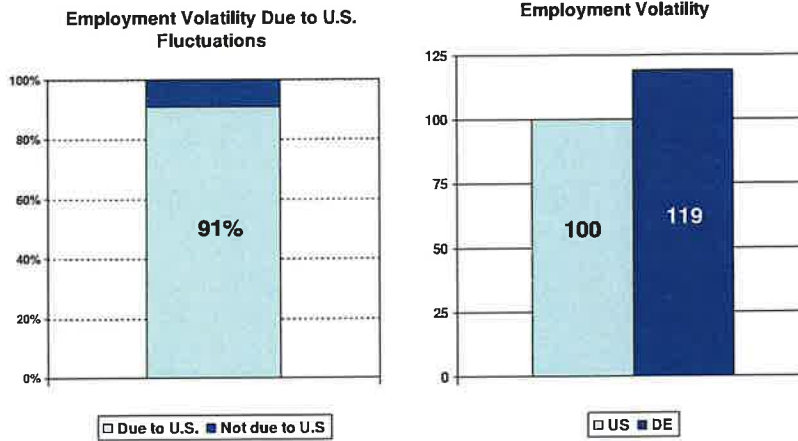
To some degree, however, these measures mask the amount of pronounced year-to-year variations in PIT collections. More frequently than in past periods, PIT over the course of the last ten years has shown more double digit growth boom years and flat or negative growth years. Over a ten year period, these annual swings tended to cancel one another out producing the ten-year growth and stability results described above. It is likely, however, that much of this shorter-term variability can be traced to the stock market and housing bubbles' impact on collections.

#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** As discussed above, Delaware's PIT will vary with fluctuations in the economy. It should come as no surprise that a tax on "personal" income is dependent upon underlying trends in employment levels and wage growth. Because of its small size, Delaware will tend to exhibit more volatility in its labor markets than the nation at large. Still most of the State's volatility in employment levels is due to changes in the broader U.S. economy. See Chart 6, below.

CHART 6

## Delaware Employment Volatility



Source: Moody's Economy.com, Inc: September 2007

The most immediate cyclical risk is the magnitude and length of the housing market's impact on the economic expansion. The extent to which the housing boom, which doubtless contributed to PIT's double digit growth rates in FY's 2005 and 2006, will limit PIT collections in the next few budget cycles is difficult to determine, but it is clearly a downside risk.

Over the longer-term, Delaware's PIT upside and downside cyclical risks appear well balanced. The tax tracks the economy's performance fairly closely. Moreover, forecasters and budget writers understand the tax's drivers and have a reasonably good handle on its ebbs and flows throughout the business cycle.

**STRUCTURAL ISSUES:**

**Tax Breaks For a Growing Senior Citizen Population:** Delaware's PIT contains several non-means tested tax breaks for the elderly. The most notable of these provisions are listed below along with the FY 2008 revenue loss estimate attributable each provision:

Provision	FY 08 Revenue Loss Estimate (millions) <sup>8</sup>
Exclusion of Federally Taxable Social Security Income	\$22.8
Additional Standard Deduction for the Blind and Persons Age 65 or Over	\$3.1
Additional Personal Credit for Persons Age 60 or Over	\$7.1
Exclusion of up to \$12,500 in Pension and Eligible Retirement Income	\$38.5

<sup>8</sup> State of Delaware, Department of Finance, Division of Revenue: "Tax Preference Report: 2007 Edition."

The point of highlighting these provisions is not to discuss their efficacy in achieving a public policy objective. They are presented because they represent a material revenue impact and, equally important, demographic trends clearly indicate that, if left unchanged, these non-means tested provisions' costs will escalate dramatically in coming years. From 2007 levels, Delaware's population aged 60 and over is expected to grow 28% by 2015 and 48% by 2020<sup>9</sup>. It is only logical that the cost of the items in foregone revenues will follow suit.

**Shifting Income Distribution:** Delaware's Personal Income Tax is skewed to the high end of the income distribution. In recent years, this trend has become more pronounced.

<b>Top One Percent of Taxpayers in Terms of Delaware AGI<sup>10</sup></b>		
<b>Tax Year</b>	<b>Total DE AGI</b>	<b>Total Tax Paid</b>
1998	16.1%	22.9%
2005	20.7%	30.6%

The causes of this trend are hotly debated and are well beyond the scope of this report. What is clear, though, is that the sources of income that differentiate the top one percent of the income distribution (e.g., business income, capital gains, rents and royalties) are much more volatile than wages and salaries, which predominate across the rest of the income distribution. Over the long haul, the performance of non-wage income should be expected to track the underlying output of the economy. In any given year, however, policymakers and budget writers need to bear in mind that an increasing portion of PIT receipts are subject to market induced gyrations.

**Federal Legislative Actions:** Delaware piggybacks its PIT on the Internal Revenue Code (IRC) because, by allowing taxpayers to use a single set of definitions and eligibility criteria, it simplifies compliance, administration and enforcement. Depending upon the type of change adopted in federal statutes, however, piggybacking can lead to unexpected revenue losses and windfalls.

Whether Delaware is stung by an unexpected revenue loss or benefits from a windfall depends upon Congress's policy aims and, equally important, how those policy aims are implemented. If, for example, Congress broadens the PIT base (eliminates or limits the availability of certain tax breaks) that affect the composition of Federal AGI or itemized deductions, then, as was the case with the Tax Reform Act of 1986, Delaware would see a revenue surge. On the other hand, if Congress seeks to use the Internal Revenue Code to spur economic growth, then, as was the case with accelerated depreciation schedules in recent tax acts, Delaware would stand to lose revenues in the short-run.

Delaware is largely insulated from the direct impact of changes to federal tax rates and federal tax credits. With the exception of the Child Care Credit and the Earned Income Tax Credit, Delaware does not piggyback on these elements of the IRC. The impact on Delaware of federal measures that deal with tax rates or tax credits is indirect. For example, an increase or decrease in the federal tax rate on capital gains may affect investor behavior in such a way that the timing

<sup>9</sup> Delaware Population Consortium: "Population Projection Series," September 29, 2004.

<sup>10</sup> State of Delaware, Department of Finance



and, perhaps, the level of realizations may be altered sufficiently to impact Delaware's PIT revenue stream.

The list of tax-related issues with which Congress may wrestle is long and includes:

- The expiration in the next three to four years of many of the tax cuts enacted since 2001;
- The federal Alternative Minimum Tax (AMT);
- The tax code's role in the health care debate;
- The broader issue of how to avert a demographically driven fiscal crisis; and
- The possibility of fundamental tax reform, including replacing the federal personal income tax or coordinating it with another major source of revenue, such a Value Added Tax (VAT) or national sales tax.

#### **REVENUE POTENTIAL FROM AN INCREASE IN TAX RATES:**

- **Each option's revenue potential:** As the State's largest source of General Fund revenue, simple arithmetic dictates that a simple rate hike in PIT offers perhaps the highest revenue potential of any source. (Net revenues exceed \$1 billion.) Both in terms of its top and overall effective tax rates, Delaware's PIT is no longer an outlier (at the high-end) among the states that levy a PIT so supply-side concerns that voters and businesses might react by leaving Delaware are less pronounced than they were 25-30 years ago.
- **The reliability of the estimates themselves:** Unlike creating a new revenue source or increasing rates on a volatile tax, like the Corporate Income Tax, PIT revenues are relatively reliable and, assuming DEFAC has a good handle on the economic outlook, over the short-term, the revenues estimated by an increase in PIT rates is something upon which policymakers seeking to balance a budget could rely upon with a reasonable amount of confidence.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in PIT rates would be simple to implement.
- **Other tax policy considerations, if significant:** Because PIT has a progressive rate structure, the manner in which a rate hike would be implemented might have implications in terms of equity. A more important consideration, perhaps, is how such an increase would be viewed in terms of Delaware's economic competitiveness with other states. Over the last three decades, Delaware cut PIT rates ten times, with the top rate falling from 19.8% to today's 5.95%. Increasing rates might be interpreted as a signal that Delaware has reversed course in terms of tying PIT rates to economic development.
- **Legal and political considerations:** A simple increase in PIT rates would not provide the basis for a legal challenge, federal preemption or similar obstruction.

## **CORPORATE FRANCHISE & LIMITED PARTNERSHIP / LIMIT LIABILITY COMPANY TAXES**

<i>FY 2007 Revenues Net of Refunds</i>	<i>\$622.5 million</i>
<i>Share of FY 2007 General Fund</i>	<i>19%</i>

**TAX CONFIGURATION:** Actually two separate taxes, broadly speaking this category consists of taxes on the privilege of being formed under Delaware law or registered to do business in Delaware. At one point it may have been true that corporations and LP/LLCs were separate and served distinct business purposes. But increasingly they are viewed as close substitutes or complements for one another. Slower growth among corporate formations has, to a large degree, been attributable to a boom in LP/LLC registrations. In this regard, the two taxes really cover the same "market." As such, the two taxes are evaluated together.

The Corporate Franchise Tax (CFT) applies to traditional "C Corporations," which, because there is no limit on the number of shareholders and shares that may issued, may become a public corporation, with its shares being bought and sold either through a stock exchange or "over the counter." The CFT also is levied upon "S Corporations," pass-through entities upon which there are limits on the number of shareholders and types of entities permitted to hold shares.

Limited Partnerships, Limited Liability Companies and General Partnerships formed in the State of Delaware are required to pay an annual tax of \$200. Taxes for these entities are to be received no later that June 1st of each year.

**CORPORATE FRANCHISE TAX FILING REQUIREMENTS:** Domestic corporations must pay a corporate franchise tax for the privilege of being incorporated in Delaware. Retention of a charter by a corporation creates an obligation to pay the tax unless specifically exempted by law. Companies incorporated in another state, but doing business in Delaware, must also register with the Secretary of State. Banks and certain other financial institutions pay a franchise tax to the Bank Commissioner in lieu of the corporate franchise tax.

**CORPORATE FRANCHISE TAX CALCULATION:** There are two methods by which corporations may determine their CFT liability:

- The Authorized Share Method, or
- The Assumed Par Capital Value Method

**AUTHORIZED SHARES METHOD:** Domestic corporations are taxed based on the number of authorized shares at the following tax rates:

<u>Corporations With:</u>	<u>Fee:</u>
Up to 3,000 shares	\$35.00 (Minimum Tax)
3,001 - 5,000 shares	\$62.50
5,001 - 10,000 shares	\$112.50
Over 10,000 shares	\$112.50, plus \$62.50 for each additional 10,000 shares or part thereof, not to exceed \$165,000

**ASSUMED PAR VALUE CAPITAL METHOD:** For taxpayers using this method, the tax base is Assumed Par Value Capital, which is derived by a multi-step process that begins with “Total Gross Assets” as reported as "total assets" on the U.S. Form 1120, Schedule L (Federal Return).

Step 1. The amount of Total Gross Assets is divided by the number of issued shares. The figure produced by this calculation is referred to as the “assumed par value.”

Step 2. Among authorized shares, multiply the number of authorized shares with an actual par value that is less than the assumed par value by the assumed par value.

Step 3. Among authorized shares, multiply the number of authorized shares with a par value greater than the assumed par by their actual par value.

Step 4. The amounts produced by Steps 2 and 3 are combined to produce the amount of Assumed Par Value Capital.

Step 5. The Assumed Par Value Capital is then rounded up to the nearest \$1 million.

Step 6. The tax liability is \$250 per million dollars as determined in Step 5.

The maximum tax, as it is with the authorized share method, is \$165,000.

**RECENT PERFORMANCE:** A review of the figures found in Table 2 shows that, although it had three negative growth years from FY 1997 to FY 2007, the performance of the combined CFT – LP/LLC taxes was the more stable among the eight revenue sources compared. In fact, despite being the State’s second largest revenue source and accounting for 19% of General Fund collections, CFT – LP/LLC revenues were more stable in absolute terms (standard deviation) than both PIT and Abandoned Property. When measured relative to its size (coefficient of variation), CFT – LP/LLC was the most stable revenue source examined.

On the other hand, the combined CFT- LP/LLC grew at the slowest rate (2.9%) and exhibited the lowest responsiveness (elasticity of 0.57) to underlying economic growth of any of the eight revenue sources examined. While the LP/LLC component has exhibited strong growth, the much larger CFT component has traveled an uneven road. CFT’s strong performance in the late 1990’s was due, in large part, to the speculative bubble that defined the tech-boom. When this bubble popped, CFT collections followed suit, falling from a peak of \$533 million in FY 2001 to \$448 million in FY 2003.

In addition, a series of national corporate and accounting scandals prompted a statutory response, the Sarbanes-Oxley Act of 2002, which added significant regulatory scrutiny, responsibility and accountability for public companies. The Act, along with the growing popularity of alternative entities (LP/LLCs), further delayed any significant rebound in Corporate Franchise Tax filings. More recently, however, modest growth has returned as record corporate profits have increased payments from taxpayers making use of the Assumed Par Value method.

While the CFT – LP/LLC category does have features that will continue to limit its growth potential (most notably, the \$165,000 cap on CFT payments), it is reasonable to question whether the economic performance that was particular to FY 1997 – FY 2007 overstates the level of stagnancy reflected in the measures contained in Table 2. Perhaps, especially as they affect this category, the economic events over the period were atypical. The period started with CFT at an unnaturally high level fueled by the tech-boom, it was followed by a cyclical downturn and then by a restructuring of the corporate regulatory environment. That revenue returns were somewhat static may be as much a reflection of the somewhat unusual times as it is the fundamental nature of the revenue source.

#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** As described above, among Delaware’s largest revenue sources, the CFT – LP/LLC category was the least responsive to variations in underlying economic growth. But as is also discussed above, this does not indicate that this revenue source is not influenced by economic factors.

Corporate and other business formations, the lifeblood of this revenue source, tend to be driven by business confidence or what Keynes referred as the economy’s “animal spirits.” Forming a corporation is a “yes / no” proposition. Only when there is a sufficient critical mass of confidence is a firm formed. (On the CFT side, this is apparent in the market for Initial Public Offerings (IPO), which is responsible for a large share of the tax’s long-term growth potential.) Conversely, firms are unlikely to give up their charters or go out of business after a modest slowdown in the economy.

In sum, in terms of cyclical affects, this category is likely to be somewhat less affected than other revenue sources by typical annual changes in broadly-based economic performance and more susceptible to prolonged trends in market psychology.

#### **STRUCTURAL ISSUES:**

**Inelastic Tax Structure:** In many respects, the CFT is unresponsive to economic growth. The tax is capped at \$165,000 per year. Large, highly capitalized companies – so called “max taxpayers” – that pay the maximum amount, by definition, cannot contribute to the tax’s growth no matter how well the economy performs. What is more, other taxpayers making use of the authorized shares method also will see their tax payments fixed, unless they act to amend their corporate charter and authorize additional shares. The bottom-line is that, for a substantial portion of the CFT tax base, underlying growth in sales, profits, employment or assets held generates no “natural” growth in tax revenues. This aspect of the CFT grows only when companies independently act to form new corporations or authorize additional shares.

For those corporations employing the assumed par value method, the structure allows for some natural growth. As corporations earn profits and increase the level of assets on their balance sheets, the amount of tax paid under this method grows. This growth, however, has an upward limit, which is the maximum tax amount of \$165,000. Moreover, recent evidence suggests that corporations have become more sophisticated in their choice of filing methods and are more aware and willing to take advantage of potential tax savings available by migrating from one filing method to the other.

The other element in the revenue category, LP/LLC, pay a flat annual tax of \$200. Again, this flat structure guarantees no natural growth in revenues on an individual taxpayer basis. The substantial growth in this part of the broader category is due to an expanding filer base driven, in large part, to the growing popularity of alternative entities within the business community.

**Growing Preference for Alternative Entities:** In FY 1997, LP/LLC comprised 1.2% of total CFT and LP/LLC revenues. By FY 2007, their share had risen to 14.5%. A substantial portion of this increased share is due to Delaware legislative changes. At the time they were adopted in 2003, the tax increases were considerably larger for LP/LLCs (estimated effective increase of about 90%) than they were for the CFT (estimated effective increase of about 15%). Nevertheless, LP/LLC's rate of growth has dwarfed that of the CFT. From FY 2005 to FY 2007, for example, LP/LLC revenues grew at an annual rate of 13.2% while CFT revenues lagged far behind at 2.1%.

As discussed above, the post Sarbanes-Oxley corporate governance environment, especially when coupled with a series of changes to the Internal Revenue Code that have made alternative entities a more practical business model, have pushed businesses away from traditional corporate structures (and the CFT) and to alternative entities (and the LP/LLC tax). The immediate effect of this change has been a somewhat lower overall yield from the combine revenue source. Eventually some of today's LP/LLC's may migrate for business purposes, register as corporate entities, and go public. It is clear, though, that an increasing share of firms paying a \$200 annual tax with no possibility of natural growth instead of the CFT, which generally has higher tax rates and some opportunity for growth driven by economic phenomena, serves to hold down aggregate revenue growth.

**Is it like other taxes?** Thus far, the analyses in this section have considered the CFT – LP/LLC taxes in the same manner as one would evaluate a sales, property or personal income tax. Such an evaluation is useful for understanding how this revenue source performs over the short-term. A strong case can be made, however, that the CFT – LP/LLC is not a tax in the traditional sense. In fact, Delaware case law considers CFT to be a fee for the “use of the State.” More precisely, the CFT-LP/LLC should be thought of as a fee for the privilege of having access to Delaware's legal system (its statutes courts and case law) and for the services provided by the State's Division of Corporations. That is, the State is not so much placing a levy on a reluctant “taxpayer” as much as it is charging a price for a desirable service that a customer, who has alternatives, is willing to pay. With respect to this revenue source, the State is actually operating an enterprise and, as a consequence, the revenues derived from this source should be evaluated accordingly.

In this case the “price” for the State’s services are the CFT – LP/LLC taxes. Like a typical business, the State, when pricing its services, needs to consider its financial requirements, its competition and the reaction of its customers. Unlike private enterprise, though, changing the price of the State’s corporate services requires the General Assembly’s approval and is thus subject to the uncertainties inherent in the legislative process.

It is clear that, without the inherent responsiveness to economic growth and given this category’s entrepreneurial aspects, CFT – LP/LLC needs more active management, both in terms of pricing (tax rates) and services, than other taxes. Great care must be exercised in the timing and level of any decision to increase tax rates and, equally important, administrators must maintain a watchful eye on developments in other states and a customer focus that ensures Delaware remains the preferred state for business formations.

#### **REVENUE POTENTIAL FROM AN INCREASE IN TAX RATES:**

- **Each option’s revenue potential:** As the State’s second largest source of General Fund revenue, again simple arithmetic dictates that rate hikes in CFT – LP/LLC offer a relatively high revenue potential. (Net revenues are forecast to exceed \$650 million.) As discussed above, however, in many ways this category operates more like a business offering services for a price, than it does a government imposing a tax. The last round of “price” increases occurred in 2003. Typically, tax rate adjustments are made only after a number of years have elapsed.<sup>11</sup> While ultimately it is a judgment call with respect to how the corporate community might react to a tax increase, given that the last increase occurred relatively recently, this option may not be tenable for a number of years.
- **The reliability of the estimates themselves:** As demonstrated above by its growth and stability rankings, under most circumstances, this source is fairly reliable indicating that the revenue estimates prepared to reflect a general rate increase should also be relatively reliable. It is also clear, however, that the CFT – LP/LLC’s behavior at or around inflection points in the economy can belie its usual steadiness. In this regard, if, as is often the case, policymakers seek a general increase in CFT – LP/LLC rates during an economic downturn, they should be prepared for a degree of variability vs estimates.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in CFT – LP/LLC rates would be simple to implement.
- **Other tax policy considerations, if significant:** Because CFT – LP/LLC revenues’ legal incidence falls on businesses, its economic incidence or true burden is passed along to these firms’ customers, shareholders and/or employees. Most of these individuals reside outside of Delaware. A more important issue involves the manner in which the corporate community’s impressions with respect to the cost/benefit calculus of maintaining a Delaware charter may be altered as a result of the tax increase.

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<sup>11</sup> Corporate Franchise Tax rates were increased in 1984, 1991, and 2003, with seven and twelve years elapsing prior to the last two increases.

- **Legal and political considerations:** A simple increase in rates would not provide the basis for a legal challenge, federal preemption or similar obstruction.

**CORPORATE INCOME TAX**

*FY 2007 Revenues Net of Refunds*

*\$140.3 million*

*Share of FY 2007 General Fund*

*4%*

**TAX CONFIGURATION:** Every domestic and foreign corporation doing business in Delaware must file a corporation income tax return, regardless of the amount of its gross income or its taxable income, unless specifically exempt by law. Corporations that maintain a statutory corporate office in Delaware, but not doing business in the state, are not required to file a corporate income tax return.

Taxes are computed on the amount of a corporation's taxable income that is apportioned and allocated to Delaware. Taxable income does not include: interest on obligations of the United States, the State of Delaware, or its subdivisions; gains from the sale of securities issued by the United States, the State of Delaware, or its subdivisions; dividends, interest, and royalties of foreign corporations that qualify for a foreign tax credit for federal purposes; and interest from affiliated corporations. Additional deductions are allowed for wages under the Federal Jobs Credit program, handicapped accessibility improvements, and donations to neighborhood assistance programs.

Income from interest, rents, royalties, patents, and gains and losses from the sale of real and tangible property, is allocated directly to the state in which the property is physically located or the transactions took place, reduced by the applicable and related expenses.

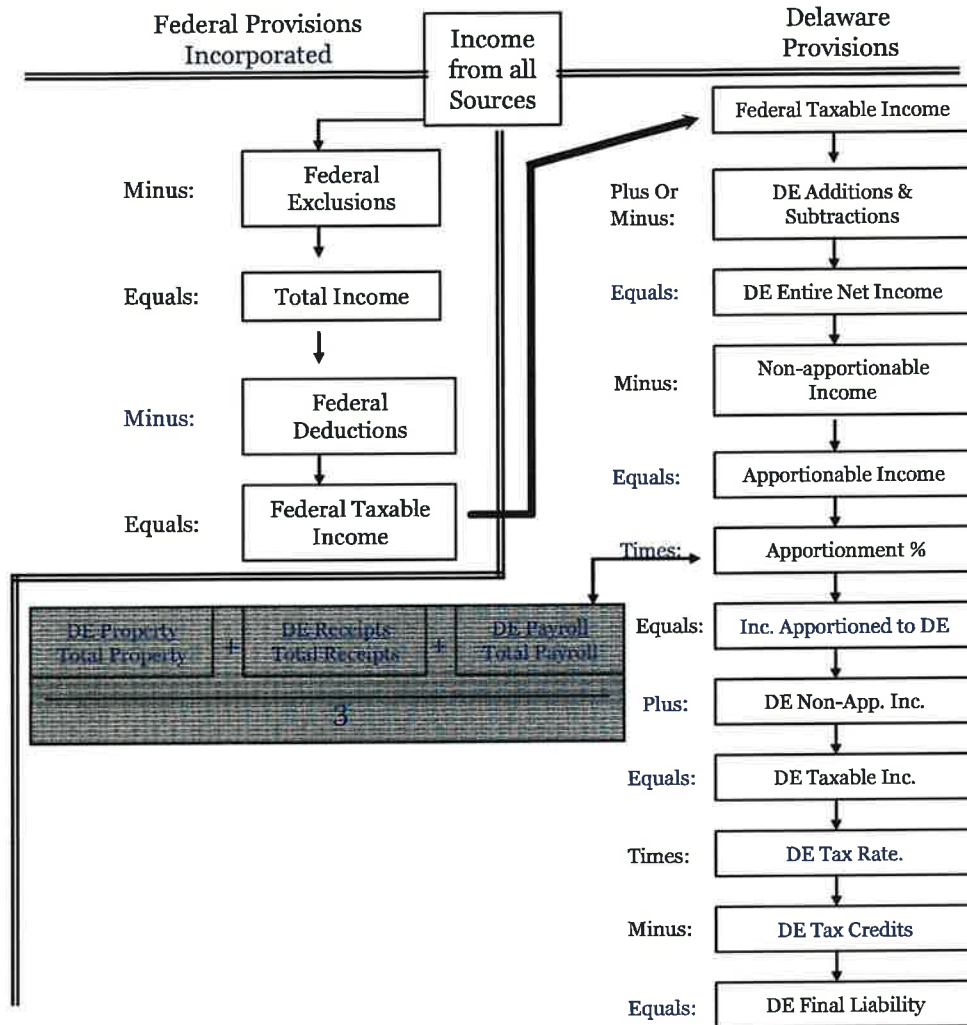
Apportionment of unallocated income is based on a three-factor formula that averages the ratios of: 1) Delaware property to total property; 2) Delaware wages to total wages; and 3) Delaware gross receipts to total gross receipts for interstate businesses. The apportionment formula is applied to a company's entire taxable income, excluding its allocated and exempt income. Arithmetically, the apportionment formula is as follows:

$$\frac{\text{Property} + \text{Salary Ratio} + \text{Sales Ratio}}{3} = \text{Apportionment Ratio}$$

A diagram of Delaware's Corporate Income Tax structure is found in Figure 2 below.



**Figure 2.  
Corporate Income Tax Structure**



The Corporate Income Tax (CIT) rate is 8.7% on income that is apportioned or allocated to Delaware.

**RECENT PERFORMANCE:** In terms of growth and stability, the performance of Delaware’s CIT from FY 1997 to FY 2007 represents the worst of both worlds. In absolute terms, CIT’s volatility appears relatively benign, ranking fourth among the categories examined. Receipts, however, fell four of the ten years covered indicating that, unlike other categories, such as Abandoned Property that exhibited high volatility that was almost uniformly positive, CIT’s variation was nearly as likely to produce negative returns. In terms of its stability relative to its size, CIT was the sixth most stable of the revenue sources examined and was nearly half again higher than PIT with a coefficient of variation 31.0 vs. 22.3 for PIT.

CIT's growth performance was also below par. Its estimated annual growth rate was 4.6% and its elasticity was 0.88, both of which were sixth out of the eight revenue sources compared. In sum, from FY 1997 to FY 2007, Delaware's Corporate Income Tax demonstrated a high degree of instability around a fairly flat growth trend. (See Table 2.)

In terms of growth and stability, perhaps CIT's lone redeeming quality is that, at about 4% of total General Fund revenues, it is a relatively small source of revenue. CIT's stability and growth characteristics also provide ample proof that the State's fiscal system needs to include a broad portfolio of revenues in order to avoid excessive reliance on any single source.

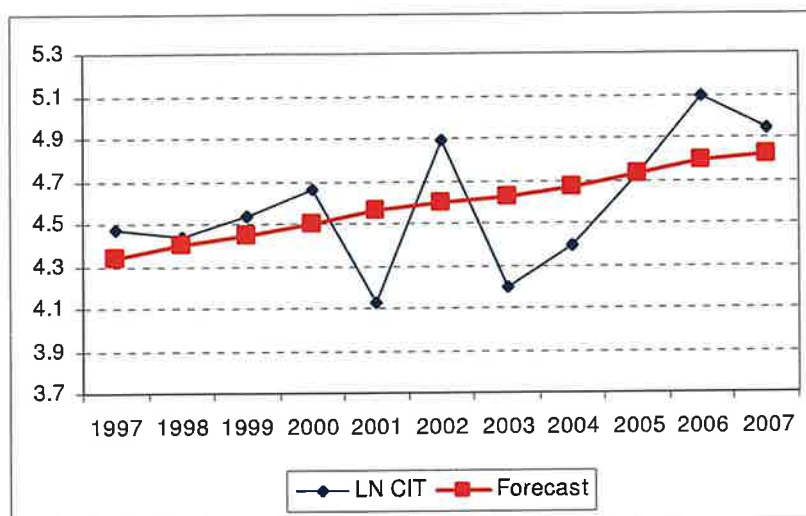
#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** Taxes that are levied upon profits, such as Delaware's CIT, are inherently volatile. While a relatively small reduction in the growth of sales translates into a corresponding reduction in tax collections for a sales or gross receipts tax, it may, if it causes revenues to temporarily fall below expenses, eliminate entirely a business's corporate income tax liability. For example, a 3% reduction in sales would cause a firm's gross receipts tax bill to fall by 3%, but could result in its CIT liability falling by 100%. On a large scale, this phenomenon is borne out in national statistics on annual changes in U.S. Corporate Profits, which, from FY 1997 to FY 2007, ranged from a low of -8.8% to a high of +32.4%. By comparison, the variability of Delaware personal income growth was much tighter, ranging from 2.8% to 7.6%. (See Charts 5d and 5g.)

In terms of its practical implications for State budgets, the problems posed by this volatility are compounded because, not surprisingly, accurately forecasting the size and timing of CIT's pronounced swings is extremely difficult. Typically, one associates revenue volatility with highly cyclical taxes, which, in turn, produce high elasticity figures. In the case of CIT, while there is undeniably a strong cyclical aspect to the revenue stream, the inherent variability around those cyclical trends is so pronounced that over certain periods it is difficult to establish firm relationships with underlying trends in broad indicators, like personal income or national corporate profits. Nevertheless, with corporate profits hovering around a historic high in terms of their share of total national output and the economy seemingly decelerating, CIT's near-term outlook appears to carry downside risk.

Moreover, in Delaware's case, this inherent instability is often magnified due to structural issues (explored below) within the tax base. This relationship (or lack of a relationship) between Delaware CIT receipts and broad economic phenomena is demonstrated in the chart below on which is plotted actual receipts versus a plot of forecasted receipts using Delaware personal income as an independent variable.

**Chart 7.  
Delaware CIT Receipts vs. Forecast Based on DE Personal Income**



As can be seen in the chart above, there is only a loose relationship between CIT collections and broad trends in the State’s economy measured in this case by Delaware personal income.<sup>12</sup>

One element of CIT’s cyclical nature is the timing of and changes in the size of tentative payments and refunds around inflection points in the business cycle. Businesses, it turns out, are no better at forecasting the economy’s turning points than economists. After the end of an expansion, businesses often continue to make tentative tax payments under the assumption that business conditions and profits will continue on an upward trajectory. Soon thereafter, however, these overpayments are returned in the form of refunds from the State, as corporations, having now realized the change in business conditions cut back or curtail their quarterly tax payments. When these two events coincide, the State is effectively “whipsawed” and net revenues plunge. The same phenomenon can occur as the economy emerges from a recession. Firms are slow to increase their quarterly payments and, in doing so, are forced to make large payments when they file their annual tax returns.

**STRUCTURAL ISSUES:** As was discussed above, nationally, corporate profits often swing significantly from year-to-year. Compared to the nation, the number of corporations making CIT payments to Delaware is extremely small. Add to this the fact that only a relative handful of taxpayers account for a disproportionate share of total Delaware CIT receipts and one can see how the performance of just a few firms can have a material affect on overall collections. In Tax Year 2005, for example, twenty taxpayers accounted for roughly half of total CIT liability.

The nature and complexity of the tax itself also adds to its volatility. A high portion of returns filed on extension or as amended returns, and loss carry-forwards<sup>13</sup> mean that: a) revenue

<sup>12</sup> It is possible that personal income may not be the best predictor of CIT receipts. However, is used for the sake of consistency with analyses conducted on other revenue sources.

surprises often occur will “after the fact,” b) the potential for significant revenue surprises is elevated relative to other taxes, and c) linking the receipt of funds or payment of refunds to the economic phenomena that produced them is often difficult.

As mentioned above, the growing popularity of S-corporations and other alternative entities may be contributing to a structural shift away from the CIT and into the Personal Income Tax paid by members. This coupled with an increased focus among large corporations on managing their state and local tax exposure has and will in all likelihood continue to constrain revenue growth in this category.

Like the Personal Income Tax, Delaware’s CIT piggybacks on the Internal Revenue Code and, as a consequence, the State’s revenue stream can be affected by changes in the federal CIT statute. As mentioned above, these changes can either decrease or increase Delaware receipts, depending upon Congress’s policy objectives. Comprehensive federal tax reform, if it were to occur, would also probably significantly affect Delaware’s CIT.

#### **REVENUE POTENTIAL FROM AN INCREASE IN TAX RATES:**

- **Each option’s revenue potential:** CIT accounts for only about 4% the State’s General Fund revenue. Without a hefty increase in the tax rate, relative to larger sources, CIT’s revenue potential is somewhat limited (Net revenues are currently estimated to be in range of \$140-\$150 million).
- **The reliability of the estimates themselves:** As demonstrated above, by its growth and stability rankings, CIT is inherently unreliable. As a result, forecasting the revenue impact of a rate hike will be at least as unpredictable as the pattern of overall collections. As such, policymakers should be reluctant to place too much emphasis on the CIT as a means of addressing an immediate fiscal shortfall.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in the CIT rate would be simple to implement.
- **Other tax policy considerations, if significant:** In 2007, Delaware’s CIT rate of 8.7% was higher than all but eleven of the states that levy a Corporate Income Tax. Increasing the rate would harm Delaware’s competitive position in an area in which it already has a somewhat unfavorable ranking. Additionally, by putting more emphasis on CIT, the State’s revenue portfolio would become more unstable and unpredictable. This added reliance would increase the likelihood of unforeseen revenue shortfalls and windfalls, each of which makes judicious budgeting more difficult.
- **Legal and political considerations:** A simple increase in rates would not provide the basis for a legal challenge, federal preemption or similar obstruction.

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<sup>13</sup> A “loss carry-forward” allows a corporation to use a loss in one tax year to offset taxable income in subsequent years. As such, one loss year can sometimes eliminate several years of tax liability.

**BANK FRANCHISE TAX***FY 2007 Revenues**\$175.2 million**Share of FY 2007 General Fund**5%*

**TAX CONFIGURATION:** The Bank Franchise Tax (BFT) covers about 70 banks and trust companies operating in Delaware. The vast majority of BFT revenues are generated from a relatively few large banks. These taxpayers are now able to elect to pay tax under either the traditional BFT structure, which has been in place since the early 1980s, or under a new alternative structure developed as an economic development incentive to assist the state in attracting and retaining large banks that provide revenue, employment and other benefits to Delaware. The largest BFT taxpayers are increasingly likely to elect the new alternative tax structure.

For banks and trust companies using the traditional structure, the bank franchise tax calculation begins with net operating income before taxes as reported on the December 31 call report on consolidated basis with subsidiaries and includes an adjustment for securities gains and losses and other appropriate adjustments. If an election is made to treat certain non-subsidiary affiliated corporations as subsidiary corporations for tax purposes, their income is also included. Reductions are allowed for: income from an insurance division or subsidiary; net operating income before taxes from specific subsidiaries that are taxable under Delaware law or the law of any other state, including shares tax; non-United States branch offices; gross income from international banking transactions and facilities; interest income from volunteer fire companies; and examination fees paid to the Office of the State Bank Commissioner. This sum is then multiplied by 0.56 to arrive at taxable income. For resulting branches in this state of out-of state banks, the calculation of taxable income also includes the addition of an imputed capital add-back.

For federal savings banks not headquartered in this State but maintaining branches in this state, taxable income is equal to the net operating income of the branch or branches located in Delaware before taxes with adjustments for securities gains and losses and other appropriate adjustments. A reduction is allowed for interest income from volunteer fire companies.

Building and loan associations are taxed on net operating income before taxes, defined as total operating income minus total operating expense. Reductions are allowed for net operating income before taxes from specific subsidiaries that are otherwise taxable under Delaware law or the law of any other state, gross income from international banking facilities and transactions, interest income from volunteer fire companies, and examination fees paid to the Office of the State Bank Commissioner. This sum is then multiplied by 0.56 to arrive at taxable income.

The bank franchise tax is paid instead of State corporate income taxes, occupational taxes, and all other State taxes except for real estate taxes.

Effective for tax years beginning after December 31, 2006, banks have the option of using an "Alternative Franchise Tax." The Alternative Franchise Tax has two parts:

1. A traditional income tax employing three-factor apportionment with a double-weighted receipts factor. The tax's regressive rates range from 7.0% on taxable income not in excess of \$50 million to 0.5% on taxable income in excess of \$1.3 billion.
2. A "Location Benefits Tax" based on net assets. The minimum tax is \$2.0 million with additional liability ranging from 0.015% on the value of net assets not in excess of \$5.0 billion to 0.005% on net assets in excess of \$20 billion but not in excess of \$100 billion. The maximum Location Benefit Tax is \$8.25 million.

#### **TAX RATES**

The rate of tax upon taxable income is as calculated under the standard Bank Franchise Tax:

<b>TAXABLE INCOME RANGE</b>	<b>TAX RATE</b>
Not greater than \$20 million	8.7%
\$20 million to \$25 million	6.7%
\$25 million to \$30 million	4.7%
\$30 million to \$650 million	2.7%
Greater than \$650 million	1.7%

The rate of tax on elective income tax base as calculated under the Alternative Franchise Tax:

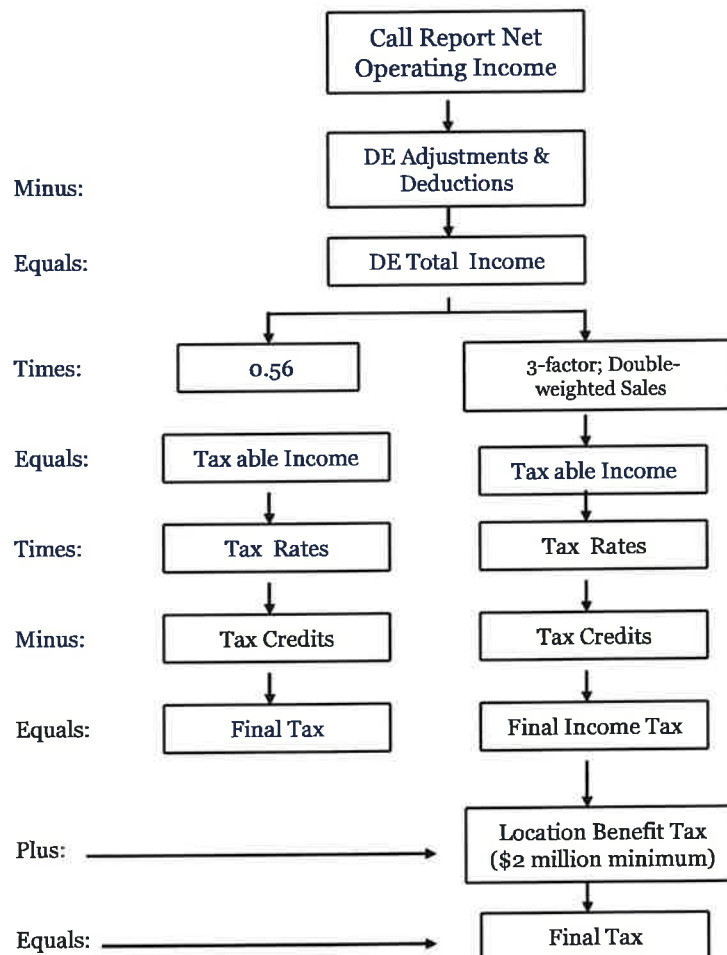
<b>TAXABLE INCOME RANGE</b>	<b>TAX RATE</b>
Not greater than \$50 million	7.0%
\$50 million to \$100 million	5.0%
\$100 million to \$500 million	3.0%
\$500 million to \$1.3 billion	1.0%
Greater than \$1.3 billion	0.5%

The rate of tax on the value of net assets as calculated under the Location Benefits Tax:

VALUE OF ASSETS	TAX RATE
Not greater than \$5 billion	\$2 million + 0.015%
\$5 billion to \$20 billion	0.010%
\$20 billion to \$100 million	0.005%

A diagram of the Bank Franchise Tax's structure is provided below in Figure 3.

**Figure 3.**  
**Bank Franchise Tax Structure**



**RECENT PERFORMANCE:** Over the past ten years the Bank Franchise Tax (BFT) has performed similarly to the Corporate Income Tax. This comes as no surprise as they share some fundamental similarities. Both taxes are levied on profits and, in both cases, a relative handful of taxpayers account for the lion's share of total collections. Both of these features tend to promote volatility in collection patterns. This volatility is evident in the fact that, between FY 1997 and FY 2007, the BFT saw annual declines in fully half of the years, the highest level among any revenue source examined. (See Table 2.)

Again, like CIT, because Delaware has a relatively low level of reliance on the BFT, its level of year-to-year volatility is not unmanageable. (While it varied substantially from year-to-year, over a ten-year horizon the BFT was measurably more stable than the CIT.) This is evidenced by the BFT's standard deviation, which ranked as the second most stable of the revenue sources examined. When the BFT's volatility is judged relative to its size a similar result is achieved with the tax again ranking as the second most stable.

In terms of growth, the Bank Franchise Tax performs like the CIT. The BFT's estimated annual growth rate was 4.2% and its elasticity was 0.76, both ranking 7<sup>th</sup> out of the eight revenue sources examined.

#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** Like the CIT, over time the Bank Franchise Tax follows economic trends, but does so unevenly. In any given year or at any particular point in the business cycle it is not uncommon for the BFT to part ways with the economy's underlying trend. For example, as the economy cooled in FY's 2000 and 2001, BFT receipts fell. On the other hand, when the economy was in the heart of its most recent expansion (FY 2004 – 2006), the BFT declined in three consecutive years. And in FY 2007, when the economy was showing signs of a slowdown, BFT revenues jumped 32%.

The composition of Delaware's Bank Franchise Tax base may explain some of the counter-cyclical performance described above. Delaware's banking industry is largely built on the credit card industry. The recent expansion's most conspicuous feature was the housing boom. (See Charts 5e and 5f.) Home values and homeownership rates jumped and, coupled with low borrowing costs made home equity loans and lines of credit an extremely attractive alternative to credit cards. This development is thought to have cut into credit card issuers' markets to a significant extent. It remains to be seen if the end of the housing bubble will translate into more credit card borrowing as lending standards on home equity loans tighten or if a general pall settles in over the entire financial sector as the extent of the damage in the sub-prime mortgage market is revealed.

#### **STRUCTURAL ISSUES:**

**REGRESSIVE RATES & ALTERNATIVE CALCULATION:** The Bank Franchise Tax, in either of its variants, has a regressive rate structure. As a consequence, as taxable income increases, effective tax rates fall. This all but guarantees that the BFT will have an elasticity below 1.0 so the 0.76 figure observed from FY 1997 – 2007 hardly comes as a surprise. All other things being equal, it is likely that, on average, BFT collections will continue to lag the general rate of economic



expansion. In terms of revenue adequacy, this structural drawback is further exacerbated by the addition in 2006 of the Alternative Franchise Tax.

The Alternative Franchise Tax was added in response to the Bank of America's acquisition of MBNA. The Alternative Franchise Tax, which allows for apportionment of income for multi-state entities, is considered to be one of the principal reasons behind Bank of America's decision to retain its Delaware charter and maintain a significant employment base in the State. In this sense, the addition of the Alternative Franchise Tax almost certainly can be regarded as a success in terms of jobs, economic activity and tax revenues.

Looking ahead, however, the Alternative Franchise Tax provides taxpayers with an additional mechanism through which they may manage their tax liability. As a result, because taxpayers may use the Alternative Franchise Tax to reduce further the liability calculated under the already inelastic "traditional" BFT, this category's growth rates may continue to moderate. In sum, it is perhaps fair to conclude that the adoption of the Alternative Franchise Tax allowed Delaware to preserve base revenues, but may mean somewhat slower rates of growth off of that higher base in the future.

**CONSOLIDATION WITHIN THE FINANCIAL SECTOR:** Over the past decade, mergers and acquisitions within the financial sector of the U.S. economy occurred with great regularity. They have greatly reduced the number of banks while simultaneously increased the average size of the "new" entities emerging from the merger or acquisition. Delaware banks have not been immune to such activity.

In a merger that combines two Delaware taxpayers into a single, larger Delaware taxpayer, the BFT's regressive tax rates will, all other things being equal, reduce the overall revenue yield. Even if the resulting entity achieves no economies of scale and its taxable income is exactly the same as the sum of that of the two pre-merger banks, the fact that more of the new bank's income is in the upper brackets that are taxed at lower rates, means that tax revenues fall as a result of the merger.

What is more, consolidation within the industry means that banks that have had only minor or no presence in Delaware may acquire a Delaware credit card bank, for example. Given that the acquiring bank's headquarters and most operations may be located in another state, there may be business reasons for moving the Delaware operations into the acquiring bank's home state.

On the other hand, in a merger or acquisition that combines a Delaware taxpayer with a non-Delaware taxpayer, the State may experience a significant tax revenue increase. This would occur when income previously taxed out-of-state becomes subject to the Delaware bank franchise tax. The Bank Franchise Tax's regressive rate structure encourages banking organizations to consolidate income generating activities in Delaware, and to keep the tax situs of those activities in Delaware, rather than relocating them to another state.

**CONCENTRATION OF THE BANK FRANCHISE TAX BASE:** Delaware's BFT is dominated by a few taxpayers. In most years, the ten largest taxpayers account for in excess of 80% of all BFT revenues. As a consequence, one or two banks' particular circumstances can have a profound

affect on revenues. In terms of risk, both upside and downside, a tax base that is so concentrated among so few large taxpayers almost by definition means that year-to-year BFT revenues will be volatile and difficult to predict.

**LEGAL CHALLENGES:** On November 7, 2007, Delaware's Supreme Court issued its decision in *Lehman Brothers Bank, FSB v. State Bank Commissioner*. While the nuances of the Lehman case are beyond the scope of this report, the substance of the decision as it pertains to this report is that the Delaware Supreme Court upheld the method by which Delaware taxes bank income under the "traditional" bank franchise tax.

There is, however, the possibility that Lehman Brothers will appeal the Delaware Supreme Court's decision by petitioning the United States Supreme Court for a writ of certiorari. The chance that the U.S. Supreme Court would agree to hear this appeal may be relatively small, because Court accepts only a few of the many such petitions for these writs that are filed every year. If the U.S. Supreme Court heard that case and overturned the Delaware Court's decision, the revenue impact on the State would be significant, probably greatly exceeding the original tax balance of \$10.5 million due in the Lehman case.

#### **REVENUE POTENTIAL FROM AN INCREASE IN TAX RATES:**

- **Each option's revenue potential:** Accounting for only about 5% the State's General Fund revenue, without a hefty increase in the tax rate, relative to other sources, BFT's revenue potential is somewhat limited (Net revenues are currently estimated to be in neighborhood of \$150 million).
- **The reliability of the estimates themselves:** As demonstrated above, by its growth and stability rankings, in any given year, the BFT is relatively unreliable. As a result, forecasting the revenue impact of a rate hike will be at least as unpredictable as the year-to-year patterns the BFT's overall collections. Like the CIT, policymakers who need to balance a budget are likely to be disappointed if they place too much emphasis on the BFT in solving a fiscal shortfall.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in the BFT rate would be simple to implement.
- **Other tax policy considerations, if significant:** The Alternative Franchise Tax was added in 2006 as a way of strengthening Delaware's competitive position vs other states. A general tax increase coming close on the heels of a "pro" economic development move may not be well received by Delaware's banking community. Like the CIT, increasing Delaware's reliance on the BFT would increase slightly the possibility of year-over-year surprises that could make budgeting more difficult.
- **Legal and political considerations:** A simple increase in rates would not provide the basis for a legal challenge, federal preemption or similar obstruction.

**BUSINESS AND OCCUPATIONAL LICENSE AND GROSS RECEIPTS TAX**

FY 2007 Revenues

\$157.3 million

Share of FY 2007 General Fund

5%

With few exceptions (hotels and motels, for example, which are taxed under a separate statute) Delaware requires that businesses obtain a \$75 annual business license. In conjunction with the license fee, Delaware also imposes a tax on the gross receipts of most businesses. In most instances, businesses with monthly gross receipts under \$80,000 or, if required to file on a quarterly basis, quarterly receipts under \$240,000, are not required to pay the gross receipts tax.

Unlike a sales tax, the gross receipts tax's legal incidence falls on the seller of the good or service. Unless specified otherwise by statute, the term "gross receipts" comprises the total receipts of a business; no deductions for the cost of goods or property sold, labor costs, interest expense, discount paid, delivery costs, state or federal taxes, or any other expenses are allowed. In instances where a taxpayer derives income from more than one type of activity, separate licenses and gross receipts taxes are required for each activity.

Tax rates range from 0.077% to 1.92%, depending upon the category of business activity. A summary of the tax is provided in Table 4.

**Table 4.**  
**Gross Receipts Tax Summary**

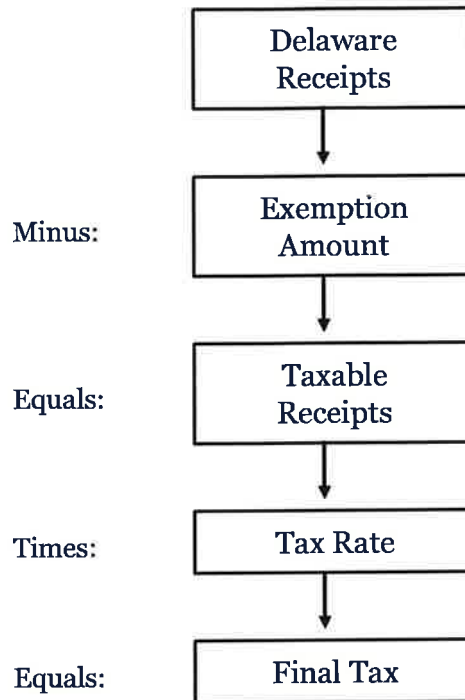
<b>TITLE 30, DELAWARE CODE; SECTION:</b>	<b>TAX TYPE</b>	<b>ANNUAL FEE</b>	<b>TAX RATE</b>	<b>EXCLUSION</b>
2703	Automobile Manufacturer	\$75 for each place of business	0.135%	\$1,000,000/month
2502	Contractors	\$75	0.499%	\$80,000/month
2907	Farm Machinery Retailers	\$75 for each place of business	0.077%	\$80,000/month
2903	Food Processors	\$75 for each place of business	0.154%	\$80,000/month
2301(b) & (d)	General Services	\$75 + \$25 for each extra establishment	0.307%	\$80,000/month
2904	Commercial Feed Dealers	\$75 for each place of business	0.077%	\$80,000/month
4305	Lessors	\$75 + \$25 for each extra establishment	0.230%	\$240,000/quarter
4302	Lessees	N/A	1.536%	None
4305	Motor Vehicle Lessors	\$75 + \$25 for each extra establishment	0.288%	\$240,000/quarter
4302	Motor Vehicle Lessees	N/A	1.920%	None
2702	Manufacturers	\$75 for each place of business	0.144%	\$1,000,000/month

TITLE 30, DELAWARE CODE; SECTION:	TAX TYPE	ANNUAL FEE	TAX RATE	EXCLUSION
2301(a) & (d)	Occupations	\$75 + \$25 for each extra establishment	0.307%	\$80,000/month
2906	Restaurant Retailers	\$75 + \$25 for each extra establishment	0.499%	\$80,000/month
2908	Grocery Supermarket Retailers	\$75 + \$25 for each extra establishment	First \$2.0 million @ 0.307%; 0.576% in excess of \$2.0 million	\$80,000/month
2905	Retailers	\$75 + \$25 for each extra establishment	0.576%	\$80,000/month
2910	Tire Retailers	None.	\$2 per tire	None
2905 (f) –(g) & 6 Del. Code, Chapter 47	Transient Retailers (defined under 6 Del. Code, Chap 47)	\$75 + \$25 for each extra establishment	0.576%	\$80,000/month
2905(f)-(g)	Transient Retailers <sup>①</sup> (defined under Title 30)	\$25	0.576%	\$3,000
2905 (i)	Transient Nursery Retailers <sup>②</sup>	\$75 for each location the applicant seeks to do business	0.576%	\$3,000
2902 (b)-(c)(2)	Wholesalers	\$75 for each place of business	0.307%	\$80,000/month
2902 (b)-(c)(4) and 7 Del. Code, § 9114	Petroleum Wholesalers	\$75 for each place of business	1.399% <sup>③</sup>	\$80,000/month
2905 (a)-(b), (h)	Petroleum Retailers	\$75 + \$25 for each extra establishment	1.476% <sup>④ ⑤</sup>	\$80,000/month

- ① The maximum length of license is 10 days.  
 ② The maximum length of license is 30 days.  
 ③ Composite rate includes the General Fund tax of 0.307%, Hazardous Substance tax of 0.9% and the Petroleum Surtax of 0.192%. (Effective July 1, 2007, the imposition of the Hazardous Substance tax is limited to the first transaction that is taxable under the general wholesale tax)  
 ④ Composite rate includes the General Fund tax of 0.576%, Hazardous Substance tax of 0.9%.  
 ⑤ Tax applies only in the event the petroleum product was not taxed at the wholesale level.

A diagram of the Gross Receipts Tax's structure is presented in Figure 4.

**Figure 4.**  
**Gross Receipts Tax Structure**



**RECENT PERFORMANCE:** The Gross Receipts Tax (GRT) provides perhaps the best example of how some of the more unusual economic events of the past ten years have produced a revenue record that parts ways with some of a tax's fundamental qualities. The GRT's broad base, which includes services, wholesaling and manufacturing, usually works to improve its stability. Unlike a sales tax, which has all of its eggs in the retail goods basket, the GRT is spread across the economy. Moreover, the fact that the GRT's base is total receipts less a flat exemption, means that it is not subject to volatile year-over-year swings as is the case with profit-based taxes like the Corporate Income and Bank Franchise Taxes.

From FY 1997 to FY 2007, the GRT fell in only a single year. As a measure of absolute stability the GRT ranked third out of the eight revenue sources compared. Its standard deviation at 26.3 was comparable those of the CIT (31.0) and BFT (18.7). GRT's coefficient of variation was 23.3, making it the fifth most stable revenue source when measured relative to its respective size. While not alarming, these results are a bit atypical. Under most economic conditions, one might expect the GRT to provide a somewhat higher degree of stability.

In terms of growth, the GRT ranked third in both its annual rate of growth (7.0%) and in its elasticity (1.31). (See Table 2.) Again, these levels are somewhat higher than what the GRT might be expected to produce over most ten year periods. While not the model of consistency it usually was, from FY 1997 to FY 2007, the GRT still managed to outperform, on balance, the

State's other taxes on business activity, the Corporate Income and Bank Franchise Taxes, which lagged behind in growth and produced much more year-over-year volatility.

#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** Because the GRT is so broadly-based it responds to fluctuations in the business cycle. Unlike the Corporate Income and Bank Franchise Taxes, which, although they are affected by the business cycle, demonstrate a wide degree of variability around their cyclical movements, the GRT tends to follow the business cycle in much less of a meandering path. In other words, GRT revenues rise and fall with the fortunes of the broader economy, but do so in a more steady and predictable manner than the Corporate Income and Bank Franchise Taxes.

As mentioned above, though, in recent years the GRT has demonstrated a somewhat higher degree of volatility. Most of this additional volatility is explained by economic circumstances that appear to be somewhat unique to FY 1997 to FY 2007. Most obviously, these events would include the tech-driven stock market bubble of the late 1990's and the more recent housing boom.

Another issue that has driven GRT growth and volatility is the changing nature of world energy markets. The fall of the Soviet Union led to a significant increase in oil supply in the 1990's. Oil markets responded and for most of the decade, the world enjoyed relatively cheap energy prices. In recent years, however, a growing world economy, and especially, the rapid expansion of the Chinese and Indian economies has pushed worldwide demand driving oil prices higher. While oil prices have not been immune to other factors, such as international political tensions, supply or refining disruptions, or the strength of the U.S. dollar, for the most part strong demand is responsible for sustained elevated prices. This is an important distinction, because in the past, supply shocks were typically responsible for larger oil price increases. These supply shocks derailed the economy and usually resulted in recession. Demand driven price increases are different because: a) they reflect economic strength and b) they tend to occur gradually giving consumers time to adjust to higher prices without economic disruption. (See Charts 5a – 5h.)

Delaware's GRT has reflected these economic events. In the late 1990's, a strong economy coupled with the "wealth effect" produced by a booming stock market, fueled gross receipts tax collections. GRT performance slowed with the recession, but picked up relatively quickly, most likely due to the housing boom and the beginning of the ascent in oil prices. Unlike a typical sales tax in other states, the GRT's broad base captures: a) contractors, b) real estate broker commissions, and c) the manufacture, wholesale distribution and retail sale of petroleum products. These were all areas of Delaware's economy that boomed in recent years and produced GRT revenue growth rates (adjusted for tax law changes) in excess of 9.0% for three consecutive years (FY 2004, 2005 and 2006).

In FY 2007, however, State officials were reminded that economic bubbles burst, as Delaware's housing markets began what may turn into a multi-year correction. The Gross Receipts Tax, too, has followed suit, with housing-related collections either static or falling. Record oil prices, despite being largely demand driven, are beginning to weigh on the U.S. economy. In fact, the impact of a prolonged housing slump coupled with elevated energy prices are beginning to filter

through the rest of the economy making a general economic slowdown the most immediate concern for the Gross Receipts Tax.

**STRUCTURAL ISSUES:** Structurally, the GRT's broad base, both in terms of the economic sectors subject to tax and a lack of deductions, make it among the soundest taxes levied by the State. Federal legislation, like the recently extended, Internet Tax Freedom Act, which limits states' ability to tax charges for internet access, and so called Business Activity Tax (BAT) legislation, which, if passed, would restrict states' ability to levy most business taxes on multi-state businesses, are exceptions, but generally speaking because the GRT does not piggyback on the Internal Revenue Code, it is not subject to revenue changes due to the impact of federal legislation.

Contrary to the popular misperception that the GRT punishes small business, the vast majority of licensed businesses in Delaware pay only the annual \$75 license fee. Most simply do not earn enough to exceed the \$80,000 monthly exemption. Among the minority of licenses (around 20% in a typical year) that actually do pay the Gross Receipts Tax, the vast majority of the total tax burden is borne by the top ten percent of all filers. Like the Bank Franchise and Corporate Income Taxes, then, the GRT is a bit "top heavy," but because the tax base – gross receipts – is much more stable than profits, this is not a cause for undue concern.

#### **REVENUE POTENTIAL FROM AN INCREASE IN TAX RATES:**

- **Each option's revenue potential:** The Gross Receipts Tax accounts for about 5% of General Fund revenues. Given its relatively small share, a hike in the GRT alone would likely be insufficient to bridge a significant budget gap. (Revenues are currently estimated to be in neighborhood of \$160 million).
- **The reliability of the estimates themselves:** As discussed above, recent economic trends have tended to destabilize the GRT somewhat. The collapse of the housing bubble and its impact on other sectors of the economy is working to depress GRT collections. Nevertheless, in any given year, the GRT is more reliable and predictable than the CIT or BFT. All other things being equal, a rate increase in the GRT would provide policymakers with a fairly reliable fiscal impact estimate.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in the GRT rate would be simple to implement.
- **Other tax policy considerations, if significant:** The GRT is an unpopular tax. Many popular misconceptions exist, including the ideas that it is a "temporary tax" and that it unfairly burdens small businesses. In 2006, the GRT was cut by more than 20%. The GRT cut, like all tax reductions was popular, but perhaps because of some of the common misconceptions about the tax, may have resonated even more strongly with the business community. Given the heightened awareness to the GRT, an increase in the tax may be interpreted as an economic development defeat. On the other hand, over the long-run, relying more heavily on the GRT would increase the revenue portfolio's stability.

- **Legal and political considerations:** A simple increase in rates would not provide the basis for a legal challenge, federal preemption or similar obstruction.



**ABANDONED PROPERTY (UNCLAIMED PROPERTY / ESCHEAT)**

*FY 2007 Revenues*

*\$364.9 million*

*Share of FY 2007 General Fund*

*11%*

**CONFIGURATION:** Abandoned property is not a tax. Generally speaking, the modern basis for escheat laws (the laws requiring that abandoned tangible and intangible property be delivered by a holder to the state) is consumer protection. For example, escheat provides consumers with a means of recovering a bank account, gift certificate, paycheck, or stock holding that at some point fell between the record keeping cracks of the property holder and/or owner.

In addition, escheat laws embody a tenet that unclaimed property should not be treated as a windfall for holders. To be more precise, the laws reflect the ideal that, to the extent that it is impractical or impossible to reunite owners with their property, such property should be used to promote the public good.

In Delaware, any debt or obligation which has gone unclaimed or undelivered or security that has remained undelivered for five (5) or more years after the date the owner should have received it or was entitled to claim it must be reported. All property that has gone unclaimed for five (5) or more years as of the preceding December 31, must be reported for all holders except Financial Institutions. Financial Institutions include all property that has gone unclaimed for five (5) years or more as of the preceding June 30. Holders also must report and deliver all underlying share certificates where the owner for five (5) years has failed to cash a dividend or correspond in writing regarding the property.

Unclaimed property is reported to the State of Delaware pursuant to the U.S. Supreme Court case Texas v. New Jersey, 379 U.S. 674 (1965). On March 30, 1993, the United State Supreme Court ruled in the case of Delaware v. New York, 507 U.S. 490 (1993), that the primary and backup rules set forth in Texas v. New Jersey still stand and remain unchanged. Pursuant to Texas v. New Jersey, unclaimed property will be reported to the state of the lost owner's last known address. If the owner's address is unknown or is in a foreign country, the unclaimed property is reported to the state of incorporation of the holder of the unclaimed property. For those lost owners with a last known address that is in a state which does not have an applicable statute for the type of property being reported, the unclaimed property is reported to the state of incorporation of the holder.

As covered in the discussion of the Corporate Franchise Tax, Delaware is the preferred "state of incorporation" for U.S. businesses. As a result, all so called "owner-unknown" and "address unknown" property held by businesses incorporated in Delaware must be remitted to Delaware after the dormancy period has run its course. Delaware, by virtue of being the legal home to a large share of the nation's corporations, also receives a large share of all owner/address unknown abandoned property.

Holders are required to report according as follows:

**REPORTING AND PAYMENT DATES**

HOLDER TYPE	PERIOD ENDING	REPORT DUE	REMITTANCE DUE
CORPORATIONS	12/31	3/1	3/1
FINANCIAL INSTITUTIONS	6/30	8/1	11/10
FINANCIAL INTERMEDIARIES	12/31	3/1	3/1
LIFE INSURANCE COMPANIES	12/31	5/1	12/20
COURTS	12/31	4/10	4/10

**RECENT PERFORMANCE:** In FY 1997 Delaware collected \$71.1 million in Abandoned Property. Abandoned Property accounted for about 4% of total General Fund revenues. By FY 2007, General Fund collections stood at \$364.9 million, or roughly 11% of total General Fund revenues.

Delaware’s Abandoned Property collections fell in only two years from FY 1997 to FY 2007. Collection patterns exhibited a high degree of volatility (almost exclusively in an upward direction, though) versus other sources of revenue and demonstrated the highest annual growth rate (15.5%) and elasticity (2.88). (See Table 2.) While certainly significant, it is difficult to make meaningful comparisons with the State’s other revenue sources because:

1. Abandoned property is not a tax. The revenues collected in any given year are based on assets that were “abandoned” at least five years ago. As a result, Abandoned Property collections cannot be expected to respond to current economic conditions in the same manner as taxes.
2. The surge in Abandoned Property revenues is due primarily to stepped-up enforcement. Despite the great success in increasing collections, Abandoned Property compliance rates remain far below tax compliance rates. In many respects, these efforts are still in their infancy making it difficult to make conclusions about the extent to which economic drivers influence collections.

It is clear, too, that Abandoned Property has a long way to go before it can be considered a mature revenue source. As was made clear in the following excerpt from a legislatively mandated report prepared in 2006, unlike taxes, in which the vast majority of total collections are received in the form of voluntary compliance, for the foreseeable future a very significant portion of collections will continue to be received as a result of enforcement actions:

During the past three fiscal years Delaware received approximately 2,300 unclaimed property returns per year. The Supreme Court ruled in Texas v. New Jersey and Delaware v. New York, that any holder in possession of unclaimed property belonging to an unknown owner must remit that property to their state of incorporation. Given the fact that over 680,000 entities, including 290,000 corporations, have made Delaware their legal home it can be concluded that there is a significant and material noncompliance rate in unclaimed property.<sup>14</sup>

In FY's 2006 and 2007, nearly 40% of total Abandoned Property collections were directly attributable to enforcement actions. What is more, a significant portion of the increase in revenues from annual filings, which have more than doubled since FY 2002, is due to enforcement actions that have brought longtime non-filers into compliance.

#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** At this point in Abandoned Property's evolution as a revenue source, the ebb and flow of the economy appears to have little if any discernable impact on collections. As stated above, given the large degree of noncompliance, the five-year lag from abandonment to remittance, and the fact that the amount of abandoned property present is driven more by a firm's operating and record-keeping processes than the state of the economy, to the extent they exist, cyclical influences are delayed and muted.

#### **STRUCTURAL ISSUES:**

**Legal Underpinnings:** Unlike other revenue sources, in which the bulk of the revenues collected are based on statutes that are, for the most part, unambiguous and relatively uncontroversial, the vast majority of Delaware's Abandoned Property collections are based on case law, and specifically on the United States Supreme Court's ruling regarding owner unknown and address unknown property.

As stated above, unclaimed property is reported to Delaware (and other states) according to the rules established in various court decisions. In the hierarchy of rules used to determine to which state abandoned property should be reported, the three most important rules are based on decisions issued by the United States Supreme Court in Texas v. New Jersey and Delaware v. New York:

1. Holders report unclaimed property to the state of the lost owner's last known address (Primary Rule),
2. If the owner's address or identity is unknown, holders report unclaimed property to the holder's state of incorporation. (Secondary Rule),

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<sup>14</sup> Department of Finance, *Unclaimed Property Taskforce Report: A Report Submitted in Fulfillment of House Resolution No. 43; 2006* (Unpublished)

3. If the owner's last known address is in a state that does not have an applicable statute for the property being reported or in a foreign country, holders report unclaimed property to the holder's state of incorporation. (This rule is supported by the Court's order in Texas v. New Jersey, though some holders have questioned it.)<sup>15</sup>

In Delaware v. New York, New York contended that it was entitled to receive owner and address unknown property for businesses headquartered in New York. This position was understandable because the property in question was largely held by brokerages and/or their transfer agents, most of which were and remain headquartered in New York. The Secondary Rule, as reaffirmed by the Court in Delaware v. New York, held that such property should be reported to the state of incorporation. This holding clearly benefits Delaware given the State's position as one of the preferred states for maintaining a corporate charter.

Owner unknown property makes up the vast majority of Delaware's abandoned property receipts. If the U.S. Supreme Court were to issue a decision that overturned Delaware v. New York and established that owner unknown property should be reported to the state in which the holder's headquarters is located, Delaware's Abandoned Property collections would be eviscerated. Because Delaware has relatively few owners of unclaimed property and a only a small number of firms headquartered in the state, it is estimated that under such an arrangement Delaware could see its escheat revenues reduced by as much as 90%. Given that the Delaware Economic and Financial Advisory Council's (DEFAC) current estimates call for gross collections in the neighborhood of \$400 million over the next three years, the cost of such a change could exceed \$350 million.<sup>16</sup>

A court challenge is not the only way in which the current hierarchy of determining to which state assets must be reported could be amended. In the wake of the Delaware v. New York decision, Congress actually considered two bills that would have established federal guidelines requiring that owner and address unknown property would be reported to a holder's headquarters state.<sup>17</sup> While a serious court challenge or Congressional preemption do not appear imminent, their possibility exists, and, with other states interpreting Delaware v. New York in ways designed to make inroads into Delaware's dominant position with respect to owner unknown property, it is not difficult to conceive of future disputes with other states. Because Delaware derives 11% of its General Fund revenues from this source, this risk needs to be taken into account as spending blueprints are developed.

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<sup>15</sup> Farther down in the hierarchy, there are two additional rules are based on interpretations of other legal decisions:

1. Some states take the position that any state with nexus to the transaction giving rise to the property or its abandonment may claim escheat (Tertiary Rule). Many holders and some states, including Delaware, question the validity of this rule.
2. Some states and, in particular, third party audit firms take the position that any state, even one with no nexus to the property, can assert a claim superior to the holder's (referred to by some as the "Brute Force Rule").

<sup>16</sup>As of September 2007, DEFAC's FY 2008, 09 and 10 General Fund estimates are \$369 million, \$380 million, and \$390 million, respectively. These estimates are net of an annual transfer to the Transportation Trust Fund of \$24 million making the estimate for gross collections: \$393 million, \$404 million and \$414 million.

<sup>17</sup> H.R. 2443 and S. 1715; 103<sup>rd</sup> Congress, First Session (1993)

**Inherent Volatility:** A more immediate risk is Abandoned Property's volatility. Unlike a tax, the performance of which can be tied to economic conditions, Abandoned Property revenues are based on a very small subset of the business community, and even then, on rare recordkeeping, communication and computing oversights that result in abandonment. The issues contributing to the volatility and unpredictability of abandoned property collections are summarized below:

- **Volatile and Unpredictable:** Because it is, by definition, the exception to the rule, estimates for revenue the state will derive from assets that are, for the lack of a better word, "lost" is and will remain difficult and subject to large revisions.
- **Enforcement is Key:** Escheat collections are far more dependent on enforcement activities than any other revenue source. This makes the escheat revenue stream fundamentally different than other sources. For example, where PIT is characterized by hundreds of thousands of taxpayers, each of whom account for a tiny fraction of the base, the escheat enforcement base is made up of relatively few holders (which changes every year), each of which account for significant part of the revenue stream. As a consequence, should a small number of enforcement cases result in collections that are well above or below the projected amount, there is a possibility that the bottom-line estimate will materially deviate from the original estimate.
- **Does Not Follow the Economy:** In terms preparing revenue estimates, abandoned property has no pertinent link to the economy. The extent of record keeping shortcomings and the nature of the asset that has been "lost" are far more important drivers. These factors are unknowable unless an audit is been conducted.
- **Small Community of Experts:** Abandoned property is an arcane area of law in which a very limited supply of highly specialized auditors exists. For the most part, these auditors are employed by private firms. Given the scope of noncompliance and the demand for their services, the State of Delaware is in competition with the other forty-five states that use contractual audit firms to assist in their enforcement programs. A similarly small cadre of experts is aligned on behalf of businesses representing holders under audit.

Like other unique and highly specialized communities, this group of experts is somewhat insular and operates an efficient "grapevine" that can stymie state collections if managed improperly. For example, if misinformation regarding a state's collection or negotiation practices is not checked, holder advocates will seek to verify, and in some cases, exploit the veracity of the misinformation to their client's benefit. Whatever the advocate's motivation, this process takes time and often results in the deferral of enforcement collections. And, when a single enforcement case may involve in excess of \$10 million, such a delay can have a serious short-term revenue impact.

- **Better Record Keeping:** A significant portion of collections owner unknown property. To the extent that improved record keeping systems could reduce the level of owner unknown property, Delaware could see its revenues reduced.

- **Balancing Act:** As discussed in the Corporate Franchise – LP/LLC section, it is useful to think of Delaware’s Division of Corporations as a business offering a service to corporate America. While Abandoned Property’s compliance rate is exceedingly low, many corporations, compelled to comply with the law for the first time, take exception to the State’s enforcement efforts causing some observers to contend that escheat enforcement will cause businesses to shift their charters to other, less aggressive, states.

While there is no evidence of this occurring, the State has made efforts to address these concerns through consistency in its enforcement approach (i.e., maintaining strict adherence to procedures) and by engaging in holder outreach and education regarding the policies and procedures of Delaware’s unclaimed property enforcement.

#### **REVENUE POTENTIAL FROM AN INCREASE IN RESOURCES:**

- **The option’s revenue potential:** Because Abandoned Property is not a tax, the State cannot simply pass a law and expect to increase revenues. The ability to increase revenues under the current business model is limited, especially in the short-run. As discussed above, there are a limited number of qualified auditors available. The State has already engaged the services of substantially all qualified contract audit firms that operate in a manner that is consistent with the State’s standards for business practices. Hiring additional in-house audit staff, while it offers revenue potential in the future, is somewhat limited in its immediate return, as new staff require roughly 18 – 24 months of training before they begin to produce concrete returns. What is more, given the inherently unpredictable nature of this revenue source, it is difficult to say with certainty what additional resources and staff might yield in terms of revenue production. (General Fund revenues are currently estimated to be in neighborhood of \$370 - 390 million).
- **The reliability of the estimates themselves:** Estimates regarding the return on additional resources and staff in Abandoned Property enforcement would be fairly speculative. Additionally, because there would likely be little in the way of a short-term return (i.e., within the next budget cycle), adding additional resources to abandoned property, while perhaps sensible and desirable from a long-term perspective, would probably not help address a more immediate fiscal shortfall.
- **Administrative and compliance ease, including the time needed for implementation:** An increase in abandoned property staffing or resources would require time to implement. The most important issue would be ensuring that new staff received the appropriate training without diverting existing staff away from the primary duty, namely conducting and closing enforcement cases.
- **Other tax policy considerations, if significant:** Increased reliance on Abandoned Property would increase the overall volatility of the State’s revenue portfolio. This volatility, if recognized up front, can be effectively managed, however through judicious budgeting. For example, a policy that dedicates unexpected windfalls to long-term issues, such as funding the State’s retiree health liability, could serve to minimize the General Fund’s exposure to revenue swings.

- **Legal and political considerations:** An increase in enforcement activity would need to be conducted in a way that maintains the balancing act described above between the corporate community and the Division of Revenue.

**REALTY TRANSFER TAX***FY 2007 Revenues**\$90.9 million**Share of FY 2007 General Fund**3%*

**TAX CONFIGURATION:** A tax is imposed on real estate transactions at the time of the execution, delivery, or presentation for recording any documents transferring the property. In general, the following are excluded from the tax: leasehold interests; mortgage foreclosure sales; conveyances between husband and wife; conveyances between parent and child; conveyances to a religious organization; conveyances without consideration; conveyances between a parent corporation and a wholly owned subsidiary; conveyances to or from a corporation or partnership from the owner thereof if the ownership in the business is identical to the proportion of ownership in the real property; and conveyances to or from the United States, this state, or to or from their instrumentalities, agencies, or political subdivisions and the University of Delaware.

The state imposes a tax at the rate of 2.0% of the fair market value of the property divided equally between the grantor and grantee. Local governments are permitted to levy a 1.5% tax. In cases in which the local levy exceeds 1.0%, the state rate decreases to 1.5%. With few exceptions, in practice, the state and local taxes are both levied at a rate of 1.5% (a combined rate of 3.0%).

Where the value of property transferred is less than \$100, no tax is imposed. A 1% tax is levied on the value of improvements exceeding \$10,000 when the underlying property has been held by the same owner for less than one year.

**RECENT PERFORMANCE:** The Realty Transfer Tax's (RTT) recent performance is probably the most influenced by the unique economic phenomena of the last ten years. Adjusted revenues grew at an annual rate of 14.7%, second after abandoned property and first among the taxes examined. In terms of volatility, RTT's standard deviation was 37.2, the 5<sup>th</sup> most stable among the categories examined. When judged relative to its size, RTT's coefficient of variation of 50.0, placed it as the most volatile revenue source examined. Somewhat ominously, the RTT fell in only a single year, the most recent year, FY 2007, and by 19% (gross collections). (See Table 2.)

**RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** The Realty Transfer Tax is highly cyclical and susceptible to wide and sometimes prolonged swings. For example, gross collections (adjusted for tax law changes) grew at an average annual rate in excess of 25% from FY 2001 to 2005. On the other hand, in the early 1990's RTT revenues fell in three consecutive years.

Arguably, the nature and depth of the current housing "bust" exceeds anything that the U.S. has experienced in more than fifty years. As with any speculative bubble, the fallout from the implosion of the recent housing bubble is difficult to gauge. The housing recession's depth and length are thought to be well beyond anything experienced in recent memory. In terms of RTT collections, the housing recession could be characterized by a severe, but relatively short, contraction in revenues followed by a respectable rebound or it could result in little or no



revenue growth for the next decade. In any event, RTT's near-term prospects appear fairly dismal.

**STRUCTURAL ISSUES:** In this sense, the RTT is fairly sound. It is a stand-alone state tax that is not influenced by federal tax law changes. With relatively few exemptions, the RTT's base is relatively broad. Large commercial transactions, however, can lead to modest unanticipated revenue "bumps."

Local governments share in the revenue stream due to legislation adopted in 1998. There is essentially a 50/50 split between the State and its localities. Though by itself this arrangement has no influence on the RTT's inherent stability or growth potential, it is periodically the subject of political wrangling between the State and its localities and, conceivably, if the revenue sharing shares were modified, could impact General Fund revenues.

#### **REVENUE POTENTIAL FROM AN INCREASE IN TAX RATES:**

- **The option's revenue potential:** The RTT is a relatively small revenue source accounting in FY 2007 for about 3% of General Fund revenues. It is plain, too, that in the immediate future, the RTT's share of total collections is likely to fall as the effects of a reeling housing market are reflected in tax receipts. As a consequence, a Realty Transfer Tax increase would likely only provide a partial solution to a revenue shortfall of any significance. (Net revenues are currently estimated to be roughly \$85 million).
- **The reliability of the estimates themselves:** Given current conditions in the housing market, an estimate of a RTT tax increase might prove to be somewhat fickle. Under more common housing conditions, however, an increase in the RTT would be anticipated with an acceptable degree of reliability.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in the RTT rate would be simple to implement.
- **Other tax policy considerations, if significant:** Delaware's RTT is among the highest in the nation. When considered in light of the State's low property taxes, the combined RTT – property tax burden is competitive and does not appear to have inhibited development in Delaware. Increasing the RTT may have a more profound impact on low-income or first-time home buyers, though. Finally, to the extent that Delaware's revenue portfolio would add weight to the cyclical tax, an increase in the RTT could result in a moderately more cyclical revenue pattern.
- **Legal and political considerations:** A simple increase in rates would not provide the basis for a legal challenge, federal preemption or similar obstruction.

## **CIGARETTE AND TOBACCO PRODUCTS TAX**

<i>FY 2007 Revenues</i>	<i>\$88.3 million</i>
<i>Share of FY 2007 General Fund</i>	<i>3%</i>

**TAX CONFIGURATION:** Actually several different levies, this category consists of:

**Cigarettes** - Every person, firm, corporation or association in Delaware who sells, stores, or receives cigarettes for the purpose of distributing them to any person, firm, corporation, or association within the state must pay a state excise tax on such cigarettes. The tax must be paid through the purchase of stamps provided by the Division of Revenue. Stamps in denominations of the amount of the tax must be affixed to each pack.

**Other tobacco products** - Any person engaged in the business of selling tobacco products in Delaware who brings, or causes to be brought, into the state any tobacco products for sale; any person who makes, manufacturers, or fabricates tobacco products in Delaware for sale in the state; or any person engaged in the business of selling tobacco products outside Delaware who ships or transports tobacco products to retail dealers in Delaware for sale by these retail dealers; is subject to a tax on the sale or use of tobacco products other than cigarettes.

### **Tax Rates:**

Cigarettes – 27.5 mills per cigarette (i.e., 55¢ per 20 cigarettes) through July 31, 2007.  
57.5 mills per cigarette (i.e., \$1.15 per 20 cigarettes) effective August 1, 2007.

Moist Snuff - 54 cents per ounce (effective January 1, 2008).

Other Tobacco Products - 15% of the wholesale price.

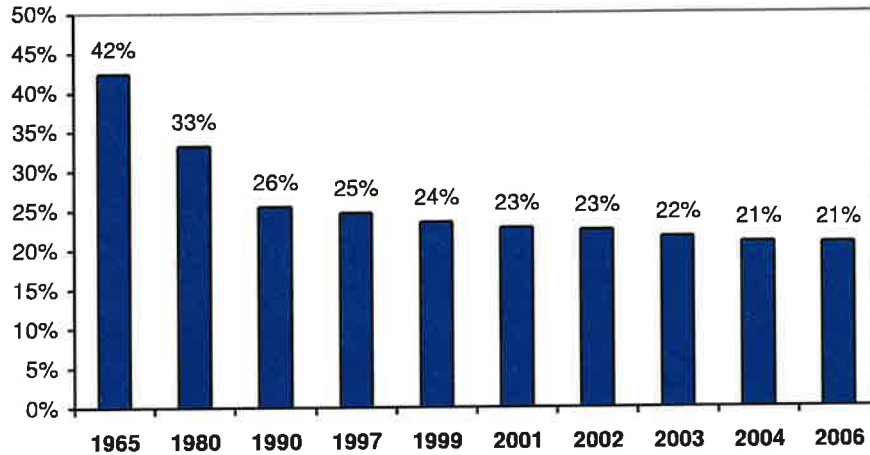
**RECENT PERFORMANCE:** The Cigarette and Tobacco Products Tax (Cigarette Tax) recorded only a single negative growth year from FY 1997 to FY 2007. As it represented only 2-3% of total General Fund revenues over that period, it is not surprising that the Cigarette Tax's standard deviation of 14.9 was the lowest of any revenue source examined. A bit of a surprise, however, is the fact that, in relative terms as measured by its coefficient of variation (21.1), the Cigarette Tax was only the third most stable revenue source.

In terms of growth, the Cigarette Tax also provided a somewhat surprising performance. It grew at an estimated 6.2% annually and it produced a healthy elasticity of 1.14, both ranking 5<sup>th</sup> among the revenue sources examined.

The rate of use of cigarettes and tobacco within the population has fallen in recent decades, although these declines have moderated in recent years. (See Chart 8.) Even with no change in smoking rates, at best, one might expect Delaware's Cigarette Tax revenues to grow more or less in line with population growth rates.

Chart 8.

**Percentage of Adult Current Smokers  
in selected years**



Source: Center for Disease Control and Prevention: National Health Interview Surveys

Clearly, the 6.2% annual growth rate in Delaware Cigarette Tax revenues grew several times faster than the rate of the State's population. The best explanation for Delaware's strong revenue growth in this category has little to do with the Tax's fundamentals. It is instead explained by tax rate differentials between Delaware and its neighboring states and the resultant cross-border economic activity, which inflated Delaware cigarette sales.

In FY 2003, Delaware's Cigarette Tax revenues increased 31.5% over FY 2002. Delaware did not enact a tax increase. In fact, roughly half-way through FY 2003 Delaware implemented a ban on indoor smoking in public facilities, yet Cigarette Tax revenues spiked by nearly a third. The reason for this spike is found in the near simultaneous implementation of Cigarette tax hikes in all three of Delaware's neighboring states. (See Table 5.)

**Table 5.**  
**Cigarette Taxes (per pack) in Neighboring States Affecting FY 2003 Delaware Collections**

	<u>Old Rate</u>	<u>Increase</u>	<u>New Rate</u>	<u>Effective</u>
Maryland	\$0.66	\$0.34	\$1.00	06/01/2002
New Jersey	\$0.80	\$0.70	\$1.50	07/01/2002
Pennsylvania	\$0.31	\$0.69	\$1.00	07/15/2002
<b>3-State Average</b>	<b>\$0.59</b>	<b>\$0.58</b>	<b>\$1.17</b>	

As can be seen in Table 5, Delaware's neighbors essentially doubled their tax rates. What is more, during FY 2002 – 2003, Delaware's tax rate was \$0.24 per pack, meaning that the average

tax differential between Delaware and its neighbors nearly tripled, going from 35¢ per pack (\$0.59 – 0.24) in FY 2002 to 93¢ per pack (\$1.17 – 0.24) in FY 2003. All other things being equal, a carton of cigarettes, which was \$3.50 cheaper in Delaware than in its surrounding states in FY 2002 was \$9.30 cheaper in FY 2003.

Delaware raised its tax to 55¢ per pack in FY 2004, but subsequent increases in all three states<sup>18</sup> helped maintain its competitive advantage. Effective August 1, 2007, Delaware increased its tax to \$1.15 per pack. The impact on Delaware's competitive position as a result of this most recent tax increase has yet to be determined. Maryland's recent tax increase to \$2.00 per pack (effective 1-1-2008) will further complicate this assessment, but will enhance Delaware's relative competitive position.

#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** The Cigarette Tax is fairly immune to changes in the business cycle with consumption not varying greatly as a result of changing economic conditions. As discussed above, this tax's generally positive revenue returns over the past ten years were not driven by what were generally solid economic conditions. As a consequence, policymakers should be prepared for more typical revenue performance from this category, most notably slow, steady growth that, in real terms, will probably fail to keep pace with inflation.

**STRUCTURAL ISSUES:** The "cigarette" portion of the Cigarette and Tobacco Products tax accounts for roughly 98% of total collections from this category. This distinction is important because, the "cigarette" portion is levied on a "unit" basis instead of on an ad valorem (according to value/price) basis. As a result, tax receipts do not rise with price increases. Structurally, unit taxes on inelastic goods, like cigarettes, virtually guarantee that revenues will lag behind the cost of the government services, which they support.

Delaware's tax rate in relation to its neighbors continues to be an important structural determinant for the State's Cigarette Tax. Maryland's tax, scheduled to double to \$2.00 per pack on January 1, 2008, could result in higher Delaware revenues. On the other hand, states, especially on the east coast, have been tapping this resource repeatedly in recent years. Tax rates, along with other cost drivers, may have helped push cigarette prices to levels at which simply driving into a neighboring jurisdiction to purchase cheaper cigarettes is the least dramatic means of coping with high prices.

In New York, for example, levels of tax avoidance are significant. According to a report prepared for the New York State Department of Health, more than half of all of New York's smokers admit to taking at least occasional measures to avoid the tax:

Overall, in 2004, 57 percent of smokers in New York purchased cigarettes at least once from any low-tax or untaxed source, while 37 percent purchased low-tax or untaxed cigarettes regularly.<sup>19</sup>

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<sup>18</sup> The current tax rates are as follows: Pennsylvania \$1.35/pack; Maryland \$1.00/ pack; New Jersey \$2.575/pack. Maryland's tax is schedule to rise to \$2.00/pack on January 1, 2008.

<sup>19</sup> Kevin Davis and Matthew Farrelly, RTI International and Qiang Li and Andrew Hyland, Roswell Park Cancer Institute: *Cigarette Purchasing Patterns among New York Smokers: Implications for Health, Price, and Revenue*,

Cigarette prices, in general, may be reaching levels at which further tax increases, whether by Delaware other states or the federal government, may elicit much more pronounced responses from smokers. Beneficially, the number of smokers actually quitting may rise and the rate of smoking among teenagers may begin to drop at a more pronounced rate. In a more disturbing development in terms of revenue potential, smokers may have already resorted to more lengthy means of avoiding high prices, including internet and black market purchases.

**REVENUE POTENTIAL FROM AN INCREASE IN TAX RATES:**

- **The option’s revenue potential:** The Cigarette Tax is a relatively small revenue source accounting in FY 2007 for about 3% of General Fund revenues. This share is expected to grow to about 4% by FY 2009 after the impact of the recent tax increase is fully realized. Given that the tax was just increased in August 2007, it is unlikely that this source could be tapped anytime in the near future. Moreover, as discussed above, the cost of cigarettes may have reached a level in which further increases fail to produce acceptable revenue gains. (Net revenues are currently estimated to grow from roughly \$137 million in FY 2008 to \$158 in FY 2009).
- **The reliability of the estimates themselves:** It remains to be seen how accurate the estimates for the August 2007 tax increase turn out to be. In the past, estimates in the year of implementation for excise taxes on items such as cigarettes and alcoholic beverages have been difficult to peg. Several factors, including the willingness and ability of wholesalers and retailers to stock up inventories with items taxed at the old (lower) rate and the propensity of consumers to cross state lines, add to this complexity. Generally, however, after 12-18 months have elapsed, consumption patterns conform more closely to the assumptions employed in the original estimates.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in the Cigarette Tax rate would be fairly simple to implement.
- **Other tax policy considerations, if significant:** Taxes on cigarettes work to internalize the negative externalities (e.g., health care costs) produced by tobacco consumption. They also fall more heavily on lower-income taxpayers meaning that their burden has a regressive distribution.
- **Legal and political considerations:** A simple increase in rates would not provide the basis for a legal challenge, federal preemption or similar obstruction.

**LOTTERY**

<i>FY 2007 Revenues</i>	<i>\$256.7 million</i>
<i>Share of FY 2007 General Fund</i>	<i>8%</i>

**OPERATING CONFIGURATION:** Delaware actually operates two lottery enterprises. The traditional lottery consists of long-established lottery products in the form of daily drawings, lotto, instant tickets, and the multi-state Powerball. The video lottery is state-operated, using video lottery machines (slot machines) or a network of linked video lottery machines restricted in operation to those locations authorized by statute (harness and thoroughbred race tracks).

#### **REVENUE ALLOCATION**

**Traditional Lottery:** The distribution of gross revenues generated through lottery ticket sales is subject to the following restrictions:

- Prizes must constitute no less than 45% of gross revenues;
- The cost of operations and administration may not exceed 20% of gross revenues, and;
- The amount deposited into the General Fund must be no less than 30% of gross revenues.

**Video Lottery:** The distribution of gross revenues generated through video lottery wagering varies depending upon levels of play and the terms of contracts negotiated between the State and video lottery machine vendors. Generally speaking, however, the distribution of gross revenues is as follows:

- Approximately 92% of the total amount wagered is returned to players in the form of prizes.
- Of the remaining 8% of the total amount wagered, funds are distributed in approximately the following pattern:
  - 48% to agents (tracks);
  - 11% to supplement the purses offered at Delaware harness and thoroughbred tracks;
  - 5.5% to machine and central computer vendors;
  - 34.5% to the General Fund;
  - Remaining proceeds are split between Department of Health and Social Service's treatment programs for compulsive gamblers, administrative costs, and a Delaware horse breeder's fund.

**RECENT PERFORMANCE:** The Lottery is, of course, not a tax at all. It is a business, and like any business, it operates in a competitive and evolving environment. Because it is a state enterprise and subject to the constraints of statutes, regulations, and the political process, the Lottery has less operating flexibility than private concerns. To the extent, however, that Delaware's competition comes in the form of other state enterprises, Delaware, it would seem, is essentially on the same footing with its competition.

From FY 1997 until FY 2001 or 2002, Delaware’s video lottery revenues had yet to reach a “mature” state. As a consequence, these years provide little insight into the Lottery’s current condition or performance potential. Presented below in Table 6 is a breakdown of the Lottery’s General Fund contribution for FY 2001 – 2007.

**Table 6.**

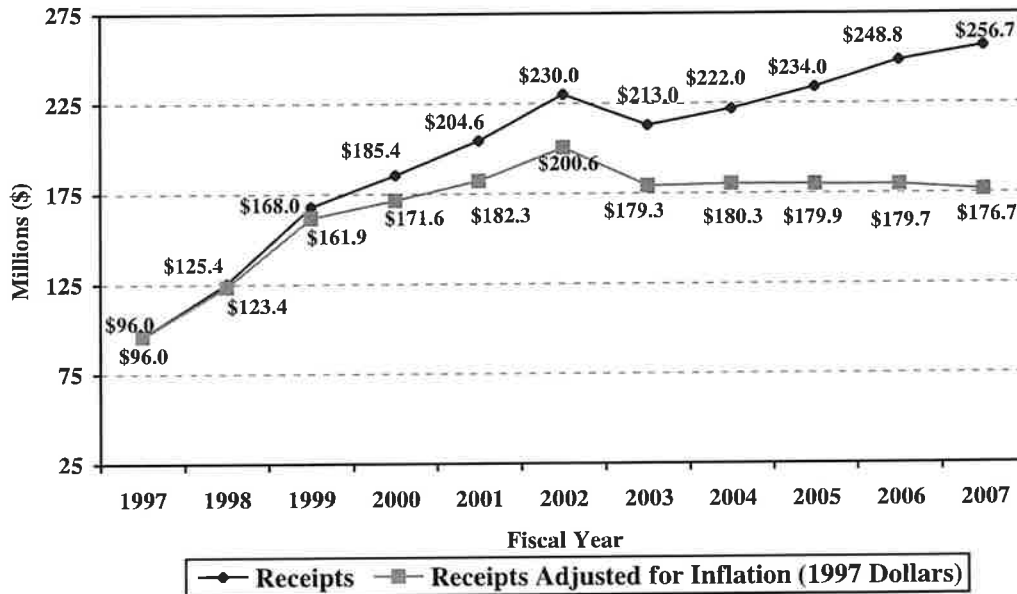
**Delaware Lottery Revenues**  
in millions

Fiscal Year	General Fund Revenue		
	Total	Video	Traditional
2001	\$204.6	\$174.1	\$30.4
2002	\$230.0	\$193.0	\$37.0
2003	\$213.0	\$180.8	\$32.2
2004	\$222.0	\$183.9	\$38.1
2005	\$234.0	\$199.6	\$34.4
2006	\$248.8	\$208.2	\$40.6
2007	\$256.7	\$218.8	\$37.9

Table 6 reflects a mature revenue stream, with FY 2003 to FY 2007 annual growth averaging about 5% with very little volatility in total revenues. It is important to note that no adjustments to the revenue series have been made. This growth figure includes the impact of Delaware video lottery expansions as well as the impact of competition in nearby Pennsylvania.

Another way of looking at the Lottery’s recent performance is found in Chart 9, below.

**Chart 9.**  
**Lottery Revenues**



As can be seen in Chart 9, on an inflation adjusted basis, lottery revenues have, since FY 2003, remained more-or-less constant.

Although it might not be evident in the annual data presented above, Pennsylvania competition, which was introduced roughly half way through FY 2007, has impacted Delaware revenues.<sup>20</sup> The Delaware video lottery's latest expansion, the Video Lottery Competitiveness Act of 2006, which was authorized on February 1, 2006, was passed in anticipation of Pennsylvania competition. The impact of Pennsylvania competition is illustrated by comparing the first six months of FY 2007 with its last six months.

Video lottery revenues, bolstered by the additional hours and higher machine limits afforded by the Video Lottery Competitiveness Act of 2006, were 15.8% higher in the first six months of FY 2007 than they were in FY 2006. Facing Pennsylvania competition in the last six months of FY 2007, the video lottery growth rate went negative, recording -4.1% growth vs the same period in FY 2006.

Two conclusions are immediately apparent. First, competition from neighboring states presents a genuine threat to this revenue stream. Second, Delaware's response to what was then pending competition was largely successful. Had Delaware not acted to expand its operations prior to Pennsylvania's venues coming online, the impact of competition on the State's bottom-line

<sup>20</sup> Philadelphia Park in Bensalem began operations in mid-December 2006. Harrah's Chester operation opened in mid-January 2007.



would have been much more serious. In sum, to date, as competition in its gaming market has intensified, Delaware has been able to respond successfully within the framework of its existing business model, which, of course, consists of video lottery terminals paired with thoroughbred or harness racing at the state's three racing venues.

#### **RISKS AND OPPORTUNITIES**

**CYCLICAL ISSUES:** For the traditional lottery, it appears that, as a mature revenue source, its growth potential and vulnerability to cyclical downturns are muted. The follow passage discussing the income elasticity of traditional lotteries summarizes the issue well:

Arguably a more interesting issue is the potential growth of lottery revenues relative to the revenue growth potential from other significant state taxes, such as personal income, corporate income, retail sales, and motor fuels. .... These income elasticity estimates are somewhat larger than the income elasticity of lottery demand estimates found here and in earlier lottery demand studies. Assuming relatively stable tax bases, this suggests that the growth potential of state lotteries with respect to income growth is much less than for traditional sources of revenue. On the other hand, lottery revenues will not fall as much as revenues from traditional sources in response to an economic slowdown. The former may explain state lottery agencies' continual updates of their lottery portfolios to increase consumer participation. The fact that we find decreasing income elasticities over time suggests that, at least for the states and games studied here, lottery revenues have become a relatively more stable (with respect to changes in income) source of revenue than traditional revenue sources.<sup>21</sup>

By and large, slot machines or relatively close substitutes, such as table games, are also income inelastic.<sup>22</sup> Delaware's recent experience seems to confirm this conclusion. From FY 2001 to FY 2002, a period marked by a recession, tepid recovery, and fairly constant number of video lottery terminals operating in the state, video lottery revenues continued to grow.

**STRUCTURAL ISSUES:** Within the constraints of the current business model which offers a traditional lottery coupled with video lottery terminals at the state's three tracks, the magnitude of structural risk dwarfs the cyclical issues discussed above and it is almost entirely downside risk. As described above, competition from surrounding states has arrived. The State successfully responded to Pennsylvania's nearby venues by expanding Delaware operations within the existing business model. It appears, though, that this tactic is largely "tapped out."

Further meaningful expansion in operating hours is impossible as Delaware's facilities now operate 24 hours per day except Sundays, when they operate 18 hours. Similarly, the per venue limit on video lottery terminals, which now stands at 4,000, while theoretically offering the tracks more room for expansion, would probably produce diminishing returns with the addition of each additional machine, especially if the machines were added in response to competition from Maryland.

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<sup>21</sup> Thomas A. Garrett and Cletus C. Coughlin, Federal Reserve Bank of St. Louis: *Inter-temporal Differences in the Income Elasticity of Demand for Lottery Tickets*; p 21, October 2007

<sup>22</sup> Opinari Research Associates, LLC; *A Policy Framework for Analyzing Gaming Taxes*; p. 21, 2006

With the Maryland slots initiative subject to referendum in November 2008 and a probable implementation timeframe of 10 – 15 months, assuming voters approve the initiative, Delaware could begin to face competition from Maryland sometime around January 2010. Based on this timetable, Delaware’s FY 2010 would be affected by approximately half a year of competition and FY 2011 would be the first full year affected by competition. Current estimates indicate that Maryland competition would cost Delaware’s treasury somewhere in the neighborhood of \$85 million annually.

Compared to other states, at 34.5%, Delaware’s share of net proceeds is well below state shares found in other states:

<u>State</u>	<u>State Share of Net Proceeds</u>
Florida	53%
Kansas	58%
Massachusetts	60% (proposed)
Maryland	48% (legislation passed, referendum pending)
New York	61%
Oregon	65% (video lottery terminals in bars)
Pennsylvania	43%
South Dakota	50% (video lottery terminals in bars)
West Virginia	38%

Source: Delaware Lottery

While there may be material differences in other aspects of video lottery operations beyond state shares of net proceeds, it is doubtful, however, that those differences are significant enough to compensate for the large disparities between Delaware’s 34.5% and figures detailed above. The average state share is 53.7%, which is 55% (53.7 / 34.5) higher than Delaware’s 34.5%. Pennsylvania’s 43% share is 25% (43 / 34.5) higher than Delaware’s share. The closest state share figure to Delaware’s level, West Virginia at 38%, is still 10% (38 / 34.5) higher than Delaware.

**REVENUE POTENTIAL FROM AN INCREASE IN THE STATE’S SHARE OF PROCEEDS:**

- **The option’s revenue potential:** The lottery is not a tax, but the State’s share of the proceeds generated by the lottery is defined by statute. In the case of the traditional lottery, the State does not have a partner in the sense that it does in the case of the video lottery in which “profits” are split between the State and the race tracks. If the traditional lottery’s formula were reconfigured to mandate that the State receive more than the 30% minimum currently in place, the effect would be to cut into prizes, which would negatively impact the games’ popularity and conceivably fail to raise needed revenue.

In terms of revenue potential to the State, a reconfiguration of the video lottery split between the tracks and the State makes more sense. Such a split could be achieved without changing the payout rate to bettors and, equally important, the video lottery’s size mean that a new split offers more revenue potential for the State. Of the 8% of gross revenues that are not returned to bettors, the tracks’ share is nearly half (roughly 48%). The State’s share is approximately 34.5%. Based on a video lottery base of \$220 million,

each additional percentage point added to the State's share could be expected to add roughly \$6.4 million (\$220 million / 34.5). A similar, and perhaps more straightforward proposal, would be to simply levy an annual license fee for video lottery operators.

- **The reliability of the estimates themselves:** Unless this change were implemented during a structural shift in Delaware's gaming market (e.g., immediately after Maryland slot machines began operating), the reliability of the fiscal estimate on such an estimate would be reasonably high.
- **Administrative and compliance ease, including the time needed for implementation:** A straightforward increase in the State's share would be fairly simple to implement.
- **Other tax policy considerations, if significant:** Lottery play tends to be relatively heavier among lower-income citizens meaning that its burden is regressively distributed.
- **Legal and political considerations:** A simple increase in the State's share would not provide the basis for a legal challenge, federal preemption or similar obstruction.

## SECTION II. POTENTIAL ADDITIONAL REVENUE SOURCES

After a review of existing revenue sources, SJR No. 5 adds a second requirement:

- In recognition of changing demographic and economic conditions, a review of potential additional revenue sources that could potentially provide additional long term stable revenue for the state.

As described in the Framework for Analysis section of the report, this part of the report will focus on evaluating revenue options that fit one of the following descriptions:

- Entirely new taxes or revenue sources (e.g., adopting a retail sales tax)
- Base-broadening or other reforms within existing tax structures (e.g., eliminating tax breaks or fundamentally changing a tax rate structure, for example, from a flat fee to tax brackets with progressive rates)
- Significant modifications to revenue administration or enforcement (e.g., outsourcing / privatization)

This section will cover the six revenue options that Legislative leadership considered during its budget negotiations in June of 2006. It also includes other proposals prepared by the research team, including staff from the Department of Finance, Office of Management and Budget, and the Controller General's Office. The options discussed below will also be evaluated in terms of how they contend with "changing demographic and economic conditions" and their potential to provide the State with "long term stable revenue."

### DIVISION OF REVENUE PARTICIPATION IN BANKS' ABANDONED PROPERTY AUDITS

**Background:** Title 12, Delaware Code, Chapter 11, § 1155 stipulates that the State Escheator within the Division of Revenue shall have the authority to examine the records of any business, except banks, to determine whether they are in compliance with the State's Abandoned Property law. In the case of banks, the Code provides "that the State Bank Commissioner shall act on behalf of the State Escheator with regard to examinations of banking organizations."

The basic rationale behind this proposal is that abandoned property is a highly arcane area of the law. It is contended that thorough and successful abandoned property audits require a very specialized set of skills possessed by a relatively small universe of abandoned property auditors.

For roughly the last dozen years, the Bank Commissioner's examiners have been conducting escheat examinations along with their other regulatory and Bank Franchise Tax audit responsibilities. Banks are on a five-year examination cycle and, presently, the Bank Commissioner's Office estimates that all banks have been examined at least twice for escheat compliance. The Bank Commissioner's Office estimated that, on average, they are able to allot approximately 100 staff hours to the escheat portion of their examinations.

Proponents of allowing the Division of Revenue (DOR) to allow its contract auditors to conduct escheat audits of banks point out that auditors who specialize in escheat are more likely to detect non-compliance by virtue of their greater experience with the issues that are particular to abandoned property. Moreover, the State's contract auditors indicated that their audits involve considerably more staff time, with examinations of smaller institutions involving perhaps 200 to 300 hours and 2,500 to 3,000 staff hours devoted to larger institutions.

#### **Evaluation:**

- **The option's revenue potential:** For this option to produce any revenue, one must accept the assumption that some of Delaware's banks are not fully in compliance with the State's escheat laws. As discussed above, Delaware's banks have all had at least two escheat examinations conducted by the Bank Commissioner's Office. However, given the general rate of poor compliance with abandoned property laws and specialized skills and time required to conduct an exhaustive abandoned property audit, it is not implausible to conclude that pockets of noncompliance may exist and that those pockets might possibly yield significant settlements. The only way to determine if employing DOR's contract auditors would detect such noncompliance would be to actually allow them to conduct audits.

Adding banks to the workload of DOR's audit plan also introduces the issue of opportunity cost. As mentioned above, an audit of a large institution may require 2,500 staff hours to complete. Add to that the time DOR spends post-audit dealing with the holder's advocate as they review the audit, seek changes to the audit and attempt to negotiate a settlement amount, and it is not surprising that, from start to finish, an audit of a large entity might take two to three years. Moreover, because the universe of non-filers is enormous, DOR's audit efforts make only a small dent in it each year. Diverting resources into bank audits means that other audits get delayed. Even if the bank audits bring in high collections, given the time it takes to complete the bank audit, those collections need to be netted against that which would have been collected had the "regular" audit schedule been followed.

- **The reliability of the estimates themselves:** As discussed above, the amount of revenue that DOR contract auditor may produce is essentially impossible to predict in advance of an audit actually being conducted. DOR's contract auditors, themselves, commented that they are continually surprised by the lack of any "advance indicator" that could provide some insight into a particular firm's level of compliance. In sum, auditors just have to do the work before they can make a determination.
- **Administrative and compliance ease, including the time needed for implementation:** As mentioned above, assuming noncompliance is confirmed, it is not uncommon for two years or more to elapse from the time an audit starts to the time that the State receives payment. This is not a problem that can be overcome immediately by simply adding more resources – e.g., more DOR staff or hiring additional contractors. DOR estimates that training an abandoned property auditor requires roughly 18-24 months of training before they are effective an addition to the enforcement team.

Adding additional qualified contract auditors is difficult because so few exist. DOR has effectively tapped all the firms with which it is comfortable forging a relationship. Unfortunately, there are contract auditors that may seek the State's business, but their audit methodology does not meet the State's standards. DOR's practices in this regard reflect its awareness of the balance it must maintain between the effective enforcement of Delaware escheat laws and the preservation of the State's reputation as a corporate center.

- **Other tax policy considerations, if significant:** None.
- **Legal and political considerations:** Allowing DOR to assume the responsibility of or participate in banks' escheat audits would not provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** This option is unlikely to provide additional revenues within the first two years of its implementation. After that time, any revenues that are provided will likely come at the expense of deferring other audits. By definition, only after an audit is complete does one understand if noncompliance exists. It is, therefore, impossible to predict how much revenue this option may produce.

Clearly, this option could not be counted on to help plug an immediate or near-term budget deficit. It also comes up short according to SJR No. 5's provision that places a priority on additional revenue that is long term and stable. Enforcement collections are neither long term nor stable. In the near-term, the crux of this proposal is less about its revenue potential and more a question of the uniformity and effectiveness of the State's abandoned property enforcement approach.

## INCREASE THE MULTIPLIER ON THE BANK FRANCHISE TAX

**Background:** As is described in the Tax Configuration section of the Bank Franchise Tax review in Section I of this report, for banks using the “traditional” method of calculating their tax, taxable income is calculated as follows:

Net Operating Income before Taxes

Minus: Allowable Reductions

Equals: Total Delaware Income

Times: 0.56

Equals: Taxable Income

In practice, the 0.56 multiplier is really a part of the tax’s rate structure. It effectively determines that 44% of taxable income ( $1.00 - 0.56 = 0.44$ ) will be subject to a marginal tax rate of 0%. By increasing the multiplier, this proposal’s ultimate effect is to reduce the size of the 0% bracket.

Unlike traditional multi-tiered tax brackets, in which all taxpayers are afforded exactly the same rate structure, the Bank Franchise Tax rate structure effectively gives banks 0% brackets that vary depending upon the amount of their Total Delaware Income. A bank with Total Delaware Income of \$100,000 receives a zero bracket amount of \$44,000 ( $[1.00 - 0.56] \times \$100,000$ ). A bank with \$1 million in Total Delaware Income, however, gets a zero bracket amount that is ten times higher, \$440,000. As a result, increasing the multiplier is really akin to an across-the-board increase in effective tax rates that, on a bank-by-bank basis, would have a somewhat different distribution than would a tax increase applied to a more conventional rate structure.

### Evaluation:

- **The option’s revenue potential:** The Bank Commissioner’s Office’s estimate for Tax Year 2007 Bank Franchise revenues is about \$143 million. Of this amount, roughly 1/3, \$48 million, is expected to come from the traditional portion of the tax.

Clearly, an increase in the multiplier could be adjusted to meet a given revenue target so this option’s revenue potential embodies a range that is based on the size of the effective tax increase as applied to a base of \$48 million. By way of example, however, the Bank Commissioner estimates that, assuming the current tax base is unaffected by the tax hike, increasing the multiplier to 0.75 would produce about \$13 million in additional revenue.

- **The reliability of the estimates themselves:** The estimate may be somewhat overstated in that it does not take into account potential movement of banks from the traditional tax to the Alternative Franchise Tax that may result as a result of a tax increase that would only impact the traditional tax. Of the \$48 million in Tax Year 2007 revenue expected to come from the traditional tax, roughly \$30 million or about 63% comes from the five largest banks expected to use the traditional method.

The Bank Commissioner's Office calculated that raising the multiplier to 0.75 would increase taxes for the top five traditional tax filers by 26%. (The increase on the remaining traditional filers is estimated to be 30%.) Given the magnitude of the increase, the Bank Commissioner's Office contends that it is likely that at least some of these taxpayers may switch to the Alternative Franchise Tax to mitigate the impact of the tax hike. Such a move would, of course, effectively reduce this proposal's positive revenue impact. Anticipating the size of the banks' responses to the tax increase is difficult to determine.

- **Administrative and compliance ease, including the time needed for implementation:** This proposal would be relatively simple to implement. Legislation increasing the multiplier at the close of General Assembly's session in June could easily be effective for the following calendar year.
- **Other tax policy considerations, if significant:** Raising the multiplier introduces equity concerns as the tax increase would only apply to "traditional" taxpayers. Banks filing under the Alternative Franchise Tax would not be affected. Banks using the traditional BFT tend to be smaller institutions that are much more likely to serve "Delaware only" markets. For most of these smaller institutions, the Alternative Franchise Tax provides, in reality, no alternative at all. In order to opt into the alternative structure, banks must pay the "Location Benefits Tax" portion of the Alternative Franchise Tax, which mandates a minimum payment of \$2 million, which is more than the total annual tax for most smaller institutions.

Using the example provided above, a policy initiative that raised \$13 million, but which resulted in a 25-30% increase in Bank Franchise Taxes for the state's smallest institutions while holding harmless the state's largest banks, is bound to be seen by many as unfair tax policy.

- **Legal and political considerations:** Unless they were willing to challenge the Bank Franchise Tax's basic structure, it is unlikely that increasing the multiplier would provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** Purely in terms of helping to plug a near-term budget gap, increasing the multiplier is a reasonably functional policy alternative. While there is a chance that a limited number of institutions may migrate to the alternative tax structure, the revenue estimates, under most scenarios, would be relatively reliable. Raising significant funds on a base of \$48 million would, however, require very large effective tax rate increases on the state's smallest banks. Moreover, higher revenue targets would obviously require higher tax rate increases, increasing the incentive for banks to switch filing methods, which, in turn, decreases the reliability of the proposal's revenue estimate. In sum, this proposal offers limited revenue potential and carries distinct policy obstacles.



## ESCHEAT OF BOTTLE DEPOSITS

**Background:** Delaware is one of eleven states that have container deposit laws, better known in Delaware's case as the "bottle bill." These laws mandate a modest refundable deposit on beer, soft drink and other beverage containers in order to improve the rate of recycling or reuse. Delaware requires a five cent deposit on certain beverage containers.

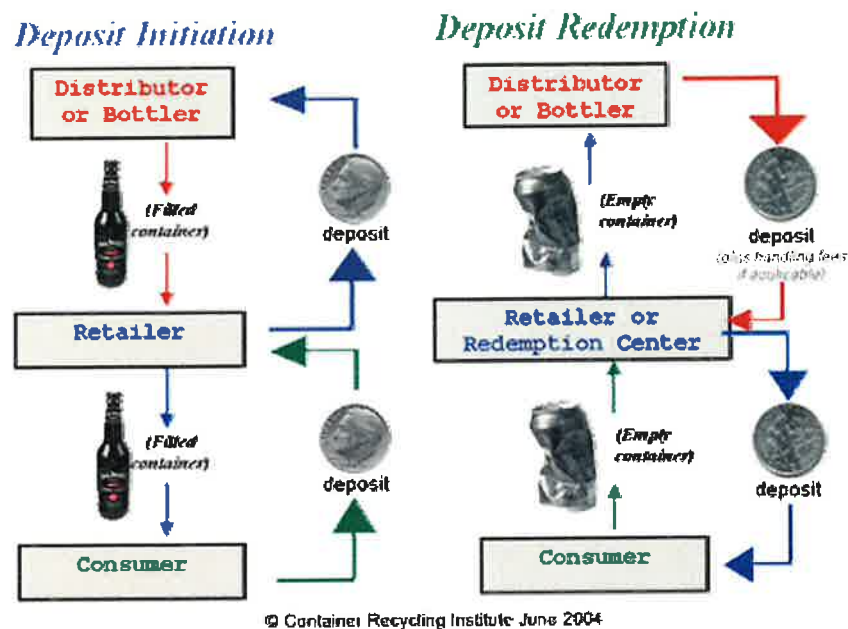
In practice, however, Delaware's bottle bill success is somewhat difficult to gauge. According to the Container Recycling Institute:

There are no published reports or surveys indicating the impact of Delaware's bottle deposit law on solid waste.<sup>23</sup>

Still, anecdotal evidence suggests that container deposit's five cent incentive is relatively weak. The fact that an estimated \$1-2 million in deposits (20-40 million containers) go unclaimed each year demonstrates that, to a significant degree, consumers are unmotivated by the law. To the extent that deposits are unclaimed, they have the economic effect of a statutorily mandated price increase, from which the beverage industry enjoys a revenue windfall.

Figure 5, below, illustrates the basic operations of the typical container deposit law.

Figure 5.



Delaware's abandoned property law predated its bottle deposit law, which was adopted in 1978. Consequently, in 1978 the State's definition of what constituted abandoned property did not

<sup>23</sup> Container Recycling Institute: [http://www.bottlebill.org/impacts/solid\\_waste.htm#del](http://www.bottlebill.org/impacts/solid_waste.htm#del)

contain any specific reference to “bottle deposits.” This lack of a specific reference to bottle deposits still exists today and virtually ensures that, if the Division of Revenue were to interpret and enforce the current statute as including unreturned bottle deposits within the definition of “abandoned property,” those actions would be subject to a legal challenge from the beverage industry.

Other states (e.g., Massachusetts and Michigan) have adjudicated this issue, with one of the central points of contention being whether the beverage wholesaler is the “holder” or the “owner” of the bottle deposit. At its core, the distinction is as follows, if the wholesaler merely “holds” the deposit, then the rightful owner (the ultimate consumer, presumably) has a right to recover that property and, as a result, the property is subject to escheat and should be remitted to the state once the dormancy period has expired. Alternatively, if the chain of steps shown in Figure 5 above actually results in the beverage wholesaler “owning” the deposits, then the holder and owner are the same entity, and by definition, there is no abandoned property.

How a Delaware court may interpret this issue and the decisions rendered in other states’ courts is difficult to predict as the outcomes in other states with respect to this issue were somewhat mixed. It is instructive, however, that both Massachusetts and Michigan eventually amended their abandoned property statutes to specifically include bottle deposits within the definition of property subject to escheat.

#### **Evaluation:**

- **The option’s revenue potential:** Without changing the abandoned property statute to specifically address the issue of bottle deposits, it is likely that any attempt to affect the escheat of bottle deposits would result in a lengthy legal battle. As a consequence, the unavoidable uncertainty regarding the level, timing and reliability of revenues under this option would render it effectively useless if the policy objective in question was filling a clear-cut gap in the next budget cycle.

It is estimated that changing the statute with a prospective application would produce roughly \$1-2 million in annual revenues. On its surface, the revenue potential of a statute that was applied retroactively is much higher. The recovery of bottle deposits stretching back decades, in theory, would produce a considerable windfall for the State treasury.<sup>24</sup>

In reality, however, Delaware’s beverage wholesalers’ viability as ongoing concerns would be threatened by such an enormous assessment. In this case, the wholesalers might choose to declare bankruptcy and reform their operations as new entities. As is the case with a strategy that is based on the premise that the current statute already includes bottle deposits within the definition of escheatable property, the retroactive application of an amendment to the statute which specifies that bottle deposits are escheatable property would likely produce far less revenue and less dependably than would be needed to reliably meet immediate budget targets.

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<sup>24</sup> The timeframe for escheat audits extends to 1981. Non-filers that agree to the terms of Delaware’s Voluntary Disclosure Agreement (VDA) have a timeframe that extends to 1991.

- **The reliability of the estimates themselves:** Assuming a statutory change that explicitly included bottle deposits within the definition of escheatable property has a prospective application, the estimate of \$1-2 million appears fairly solid. In practice, however, the effective date may need to be one or two years after enactment to allow the beverage wholesalers to change their business practices and to accumulate sufficient cash reserves to meet the initial payment in what would become an ongoing expense.
- **Administrative and compliance ease, including the time needed for implementation:** As mentioned above, in terms of the time needed to prepare for compliance, in fairness to the industry, this proposal's effective date may need to lag its approval by a year or two.
- **Other tax policy considerations, if significant:** None.
- **Legal and political considerations:** If the statute is amended to specifically include bottle deposits within the definition of escheatable property, no legal issues should arise. On the other hand, without a change to the statute, attempts to enforce the escheat of bottle deposits would almost certainly result in a legal challenge.

**Summary:** Practically speaking, this option's only reliable variant is a change to the statute that would explicitly include bottle deposits within the definition of escheatable abandoned property. The change needs to be prospectively applied. This option's revenue potential is somewhat limited at \$1-2 million annually and, in fairness to the industry, probably would require a year or two to implement, meaning that the first Abandoned Property annual filing remittances received might not be received by the Division of Revenue until three years after the statute's adoption.

Given its practical limitations, this option would be of little use in helping to meet an immediate fiscal shortfall. Nevertheless, once implemented, despite its relatively small fiscal impact, escheat of bottle deposits is consistent with SJR No. 5's pursuit of potential long term and stable revenue sources.

## NONRESIDENT PERSONAL INCOME TAX PROVISIONS

**Background:** The proposal actually includes two related items. The first item would mandate that all pass-through entities make quarterly estimated payments on behalf of their nonresident partners/owners. The second item again addresses pass-through entities, but in this case, it involves the State's ability (or inability) to tax capital gains on nonresidents' interests in "Delaware" property or businesses.

### **Pass-through Withholding at Source**

This item is not a tax increase. Instead, it is simply an administrative tool that would allow the Division of Revenue to collect revenue that is legally owed to the State at the "front end" of the process.

To elaborate, business entities that pay no tax, but pass their taxable income through to their partners, shareholders, or members ("pass-through entities") are becoming an increasingly popular form of business organization. Many pass-through entities are organized with multiple levels of owners and subsidiaries, some of these being other pass-through entities, corporations, and resident and non-resident individuals. The complexity of complying with and enforcing the payment of taxes on the income of pass-through entities and their owners generated in Delaware has increased accordingly.

One long-standing form of pass-through entity is the "S" corporation, i.e. a corporation electing pass-through entity status under the Internal Revenue Code. Delaware has statutes requiring an S corporation with Delaware source income and non-resident shareholders to collect and pay withholding on the estimated income of the corporation distributable to the non-resident shareholders.

The concept of "withholding at the source" is recognized as a sign of an effective system of taxation and is especially important where taxable income is realized by persons located outside the taxing jurisdiction. This proposal would extend the principle of entity level income tax withholding for non-resident owners to all forms of pass-through entity. Currently, compliance rates among nonresident pass-through members and partners are generally below those of other taxpayers and the Division of Revenue is forced to engage in relatively costly enforcement measures.

The idea of extending the principle of withholding at source for all pass-through entities distributions to nonresident owners was brought up for consideration in the recent past. House Bill No. 91 in the 142<sup>nd</sup> General Assembly, which was among the items under consideration to close a budget gap that existed at that time, sought to extend withholding at source to all pass-through entities. Obviously, it was not included in the final package.

In 2003, when HB 91 was being debated, one of the notable objections was that forcing quarterly estimated payments from pass-through entities might place an arbitrary hurdle before enterprises that have uneven or highly seasonal cash flows. Moreover, it was asserted that, in more complex business structures, such as those organized with multiple levels of owners and subsidiaries, just calculating the proper quarterly payment can be an onerous burden. On the other hand,

Delaware's S corporation withholding at source requirement, which was and is subject to the same conditions, operates smoothly and has generated relatively few complaints in this regard.

In 2003, there were at least a dozen states that used such a system for all pass-through entities. What is more, by 2007, the obligation that quarterly estimated payments are made by a partnership on behalf of its nonresident partners' distributive share of income was a common requirement among Delaware's neighboring states.

#### **Evaluation:**

- **The option's revenue potential:** When fully implemented, HB 91 was expected to bring in roughly \$4 million annually. The estimate was based on the results obtained in other states that had adopted similar measures. Since 2003, DOR has engaged in an audit program that has confirmed withholding at source's upside revenue potential. Because the Division of Revenue's compliance efforts in this area are based on a sample of returns, however, there is admittedly some imprecision involved in gauging just how large this proposal's revenue potential might be. Given the general expansion in Personal Income Tax receipts since HB 91's introduction in 2003, a reasonable range would be \$4-6 million when fully implemented.
- **The reliability of the estimates themselves:** As discussed above, as with any new administrative regime, this proposal's revenue outlook has some uncertainties. Generally, speaking, however, the proposal's revenue potential can be characterized as relatively reliable and, while it is clear that at \$4-6 million this proposal alone would not be the answer to a significant budget short fall, it could be a reliable component within a larger plan.
- **Administrative and compliance ease, including the time needed for implementation:** Implementing his proposal would be a fairly straightforward endeavor. With the S corporation process as a model, the Division of Revenue could certainly have quarterly estimated filing for other pass-through entities in place for the calendar year following the close of a legislative session (assuming that this proposal would be part of a financial package that is adopted on June 30).
- **Other tax policy considerations, if significant:** To the extent that compliance among nonresident partners appears to be below the general rate of PIT compliance, this proposal would increase equity in the system by ensuring that all taxpayers pay that which is owed to the State.
- **Legal and political considerations:** Given its successful use in other states and Delaware's longstanding requirement for S corporations, it is unlikely this proposal's adoption would provide the basis for a legal challenge, federal preemption or similar obstruction.

## Nonresident Capital Gains on Interests in Delaware Pass-through Entities

**Background:** Generally speaking, when determining which states may claim a taxpayer's income within its tax base, income and gains from the sale of intangible assets are "sourced" to the taxpayer's state of residence. A Baltimore resident, for example, who works in Delaware, would have his/her stock dividends and capital gains sourced to Maryland.

Based on a judicial interpretation of Delaware's Personal Income Tax Statute, a nonresident owner of a pass-through entity (e.g., an S corporation or LP/LLC) who sells his/her interest in that entity is not required to pay Delaware income tax on the capital gain generated by the sale, even if the entity in question consists entirely of Delaware real estate holdings or is a business that operates solely in Delaware.

The important distinction vs the general rule is that, with respect to a stock that is traded on an exchange, it is impossible to determine from which state or combination of states that a capital gain was derived. With respect to a Delaware real estate investment, such as an apartment building or beach property, that just happens to be held in a pass-through entity, there is little doubt about where the inherent economic value behind the capital gain is found. According to the Delaware Supreme Court decision, though, a nonresident earning a gain on the sale of an S&P 500 Index mutual fund and the nonresident owner of a Delaware beach home held as a pass-through who realizes a gain on its sale are identical for Delaware tax purposes – both are sourced to the Delaware nonresident's home state. This proposal would require that capital gains realized by nonresidents on "Delaware" assets are taxable in Delaware even if those assets had been held in the form of a pass-through entity.

Holding Delaware assets in the form of pass-through entities is a popular tax planning technique. If the gains on those assets are not sourced to Delaware, they follow the general rule sourcing the gain to the state of residence, which, if it is a relatively low tax state, like Pennsylvania, or a state that does not levy an personal income tax, like Florida, can result in a significant tax savings.

### **Evaluation:**

- **The option's revenue potential:** Because this is a tax planning device that goes unreported in Delaware, the Division of Revenue has no information on the extent of its use. Moreover, capital gains, especially on Delaware specific enterprises and real estate, tend to exhibit considerable volatility from year-to-year. Therefore, pegging a fiscal impact estimate is very difficult. Nevertheless, this proposal does include the potential for relatively large, intermittent revenue surges due to realized gains on the sale of Delaware entities organized as pass-through entities that are currently sourced to other states.
- **The reliability of the estimates themselves:** As described above, the unknowable aspect of the extent to which pass-through entities are used as a tax planning device for nonresidents and the volatility of capital gains themselves would make it difficult to employ this measure as a sure fix to a clear-cut budget gap.

- **Administrative and compliance ease, including the time needed for implementation:** Implementing his proposal would be a fairly straightforward endeavor. It could easily be in place for the calendar year following the close of a legislative session (assuming that this proposal would be part of a financial package that is adopted on June 30). Making this proposal effective upon enactment, however, is not only possible, but probably preferable as it would eliminate the ability to sell a Delaware asset after legislative approval but before enactment in order to source the gain to a low or no tax state.
- **Other tax policy considerations, if significant:** None.
- **Legal and political considerations:** Given that this proposal would address a judicial decision with specific language regarding the Delaware tax treatment of such gains, it is unlikely that, if adopted, it would provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** Extending withholding at source to nonresidents partner/owner's distributive income shares is not a tax increase; it is merely a method by which the Division of Revenue is better able to collect and administer the Personal Income Tax. While it has been met in Delaware with some resistance in the past, it has been employed successfully in other states. It has a somewhat limited revenue potential (\$4-6 million annually), but would allow the Division of Revenue to better allocate its resources.

The proposal to source nonresidents' gains on the sale their ownership interests in "Delaware" pass-through entities to Delaware, in practice, probably results in a tax increase of sorts. For example, presumably, a nonresident would not hold his/her beach house as a pass-through entity if he/she resided in a state with a higher income tax than Delaware. Under current law, doing so would, of course, mean that the gain on the intangible would be sourced to the higher-tax state of residence. This proposal's revenue potential is difficult to pin down, but it is clear that it could produce a considerable, if somewhat uneven, stream of revenues.

## REINTRODUCE THE ESTATE TAX

**Background:** Although it still exists, in practical terms Delaware's Estate Tax ceased functioning in 2005. Delaware's estate tax is sometimes referred to as a "pick-up" tax. Prior to 2005, the Internal Revenue Code permitted a reduction (credit against tax) in the amount of federal estate tax owed equal to the amount of state estate or inheritance taxes paid. Federal law, however, placed a limit on the amount of the reduction for state taxes paid meaning that, if the decedent's state failed to levy a tax that met the federal limit for state taxes paid, then the decedent's federal tax increased by an amount equal to the difference between the federal limit and the state tax actually paid.

Delaware, like most states, simply declared that its tax would, in fact, equal whatever the federal limit was for the state tax credit. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) implemented a phase out of the state credit followed by its repeal in 2005.

In the wake of its passage, seventeen states and the District of Columbia retained their estate taxes by "decoupling" from the federal law and essentially reestablishing their estate taxes based on pre-EGTRRA law. Delaware did not "decouple" and, as a result, has effectively seen its Estate Tax revenues dry up.

Under current federal law, however, the federal estate tax will be reinstated in 2011 as it existed prior to EGTRRA. DEFAC, which prepares its estimates based on current law, recognized the reinstatement of the estate tax in its September 2007 estimates recording \$35 million for its FY 2012 estate tax projection. Given that the manner in which Congress chooses to deal with the sunset of EGTRRA's tax cuts and the estate tax, in particular, is among the most controversial issues it faces, there is no guarantee that the federal estate tax (and the credit for state taxes) will return as currently provided in federal law. This proposal would act to guarantee that Delaware's estate tax returns in the form it existed prior to EGTRRA.

### **Evaluation:**

- **The option's revenue potential:** The FY 2012 estimate adopted by DEFAC is a partial year estimate. Though highly variable, a full-year figure would be in the range of \$35 to \$45 million.
- **The reliability of the estimates themselves:** The majority of the estate tax in Delaware is paid by a very small number of taxpayers. It was not uncommon for fewer than ten estates to account for most of the total tax collected. In this respect, the tax itself is inherently volatile and, as a consequence, the fiscal impact estimate projecting the affect of reinstating the tax also would be subject to the same unpredictability.
- **Administrative and compliance ease, including the time needed for implementation:** Implementing this proposal would require some time, a minimum of nine months. Under the law, estates have nine months from the decedent's date of death to file the return. Given the estate planning considerations and the Division of Revenue's need to reinstate its procedures a bit ahead of schedule, it would probably make sense to delay its effective date until the calendar year following the proposal's adoption.



- **Other tax policy considerations, if significant:** “Death” taxes often bring out competing versions of the concept of equitable taxation. On the one hand, they are typically paid by the well-to-do, making those who favor progressivity strong proponents. On the other hand, opponents contend that they amount to double taxation in that the income that built the assets that are transferred after death has already been taxed. A final view is that the tax’s themselves are unfair because they are arbitrary in their application due to the fact that estate planning has become so sophisticated that, those who choose to do so, can effectively plan around the tax.
- **Legal and political considerations:** Given its successful use in other states, it is unlikely that this proposal would provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** Given the uncertain political climate around the status of the federal estate tax and, by extension, Delaware’s estate tax, this proposal would add a measure of certainty to Delaware’s fiscal picture by mandating the estate tax’s return to the revenue portfolio. Bringing the estate tax back would, however, require some implementation time to allow taxpayers to plan for its return. As such, this proposal may be of limited use in an immediate budget crisis. Nevertheless, despite its inherent volatility, over the longer-run, adding the estate tax could be expected to add, on average, in the neighborhood of \$35 to \$45 million annually to the State’s revenue stream.

## PUBLIC-PRIVATE PARTNERSHIPS

**Background:** First explored in Delaware as part of the analysis for the *Governor's Transportation Development and Funding Options Task Force Report* in 2005, broadly speaking, this idea requires that the State allow a private entity to earn a profit while operating a State enterprise in exchange for a stream of contractually determined payments. A municipally-owned golf course that is run by a private operator that specializes in golf operations is a common example of such an arrangement. Contrary to a popular misconception, the government asset is not "sold" to the private management company. For example, the municipality does not transfer the golf course's title to the private operator. In the case of use of a public-private partnership for transportation assets, the partnership arrangement was essentially like the municipal golf course example, albeit on a much larger scale and pertaining to a much more essential public asset.

Failure to transfer title, however, does not mean that the State would not cede a certain level of control in the day-to-day operation of the enterprise. That is, after all, the essential point of the arrangement. The operating company, due to its business expertise within a specific industry, access to capital markets, and increased operating flexibility in terms of pricing, use of technology and staffing, is able to operate the enterprise more profitably than the State. The State, in exchange, receives a large infusion of funds (often front loaded) that it can employ to retire its debt or meet new or evolving long-term capital needs. When properly structured, a public-private partnership can offer a "win-win" for both government and operator.

The structure of the agreement between the State and the operator is critical, as it would be the blueprint that determines how the asset would operate and to what degree the State could shift operating risk to its private partner. The agreement, for example, would cover:

- The term of the partnership
- Limits on pricing – e.g., tolls in the case of a transportation asset, greens fees in the case of a golf course
- Other revenue streams available to the operator, if any
- Operating standards for the asset(s)
  - Maintenance
  - Renewal and replacement
  - New construction
  - New technologies – e.g., Electronic tolling
  - Contracting for outside services
- Future expansion options or mandates
- Work force requirements
- Environmental Issues
- Financial Covenants from the Private Operator

#### **Evaluation:**

- **The option's revenue potential:** The revenue potential depends on the nature of the asset employed in the public-private partnership and the terms of the contract between the State and the private operator. A large asset, like a toll highway, for example, has the potential to yield tremendous amounts of funds. For example, the Chicago Skyway partnership reportedly yielded \$1.83 billion in proceeds. Typically, some portion of the funds would be required to retire any outstanding debt on the asset cutting into the cash available to the State. Depending upon the terms of the contract, these funds could be paid in a lump sum, as an annuity, or as a combination lump sum – annuity.
- **The reliability of the estimates themselves:** Because they would be contractually based, the funds received from a public-private partnership would likely be very reliable. The degree of reliability depends on the terms of the contract.
- **Administrative and compliance ease, including the time needed for implementation:** During the Governor's Transportation Development and Funding Options Task Force meetings in 2005, Goldman Sachs presented a timeline that anticipated that the entire process, from the initial press release announcing the program to the receipt of proceeds, would take about one year to complete. In practice, implementing this option would probably require a longer lead time as it is clear that there is still reluctance among many policymakers to embrace the concept.
- **Other tax policy considerations, if significant:** None.
- **Legal and political considerations:** Given its successful use in other states, it is unlikely that this proposal would provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** It appears that the idea of large scale use of public-private partnerships in the operation of State enterprises has been deferred for the time being. Public-private partnerships have been used successfully in other states and are very common around the globe. When considered in 2005, however, the idea was new to Delaware and, as one might expect when encountering a new idea, the reaction among policymakers was mixed. Admittedly, employing public-private partnerships on this scale would be a fairly large departure from current practices within Delaware. The fact that they would represent significant change and probably require a continued education effort on their operation, are not reasons to permanently abandon the concept. Public-private partnerships remain viable option worth considering for a number of State assets.

## INDEXING BANK FRANCHISE TAX BRACKETS FOR INFLATION

**Background:** As discussed above, the Bank Franchise Tax's regressive rate structure hinders the tax's ability to produce a revenue stream that grows in real terms. As growth and inflation generally push banks' taxable incomes' higher, their effective tax rates fall. Although the marginal tax rates established by statute would remain unchanged, indexing the brackets (adjusting the starting and ending points for each bracket for the effects of inflation) would ensure that effective tax rates would remain constant.

### **Evaluation:**

- **The option's revenue potential:** Assuming 2-3% annual inflation adjustments, the Bank Commissioner's Office estimates that indexing the tax's brackets could bring in an additional \$1.0 to \$1.5 million annually. The idea behind indexing the brackets is not that it would result in a large and immediate increase in revenues. The concept embraced by indexing is that it prevents the erosion of Bank Franchise Tax over a number of years. For example, in ten years time assuming relatively constant inflation of 2-3%, employing this option could mean revenues would be \$10-15 million higher than they would be under the current statute.
- **The reliability of the estimates themselves:** Notwithstanding this tax's inherent volatility and some level of uncertainty regarding the growth of inflation, this proposal's reliability is high as it is dependent on a straightforward arithmetic calculation.
- **Administrative and compliance ease, including the time needed for implementation:** Implementing and administering this concept would be fairly straightforward. It could easily be effective for the calendar year following its adoption.
- **Other tax policy considerations, if significant:** The Alternative Franchise Tax was added in 2006 as a way of strengthening Delaware's competitive position vs other states. A general tax increase coming close on the heels of a "pro" economic development move may not be well received by Delaware's banking community. Increasing Delaware's reliance on the BFT would increase slightly the possibility of year-over-year surprises that could make budgeting more difficult.
- **Legal and political considerations:** It is unlikely that this proposal would provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** While not a useful "plug" for an immediate budget crisis, this option would strengthen the Bank Franchise Tax's growth potential by addressing a shortcoming (in terms of revenue adequacy) in the tax's basic structure.

## LONG-TERM COMMITMENT TO ABANDONED PROPERTY ENFORCEMENT AND ADMINISTRATION

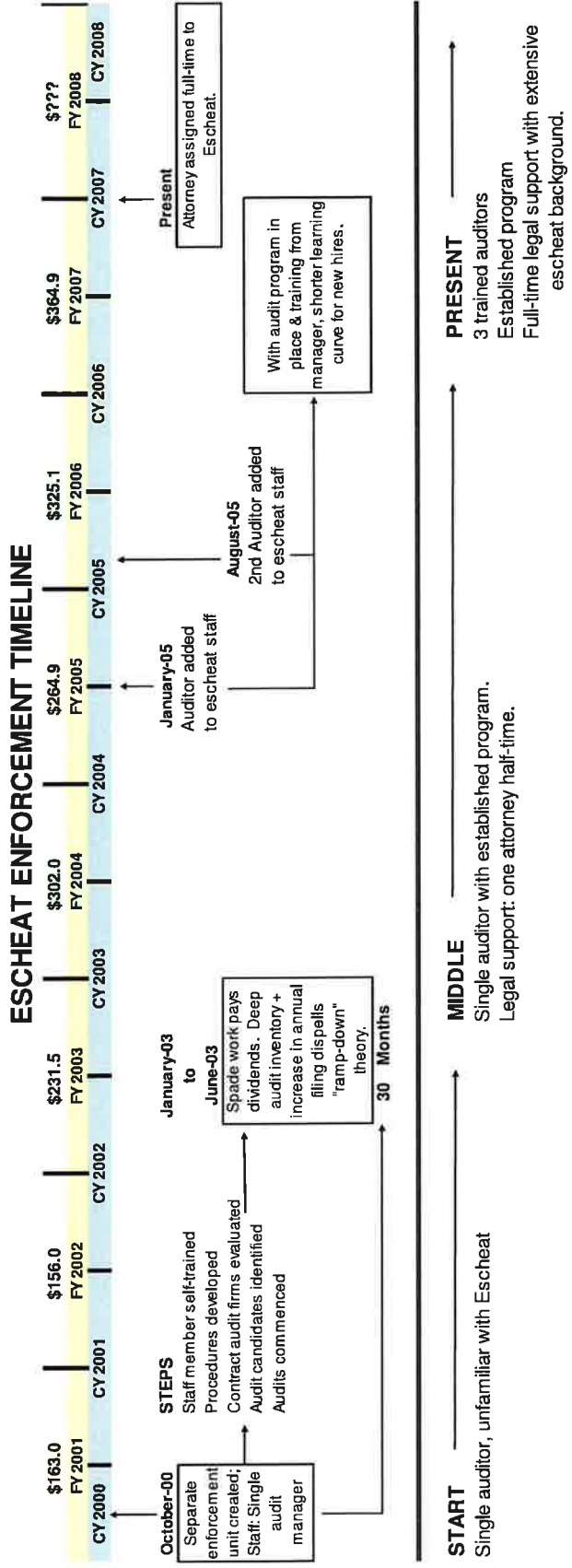
**Background:** Abandoned Property is the State's third largest revenue source. Roughly 40% of the past two years' collections were directly attributed to enforcement activities.<sup>25</sup> Abandoned property compliance, though, remains well below tax compliance rates. As discussed above, due to Abandoned Property's highly complex and specialized nature, the availability of qualified employees and private contractors within this field is extremely limited. Given current resources, the State's ability to put a dent into the compliance gap is likewise limited.

In FY 2001, the Division of Revenue formally established a separate enforcement unit for Abandoned Property and refined its VDA and Audit programs. The audit program's origins were humble as it consisted of a single auditor who was responsible for managing the entire operation. In recent years, the Division of Revenue has years expanded its enforcement staff and is reaping the benefits. Figure 6 outlines the development of DOR's abandoned property enforcement team.

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<sup>25</sup> If indirect collections are included, this figure would be higher. Former non-filers, which, as the result of under going and audit or participating in a Voluntary Disclosure Agreement, are now in compliance, have caused a marked increase in annual filings.

Figure 6.



Generally speaking, though, relative to the amount of revenue produced and relied upon by the State, the Abandoned Property enforcement unit is lightly staffed. As is evident in Figure 6, however, small increases in staffing and support have yielded tremendous revenue returns.

This proposal contemplates a much more comprehensive approach to Abandoned Property staffing and funding with an ultimate goal that is twofold: 1) the expansion of in-house DOR staff to ensure the continued growth in Escheat compliance and revenues, and 2) to develop a “deep bench” in DOR’s abandoned property area to ensure that the loss of key staff would not result in the disruption of the enforcement program and the revenues it generates, which, if key staff members were to leave the unit as presently constituted, is a likely outcome.

In order for the approach to succeed, it would require the following:

- A Multi-year Approach – assuming that a candidate enters a position with a solid general background in auditing / accounting, it takes approximately 18 months to train them in specifics of abandoned property audits before they are contributing to enforcement efforts in a meaningful way.
- Help from Outside – in order to ensure that a large expansion of audit resources does not require current staff to largely redirect their efforts away from auditing and into training new staff, preferably, the State should consider enlisting outside experts to help train new staff. If current staff is tasked with training a large increase in the number of enforcement staff, near-term enforcement collections would probably suffer.
- A Secure Source of Funding – because of its importance to solidifying this revenue source’s future performance and the multi-year commitment required for success, this initiative would require a reliable source of funding in order to ensure that training is complete and the desired staffing levels are attained.
- A Balanced Approach – the training program should not concentrate on the audit function exclusively. The commitment should include the development of adequate staffing for legal and support functions as well.

#### **Evaluation:**

- **The option’s revenue potential:** It is difficult to determine how much revenue this proposal would ultimately produce. If faced with an immediate budget shortfall, it is clear that this option would do little, if anything, to address an imminent fiscal crisis. It is clear, though, that the additional resources that this proposal would bring to bear would ultimately improve compliance and add revenues. Moreover, they would insure against Abandoned Property revenues “hitting an air pocket” in the event of staff turnover

- **The reliability of the estimates themselves:** As described above, this is a long-term measure, the fiscal impact of which is difficult to determine.
- **Administrative and compliance ease, including the time needed for implementation:** As described above, this proposal requires a multi-year commitment.
- **Other tax policy considerations, if significant:** None.
- **Legal and political considerations:** It is unlikely that this proposal would provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** The State's efforts to improve Abandoned Property compliance have thus far proven to be a resounding success. With revenues growing from \$71.1 million in FY 1997 to \$364.9 million in FY 2007, Abandoned Property now represents 11% of Delaware's General Fund revenues. Moreover, these revenues can no longer be characterized as annual "windfalls" that are largely directed to the State's Capital Budget in the form of "cash to the bond bill." Abandoned Property revenues are now a vital element supporting the State's Operating Budget. This reality, of course, also means that, to a significant extent, the State's ability to meet growing needs in the Operating Budget is contingent upon the continued growth of Abandoned Property revenues.

In this respect, the State's third largest revenue source has become a victim of its own success. Unless policymakers are willing to limit the Operating Budget's reliance on Abandoned Property by, perhaps, capping its contributions to the General Fund and using any surpluses to fund "one-time" items, finding ways to ensure that revenues keep pace with expenditure pressures becomes imperative. Unlike a traditional tax, the General Assembly cannot simply mandate higher revenues through a statutory change. Abandoned Property, like the Lottery, requires active management. Given the current staffing levels and the need for specialized training, this proposal would represent another proactive step to actively manage this revenue source's long-term viability.



## TAXATION OF LIGHTERING / OIL TRANSPORT ON DELAWARE WATERWAYS

### Background:

**The Region's Refining Industry and the Lightering Process:** The Delaware River is home to six oil refineries that, in aggregate, account for just over six percent total U.S. refining capacity. (See Table 7.)

Table 7.

### Delaware River Refineries Operable Capacity

(Atmospheric Crude Oil Distillation Capacity as of January 1, 2007)

Company Name	State	Site	Barrels per Calendar Day	Barrels per Year (millions)
Sunoco, Inc.	PA	Philadelphia	335,000	122.3
Sunoco, Inc.	PA	Marcus Hook	178,000	65.0
Conocophillips	PA	Trainer	185,000	67.5
Premcor Refining Group	DE	Delaware City	182,200	66.5
Valero Refining Co.	NJ	Paulsboro	160,000	58.4
Citgo Asphalt Refining Co.	NJ	Paulsboro	32,000	11.7
Total			1,072,200	391.4

Source: U.S. Department of Energy, Energy Information Administration

The crude oil feeding these refineries is produced overseas. As a consequence, the Delaware Bay and River's shipping channel is the refineries' means of access to roughly one million barrels crude oil each day. Transporting this volume of crude oil is a complicated process, which often-times requires that larger ships must be "lightered" in order to complete the final leg of their voyages. Lightering is the process of off-loading cargo from a large ship to a smaller vessel in order to reduce the draft of the large ship to enable it to proceed through a shipping channel or to divide the lading of the large ship for dispatch to different destinations. Lightering is fairly common and is a necessary practice for the crude oil carried by larger ships to proceed up the Delaware River:

The STBLs (ships to be lightered) that supply the East Coast refineries are typically Suezmax vessels of 120,000 to 165,000 DWT (approximately 1 million barrels) or, in some cases, Aframax vessels of 80,000 to 105,000 DWT (approximately 650,000 barrels). When these vessels are fully loaded, their drafts exceed the maximum channel depths in the Delaware River (40 feet) or New York Harbor (40 feet or less, depending on the location in the port).<sup>26</sup>

<sup>26</sup> Committee on Oil Spill Risks for Tank Vessel Lightering, National Research Council: *Oil Spill Risks From Tank Vessel Lightering*; National Academy of Sciences, 1998, p 31.

Most of the crude oil lightering that is necessary to supply U.S. refineries is conducted “offshore” in the Gulf of Mexico. Offshore lightering typically takes place either twelve or more miles offshore or at a deepwater anchorage. In contrast, “inshore” lightering occurs inside the of the twelve-mile contiguous zone extending from shore. “Most lightering along the East Coast takes place in protected and semi-protected coastal areas, primarily Big Stone Anchorage in Delaware Bay and, to some extent, in Long Island Sound, New York Harbor, and Boston Harbor”.<sup>27</sup> Big Stone Anchorage in Delaware Bay is located entirely within Delaware territorial waters.

With inshore lightering, like that which occurs at Big Stone Anchorage, the ship to be lightered is always at anchor, with the service vessel maneuvering alongside, resulting in a very limited geographical scope of operations. The transfer usually takes between 8 to 15 hours, depending on the size and the configuration of the service vessel and type of cargo.

Lightering is usually done for economic reasons. Because of economies of scale, it is more economical to move oil in large tankers over the greatest distances possible and then, near the destination, transfer it to smaller vessels to move the same amount of oil the entire distance in six or seven smaller tankers.

Big Stone Anchorage is the only protected, in shore location on the Eastern Seaboard that can accommodate tankers that require drafts of 55 feet or more. This natural advantage, along with its proximity to six refineries, makes it an ideal lightering location. Approximately 100 million barrels of crude oil are lightered annually in Delaware waters onto barges to navigate the 40-foot deep channel in the Delaware River.

The Delaware River refineries have an aggregate annual refining capacity of about 390 million barrels. With about 100 million barrels lightered each year at Big Stone Anchorage, approximately 25% of all the crude oil fed into the region’s refineries was lightered in Delaware waters. This, of course, means that most of the crude oil delivered to the six refineries was delivered without making use of lightering at Big Stone Anchorage.

Offshore lightering occurs off of Cape Henlopen, Delaware. Its desirability as a substitute for Big Stone Anchorage is limited by weather conditions:

Offshore lightering on the East Coast is subject to different weather and wave conditions than those found along the other U.S. coasts. Along the East Coast, storms and rough seas are more prevalent in the winter, spring, and fall seasons than in the Gulf of Mexico, but the large swells that occur offshore in the Pacific (off the West Coast) are not as prevalent along the Atlantic coast.<sup>28</sup>

Given the refining industry’s narrow margins and its need to operate its facilities at or near capacity, offshore lightering’s higher likelihood of weather-related interruptions in the supply of crude oil serve to highlight Big Stone’s desirability as a reliable lightering site.

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<sup>27</sup> *Oil Spill Risks From Tank Vessel Lightering*, p 35.

<sup>28</sup> *Oil Spill Risks From Tank Vessel Lightering*, p 36.

Still, with roughly 75% of the region's refineries getting their crude oil without lightering at Big Stone Anchorage, it is clear that viable shipping alternatives must exist. This conclusion is further supported when one considers that in recent years only one of the region's refining companies, Sunoco, is reported to account for virtually all of the lightering that occurs at Big Stone Anchorage.

"Under federal law, petroleum imports that are lightered within U.S. territorial waters must be transferred to U.S.-flag service vessels (OTA, 1989), which are subject to different standards and regulations than vessels engaged in offshore lightering."<sup>29</sup> One such company, Maritrans, has been responsible for nearly 99% of the lightering activity in the Delaware Bay and Delaware River. Overseas Shipholding Group ("OSG") recently acquired Maritrans. OSG is the only company that has an air permit from DNREC with respect to its lightering activity. It is also reported that there are several minor lightering operations that lack permits.

Crude oil accounts for the great majority of Big Stone's lightering activity, but there are small amounts of gasoline, distillates and No. 6 bunker oil. As mentioned above, all crude oil entering the Big Stone Anchorage comes from overseas. Some of the small amounts of petroleum distillates, however, come from other points in the United States.

**Legal Issues:** During the lightering process, ownership of the crude does not change hands. The cargo owner retains title to the crude oil. The lightering company's (OSG) role is limited to the provision of the services of offloading and transporting crude oil.

The idea of taxing the activity of lightering and/or the interstate waterborne transport of crude oil has not been attempted in other states in the manner contemplated under this proposal. For example, Texas and Louisiana both impose a crude oil barrel fee levied on each barrel transferred from a vessel at a marine terminal. The owner of the oil is liable for the fee. The marine terminal operator is responsible for collecting the fee and file reports stating the number of barrels and remitting payment.

Texas imposes a rate of 1.333 cents a barrel and Louisiana imposes a rate of 2 cents a barrel. Both states use the fees to fund a Special Fund (Coastal Protection Fund in Texas, Oil Spill Contingency Fund in Louisiana). The fee may be suspended if the funds reach a certain level. Likewise, the fee may be increased if the Fund falls below a designated level or under specific emergencies. There is also a Federal fee of 5 cents a barrel that funds the Oil Spill Liability Trust Fund.

If Delaware were to follow the model describe above, it would levy a tax only when crude oil was transferred from a ship to the Delaware City refinery's marine terminal. The crude oil bound for New Jersey and Pennsylvania would not be subject to tax.

The designer of the statute contemplated under this proposal would be faced with a thorny combination of legal issues. A brief summary of these issues is presented below:

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<sup>29</sup> *Oil Spill Risks From Tank Vessel Lightering*, p 36.

- **Import-Export Clause of the U.S. Constitution:** In this case, the crude oil produced in a foreign nation is making its initial entry into the United States. Broadly speaking, if Delaware were to pursue this proposal, its statute would have to be constructed in a way that it falls on an activity with reasonable nexus to Delaware, does not discriminate and relates reasonably to the services provided by the State, does not fall directly on goods in import transit, and does not encroach on the Federal Government's authority to cohesively regulate international commerce.
- **Commerce Clause of the U.S. Constitution:** The extent to which states may levy taxes on interstate commercial activity has largely been determined by courts' interpretation of the Commerce Clause. Generally speaking, state taxes that meet the following four conditions are considered acceptable:
  1. The tax is fairly apportioned.
  2. The tax is applied to an activity with a substantial nexus to the state.
  3. The tax does not discriminate against interstate commerce.
  4. The tax is fairly related to the services provided by the state.
- **Unique Maritime Issues:** By definition, lightering and/or the transport of crude up the Delaware Bay and River introduces the added complexity of maritime law and regulations. While not meant to be an exhaustive list, two of the issues with which this proposal might have to contend include the Ports and Waterways Safety Act of 1972 and Delaware's Coastal Zone Act.
- **A Tax Base Consisting of One Business:** Currently, only one firm, OSG, is permitted to provide lightering services at Big Stone Anchorage. While there are no doubt business and regulatory reasons for this situation, the tax contemplated by this proposal would have a legal incidence that would fall on OSG alone. Because a tax applies to just a single taxpayer, does not, on its face, mean that the tax is discriminatory. Practically speaking, however, it does mean that extra care must be taken in crafting the statute proposed under this option to ensure that its is constructed in such a way that its application is neutral.

These hurdles, while considerable, are not necessarily insurmountable. However, constructing a solid statute that would have a high likelihood of withstanding a legal challenge would require more information about the specific business practices of the lightering operations in the Delaware Bay.

#### **Evaluation:**

- **The option's revenue potential:** On its surface, this proposal's revenue potential may seem easy to calculate: simply multiply 100 million barrels by a tax rate. This proposal's revenue potential, however, is extremely difficult to estimate and, in the short-run, is practically impossible. Only 25% of the crude oil that makes its way to the region's refineries is lightered at Big Stone Anchorage. Therefore, there are viable alternatives to lightering at Big Stone. The economic viability of these alternatives depends on this proposal's effective tax rate. The higher the tax rate, the more likely the

oil companies are to change their behavior. Attempting to ascertain the extent of the oil companies' practical ability to legally avoid the economic incidence of a proposed tax at different rates is at this point little more than guesswork.

In addition, given this proposal's originality coupled with the myriad of complex legal issues it raises, there is a very significant probability that, if enacted, such a statute would be challenged, perhaps immediately. This complicating factor, coupled with the practical ability to legally avoid the tax, further diminish the certainty of the proposal's revenue potential. Obviously, this proposal has no place in a fiscal plan that is designed to solve an immediate budgetary shortfall.

- **The reliability of the estimates themselves:** As described above, at this point, any revenue estimates associated with this proposal are highly speculative.
- **Administrative and compliance ease, including the time needed for implementation:** This proposal would require considerable time to develop and implement. Additionally, once in place, it may prove to be an administrative challenge for the Division of Revenue as the taxable activity would occur on the Delaware Bay and/or River.
- **Other tax policy considerations, if significant:** This proposal would probably increase gasoline and home heating oil prices in the region. A general rule of thumb is that each 42 gallon barrel of crude yields somewhere on the order of 26 gallons of gasoline. A tax, whether levied per barrel, on the activity of lightering, or on an apportioned transport basis, that effectively amounted 50 cents per barrel of crude could be expected to add roughly two cents per gallon ( $50 / 26 = 1.92$  cents) to the price at the pump.
- **Legal and political considerations:** As discussed above, there is a high likelihood that this proposal's adoption would result in a legal challenge. It is difficult to speculate with any degree of accuracy how a court may rule on a statute that does not yet exist. It is clear, though, that if such a statute were challenged, the case's ultimate resolution could take years. In other words, Delaware, even if it were to prevail, might see several budget cycles come and go before it collected a dime in revenues.

Even more concerning is the possibility that Congress could act to preempt the proposal altogether. The oil industry and perhaps elected officials and their constituents in other states are likely to view the State's adoption of this proposal as an example of Delaware aggressively attempting to export its tax burden. Given the importance of the refining industry to the region and the fact that gasoline and heating oil are necessities with price levels hovering around their historic highs, it seems clear that Congressional action that would specifically prohibit Delaware from levying such a tax would be a distinct possibility.

**Summary:** The taxation of lightering and/or the transport of crude oil in the Delaware Bay and River is an intriguing source of potential revenue. The proposal, however, is fraught with complex issues and potential pitfalls. If they choose to pursue this option, policymakers need to

do so with their eyes wide open. While it is conceivable that one day this proposal could become a viable source of State revenue, it is not a panacea, especially for an immediate budget shortfall.

## APPLY THE CORPORATE FRANCHISE TAX STRUCTURE TO PUBLICLY-TRADED ALTERNATIVE ENTITIES

**Background:** As is described in Section I of this report, Delaware limited partnerships and limited liability companies are subject to a \$200 annual tax. Delaware statutory trusts pay no annual tax. Delaware corporations pay a corporate franchise tax (CFT) based on the corporation's authorized shares or alternatively, the corporation's "assumed par value capital". The minimum CFT is \$35 and the maximum tax is \$165,000.

Corporations with 3,000 or fewer shares pay the minimum tax regardless of the corporation's capitalization. Corporations with more than 26.4 million authorized shares will typically owe the maximum franchise tax; however, under certain circumstances, corporations may owe less than the maximum tax if they file using the Assumed Par Value Capital Method (APVC). Corporations with more than 26.4 million authorized shares and \$660 million in taxable gross assets will always owe the maximum tax. Approximately 1,500 corporations pay the maximum franchise tax. Another 7,100 corporations pay taxes of between \$5,000 and \$165,000. The vast majority of these taxpayers are publicly-traded corporations listed on one of the three major U.S. stock exchanges.

It is possible for alternative business entities, such as limited partnerships, limited liability companies and statutory trusts, to be listed on the major stock exchanges. Rather than offering shares, such entities may issue limited partnership units, membership units, or units of beneficial interest. In May 2007, the Division of Corporations identified 74 publicly-traded limited partnerships and limited liability companies formed in Delaware. Each entity pays an annual tax of \$200 to the State. The Division did not attempt to quantify the number of statutory trusts offering publicly-traded securities.

In April 2007, Fortune Magazine listed seven Delaware limited partnerships among the Fortune 500, a list of the 500 largest businesses by revenues in the United States. The largest such limited partnership recently reported book assets in excess of \$9 billion and more than 115 million common units. Two of the largest private equity firms in the United States conducted initial public offerings in 2007 as Delaware alternative entities. The combined market value of these two firms as of November 30, 2007, was \$7 billion.

Typically, structural changes to the State's business entity taxes or fees have been made in response to General Fund revenue shortfalls often times extensively attributable to significant declines in collections of these taxes and fees. Historically, the affected business and legal community have been willing to support tax restructurings to make up for cyclical declines in the CFT provided sufficient time has elapsed since the last tax increase. The last tax hike occurred in 2003. Since FY 2005, aggregate CFT-LP/LLC taxes have grown at an average annual rate of 5%. Although this proposal is much more narrowly focused (as opposed to the "across-the-board" approach employed in 2003), in the present context, it might be very difficult to build support for any proposal to materially change the CFT-LP/LLC tax structure. Such a proposal would likely enjoy significantly more support if the State began to see material declines in CFT due to corporations merging into publicly-traded alternative entities or a major increase in IPO

activity involving alternative entities. To date, there has not yet been a major movement in that direction.

**Evaluation:**

- **The option's revenue potential:** Applying a tax structure similar to the CFT to publicly-traded alternative entities might generate as much as \$10 million of additional revenue for the State assuming that all taxpayers used the "Authorized Shares Method".
- **The reliability of the estimates themselves:** The estimate is likely overstated for two major reasons. First, it seems likely that at least some of the smaller publicly-traded alternative entities would seriously consider merging to another State if they were subject to a substantial increase in annual taxes. Clearly such firms would need to weigh the value of forming in Delaware against the cost. Some firms might determine that, as LPs and LLCs, they are less likely to have a legal dispute needing resolution in a Delaware Court. While typically a corporation cannot change its state of incorporation without a formal vote of shareholders, it might be relatively easy for an LP or LLC to switch its state of formation if the decision were delegated by contract to the general partner or managing member.

Second, the State lacks access to information that would help determine how many such entities might elect to take advantage of the APVC Tax Method. LP's and LLC's are not required by Delaware law to disclose how many units they are authorized to issue, nor are they required to disclose taxable gross assets. The State does have access to disclosures filed with the U.S. Securities and Exchange Commission. Assuming that "issued units" are a good proxy for "authorized shares", it would appear that more than 60% of the subject business entities might fall into the category of being maximum taxpayers under the "Authorized Shares Method". However, assuming that "book assets" are a reasonable proxy for "taxable assets", it also appears that more than 40% of the subject business entities might prefer to file using the APVC method, thereby significantly reducing the revenue potential.

Third, since many publicly-traded LPs and LLCs are affiliated with other publicly-traded corporations (many of which are maximum taxpayers), legislators would need to decide whether to exempt related parties from having to pay the maximum franchise tax multiple times. Such an exemption would also reduce the revenue potential of this idea.

- **Administrative and compliance ease, including the time needed for implementation:** This proposal would require a number of significant statutory changes and changes in policy. For example, the legislature would first need to decide whether to require additional disclosure from all 525,000 LPs and LLCs in order to determine whether they are subject to the CFT formula or whether to delegate that determination to the Secretary of State based on an analysis and tracking of all worldwide stock exchanges. Under the latter scenario, only entities identified by the Secretary would be required to file additional disclosures.



Next, legislation would be needed to amend the State's LP and LLC Acts to make such entities subject to some, if not all, of the same reporting, filing and cancellation requirements as corporations. The State would likely need the assistance of securities lawyers to draft legislation in order to avoid inadvertently taxing entities that had been delisted. The State might also wish to exempt any entity deemed to be a passive investment. Since many publicly-traded LPs and LLCs are affiliated with other publicly-traded corporations, legislators would need to decide whether to exempt related parties from having to pay the maximum franchise tax multiple times. Since nearly any publicly-traded entity would owe more than \$5,000 in annual taxes, presumably they would be subject to quarterly filings similar to CFT payers.

Implementation of such a change could be made effective in the same tax year that legislation passes, although quarterly collections could not begin until the following tax years. The State would have to consider whether to make such a tax retroactive to January 1 or whether to wait for it to take effect until the following tax year. The State could begin collecting revenue in the first or second fiscal year after passage of legislation depending upon the effective date selected.

- **Other tax policy considerations, if significant:** If the State were to apply the CFT maximum tax rate to publicly-traded alternative entities, many in the legal and business community would argue that the State should apply the same minimum tax rate as well. More than 90% of Delaware corporations pay the minimum tax rate for the use of the State of \$35. LPs and LLCs pay a flat tax for the use of the State of \$200. Lowering the minimum tax to \$35 for LPs and LLCs would cost the State approximately \$85 million.

It is extremely difficult to predict the possible negative impacts, if any, from restructuring this tax. Ten years ago, more than 75% of all business entities were formed as corporations. Today, 75% of new entities are formed as LPs and LLCs. While CFT remains the largest revenue source collected by the Division of Corporations, LP/LLC annual taxes contribute more than \$100 million to the State and related filing fees contribute more than half of the State's business entity fee income. LP and LLC filing fees provided \$4.7 million to Wilmington, Dover and Georgetown in fiscal year 2007.

Doubling the tax in 2003 had no apparent downside impact. However, the simplicity of Delaware LPs and LLCs are one of their principal attractions. Adding significant reporting or disclosure requirements for LP/LLCs might well reduce the attraction. Even if such disclosure were limited to publicly-traded entities, it might be interpreted as a first step toward requiring full "franchise tax" disclosure to alternative entities.

- **Legal and political considerations:** If adopted, it is unlikely that this proposal would provide the basis for a legal challenge, federal preemption or similar obstruction.

**Summary:** In terms of helping to plug a near-term budget gap, applying the CFT structure to publicly-traded alternative entities is an option – although one that is likely to be opposed by some as unwarranted in light of ongoing and relatively strong growth in aggregate CFT and LP/LLC taxes and the relatively short time since the last increase in 2003. There is a chance

that some or perhaps many publicly-traded LPs/LLCs would migrate elsewhere taking related subsidiaries with them. It seems likely that any such shift out of Delaware would be limited to firms with smaller capitalizations. Revenue generated from such a change would likely be in the range of \$5 to \$10 million.

APPENDIX: SENATE JOINT RESOLUTION NO. 5



SPONSOR: Sen. DeLuca & Sen. Adams Sens.  
Sens. Reps.  
Blevins Cathcart  
Cook Gilligan  
Copeland Hudson  
Marshall Keeley  
Sorenson Lee  
Cloutier Oberle  
Connor  
Still

DELAWARE STATE SENATE  
144th GENERAL ASSEMBLY

SENATE JOINT RESOLUTION NO. 5

DIRECTING THE DIRECTOR OF THE OFFICE OF MANGEMENT AND BUDGET, THE SECRETARY OF FINANCE AND THE CONTROLLER GENERAL TO ANALYZE EXISTING REVENUES AND MAKE RECOMMENDATIONS TO ENSURE A STABLE LONG TERM REVENUE BASE.

- 1 WHEREAS, the State of Delaware has a long tradition of prudent financial management, and  
2 WHEREAS, this record has come about through the enactment of constitutional provisions such  
3 as the establishment of a Rainy Day Fund, and a 98% limit on appropriations; and  
4 WHEREAS, this record has also come about through the efforts of the Delaware Economic and  
5 Financial Advisory Council (DEFAC) that provides objective, consensus forecasts of Delaware revenues  
6 and expenditures upon which the General Assembly and Governor bases appropriations and fiscal  
7 policy; and

8           WHEREAS, the State of Delaware has been recognized nationally for said financial management  
9 through achieving a Triple A bond rating from all three major bond rating agencies; and

10           WHEREAS, in order to maintain excellent financial status the State of Delaware must ensure  
11 that the revenues supporting state government provide a solid base from which to provide the necessary  
12 services for all Delawareans; and

13           WHEREAS, it is prudent to investigate and thoroughly analyze additional potential sources of  
14 revenue that could serve to mitigate potential downturns to existing revenue sources.

15           NOW THEREFORE:

16           BE IT RESOLVED by the Senate and the House of Representatives of the 144th General  
17 Assembly of the State of Delaware, with the approval of the Governor, that the Director of the Office of  
18 Management and Budget, the Secretary of Finance and the Controller General provide the following:

- 19           1. A review of existing general fund revenue sources providing, in particular, an analysis of the  
20 various risks and opportunities associated with each source.
- 21           2. In recognition of changing demographic and economic conditions, a review of potential  
22 additional revenue sources that could potentially provide additional long term stable revenue for  
23 the state.

24           BE IT FURTHER RESOLVED that no later than December 21, 2007 the Director of the Office  
25 of Management and Budget, the Secretary of Finance and the Controller General provide the Governor  
26 and the General Assembly with the results of said review and any recommendations contained therein.

### SYNOPSIS

This Resolution requires the Office of Management and Budget, the Secretary of Finance and the Controller General to provide a review of existing and potential long term revenue sources for the state. It further requires the results of said review to be presented to the Governor and the General Assembly by December 21, 2007.

Author: Senator DeLuca

