INSIDE: Unclaimed Property • The Corporation Franchise Tax • Bruce Stargatt Remembered

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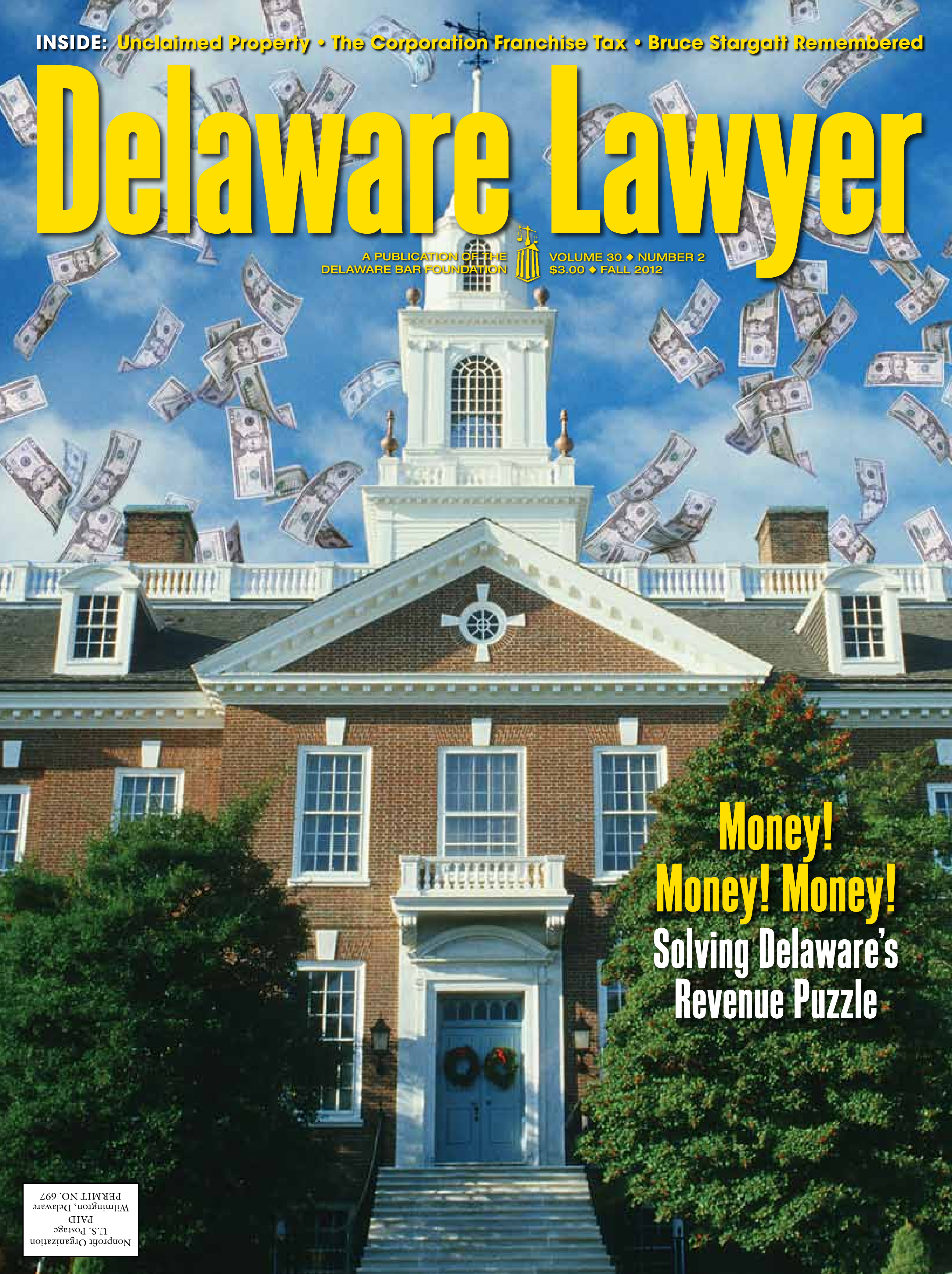
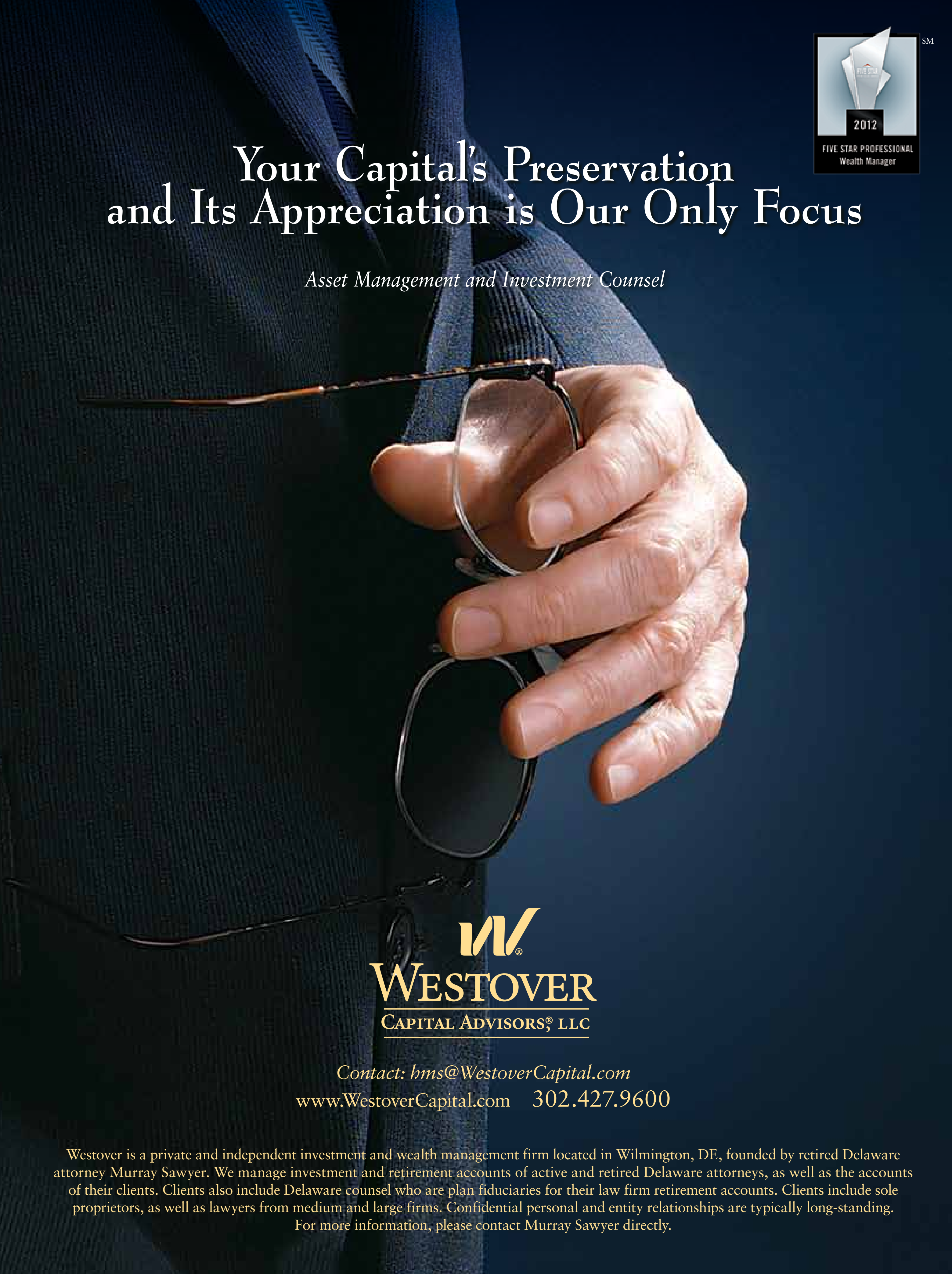


Money! Money! Money!
Solving Delaware's Revenue Puzzle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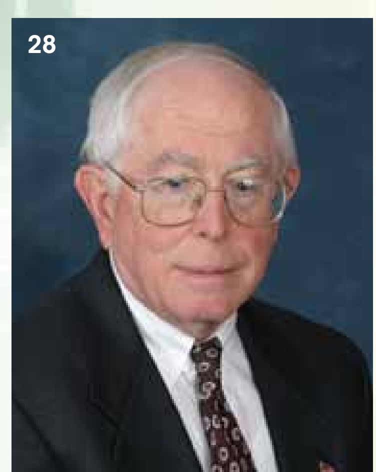
CONTENTS FALL 2012



Former *Richards Layton & Finger* President Tom Sweeney

Blake Rohrbacher and Charles J. Durante

Particularly because of the country's economic troubles, the state of our state's finances is an important and pressing topic. Many of us have a vague sense of how our state collects money (and we see some of it in action while waiting at the toll booth on I-95). We may not, however, understand the specific revenue sources or the challenges facing those revenue sources.

To some extent, much of Delaware's revenue derives, directly or indirectly, from its status as the premier jurisdiction for business formation. Obviously, Delaware takes in filing fees and corporate franchise taxes directly from entities formed here, but that is just the beginning.

Lawyers and registered agents in Delaware provide additional revenue to the state in the form of fees and taxes while assisting in corporate formation. Delaware also benefits from the court fees that derive from litigation against Delaware-incorporated entities.

Less directly, Delaware benefits from the entire legal community that supports this type of practice — litigators in the Superior and Chancery Courts, as well as those in the federal courts, since bankruptcy and intellectual property practitioners benefit greatly from Delaware domicile. Those lawyers work in buildings that support a property tax to the state, and they pay income tax to the state. They also engage a network of litigation-support services, from caterers to couriers, who also contribute to the state's coffers.

In this issue, we examine two specific, and important, sources of the state's revenue: unclaimed property (escheat) and the corporate franchise tax. Delaware receives a significant amount of revenue as a result of laws regarding unclaimed property (such as uncashed checks and unused gift cards). It also receives a substantial amount from the corporate franchise tax, which is less a "tax" than a license fee for the privilege using Delaware's corporate laws.

We also have two prominent experts on Delaware public policy discussing challenges to Delaware's revenue sources. One looks at some of the micro- and macroeconomic stressors on Delaware's revenue portfolio. The other examines Delaware's primary new (and old) revenue sources and asks whether politicians will be able to make the hard decisions that may be necessary.

Through these bottom-up and top-down approaches to understanding the money flowing into the state, we hope that you will gain a greater appreciation for the difficulties that our public and private stewards face in ensuring necessary cash flow for the future.

Blake Rohrbacher

Charles J. Durante

Mark DiMaio

works for the Delaware Public Policy Institute, an affiliate of the Delaware State Chamber of Commerce, analyzing public finance, health care, manufacturing and public education. He previously worked at AstraZeneca as a lobbyist on pharmaceutical and health care issues in 17 states, including Delaware, after beginning his career as a sales representative for the firm. He is a graduate of Lafayette College.

Charles (Chuck) Durante

heads the tax, estates and trusts department at Connolly Gallagher LLP. An honors graduate of Haverford College who received his J.D. and LL.M. from Villanova Law School, he is chairman of the Board of Editors of *Delaware Lawyer* magazine.

Rick Geisenberger

is the Director of the Delaware Division of Corporations. Since his appointment in 2001, the number of business entities in Delaware has increased 80 percent while the Division earned ISO 9001 certification in 2012 and the prestigious Delaware Quality Award in 2008. Governor Jack Markell appointed Rick in 2009 to help lead the Delaware Government Performance Review, which set in motion dozens of successful initiatives to make state government more efficient and cost-effective. Rick previously worked for Manufacturers Hanover and Delmarva Power in a variety of M&A, finance, lending, treasury and strategic planning positions.

Jack B. Jacobs

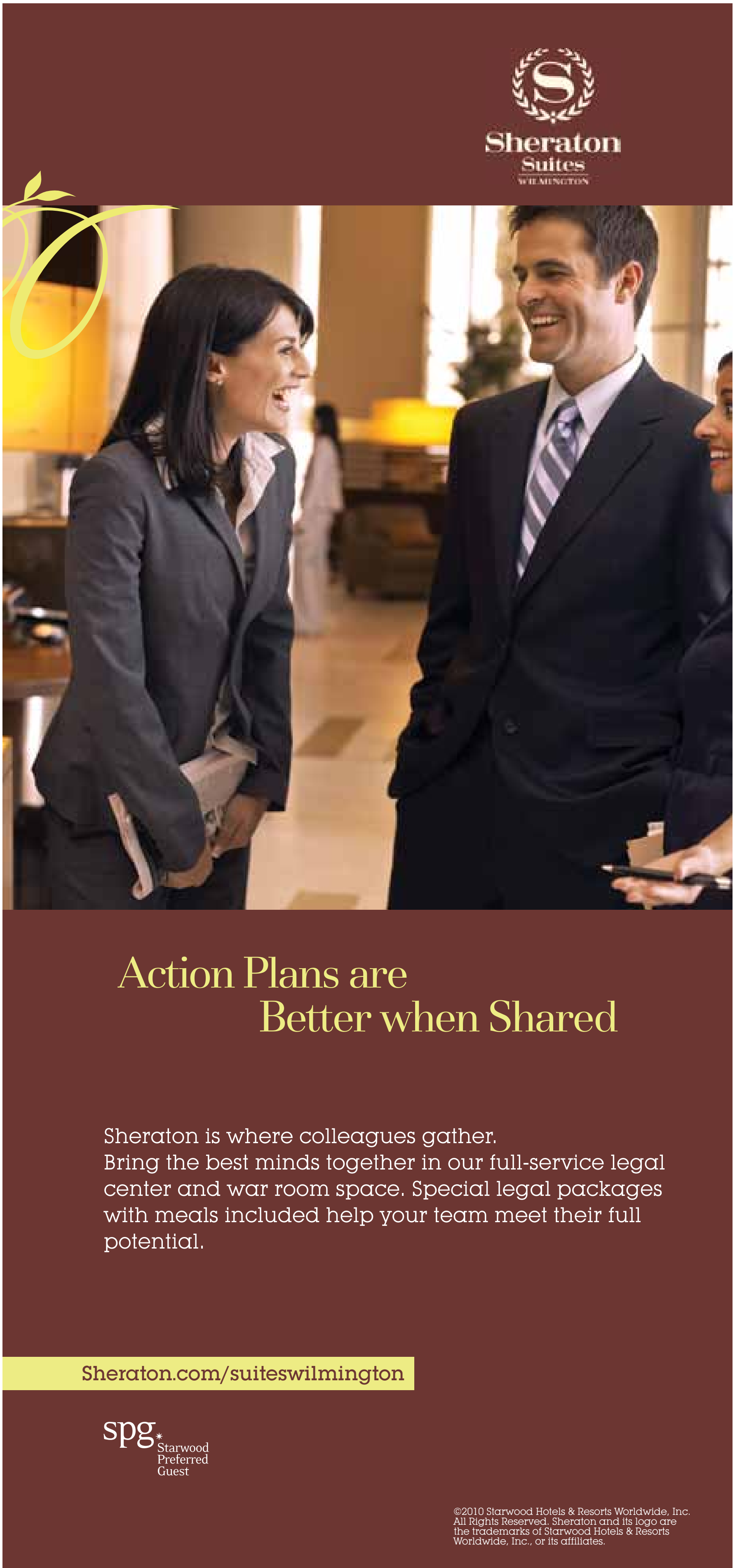
is an Associate Justice of the Supreme Court of Delaware. Before his appointment to the Court of Chancery in 1985, he was a partner of Bruce Stargatt at Young Conaway Stargatt & Taylor. A graduate of University of Chicago and Harvard Law School, he is an Adjunct Professor of Law at the Law Schools of New York University, Columbia University, the University of Chicago and Widener University.

Edward C. Ratledge

is director of the Center for Applied Demography & Survey Research at the University of Delaware, where he received his undergraduate and master's degrees in economics. A former Army captain, with service in Vietnam, he has been a member of the Delaware Economic and Financial Advisory Council and the Delaware Population Consortium since their inception. His current work — which integrates economics, statistics, demography and computer science — includes developing the Delaware Health Information Network; building Delaware's hospital discharge data system; advising the Perinatal Board on scientific issues; implementing studies of travel behavior in Delaware and evaluating the impact on the state's road network; producing small-area population and employment projections for the state; and developing measures of, and attitudes toward, options for long-term economic growth. He and his colleague Bill Boyer authored *Delaware Politics and Government* (University of Nebraska Press, 2009).

Stanford Stevenson

is a director with the firm of Richards, Layton & Finger, P.A., in Wilmington. He focuses his practice on federal income taxation and Delaware taxation, exempt organizations, employee benefits and unclaimed property. He is a former Chairman of the Delaware State Bar Association Tax Section and is a member of the American Institute of Certified Public Accountants (AICPA) and Unclaimed Property Professionals Organization (UPPO). He has been recognized by *Who's Who Legal* and *Best Lawyers in America* in the area of taxation. In the 10th grade, he was voted "Most Likely To Write A Mildly Interesting Article On The Topic Of Delaware Unclaimed Property" and this past season batted over .750 in the Wilmington Lawyers Softball League.



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Subscriptions orders and address changes, call:
Chris Calloway 302-656-1809

Advertising information, call:

Jessica Stryker, 302-504-1365
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FEATURE

Edward C. Ratledge

Delaware's Revenue Portfolio Under Stress?

Depressed by recession, the state's traditional funding sources may not be adequate to handle rising costs and new challenges.

Three years ago in this journal, I provided a broad description of Delaware's revenue portfolio.[1] Some categories were performing adequately in spite of the tenuous economic situation. Others suffered from a lack of growth or even the potential for growth. Still other categories were declining.

This article will take another look at the portfolio, will review it in the context of pressures coming from the expenditure side of the state's budget, and will close with some revised suggestions regarding potential solutions, many of which were offered in the original essay.

Delaware is now entering the fourth year of recovery from the recession that began in the fourth quarter of 2007 and ended in the second quarter of 2009. It would seem reasonable to expect that significant progress would have occurred in economic activity by this time.

At the peak in 2007, the unemployment rate was 3.5 percent with 15,000 unemployed. There were 429,000 persons employed and the labor force was 446,000. At the bottom in 2010 the Delaware unemployment rate peaked at 8.5 percent with 37,000 unemployed. The labor force fell to 436,000, and the number of employed was 399,000.

Today, the unemployment rate is hovering at 6.7 percent with 30,000 still unemployed, approximately double the 2007 number but still below the peak. Employment has increased by 12,000 from the bottom to 411,000, but is still 18,000 less than the number employed in 2007. The labor force is now 6,000 below the peak observed in 2007.

By most of these measures, the recovery is barely halfway complete after three full years. Very little progress has been made during the first half of 2012. At the current rate, one could forecast that a recovery to 2007 levels could take another three to five years. Further, recovery to those levels ignores the increase in population of 30,000 persons that has occurred during the last five years and the commensurate labor force and employment gains of potentially 15,000.

The construction industry usually recovers before the overall economy has a sustainable robust recovery. Employment in this industry remains at the bottom, losing more than 10,000 jobs from the peak in 2006.

There has been a recent increase in building permits for single-family homes and even some upward movement in the price level. The increase from 1,400 permits to 1,600 permits in the first half of the year is positive, but anemic compared to 2007 when 2,900 permits were issued in the same time period.

The historical average for Delaware building permits is 4,200 per year. Its peak was 8,200 permits during the bubble and was 2,495 in 2011. There is a long way to go if this industry is to fully recover.

Recent increases in housing prices are positive, since they may encourage those who are in the market to buy. Many potential homeowners have been reluctant to buy with prices still falling. The question at hand is whether the observed price increase was caused by an increase in demand or a lack of supply.

There are reports that as many as 30 percent of homeowners nationally with mortgages are "under water" (house is now worth less than the mortgage balance), and many of those are unwilling to sell and realize the loss. Until there is a price movement sufficient to reduce these losses significantly, these properties will not reach the market. Once they do reach the market, they will dampen rising house prices.

One positive factor for Delaware is that the percentage of mortgages in foreclosure has fallen from 4.18 percent at the peak to 3.64 percent in the first quarter of 2012. This figure needs to fall to the vicinity of 1.5 percent to reach typical historical levels.

All of these factors affect the financial well-being, the risk tolerance, and the confidence of parties to make long-term decisions. Those decisions affect Delaware's revenue base through the income tax, the gross receipts tax, and the realty transfer tax (currently a fraction of its yield at the peak of the bubble). This in turn affects state revenues and the revenues of the counties and municipalities that levy those taxes.

Impact on the Revenue Portfolio

The recession's effect on employment created a significant impact on personal income and on personal taxes. The wages that would have been earned by the employed and the additional economic activity that would accompany those transactions would have, at the very least, reduced personal income taxes.

Net personal income taxes for FY08 were $1.008 billion and $1.042 billion for FY12. This implies an annual increase of less than 1 percent per year. The slow growth in revenues is despite a one percentage point increase in the tax rate for Delaware taxable incomes above $60,000 effective in FY10.

The corporate income tax was a predictably volatile source of tax revenue. After peaking in FY08 with tax payments of $178.5 million, the FY09 payments fell to $126.5 million as consumers began to reduce their borrowing and consumption.

That pattern continued in FY10 with payments of $87.9 million but recovered significantly in FY11 to $169 million as businesses reduced their workforces and significantly improved worker productivity.

This pattern reversed in FY12 as corporate income tax payments fell again, to $119 million. Revenue forecasts for the corporate income tax out to FY14 are similarly volatile.

In contrast, the bank franchise tax, which is really an income tax, reached its peak at $175 million in FY08. It then fell to $54 million in FY10 but recovered and stabilized near $110 million in FY12. Current forecasts show modest growth in the near future.

Revenues from the gross receipts tax were essentially flat for the three years after the recession, although a FY10 tax rate increase of 8 percent did produce additional revenue. This source was also helped by the reopening of the Delaware City Refinery, a significant contributor to gross receipt tax revenues. Since the end of the recession at the beginning of FY10, this source has produced increases in revenue but in an irregular way.

The corporate franchise tax and the LLC tax when taken together produced slow growth (excluding the tax increase in FY10). The LLC tax was growing rapidly until FY10 and then has stabilized at a level sufficient to counter the shallow decline of the corporate franchise tax.

The last two major sources of revenue are the lottery and abandoned property tax (aka the escheat tax). The lottery, in spite of new competition from Maryland, has continued to grow at roughly 3 percent per year. The lottery is expected to face an initial decline of 7.5 percent in FY13 and then stabilize until other competitive actions are implemented.

The abandoned property tax continues to produce staggering amounts of revenue, and new changes in procedures could increase that flow. This revenue source, $566.5 million in FY13, could replace the corporate franchise tax ($604.2 million in FY13) as the second most important tax in the portfolio, but the long-term sustainability of this largess is unclear.

There are continuing attacks from those that pay and from others across the country who would like to have a larger share of the pie. Also, the great recession generated an increase in mergers and acquisitions. The exercise of merging records and accounts tends to uncover abandoned property in the participating firms.

There are risks associated with many if not all of these revenue sources. These risks are addressed in detail in a 2008 report from the Department of Finance, the Office of Management and Budget, and the Controller General's Office which was submitted to the General Assembly detailing the good, bad, and the ugly of Delaware's revenue portfolio.[2]

Outlined for each revenue source were the "Risks and Opportunities," any "Structural Issues," and further "Revenue Potential." The report is comprehensive and offers a good starting point guiding the Governor and the General Assembly. This report and a related volume, the annual "Tax Preference Report" are both available at the Department of Finance's web site.[3]

Pressures on the Revenue Portfolio

The budget process for FY14 is well underway. Departments have submitted their requests to the budget development group, which will produce a draft budget for the Governor to submit to the General Assembly in January 2013. That budget will have to be balanced and will be constrained by DEFAC's forecast for FY14.

The budget will have to address certain "door openers," which are items over which the state has little control, such as increases in prices of goods and services required for state operations, statutory benefits and pension obligations, and funds for matching state/federal programs. The budget can be balanced by a combination of expenditure reductions and increases in taxes/fees. Some of the more serious issues are discussed here.

Sunset for Past Tax Increases

The General Assembly in June 2009 passed several tax increases that were subsequently approved by the Governor to provide the revenue that was required to balance the FY10 budget. The personal income tax, the gross receipts tax, and the estate tax are expected to begin the sunsetting process on January 1, 2014. They should initially reduce General Fund revenues by $35.2 million.

When sunset takes effect for these three sources, in FY15, the General Fund will lose an estimated $100 million. In addition, the increases to the corporate franchise tax also sunset with a full impact of $80 million, bringing the combined impact of the sunset provisions to roughly $180 million.

In addition to the tax sunsets, ongoing commitments have been to transfer $75.9 million from the General Fund to special funds with specific goals. These funds are no longer available to pay for the day-to-day expenditures of the General Fund. Their continuing nature seems to be more consistent with earmarking than one-time transfers designed to avoid adding to the base budget.

The newly elected General Assembly will have to deal with these issues in order to balance the FY14 and FY15 budgets. While these members may not feel constrained by the commitments made in 2009 that the increases would be temporary, Delaware's reputation as a business-friendly state might be further eroded. In a recent CNBC study, Delaware ranked 43rd overall, 32nd in the Cost of Business, and 19th in the Business Friendly category.[4]

Backtracking on prior commitments seems not to be helpful given the current economic situation where a robust recovery is dim on the horizon and the light at the end of the tunnel may be a future recession.

Demographics

Economic activity in Delaware and elsewhere is largely driven by people who are working, consuming and, hopefully, saving for the future. Many also will pay a variety of taxes as a result of these activities to fund the government expenditures as approved by their duly elected representatives.

Delaware for many years has enjoyed steady population growth approaching 12,000 people per year. Somewhat less than half comes from natural increase (births less deaths) with the balance coming from net in-migration (more people moving into Delaware than leaving).

Many of those coming in were taking plentiful jobs when the unemployment rate was 3.4 percent (now 6.8 percent) and there was a large block of people who chose Delaware as a place to retire.

The last several years have produced population growth of only 8,000 a year, the change almost entirely due to a decline in net in-migration. While there has been a modest reduction in the retirement bound in-migrants, the largest decline is from those no longer coming to new jobs in Delaware. The collapse of the construction industry, particularly in residential housing, is a large part of the answer, but the gradual decline of jobs in the financial sector is ongoing.

Beyond the migration component, the rest of the population is aging. For the tax base that has usually been a good thing. As people age they reach their maximum earning power. That usually means that they consume more and pay more taxes.

After 50 years of age, however, most income gains are gone as promotions become less frequent and many look forward to retirement. Health care costs and a renewed interest in (or, more likely, panic about) retirement income will alter consumption, saving patterns, and economic activity.

As more baby boomers retire, the growth of the labor force will slow since only a fraction of retirees, 10-12 percent, participate in the labor market either full-time or part-time. For that reason, they pay fewer income taxes. Moreover, their Social Security income is excluded from taxation in Delaware, thanks to a generous pension exclusion which includes interest, dividends, and pensions.

As more boomers retire, a process that began in 2011 for most, the percentage of those 65 and older of the population will grow from 12 percent to almost 24 percent by 2030.

While the cost of the pension exclusion can be calculated with reasonable accuracy, the same cannot be said about the income levels of those that follow the baby boomers. Will they have the same returns to their college investment, their high school diploma, or their technical training? Will the opportunities for promotion and benefits be the same as they were with the giants like IBM, DuPont, and General Motors?

The impact of globalization and competitiveness suggests that the patterns of income over a lifetime may be more compressed. The end result is that relatively lower real yields from income and consumption taxes will be felt over the coming years.

If the boomers are replaced with

a generation that is equally successful, then the tax base will be relatively smaller, but it will survive. However, the financial crisis that started in 2008 and is still here in 2012 has fundamentally shaken the labor market, and it may not be business as usual even when the last vestiges of the crisis disappear.

Many businesses may have fundamentally restructured their use of labor and capital. Firms are much more critical in assessing the need to replace recently vacated positions. They will attempt to have another existing employee absorb all or part of that workload, train an existing employee to assume new tasks, or find a way to automate all or part of the function.

World competiveness as well as the past financial crisis will likely continue this process. The net result is that the growth of employment may slow to near replacement and may not be fully offset by wages and salaries paid to the fewer, but more productive, employees.

Key Expenditures

Revenue adequacy is one of the key attributes of the revenue portfolio. Revenue adequacy can only be determined if one knows what must be funded.

An excellent example of this problem is the Transportation Trust Fund, which is funded by a series of transportation-related fees and taxes (motor fuel, registration, and documentation fees). This revenue is inadequate to fund the expenditures of the transportation fund. To pay the bills, $40 million of escheat revenue is transferred from the General Fund to support the transportation fund.

The General Fund does not have that luxury. Shortages in the General Fund must be addressed in the budget process to either reduce expenditures or increase taxes as was done in 2009.

Probably the most significant pressure on the General Fund is Medicaid, the health care program for those in or near poverty. Today the General Fund is asked to fund roughly 47 percent of the cost while the federal government contributes the balance. For FY13, Medicaid will cost $657.3 million, or 18.1 percent of the total budget.

Since 2005 this category has increased by 8.6 percent a year, while the overall budget has increased by 3.2 percent annually and payroll has increased by 2.7 percent annually. The growth in Medicaid enrollment has increased annually at roughly 6 percent per year in good times and bad.

Enrollment is not highly correlated with unemployment. Even in 2007 when the economy reached its peak, the enrollment was flat, but did not decline. As soon as the recession started, enrollment resumed its usual growth rate. Since the growth in enrollment is lower than the growth in costs, the balance is attributed to rising health care costs.

Pension costs are not as large a component of expenditures as Medicaid. Pension expenditures are expected to be $262.9 million or 7.2 percent of the FY13 budget. General Fund pension expenditures were 5.2 percent of the budget in FY05 and have increased at 7.5 percent per year over the past eight years. During that same period, benefits for state employees have increased at 4.7 percent per year.

All of these expenditures have growth rates exceeding those of Medicaid, and they are growing at rates considerably higher than revenues.

The revenue base since 2005 has grown by 2.8 percent per year including various tax cuts and tax increases, as well as various fund transfers. The most recent DEFAC report suggests that General Fund net receipts will grow only by 1 percent per year from FY11 to FY14.[5]

In fact, revenues actually fall between FY13 and FY14, since the growth of all revenue sources is not sufficient to offset the tax sunsets discussed earlier. Under any circumstances, the growth in revenues is probably inadequate to deal with rapidly growing expenditure categories.

Medicaid expenditures are made even more difficult with the implementation of parts of the Affordable Care Act. The state is being encouraged to enroll all persons who are under 133 percent of poverty level. This might add another 24,000 or more to the rolls, totaling nearly 238,000. The federal government is expected to pay 95 percent of the costs initially, declining to 90 percent by 2020. Delaware will get some enhanced matching of costs because it already has one of the programs in place.

The net effect on health care costs is unclear. Medicaid already pays less than private insurance, and many physicians already limit the number of Medicaid patients they will see. If the reductions in Medicare payments required to fund the Affordable Care Act take place or the ability of the federal government to fund either program is impaired, the state may have some serious issues to address.

In any event, increased health care costs will clearly affect the state's budget and thus raise questions about the adequacy of the revenue portfolio.

Next Steps

The General Assembly will have to deal with these issues when it receives the governor's FY14 budget in January 2013. It will have to address the first wave of the sunset provisions and the upcoming expansion of Medicaid if the state chooses to opt in.

These decisions should take place in full awareness of the impact of rapidly increasing expenditures in FY14 and beyond. That discussion should take place with full recognition of the issues, risks, and opportunities in the revenue portfolio. A comprehensive solution dealing with the likely mismatch between revenues and expenditures would be better than a patchwork attempt in FY14.

The problems to be addressed are structural and will surface yearly if solutions are not developed soon. The "door openers" can ultimately consume all the growth provided by the revenue portfolio and will squeeze resources currently used for programs in all the departments.

After excising all of the "waste, fraud, and abuse," reinventing government to the extent possible, and prioritizing all existing functions, there will likely be the need for a new revenue source to reduce some of the risk in the current portfolio.

One of the most appropriate and least costly sources to implement is the property tax. Currently, the property tax in Delaware is approximately 6 percent of all state and local tax revenues combined. The national average is 13 percent. The primary users of the property tax are local governments and the public school districts, and the schools are by far the largest recipient of these revenues.

At the same time, the state provides roughly 70 percent of total public education funding from the General Fund. About $80 million of the General Fund is used to partially equalize the differences in the property tax base between districts. It would be appropriate to use the property tax for this purpose.

In addition, many functions currently left to the school districts are more appropriately funded at the state level (e.g., special schools and students with special needs). Before this could even be operationalized, a statewide property reassessment is needed. The last reassessments were conducted in 1986, 1983, and 1974 for Kent, New Castle, and Sussex counties respectively.

There even has been discussion by some about a potential class action suit to force the proper valuation of real estate in the state. This issue has been studied repeatedly. A task force developed a plan and prepared a report recommending a complete overhaul of the property tax in Delaware.[6]

This overhaul should be implemented as soon as possible so that this revenue source can be utilized immediately if the current revenue structure continues its lackluster performance. It also can act as a backup to the risks associated with the lottery, abandoned property, realty transfer, and/or corporate franchise taxes.

It also would be appropriate to use the property tax for funding, in part, the Transportation Trust Fund. This fund is currently underfunded and requires subsidization from the General Fund. It will likely continue to need funding as fuel efficiency increases and the motor fuel tax declines. Infrastructure is directly related to the service of property, including residential, commercial, and industrial uses. Approximately 40 percent of the tax is paid by businesses and nearly 15 percent of the tax is exported to non-residents.

During the housing bubble of 2003-2006, the realty transfer tax provided substantial revenue to local governments. When the bubble burst, transfer tax revenues dropped to a fraction of prior levels, placing those governments in serious difficulty. While the same volatility exists at the state level, the proportion of total revenue provided by the tax is significantly lower.

One approach to avoid this in the future is to repeal sharing the transfer tax and replace it with revenue sharing funded at the state level by the property tax.

Any plan to improve the revenue portfolio should include a complete review of tax preferences. While most were implemented in good faith, conditions change and some may now require significant revision or elimination.

For example, the pension exclusion for the older population (of which I am one) may become onerous and inequitable as the population of seniors doubles over the next 20 years.

There should also be a complete review of the earmarking of General Fund revenues. Examples include assigning part of abandoned property revenues to school construction or to the Transportation Trust Fund. There is a legislative process for dealing with capital funds. Earmarking in general reduces flexibility in a downturn and puts receiving programs higher on the priority list when that may not be what was intended.

It may also be an appropriate time to revisit the foundations of the Transportation Trust Fund. Today nearly 70 percent (and rising) of state expenditures from the fund are for operations and administration of the Department of Transportation, which was not the original intent. By isolating this function of government, it both reduces flexibility of the General Fund and starves the trust fund.

Overall, it seems safe to conclude that the current portfolio will produce on average 4 percent growth on the up cycle and perhaps -5 percent on the down cycle.[7] The rainy day fund will protect the state for a single year but two down years would require immediate action for budget cuts or tax increases.

The upside will accommodate small real increases in expenditures above inflation but will have difficulty with expenditures like Medicaid, which has been growing significantly faster than the portfolio. Stimulus funds from the federal government that reduced this burden ended after 2011.

Successive years of tax raising and budget cutting are not only debilitating to the political process, they are bad for business, for state employees and for citizens of the state. An intense examination of programs that are growing faster than the revenue portfolio can support is needed.

Most if not all programs have their past supporters, but not every program is a high-priority program. Adding a new program may make sense, but funding it may require ending older programs.

Adding to the revenue portfolio is not a casual decision either. There needs to be balance and there needs to be foresight. The General Assembly should ask for a report from the Department of Finance, the Office of Management and Budget, and the Controller General's Office that details the long-range (five years) needs for state government services and the likely cost thereof.

Such a report would include not only the General Fund but also special funds, both appropriated and non-appropriated. Having an up-to-date and complete picture of the state's fiscal health is the foundation required for leading and managing in these difficult times. ◆

FOOTNOTES

1. Edward C. Ratledge, *Delaware's Fiscal Health: Time for Tax Policy Reform?*, Del. Law., Fall 2009, at 14.

2. http://www.finance.delaware.gov/publications/GP2008.pdf.

3. http://finance.delaware.gov/publications/taxpref.shtml.

4. http://www.cnbc.com/id/46413845.

5. http://finance.delaware.gov/publications/DEFAC.shtml.

6. http://finance.delaware.gov/publications/propreassess.pdf.

7. September 2012 Revenue Forecast, http://finance.delaware.gov/publications/DEFAC.shtml.

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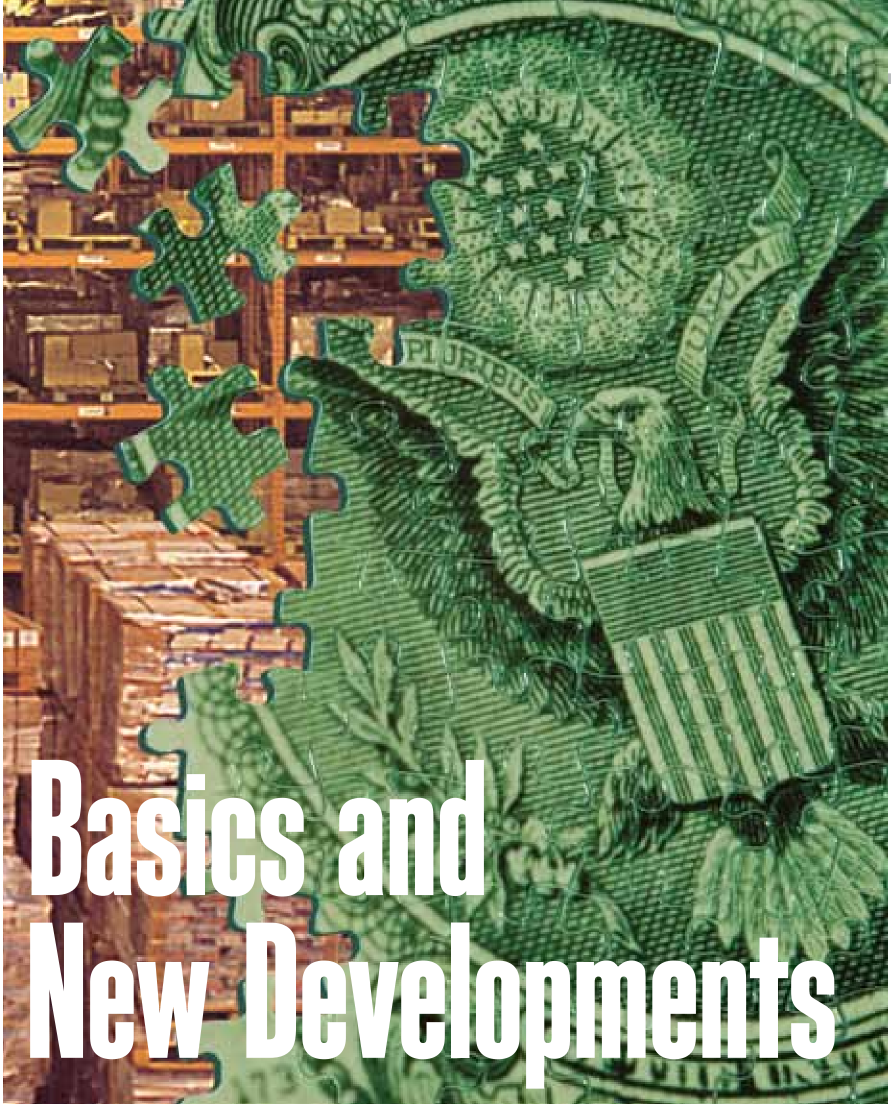
FEATURE

Stanford Stevenson



Unclaimed Property: Basics and New Developments

Is a recent drop in this lucrative revenue source a blip or a trend? How will changes in the law affect unclaimed property receipts?

According to the Delaware Division of Corporations' website, more than 980,000 business entities are currently formed under Delaware law, including more than half of all publicly traded U.S. companies and more than 63 percent of the Fortune 500.[1]

This status as the preferred jurisdiction of formation has provided Delaware with a generous source of revenue for many a decade in the form of corporate franchise taxes, as well as the resulting economic impact from the legion of gainfully employed Delaware legal professionals advising these entities.

Over the last decade and a half, this status also has yielded Delaware with another significant source of annual revenue in the form of "unclaimed property." During fiscal year 2011,[2] the $427.9 million of unclaimed property received by the State of Delaware represented more than 12 percent of the state's total revenues. The Delaware Economic and Financial Council (DEFAC) projects that percentage to increase to more than 15 percent for fiscal year 2013.

Unclaimed property as a revenue source to the State of Delaware has grown to the point where it now consistently represents the third largest source of revenue, behind only personal income tax and the corporate franchise tax.

In simple terms "unclaimed property" (also referred to as "abandoned property") is property that is owned by someone but held by someone else and with respect to which the period of dormancy has expired. The simplest example of unclaimed property is an uncashed check.

Imagine a corporation writing a

check to satisfy a liability — whether it be to an employee for services rendered or to a vendor for products delivered or to its lawyer for excellent advice provided at a reasonable rate. If that check, for whatever reason, is never cashed, then the corporation that wrote the uncashed check is considered to be "holding" the property of the rightful owner (the payee).[3]

After the statutory period of dormancy runs, in most cases five years, then the holder (the corporation) is required to remit an amount equal to the amount of the uncashed check to the state.

Unclaimed property can take many forms: accounts payable, accounts receivable credits, unredeemed gift cards or gift certificates, uncashed dividend checks, unclaimed merger consideration, dormant equities, and unclaimed royalty payments, just to name a few.

To some (including the CFO of most any holder about two weeks after an audit notice from the state) the entire concept of unclaimed property (or escheat) statutes is unsettling. One could argue that the state is requiring the holder to prove that it actually owns the property in its possession, and if the holder cannot prove that then it has to turn the property over to the state.[4]

Various justifications are offered in support of unclaimed property statutes. One justification is that such statutes are beneficial because the state is more likely than the private holder, and better able, to reunite the unclaimed property with the rightful owner. A second justification is that, even if the state is not more likely to reunite the property with the rightful owner, society is better off treating the unclaimed property as a windfall that benefits the entire public rather than just benefitting the private party that is the holder.

In most cases, the second justification is more relevant because only a small percentage of unclaimed property ever gets paid back to the rightful owner, which is how unclaimed property ends up being the third largest revenue source to the State of Delaware.

Address Property v. Non-Address Property

Although most states publish lists of names and amounts of unclaimed property in their possession, a very small percentage of unclaimed property turned over to the states is paid back to a claimant. In general, Delaware pays claims to owners equal to less than 3 percent of the amount of the unclaimed property it collects.[5] Thus, as previously noted, unclaimed property serves as an additional revenue source to the states.[6]

As businesses often are formed under the law of one jurisdiction, are headquartered in another, and have vendors and customers across the United States, the states began to assert conflicting escheat claims against holders. Those conflicting claims were largely resolved pursuant to three U.S. Supreme Court cases: *Texas v. New Jersey*,[7] *Pennsylvania v. New York*,[8] and *Delaware v. New York*.[9]

Those cases established bright-line priority rules regarding escheatment. Essentially, they divided the world of unclaimed property into two types: (i) property for which the holder has a last known address of the rightful owner on its books and records ("Address Property"), and (ii) property for which the holder does not have a last known address on its books and records ("Non-Address Property").

In *Texas v. New Jersey*, the Supreme Court established priority rules designed first to most likely reunite the unclaimed property with the rightful owner and then to provide holders with a bright-line rule to follow that avoids multistate liability with respect to the same amount. Pursuant to that case, Address Property first escheats to the state of the last known address on the books and records of the holder.

However, to provide a clear rule, the Supreme Court further provided that Non-Address Property should escheat to the state of corporate domicile of the holder.

In *Pennsylvania v. New York*, the Supreme Court re-affirmed the priority rules established in *Texas v. New Jersey* and further clarified that the corporate domicile of the holder was the holder's state of incorporation.

Finally, in *Delaware v. New York*, the U.S. Supreme Court once again affirmed both of the aforementioned positions. As less than 0.3 percent of the U.S. population resides in Delaware, Delaware receives, as you might expect, very little Address Property. However, as the primary jurisdiction of incorporation, Delaware generally receives an annual avalanche of Non-Address Property.[10]

Audits, VDAs and Annual Reports

Delaware imposes an annual reporting obligation upon holders of unclaimed property escheatable to Delaware. This report is due on March 1 of each year with respect to property that went dormant during the previous calendar year. Although somewhat counterintuitive, Delaware fares much better financially when holders have been noncompliant with their unclaimed property annual reporting.

Delaware has historically audited and asserted liability with respect to unclaimed property back to 1981. Just as a point of reference, the first space shuttle was launched in 1981, Joan Jett and the Blackhearts were huge, and I was in the seventh grade — it was like 16 Olympics ago.

As you might expect, when Delaware's auditor shows up to audit a Delaware-incorporated company and asks to see the business records showing uncashed checks back to 1981, it is highly unlikely that such records still exist. As a result, the corporation's ultimate liability to Delaware with respect to unclaimed property will be the product of estimation, statistical sampling, and extrapolation.

In the absence of records going back to the initial year that is the subject of the audit, Delaware's auditors will review whatever records of the company that can be produced. The auditors will use those records to calculate an "error rate" with respect to the various forms of unclaimed property — whether it is payroll, accounts payable, accounts receivable credits, unused gift cards, etc. — to calculate unclaimed property liability for the years with respect to which incomplete records exist.

Then, that error rate will be multiplied against a certain metric that may be available all the way back to the first audit year (such as total payroll, or gross income or total expenditures, etc.) to calculate unclaimed property, for each category of unclaimed property, for the years with respect to which complete records do not exist.

From the State of Delaware's point of view, the elegance of this method of calculating unclaimed property liability is that, as a matter of course, any liability which is determined by statistical sampling, estimation, and extrapolation does not have a specific "owner" to whom the actual liability is owed.

As there is no specific identified owner, there is, of course, no last-known address on the records of the holder of such nonexistent owner. As a result, all unclaimed property liability that is calculated by extrapolation is necessarily assumed by Delaware to be Non-Address Property to which Delaware, rather than another state, is entitled under the Supreme Court's prescribed priority rules.

Thus, the lack of annual unclaimed property compliance and lack of maintained books and records by Delaware-formed companies creates what some might call a windfall of unclaimed property revenues to Delaware.

Unclaimed liability to Delaware had been calculated by extrapolation and estimation for years, both by the state's auditors and by holders themselves despite there being no specific authority providing for this technique. It was not until the enactment of 77 Del. Laws ch. 417 in 2010 that the Delaware State Escheator received express statutory authority to require holders, where records are insufficient to calculate liability, to pay an amount that the State Escheator reasonably estimates to be due and owing based on the records that are available.

After Delaware's initial huge bite of the apple, it is likely to get very little from the same holder in the future on a year-to-year basis.

Needless to say, in pretty much every audit, what constitutes a "reasonable" estimation is a source of lively discussion.

To the extent that a company is not currently under audit by the Department of Finance with respect to unclaimed property, it may choose to enter into a voluntary disclosure agreement (a "VDA") with the Department of Finance and self-report its total outstanding Delaware unclaimed property liability. The first obvious benefit of filing a VDA is that a company is only subject to liability back to 1991 (rather than 1981 under an audit). Accordingly, a company may avoid 10 years of liability by filing a VDA before being audited by Delaware.

However, there is often much negotiation between the holder and the Department of Finance regarding the liability calculation, even in the VDA process, so the VDA filer and Delaware may not be able to reach an agreement regarding the amount owed. Thus, it is conceivable that a submitted VDA may ultimately become an audit or end up in litigation.

Although the ultimate Delaware unclaimed property liability will be determined by many factors, including the nature of the business, the size of the business, and the diligence and record-keeping policies of the company, six-, seven-, and even eight-figure liability determinations are probably more the rule than the exception.

However, after a Delaware-formed company initially resolves its liability from past years, whether pursuant to an audit or a VDA, with certain exceptions, it is unlikely to have a significant Delaware unclaimed property liability on an annual basis going forward.

Once a company goes through the Delaware unclaimed property process for the first time a couple of things tend to happen. First, they tend to be more diligent about tracking down unpaid creditors. Second, they tend to keep better and more detailed records. As a result, almost all future unclaimed property liability of a previously audited company will likely be Address Property rather than Non-Address Property.

As previously noted, Delaware represents less than 0.3 percent of the nation's population. Thus, its share of Address Property will be likely equally as minimal. So in that regard, after Delaware's initial huge bite of the apple, it is likely to get very little from the same holder in the future on a year-to-year basis.

Litigation Developments

There are none. Well, almost none (I exaggerated for literary effect). One of the more fascinating aspects of the Delaware unclaimed property history is that, despite the huge amounts at stake in nearly every case and the fact that almost always the liability of a holder is the product of arguable statistical sampling and extrapolation, the last two decades have seen almost no litigation regarding Delaware unclaimed property. For many years, no cases were even filed.

In the past four years, however, three cases were actually filed: *CA, Inc. v. Cordrey*,[12] *McKesson Corp. v. Cook*,[12] and *Staples, Inc. v. Cook*.[13] Nonetheless, in each of these cases, a settlement was reached before an ultimate decision on the merits.

Accordingly, the "law" constituting Delaware unclaimed property law, generally speaking, remains the statutory provisions appearing in Chapter 11 of Title 12 of the Delaware Code, as well as the somewhat minimal regulations promulgated by the Delaware Department of Finance.[14]

Where Have All the Years Gone?

As previously mentioned, in the case of a company that has never filed an annual Report of Unclaimed Property, Delaware has consistently audited with respect to years back to 1981. In other words, property that normally would have been first reportable to Delaware after 1986 is subject to the audit. To the extent that an entity entered into a VDA, such entity would only be subject to potential liability back to 1991 (*i.e.*, property that normally would have been first reportable to Delaware after 1996).

Thus, by participating in the Department of Finance VDA program (assuming that such entity can reach an agreement with Delaware with respect to such post-1996 liability), an entity might save itself 10 years of liability.

Even as the years have passed, however, the liability years comprising the Delaware audit process (back to 1981) and the Delaware VDA program (back to 1991) have remained the same. As one might imagine, the companies that might be subject to a Delaware unclaimed property audit are increasingly more likely to have been created after 1981, and perhaps even after 1991.

Thus, it is more and more likely that a particular company will receive less than the full ten-year benefit of participating in the VDA process. In the case of a company created after 1991, such a company would be liable for the same amount of years under the VDA process as if it merely remained noncompliant and waited for Delaware to audit.[15]

Another interesting development is that, while Delaware's unclaimed property revenues were a robust $427.9 million for fiscal year 2011, as of June 2012 DEFAC was projecting they would drop by over 25 percent to $318 million for fiscal year 2012.

Perhaps to address the potentially declining benefit of participating in the Department of Finance VDA program in 2012 and most certainly to attempt to reverse Delaware's declining 2012 unclaimed property revenues, Delaware enacted 78 Del. Laws ch. 317 (signed by Governor Markell on July 11, 2012). That act established an alternative voluntary disclosure program ("New VDA") to be administered by the Office of the Secretary of State rather than the Department of Finance.

Under the New VDA program, (i) if a holder files an intent to enter into a New VDA with the Office of the Secretary of State by June 30, 2013, and resolves its liability with Delaware by June 30, 2014, such holder will only be liable for Delaware unclaimed property for years back to 1996 (an additional five-year reduction); or (ii) if a holder files an intent to enter into a New VDA with the Office of the Secretary of State by June 30, 2014, and resolves its liability with Delaware by June 30, 2015, such holder will only be liable for Delaware unclaimed property liability for years back to 1993 (an additional two-year reduction).

Thus, if non-compliant holders act fast they can potentially save an additional five years of liability. To provide some fairness to entities that were already in the Department of Finance VDA process when 78 Del. Laws ch. 317 was enacted, the act provides the same additional five-year (or two-year) reduction benefit to such entities, assuming that the entity meets the same liability resolution deadlines.

As of now the Office of the Secretary of State's authority to accept written intents to file a New VDA expires on June 30, 2014. A week before the Governor had even signed 78 Del. Laws ch. 317, the Office of the Secretary of State issued a Request For Proposals to engage someone to administer the program on behalf of that office, with submissions due on July 19, 2012.

In September 2012, the law firm of Drinker Biddle and Reath LLP was selected by Delaware Secretary of State Jeffrey Bullock to administer the program. More information on the New VDA program and how it differs from the current audit and VDA process administered by the Department of Finance recently became available at www.DelawareVDA.com.

Finally, in addition to the potentially fewer years of liability under both the New VDA program and the existing Department of Finance VDA program, on November 1, 2012, the Delaware Department of Finance promulgated final regulations that move the first year for potential liability with respect to a company under Delaware unclaimed property audit from 1981 to 1986 temporarily. In other words, the proposed regulations offer a parallel five-year benefit for companies currently under Delaware audit.[16]

This potentially shortened audit period would be in effect contemporaneous with the New VDA program operated by the Office of the Secretary of the State.

Conclusion

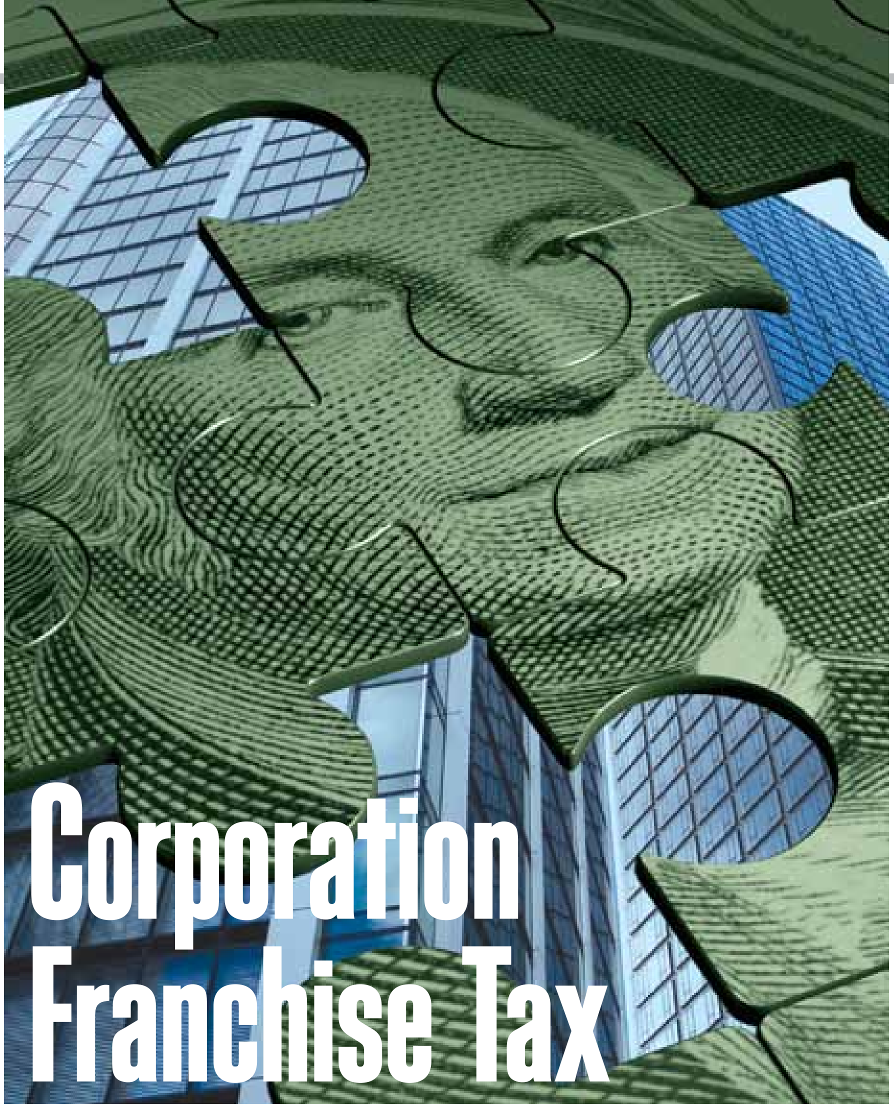
For more than a decade and a half Delaware has received the benefit of unclaimed property revenues in the form of Non-Address Property. Time will tell whether fiscal year 2012 was a one-year blip in the volume of these revenues or whether it indicates that the number of large noncompliant companies left for Delaware to audit is ever diminishing.

During June 2012, when the new act had not been finalized but was anticipated to pass, DEFAC was already estimating that unclaimed property revenues would jump to $566.5 million in fiscal year 2013 and would remain at $514 million for fiscal year 2014.

Perhaps 78 Del. Laws ch. 317 will entice a cache of currently noncompliant companies to voluntarily calculate and remit Delaware unclaimed property under the New VDA, or perhaps the New VDA program will merely cannibalize the existing Department of Finance VDA and audit programs. ◆

FOOTNOTES:
See Unclaimed Property on page 25

Rick Geisenberger



The Delaware Corporation Franchise Tax

Companies from around the world make Delaware their legal home — and deliver a steady stream of revenue to the state.

In 2003, *Sports Illustrated* celebrated its 50th anniversary by having sportswriters visit each of the 50 states to highlight an athletic event. In his article "Worth Clucking About," Jeff Pearlman joked that Delawareans are crazy about their UD Fighting Blue Hens football team because otherwise Delaware is "known worldwide for, ahem . . . , almost nothing."

I immediately fired off a letter reminding his editor that Delaware is known world-wide as the Corporate Capital of the United States. And I invited Mr. Pearlman to "come home more often" since his parent and publisher — Time, Inc. — is domiciled right here in Delaware.

Take a leisurely stroll down Wilmington's Market Street or Rehoboth Avenue and ask locals to name Delaware's top institutions; they might say Joe Biden, DuPont or Grotto's Pizza.

Ask lawyers, corporate executives and money managers from New York to London to Hong Kong and they'll say Delaware's corporate law. Delaware corporations are a globally recognized brand, contributing thousands of jobs and generating billions of dollars for the State's economy.

Delaware has many things to cluck about — but perhaps none as unique as the State's corporate franchise. The State enacted its General Corporation Law (the "DGCL") in 1899, and today 64 percent of Fortune 500 companies and 55 percent of businesses listed on the New York and NASDAQ stock exchanges have their legal home in Delaware.

There are more legal entities (980,000) in Delaware than residents (905,000), and over the last decade more than 75 percent of new U.S. initial public offerings were of Delaware corporations.

Businesses around the world choose Delaware as their legal home for four reasons. First, the DGCL is widely regarded as the most advanced and flexible business formation statute in the nation. Second, our Court of Chancery is a unique, centuries-old business court that, along with the Delaware Supreme Court, has authored most of the modern U.S. corporate case law.

Third, Delaware's legal services community has unparalleled expertise in the application of Delaware's business statutes and receives strong, bi-partisan support from Delaware's elected leaders in their efforts to continuously improve the State's laws.

Finally, the Delaware Division of Corporations provides prompt, friendly and professional service to customers and strives to continually improve services based on customer feedback.

In exchange for providing a fair, efficient and predictable corporate legal system, companies pay a variety of fees and taxes to the State. In fiscal year 2012, the Delaware Division of Corporations collected $870 million — approximately 25 percent of the state government's general fund revenue. These revenues include annual taxes paid by Delaware corporations, limited liability companies and limited partnerships, as well as fees for filings, certifications, searches, copies and other services.

A Brief History of the Corporation Franchise Tax

The largest single source of revenue is Delaware's Corporation Franchise Tax. Over 113 years, there have been only 14 changes to the tax. This remarkable stability is perhaps owing to the fact that our State Constitution requires a two-thirds vote of both houses of the General Assembly to amend the DGCL.

From 1899 through 1936, the structure of the franchise tax went through several iterations. Initially, the tax was assessed on the par value of shares issued and outstanding and later on the amount of authorized capital stock. In 1927, the State began assessing the number of authorized shares.

A 1937 amendment to the DGCL created the modern structure of the franchise tax that we know today — a structure that has stood the test of time for 75 years. Corporations with a few shares pay a minimum tax; corporations with more than 10,000 shares pay a tax on every 10,000 shares; and no corporation pays above a maximum tax.

Corporations are also eligible to use an alternative tax basis called the assumed par value capital method. This method generally establishes a company's franchise tax based on the product of the company's assets and the ratio of its authorized to issued shares.

While the basic structure of the franchise tax has remained unchanged since 1937, tax rates have increased nine times — an average of once every 8.3 years. In 1937, the minimum tax for a corporation was $5. Today, the minimum tax is $75. In 1937, the multiplier for every 10,000 shares was $27.50. Today, it is $75.

The tax rate in 1937 for each $1,000,000 of taxable gross assets under the assumed par value capital method — the so-called "gross asset multiplier" — was $100. Today, it is $350. In 1937, the franchise tax topped out at $25,000. Today, the maximum tax is $180,000.

When Is a Tax Not a Tax?

When is a tax not a tax? When it's the Delaware corporation franchise tax. While the governing statute is replete with the language of taxation, including tax exemptions, penalties and interest, 8 *Del. C.* § 501(a) requires that corporations "shall pay an annual tax, for the use of the State, by way of license for the corporate franchise as prescribed in this chapter."

In *State v. Surety Corp. of America* in 1932, Chancellor Josiah Wolcott cited a New Jersey case to assert that Delaware's franchise tax, in fact, is "not, strictly speaking, a tax at all, nor has it the elements of one. It is in reality an arbitrary imposition laid upon the corporation, without regard to the value of its property or of its franchises, and without regard to whether it exercises the latter or not, solely as a condition of its continued existence." [1]

And so the Court has spoken — the franchise tax is not a tax. It's a license fee for the privilege of using Delaware's corporate laws.

Admittedly, "tax versus fee" is a distinction without a difference to the average franchise taxpayer. But it does shed light on how Delaware policymakers have historically administered and amended the levy for generations.

Academics who have studied the franchise tax have often suggested that Delaware's corporate franchise tax could be or should be significantly higher — at least relative to the valuations of some of the largest companies incorporated here.[2] But Delaware has never taken this approach in setting the tax rate.

Viewing through a "licensing fee" lens, policymakers focus not on the value of the corporation but on the value of Delaware's laws to the corporation. There is no clear correlation between a company's revenues, profits or market capitalization and the value it realizes from the use of the State's laws.

A closely held company worth billions may realize less value from Delaware law than a widely held company worth far less, so franchise tax rates are applied against the number of authorized shares. The assumed par value capital method was created to help reduce the burden on smaller companies that may authorize excess shares for other purposes.

Owners and managers have choices on where to incorporate, and companies with one or only a few shareholders may be less likely to make extensive use of the State's laws. So the minimum franchise tax is a very competitive $75.

Likewise, since no group of shareholders would willingly pay an unlimited premium for Delaware law, the State maintains a maximum tax.

Finally, policymakers want to avoid volatility and cyclicality. A tax based on authorized shares or assets — variables that can be controlled by corporate managers — is inherently more efficient, fair and predictable — and less volatile and cyclical — than one based on revenues, profits or capitalizations.

Indeed, for the last 40 years, Delaware has been successful at promoting moderate growth in incorporation revenues while steadily reducing the volatility of this important revenue source for the State.

The "Onshore Tax Haven" Myth

Delaware's maximum franchise tax is the highest in the nation — one that corporations have been willing to pay for the value derived from Delaware's highly regarded business laws, courts and services. To paraphrase Chancellor Leo Strine, Jr., Delaware is Bergdorf Goodman and not the Dollar Store.

So what accounts for the splashy *New York Times* article that recently suggested that Delaware is a new-found corporate tax haven with secrecy laws rivaling the Cayman Islands?[3] The article posits that Delaware has succeeded by allowing corporations to minimize taxes and wrongdoers to hide their activities.

The facts tell a very different story: Delaware is one of 45 states with a corporate income tax. Each state's tax code provides certain deductions, exemptions and credits. Delaware's corporate income tax exempts firms that derive all of their income from passive economic activity such as licensing of intangible assets.[4] This exemption helps the State attract multi-state enterprises to locate operations in Delaware. Less than 1 percent of Delaware legal entities are Delaware holding companies.

While the income of a Delaware holding company in Delaware is exempt from taxation, expenses incurred by a Delaware holding company don't automatically qualify for tax deductions. Why? Because 23 U.S. states use a "combined reporting" tax system that blocks multi-state corporations from shifting income from high-tax states to low- or no-tax states.

Other states have regulatory "addback" authority to disallow certain tax deductions for intercompany transactions designed to avoid paying taxes.

What accounts for the splashy New York Times article that recently suggested that Delaware is a new-found corporate tax haven with secrecy laws rivaling the Cayman Islands?

Some high-tax states have simply chosen to not implement combined reporting or use their add-back authority.

The truth is that it's much easier for politicians in those states to attack Delaware rather than confront the negative economic consequences of eliminating allowable tax deductions in their own states.

It is true that some financial-crime watchdogs accuse the United States of being a tax haven due to the way the federal government treats U.S. corporate income that is generated outside our country by non-U.S. citizens. But this is a function of U.S. tax law and has nothing to do with any state tax or corporate laws.

As for the secrecy allegations, *no* states collect the names of beneficial owners — the individuals that own, control or derive benefits from a company. For corporations, Delaware and the majority of states require disclosure of the names of natural persons who serve as corporate directors. Many states require the disclosure of members or managers of an LLC. But frequently the members or managers identified are other legal entities and not individuals. So Delaware has actually taken a better — and more transparent — approach by requiring a direct contact person designated to represent each LLC.

Regrettably, financial criminals do use the U.S. to launder money. The keys to policing international tax evasion and money laundering are both strong enforcement by the U.S. Treasury Department and other competent federal law enforcement agencies of existing anti-money-laundering laws for U.S. financial institutions and strengthened anti-money-laundering enforcement in countries with weak financial regulatory systems.

But the legislation noted in the *Times* article, Sen. Carl Levin's Incorporation Transparency and Law Enforcement Assistance Act,[5] is a bureaucratic nightmare for states and would do nothing to stop criminals from falsifying information. The *Times* also inaccurately reported that the proposed bill exempts mom-and-pop businesses and failed to report that it would create significant new reporting, identification and disclosure requirements for entrepreneurs and investors.

It's important to note that the federal government already collects beneficial ownership information from businesses and investors when they apply for a tax identification number, file tax returns, open a U.S. bank account and file Foreign Bank and Financial Account (FBAR) and Foreign Account Tax Compliance Act (FATCA) reports of any overseas banking or investment accounts.

A better approach may be to strengthen these controls. For example, the federal government could require U.S. legal entities to secure a federal tax identification number. Law enforcement would then be able to access beneficial owner information subject to substantial protections for financial privacy rights, rather than requiring 50 new systems for collecting, holding and accessing this information.

In the meantime, the Delaware General Assembly, Delaware State Bar Association and Secretary of State's Office are working aggressively to do our part. In 2002, Delaware became the first state in the nation to statutorily ban the sale of bearer shares. In 2006, Delaware became the only state in the nation that requires companies to provide a direct contact person — providing law enforcement with a way to access the name of a natural person representing every company.

In 2006, Delaware enacted a first-in-the-nation Commercial Registered Agent statute covering company-formation agents under a limited form of regulation empowering the State to police deceptive or fraudulent practices.[6]

And this year, Delaware's Secretary of State adopted listing standards that cracked down on company formation agents that market "shell and shelf companies" or "anonymity and secrecy." In the years ahead, Delaware will continue to support practical and meaningful efforts to deter illegal activity.

The Future of the Delaware Franchise Tax

The corporate franchise tax has stood the test of time, but rate adjustments are inevitable. For example, the trend of adjusting the maximum tax periodically and more closely aligning the minimum franchise tax with alternative entity tax rates is likely to continue.

Alternative entity taxes are also an area of interest for policymakers. Widespread adoption of alternative entities as a preferred business form has profoundly affected the State's incorporation industry. Fewer than 25 percent of all new legal entities formed in Delaware are corporations.[7] The total number of Delaware corporations peaked at 318,000 in 2000 and today stands at just 260,000.

Meanwhile, the number of alternative entities formed in Delaware has grown to 720,000. Yet alternative entities account for less than 25 percent of Delaware's incorporation-related revenues.

Years ago, nobody would have predicted the scores of publicly traded limited partnerships and LLCs listed on U.S. stock exchanges. The value they derive from the use of Delaware laws is similar to that for widely held corporations. Increasingly, LLCs are the preferred vehicle for multi-billion dollar transactions with complex ownership structures — again deriving considerable value from the use of Delaware's sophisticated laws and courts.

Lawmakers fine-tuned the structure of the corporate franchise tax in its infancy, and it may be time to do the same for alternative entity taxes, and sooner rather than later.

Delaware policymakers understand, however, that any changes in our corporate law are a big deal. This much is certain — any future proposals to change tax rates or structures will be deliberated carefully and fully vetted with the goal of maintaining a tax system that is fair, predictable and efficient.

A Final Word

No article about the franchise tax would be complete without recognizing the dedicated professionals who work in the Division of Corporation's franchise tax section. The emails I receive regularly from taxpayers testify to their courtesy, efficiency and integrity.

Eileen Simpson, "Delaware's Friendly Franchise Tax Administrator," led the group for 21 years before her retirement earlier this year. While Delaware's corporate franchise is global, our corporate legal community is small and the work of each individual makes a big difference. This article is dedicated to Eileen Simpson, who made immeasurable contributions throughout her career to maintaining Delaware's reputation for service and excellence. ◆

FOOTNOTES

1. 162 A. 852, 855 (Del. Ch. 1932).

2. *See* Michael Barzuza, *Delaware's Compensation*, 94 Va. L. Rev. 521 (2008); Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 Cornell L. Rev. 1205 (2001).

3. Leslie Wayne, *To Delaware, With Love*, N.Y. Times, June 30, 2012, at BU1.

4. 30 *Del. C.* § 1902(b)(8).

5. S. 1483, 112th Cong. (2012).

6. 8 *Del. C.* § 132.

7. http://finance.delaware.gov/defac/june2012/revenues.pdf.

FEATURE

Mark DiMaio

Revenue Sources, Revenue Threats

As the national and state economies have changed, Delaware has proved nimble in finding new ways to generate government funding.

For years, Delaware flourished from a fantastic revenue ride fueled by a series of industries that provided good jobs and substantial economic development. What could go wrong?

The Old Three C's: Chemicals, Cars and Courts

As the DuPont Company embarks on its third century as Delaware's most important employer, times have changed. Growing up in Delaware everyone knew someone who worked for Uncle Dupey — usually until retirement.

DuPont remains a great company but corporate restructuring has produced a leaner, more focused DuPont. Gone are numerous facilities across Delaware and employment exceeding 25,000. DuPont, along with other chemical giants such as ICI and Hercules (now Ashland), provided steady revenue through corporate taxes, gross receipt taxes and personal income taxes. The industry's revenue stream remains important, but not to the same extent as 50 years ago.

The once-mighty Delaware auto industry is all but gone. Chrysler and GM had tremendous runs after World War II, providing thousands of great-paying jobs and generating tens of millions in tax revenue annually. Through the early 1980s, a high school graduate could get training and land an auto plant job.

Then the automobile industry became more globalized and buyers had more car choices. The GM and Chrysler plants produced solid products but factors beyond Delaware's influence ended their runs. Recently, Fisker Automotive offered a ray of hope to renew the State's revenue stream by reopening the shuttered GM plant. Now they don't look ready to build cars anytime soon.

Everyone wanted Fisker to be successful. Could Delaware attract another foreign car manufacturer? Maybe, but established foreign manufacturers seem to favor states with large tax breaks and right-to-work laws. Could Delaware's new slogan be "Our GM plant is dead and Fisker is barely alive?"

I'll discuss the courts later on.

The Newer Three C's: Credit Cards, Casinos and the Courts

MBNA/Bank of America, First USA/Bank One/Chase Cards Services and others came to Delaware at the perfect time. Delaware had the foresight and good luck to eliminate the cap on credit card interest rates cards before other states in the Financial Center Development Act of 1981.

The migration of credit card issuers to Delaware fueled a two-decade-plus economic boom. Banks provided high-paying jobs to recent college graduates as well as displaced workers from other fields. Love them or hate them, the banks remain a key player in Delaware's economic future.

Industry consolidation and the call for the removal of federal preemption laws have created a less certain time for the banking and credit card industry. The governor's FY 2013 budget estimated that $112.5 would be collected in bank franchise taxes.[1]

Video lottery casinos have contributed more than $2 billion to the state's General Fund since December 1995.[2] Thank you Richard Forsten and others for crafting Delaware's Video Lottery Act. Casinos provide a mature and steady revenue source that has far exceeded the state's original revenue forecast.

Delaware launched the video lottery to save the horse racing industry, provide jobs and extract tax revenue. Mission accomplished. And the best part was that most of the gamblers came from out of state.

After a decade of watching their citizens travel to Delaware racetrack casinos, Maryland and Pennsylvania jumped into the gambling game to keep their gamblers closer to home and collect their voluntary taxes. Delaware's 2008 General Fund Revenue Report recognized this and predicted that competition from other states would pressure Delaware's revenues.

Casino tax revenue remains a major revenue source, but Delaware's share of the regional gaming pie is not likely to increase. The easiest way for Delaware to increase tax revenue is to increase its share of the video lottery net proceeds. A debate continues whether additional Delaware casinos would generate significant tax revenue beyond new licensing fees. While that debate continues, casinos are a reduced revenue source.

Once known as the "Chemical Capital of the World," Wilmington is now widely regarded as the "Corporation Capital of the World." Delaware is the corporate home to more than 50 percent of U.S. publicly traded companies and more than 60 percent of the Fortune 500.

For the ninth consecutive year, the Delaware courts are rated number one in the nation according to a U.S. Chamber of Commerce Survey.[3] The national business community appreciates the Delaware courts and recognizes their impartiality, timeliness of decisions and competence. In contrast, the same survey rated the Philadelphia courts as one of the nation's five worst.

Law schools host conferences dedicated to Delaware law. A Columbia Law School conference this past spring, drawing more than 300 professors, litigators and counselors in corporate and securities law, focused specifically on the Court of Chancery and examined such topics as the Court's competitors and the Court's future. That's a lot of otherwise billable time spent at a day-long conference on Delaware's courts.[4]

So Delaware's courts are heralded as the nation's premier business courts, which is great for the State. But not everyone is happy with Delaware's position as the premier Incorporation State. Some believe that Delaware provides too much protection for corporations, especially with the large number of corporate scandals involving shareholders' rights and executive compensation.

It's no wonder Senator Charles Schumer (D-NY) has been pushing for large public corporations to be federally registered, with a federal "say on pay" and other corporate governance issues.

Our congressional delegation with likely help from Vice President Biden has done a fantastic job fighting the one-size-fits-all approach to corporate governance and maintaining the state's traditional ability to provide a corporate law system. The Delaware Courts vs. the Federal Courts issue has been studied and debated for years and it appears that the status quo will remain in place for the foreseeable future. The Delaware Economic and Financial Advisory Council (DEFAC) estimates the Franchise Tax and Limited Partnership/Limited Liability Company tax will generate $769.8 in revenues for FY 2013.[5]

That's great news for Delaware. We'll just keep adding corporation names on our doors.

Delaware's court system and the corporations that incorporate here provide another benefit to Delaware's revenues: abandoned property. The State's abandoned property collections exploded from $71 million in FY 1997 to $364.9 million in FY 2007.[6] This now accounts for about 11 percent of Delaware's total revenues. This windfall revenue is inherently volatile. It's like having a very rich relative who seems likely to die every year, but you don't know which one or how much inheritance you'll receive.

DEFAC estimates for FY 2013 suggest that abandoned property could generate up to a whopping $566 million in revenues. Together, abandoned property and franchise taxes are estimated to deliver $1.331 billion to the State's coffers. That's around a third of DEFAC's projected FY 2013 revenues.[7]

Why Worry, What's at Stake?

Delaware's tax revenues have transitioned from an industrial base to a corporate/banking base. The tax revenues from corporate income, bank franchise and gross receipts taxes seem to be stable. Personal income tax collections should increase as the economy improves. The status quo is great, but how long can it last?

Delaware taxpayers have greatly benefited from a Supreme Court decision, a Chancery Court that started a few hundred years ago, and elected officials who have created revenues streams with bank franchise tax and casinos. Is there any more low-hanging revenue fruit? I don't think so, and the Delaware General Fund Revenue Portfolio, February 2008 report didn't have any revolutionary ideas.

Would it have been blasphemy for the report to discuss a state sales tax or property reassessments as potential revenue sources? What could hasten ending Delaware's "exported tax burden?"

Who cares about Delaware's three electoral votes? We've become a solid blue state and we get some extra attention from Vice President Biden. But really, the three electoral votes are not that important in the overall general election. We do get two votes in the Senate and that's important in a Democratic-controlled Senate.

But what about when we have neither V.P. Biden nor a Democratic Senate? Could Delaware block changes to federal legislation that could adversely affect its court system? Could legislation against Delaware's interest be traded to satisfy another state's needs or wants? Could there be payback for blocking the interest of other states? A possible dispute with Pennsylvania over natural gas fracking and the LNG dispute with New Jersey come to mind.

Are we just another national corporate debacle away from more cries for federalizing corporate governance? Politics is an ugly business and it's not easy to maintain Delaware's perfect batting average.

What if Delaware loses some of its luster for business incorporation?

Governor Jack Markell has done a fantastic job bringing corporations to Delaware. His corporate background and business acumen are important tools in recruiting companies, especially in difficult economic times. With his re-election accomplished, I would expect him to continue bringing companies to Delaware. So we're good on that front for the next four years.

But in 2016, who will be elected the next governor? One could persuasively argue that Delaware did fine attracting business before Markell. Democrats have a strong bench of qualified gubernatorial candidates, and Republicans will likely field a pro-business candidate, but the odds are the governor taking office in 2017 will have limited business/private sector experience.

Will this hinder the Governor in attracting businesses? I don't know, but the Delaware General Assembly's attitude toward taxes and revenue over the next four years could be a factor. With the seasoned assembly leadership departing in 2012, the new Senate and House Democratic leadership will likely have a more progressive membership.

How will the General Assembly address any short-term revenue needs? Democrats have maintained a 3/5 majority in both chambers. Therefore, the constitutional requirement of a 3/5 majority vote in both houses to increase or enact new taxes may not be a strong selling point to attract new business.[8] Time will tell.

A delicate balance exists regarding increasing taxes and fees and maintaining Delaware's image as great place to locate and incorporate. Over the years, the General Assembly has been fair in spreading tax increases around and has taken steps to roll back some increases when Delaware's economy improved. With a state sales tax a non-starter and little appetite to raise the personal income tax, it is likely that businesses will bear the cost when new revenue is needed.

The legislature is really left with few choices because business revenue sources, like the gross receipt tax, are the most reliable revenue generators.[9] Would an increased business tax burden make Delaware less attractive to businesses? The 2008 Delaware General Fund Revenue Portfolio Report suggests hefty business tax hikes could hurt Delaware's competitive position.[10]

So, slightly increasing the business tax burden in tough times may not hurt Delaware's business climate. If the external perception is that reaching the 3/5 vote needed to raise taxes is not a huge hurdle, it may become a factor when recruiting new companies or maintaining existing companies.

Perception is an interesting thing. It's sometimes hard to measure and changes can be hard to detect. The Delaware Supreme Court's recent approval of a $304-million award in attorney's fees[11] has caused observers to wonder if the decision was a signal to the plaintiffs' bar that they will be rewarded for bringing successful actions in Delaware.

Big numbers generate interest, in and outside the state. Do such cases generate significant state tax revenue? If so, in what direct or indirect ways? Could legislative tweaks bring more large cases to Delaware? How much tweaking would be needed to change the perception of Delaware as an "incorporation friendly" state?

External pressures will not go away. Maybe not in the near future, but some of Delaware's exported taxes could be erased with the stroke of a President's pen. That would create a giant hole in state revenues. Delaware collected $759.7 million from the franchise and limited partnership taxes, abandoned property collections chipped in $427.9 million, and the bank franchise tax added another $119.7 million in FY 2011. These revenue items accounted for 37 percent of Delaware's revenues collected.[12]

Hopefully, Delaware will keep the delicate balance of generating revenues and maintaining a positive business climate. If that perception changes, it's very difficult to reverse. Just look at some folks' perception of Delaware's public schools versus southeastern Pennsylvania public schools. ◆

FOOTNOTES

1. Governor's Budget Financial Summary and Charts for FY 2013, at 2.

2. Delaware Lottery Web Site, http://www.delottery.com/wherethe.asp#mission.

3. *Lawsuit Climate 2012: Ranking the State (September 2012)* - The U.S. Chamber of Commerce's Institute for Legal Reform.

4. Columbia Law School Magazine, Spring 2012 issue.

5. Minutes of the Delaware Economic & Financial Council, June 15, 2012 Revenue Worksheet, at 13.

6. Delaware's General Fund Revenue Portfolio, February 2008, at 8.

7. Minutes of the Delaware Economic & Financial Council, June 15, 2012 Revenue Worksheet, at 13.

8. Delaware Economic Development Office's Data Book (update May 2012), at 5.

9. Delaware's General Fund Revenue Portfolio, February 2008, at 7.

10. Delaware's General Fund Revenue Portfolio, February 2008, at 49, 55.

11. *Americas Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012), *aff'g In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 30 A.3d 60 (Del. Ch. 2011).

12. Minutes of the Delaware Economic & Financial Council, June 15, 2012 Revenue Worksheet, at 13.

Unclaimed Property FOOTNOTES *(continued from page 17)*

FOOTNOTES

1. *See* corp.delaware.gov.

2. The fiscal year of the State of Delaware runs from July 1 to the following June 30.

3. The author promises that if you send him a check, he will cash it. Guaranteed.

4. Whether the state or the holder bears the burden of proof on ownership (or lack thereof) has not yet been substantively challenged in Delaware.

5. Randall Chase, *Delaware Among States Eyeing Unclaimed Property*, Associated Press, Nov. 24, 2010.

6. Delaware, for example, does not keep a separate unclaimed-property fund or account. Rather, amounts remitted to Delaware as unclaimed property are deposited in the General Fund. *See* 12 *Del. C.* § 1205.

7. 379 U.S. 674 (1965).

8. 107 U.S. 206 (1972).

9. 507 U.S. 490 (1993).

10. In addition, Delaware also consistently takes the position that it is entitled to foreign Address Property. I presume that this is based on the position that the U.S. Supreme Court decisions were only resolving disputes among the states, and logically no state could have a higher claim to foreign Address Property.

11. C.A. No. 4111-CC (Del. Ch. Oct. 28, 2008).

12. C.A. No. 4920-CC (Del. Ch. Sept. 25, 2009).

13. C.A. No. 5447-CS (Del. Ch. Apr. 30, 2010).

14. As of the writing of this article there is a case currently pending before the Delaware Superior Court relating, at least tangentially, to Delaware unclaimed property. In *State ex. rel. Higgins v. Sourcegas, LLC,* C.A. No. N11C-07-193 MMJ CCLD (Del. Super. Ct.), a terminated former employee of a Delaware-formed entity filed a private action in the Delaware Superior Court asserting that the failure of his former employer to correctly remit its Delaware unclaimed property to the state constituted a violation of the Delaware False Claims Act (6 *Del. C.* § 1201 *et. seq.*). The State of Delaware intervened in the action.

15. One additional benefit of participating in the VDA process, however, is the express elimination of potential interest and penalty.

16. 16 Del. Reg. 530 (Nov. 2012).

Jack B. Jacobs

Bruce M. Stargatt: A Delaware Legacy

In July of this year, Bruce M. Stargatt, one of the remaining few of the Great Generation of Delaware Lawyers, left us all too soon. Over five decades as a premier Delaware lawyer, Bruce accumulated many well-deserved honors. To name a few: the First State Distinguished Service Award, the American Judicature Society Herbert Harley Award, and, most recently, the Order of the First State, which is the highest honor the Governor of Delaware may bestow.

His career demonstrated a strong commitment to public service. Over the years, Bruce served as President of the Delaware State Bar Association; as President of the American Bar Foundation; as a Fellow of the American Bar Association and of the American College of Trial Lawyers; as a Member of the American Law Institute and the Board of Governors of the American Bar Association; and as President of Congregation Beth Shalom.

While these honors may portray something of the public Bruce Stargatt, they reveal very little about his private person. The Editor of this publication invited me to fill in that portrait, but candidly I am inadequate to the task. Bruce was a multidimensional human being, not easily summarized in a few pages. Moreover, my 17-year professional association with him, first as his associate and then as his law partner, ended when I became a judge in 1985.

For these reasons, a fully developed portrait of Bruce Stargatt the person must await completion by others. That said, I can fill in some segments and do have a perspective to share, since Bruce Stargatt was a valued mentor who profoundly influenced my legal career.

To say that being Bruce's student was an unmitigated pleasure would be misleading. No one is born knowing how to be a lawyer. To learn that craft,

particularly at the highest level at which Bruce uncompromisingly performed, took years of hard, and sometimes anxious, work. No novice tutoring under a master craftsman who refused to tolerate any performance below the most exacting standard can navigate such an experience without some emotional scars and sleepless nights.

Was the experience worthwhile? For me, absolutely. In an era where the practice of law is becoming commoditized, our profession's most valuable, yet scarcest, resource is quality mentoring. As a mentor, Bruce Stargatt was world class. Without his tutelage I would never have made it beyond the starting gate. I daresay that others who were similarly privileged to have been Bruce's mentees, if asked, would nod their heads in agreement.

What are those qualities for which Bruce achieved such acclaim? Space limitations permit me to highlight only three. First, he fully grasped and wielded the power of words, whether expressed orally or in writing, as a tool to protect his clients' legal rights. This observation may seem banal, yet it is anything but.

Bruce could express in one short sentence a complex thought for which other lawyers required at least a page. The logical and emotional power of that thought, when combined into a paragraph with two or three other such sentences, elevated the banal into an art form that was impossible to put down. I say this with authority, since practically every brief I drafted for Bruce was reduced page-wise by 80 percent.

Nor was Bruce, as a mentor, one for meandering conversation. When my discussions with him about a law-related subject went over three minutes, he would say "talk fast, I have an appointment." Chastening experiences of this kind taught me the importance of getting to the point — and quickly — a skill that has served me (and my suffering law clerks) well during my time on the bench.

In fairness I must add that, when not wearing his lawyer's hat, Bruce was a warm and empathetic person. His mischievous smile and wry sense of humor, and concern for his colleagues, were legendary.

That brings me to the second quality that Bruce personified — integrity. He had a moral compass that led him always to say and do the right thing. By that I do not mean choosing whatever unconstrained course of action that might ultimately prove successful for the client — although his choices most often did. By "the right thing" I mean what was ethically and humanly right.

As an advocate before a Delaware court, Bruce would never fudge or shade any facts that were unfavorable to his position. He would quickly disclose them and then argue why, nonetheless, his client was legally entitled to win. That kind of advocate is a judge's dream, and is why Delaware judges uniformly would echo: "Whatever Bruce Stargatt says, you can bank on it."

If a client's case did not contain that "little patch of hard ground" upon which Bruce could stand, then he would either not take the case, or would refuse to make the argument that could not pass the blush test — despite any entreaties of out-of-town counsel.

That lesson struck home whenever I recalled my own experience. On one occasion I wrote an opening brief in an appeal that, in hindsight, I should never have taken. The answering brief tore my argument to shreds. I went to Bruce and asked what I should do in response to a brief that demolished my argument. His answer, to my chagrin, was "Don't make a demolishable argument." I never again did.

The third (but hardly the last) of Bruce's signature qualities was civility. In the courtroom he was an indefatigable and hard-hitting advocate, but he would never treat or refer to opposing counsel in anything but the most respectful manner. Disagreements were always about issues and legal positions, not a lawyer's personality or character.

> Delaware judges uniformly would echo: "Whatever Bruce Stargatt says, you can bank on it."

That same ethos carried over into the law office. Letter battles, often vituperative, between lawyers in cases where the stakes are high have lamentably become frequent. I recall no case, however, where Bruce permitted his correspondence to descend below the proper level of civility.

Much more could and should be told, but that must be done by others. What I have described so briefly here is Bruce Stargatt's legacy — his addition to the pantheon of legendary members of the Delaware Bar.

For the "Great Generation" of Delaware lawyers whose words and deeds were celebrated in an earlier edition of this publication,[1] Bruce's professional standards would not have been viewed as remarkable. Like breathing out and breathing in, they were simply expected of any member of the Delaware Bar.

May that always be so for every next generation. As part of that "Great Generation," and wherever he may currently reside, Bruce will always walk with the best of them. ◆

FOOTNOTES

1. *See The Delaware Bar Salutes A Great Generation*, Del. Law., Winter 2001. A lead article, *"Reminiscences,"* was authored by Bruce Stargatt.

Chuck Durante

OF COUNSEL: Thomas P. Sweeney

Tom Sweeney has adapted to retirement in a way consistent with his lifetime of intense work and professional leadership.

Over 40 years at Richards Layton & Finger, Thomas P. Sweeney built a tax, estates and trust department from scratch to national repute with prodigious work habits and an uncanny eye for detail. He helped steer the firm for years, eventually serving as its president — at the same time that he was president of the American College of Trust and Estate Counsel, the leading professional society for probate lawyers.

"I never asked anyone to work harder than I worked myself," says Sweeney, who would be the earliest to arrive in the office, even after attending Mass daily. For years, his schedule included running before church. Yet, he never let his work overtake him. He left the office on schedule — by 6 on evenings, 1 on Saturdays. His homework was comparable to what his children were doing at Ursuline and Salesianum, but it was done at home.

His practice covered much terrain; the span of his expertise was uncommonly broad. Yet, he overcame the blizzard of detail to become one of the most influential Delawareans whom the general public didn't hear about. He served on the executive committee of the board of Wilmington Trust as it vaulted from regional bank to national prominence. A trusted confidant of Senator Bill Roth, for whom he was campaign treasurer for several cycles, he had the ear of one of the nation's most important tax policy-makers.

He also devoted time and treasure to numerous charities, focusing his greatest energies on Catholic causes — Salesianum School, Ursuline Academy, St. Edmond's Academy, the Catholic Youth Organization, Catholic Social Services and the Ulster Project, among many others.

He was among Delaware's pioneer tax lawyers when he came to Delaware in early 1967. Richards Layton never before had a tax practitioner. Its tax work was referred to a Washington firm, one of whose partners, Mac Asbill, suggested to Sweeney that he consider coming to Delaware at a crucial point in his career, just as partnership with a St. Louis firm beckoned.

Wilmington was a long way from Utah, where he was among seven children of a forest ranger and a high school teacher. He brought a ken for accounting from his undergraduate work at University of Utah to University of Colorado Law School, then east to NYU's graduate taxation program and a clerkship for Judge Paul Hayes of the Second Circuit.

Having joined Richards Layton six years into his legal career, he would hire lateral candidates more often than others at the firm. Sweeney valued associates with varied experience and sought colleagues who could parry his views on the law and on tactics. In his department, "You didn't work for me. You worked with me."

Sweeney's career coincided with the expansion of Delaware's advantages in trust law and tax opportunities, many of which he helped conceive and craft. His team became known for their expertise in this law.

Meanwhile, Sweeney earned notice in the larger pond with his work on ABA committees, including chairmanship of the Committee on Income of Estates and Trusts, and his presentations at nationally prominent tax institutes. With his Morris Nichols counterpart Hans Krahmer, he established the Delaware standard that taxation be housed in the same department as trusts and estates.

A 1990 heart attack reminded him to look out for Number One, and he headed into his years of double presidency with a renewed vigor. Soon after the century changed, with telephone messages still piling deep in his in-box, he began to look beyond the horizon.

Richards Layton's retirement age is 70, a figure that Sweeney and his peers adopted a generation ago, and which he continues to support. "It's important for the health of the firm that the older lawyers get out of the way."

His career was crowned in the witness chair. His testimony, drawn from decades of advice to C. Porter Schutt, helped the estate overcome a heavy burden of proof to yield a taxpayer victory in a 2005 Tax Court case on the valuation of family investment entities.[1]

Since retiring from Richards Layton five years ago, Tom has consulted for Wilmington Trust and certain other longtime clients. He has devoted his time to, among other organizations, the Delaware Bar Foundation. He has accelerated his travel with his wife Rita, and continued to follow the careers of his children Stephen, Bridget, Katie and Peter, and the growth of their children.

He has also sported a small ornament that means more to him than a wall of professional certificates. The lapel of his blazer bears a gold pin, modest in size, enormous in connotation. Ask and you will find it is the Pro Ecclesia et Pontifice medal, presented by the Pope for sustained service to the Catholic Church, the highest honor that can be awarded to a lay person. He has a titanic body of work, with a professional impact on Rodney Square and far beyond, but this recognition for a lifetime of understated public service means the most to him. ◆

FOOTNOTES

1. *Estate of Charles Porter Schutt, v. Comm'r,* T.C. Memo. 2005-126