INSIDE: Delaware's Challenging Fiscal Future • New Federal Tax Rules • The Business Perspective on Growth

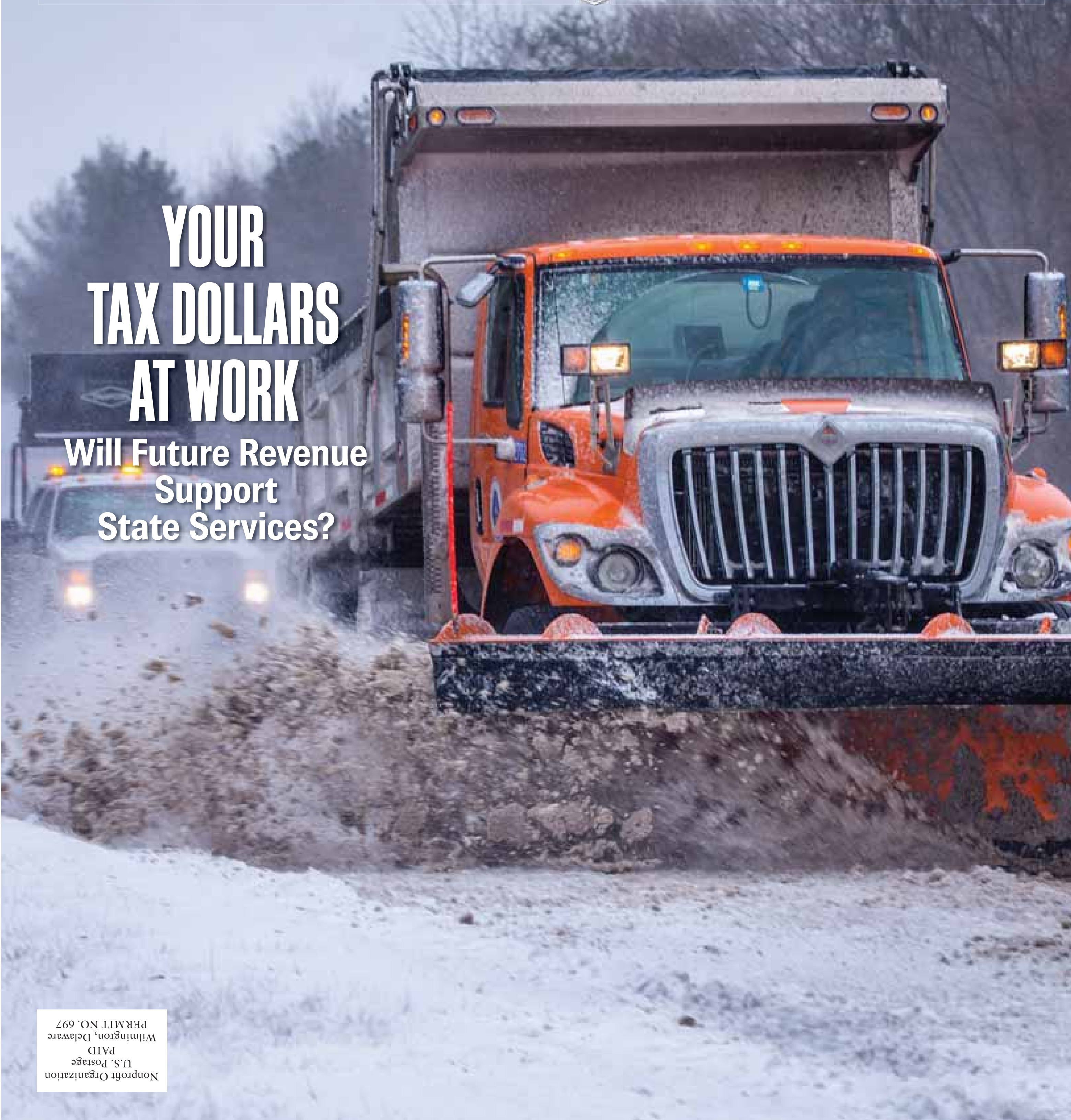
Delaware Lawyer

A PUBLICATION OF THE
DELAWARE BAR FOUNDATION

VOLUME 35 ◆ NUMBER 4
$3.00 ◆ WNTER 2017/2018

YOUR TAX DOLLARS AT WORK

Will Future Revenue Support State Services?



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Delaware Lawyer

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Cover and editorial pictures by BobCraigPhoto.

Delaware Lawyer

A publication of Delaware Bar Foundation
Volume 35 Number 4

DELAWARE BAR FOUNDATION

100 W. 10th Street / Suite 106
Wilmington, DE 19801
302-658-0773 / 302-658-0774 (fax)

DELAWARE LAWYER

is produced for the
Delaware Bar Foundation by:

Today Media Custom Communications
3301 Lancaster Pike, Suite 5C
Wilmington, DE 19805

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Art Director: Samantha Carol Smith

Subscriptions orders and address changes, call:
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Chuck Durante

A succession of creative ideas and a culture of responsibility have helped Delaware maintain solvency, infrastructure and reasonably acceptable state services, without panicked interludes, for 40 years. Through good years, lean years and all the in-between years, the state has approached its financial cycle with a discipline that has been a model for other states. Above all, its political factions have attacked the inevitably recurring challenges not as a zero-sum game, but as a shared challenge.

The prevailing mood has changed over the past 24 months. Former Gov. Markell's 2014 proposal to increase gas and property taxes, focused to fund overdue infrastructure and environmental projects, was ducked by a nervous legislature, which settled for bumping highway tolls.

Outsourcing the tax burden to interstate travelers was a reliable habit, but harder choices loom for Delaware. Low taxes sound like a congenial short-term policy, but can mean dangerously deferred maintenance, underfunding of critical services, sagging schools and a debased environment in a state whose quality of life has always been a signature selling point.

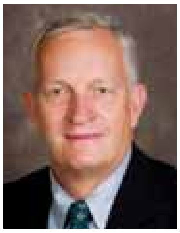
This issue features Jim Butkiewicz, one of the state's most knowledgeable economists, who provides a sober explanation of the challenges facing Delaware's economy and government. Richard Popper and Vince Thomas, two leading tax lawyers, explain the impact of the new federal tax law on Delaware taxpayers. Robert Perkins, executive director of the Delaware Business Roundtable, outlines a strategy to ensure the state's future economic vitality and issues a call to action for Delaware policy-makers. Jenn Hudson, a tax lawyer who has become the state's Director of Revenue, discusses the challenges of a department whose superlative adaptation to technology has enabled it to raise more money with fewer personnel. I conclude with observations about taxes, exemptions and received wisdom.

Many issues of this magazine describe things that this state does well. Other editions focus on things it can do better. It will be impossible to improve, and difficult to maintain the status quo, without decisions to assure continuing long-term solvency.

It's been asked before: will Delaware become a modern version of Macedonia, a minute mammoth whose dominance of its larger neighbors was fated to end? An Era of Good Feelings is easy when times are flush. Now is a true test of our creativity, resolve and vision.

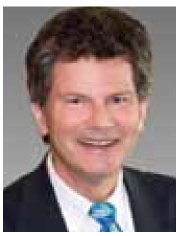
Chuck Durante

Chuck Durante



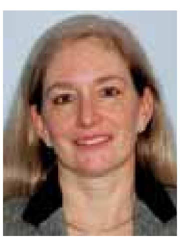
James L. Butkiewicz

is professor of economics at University of Delaware, where he has served as department chair, associate dean and acting director of graduate studies. A macroeconomist, he specializes in policy analysis and determinants of economic growth, with expertise in monetary theory and history, the economics of the Great Depression, and Delaware's economy.



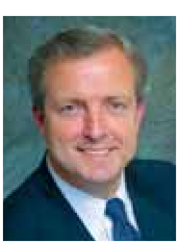
Chuck Durante

is a partner at Connolly Gallagher LLP, a fellow of the American College of Trust and Estate Counsel and President of the Delaware Sportswriters and Broadcasters Association. A member of the Delaware Track and Field Hall of Fame, he has received the Haverford College Alumni Award and is Chairman of the Board of Editors of *Delaware Lawyer*.



Jennifer Hudson

(formerly Jennifer Noel) was appointed to serve as the Director of the Delaware Division of Revenue as of October 1, 2017. Prior to her appointment, Ms. Hudson was a Deputy Attorney General with the Delaware Department of Justice for five years, representing the Department of Finance, the Division of Revenue and the Division of Accounting. Before entering public service, she was an attorney in the Tax Section at Young Conaway Stargatt & Taylor, LLP, in Wilmington.



Robert W. Perkins

has been Executive Director of the Delaware Business Roundtable since 2014. He also is President of Brandywine Public Strategies, LLC, a consulting firm he founded in 2012, which develops strategies for dealing with challenging public issues by working at the crossroads of policy and politics. He was Vice President of Global Public Policy at AstraZeneca, leading the company's efforts to enhance transparency, create industry-leading access to health programs, and develop external messages on the value of pharmaceutical innovation. At DuPont Pharmaceuticals, he created a nationwide initiative on patient safety that protected patients and improved sales performance. In the non-profit sector, Mr. Perkins served as Executive Director of Together Rx, a coalition of pharmaceutical companies offering senior citizens discounts on prescription drugs prior to the advent of Medicare Part D. Under his leadership, Together Rx became the largest private-sector prescription drug savings card in the US. He also served as Chief of Staff and Press Secretary to two Delaware Governors, Pierre S. du Pont IV and Michael N. Castle, and was Deputy Campaign Manager for Pete du Pont for President in 1988. He presently serves as Chairman of the Board of Trustees of the Delaware Public Policy Institute, an affiliate of the Delaware State Chamber of Commerce.

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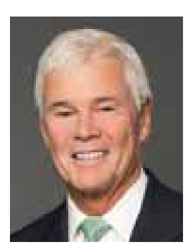


David H. Williams

has been a leader in employment law and education law for four decades, representing employers, school districts, independent schools and a college. His work involves litigation, administrative proceedings, arbitration, collective bargaining and counseling across the full spectrum of legal issues. A graduate of Gettysburg College and Penn State Dickinson Law School, he has been managing partner of Morris James LLP for 14 years.

James L. Butkiewicz

The Root Causes of Delaware's Fiscal Challenges

Slow growth and over-reliance on uncertain or declining revenue sources threaten the state's long-term fiscal health.

Delaware faces a challenging fiscal future. The nature of the challenge is two-fold. Delaware's weak economic performance since the turn of the century is a disturbing cause of slow revenue growth and pressure on state spending. The state also has come to rely on several revenue sources that may provide relatively less revenue going forward.

Economic growth in Delaware has been anemic, even compared to a reduced national rate of growth. From 2000 through 2016, real GDP in Delaware grew by 11.72%, or just 0.7% per year.[1] In contrast, the U.S. economy grew 33.1%, or 1.8% annually.

The national rate of growth has declined significantly from the early postwar growth rate of over 3% annually. The slow national rate of growth is a cause of concern among economists, as slower GDP growth means slower growth of living standards and a more slowly growing revenue base for governments, exacerbating fiscal challenges. That Delaware's economic growth is less than half of the reduced national rate is especially troubling.

Other economic data also reflect the poor health of Delaware's economy. Since 1982, following the 1981 enactment of the Financial Center Development Act, the ensuing development of Delaware's financial service industry resulted in Delaware's unemployment rate being consistently below the national rate until last year.

In January 2017, the state unemployment rate began rising steadily, passing the falling national rate in April. The Delaware rate of 4.8% in October was substantially above the national rate of 4.1% in both October and November.

Median household income adjusted for inflation has decreased from a peak of $70,220 in 2000 to $58,046 in 2016. Median household income, not adjusted for inflation, has grown at an annual rate of 1.02% from 2006 through 2016.

Personal income, the basis of the personal income tax, has grown at an average rate of 2.75% from 2006 through 2017. Nationally, personal income has grown at a 3.67% rate during the same period.[2]

A weak economy increases dependence on income support programs. The number of Delaware recipients of aid from the Supplemental Nutritional Assistance Program (formerly the Food Stamp Program) has increased from 31,121 in 2000 to a peak of 152,235 in 2012 and was still close to that peak with 150,521 recipients in 2014, the most recent year for which data are available. In 2017, almost 25% (24.67%) of Delaware's population received Medicaid, compared to the national average of 22.7%.

This grim economic picture is the root cause of the state's fiscal challenges. Demands for state spending increase while the income tax base grows slower than the national average. The state has increasingly relied on alternative revenue sources to balance its books. However, revenue from several of these sources may not be sustainable in the long run.

The largest source of revenue for the state is the individual income tax. In recent years this source has generated about 33% of general fund revenues.[3] From fiscal year (FY) 2006 through FY 2017, income tax revenues have grown at a rate of 2.5% annually, slightly less than Delaware's 2.7% growth rate of personal income. The state income tax structure is progressive. If growth in the tax base is due to relatively more low-income households, which are taxed at lower rates, revenue will grow more slowly than total personal income.

The share of the individual income tax as a percentage of total general fund revenue has increased from 32% in FY '06 to 33.3% in FY '17. Overall revenue growth during these years was 2.15% annually. Income tax revenue grew faster than total revenue, offsetting erratic and sometimes negative growth in other revenue categories.

Two other taxes that generate significant revenue are the franchise tax and the gross receipts tax.[4] From FY 2006 through FY 2017 Delaware's franchise tax revenue grew by 2.6% annually and gross receipts tax revenue grew by 2.65% annually. Both sources now contribute a marginally higher percentage of total state general fund revenue.

> The largest category of spending in Delaware is for public education. During the past decade public education spending grew 2.8% annually, faster than revenues.

Two sources that have become important in Delaware are the lottery and unclaimed property. Lottery revenue peaked in dollar value in 2011 and has been declining ever since. It will not recover. For many years Delaware enjoyed a regional gambling monopoly. Then, Pennsylvania and Maryland legalized gambling, making the regional industry competitive. Increasing the casino tax rate in 2009 provided a temporary boost to revenue, but the long-run decline since has been inevitable. Competition always erodes monopoly profits.

Currently the United States Supreme Court is considering a case seeking to overturn the rules that effectively ban sports betting in all but four states. Even if the restrictions are overturned, Delaware will enjoy little benefit. Pennsylvania and New Jersey are both prepared to begin sports betting pending a favorable decision. Casino operators are advocating legislation to allow sports betting in Maryland casinos.

Better siting of casinos could improve lottery revenue. Locating casinos at existing race tracks is not ideal. A casino in Wilmington and a casino near the beach resorts would be better situated near population centers. While this issue has been considered, there are no current plans to relocate or add casinos.

Abandoned Property is currently Delaware's third largest source of general fund revenue. First collected in 1990, revenue has grown rapidly, albeit erratically. From 2006 through 2017, annual revenue growth has averaged 4.45%.

Abandoned Property is also Delaware's most controversial source of revenue. Delaware has earned a reputation as one of the most aggressive of all states in its pursuit of unclaimed property from corporations.

Corporations are fighting back in court, claiming Delaware's methodology for estimating unclaimed property many years past and its use of a third party that is self-interested in the outcome of claims are unfair and involve a conflict of inter-

est. There are two considerations. First, the outcome of legal cases will set parameters for future claims for unclaimed property. More importantly, Delaware's aggressive policies have harmed its reputation as the preferred state of incorporation. Short-run pursuit of abandoned property may result in a long-run loss of franchise tax revenue.

Delaware is required to balance its operating budget. For the period FY 2006 through FY 2016, general fund revenue grew at a 2.15% annual rate. Expenditures correspondingly grew at a 2.1% annual rate. Increased demands for certain categories of spending require difficult choices and trade-offs.

The largest category of spending in Delaware is for public education. During the past decade (FY 2006 through FY 2016) public education spending grew 2.8% annually, faster than revenues.

Health and social services grew even faster, at a 3.6% annual rate. The rapid growth of this category is consistent with the need to provide Medicaid and income support to an increasing number of Delaware residents.

Spending for corrections also grew faster than average general fund spending, growing at a 2.45% annual rate during the recent decade. This spending growth is necessary but is an unfortunate reflection of social decay.

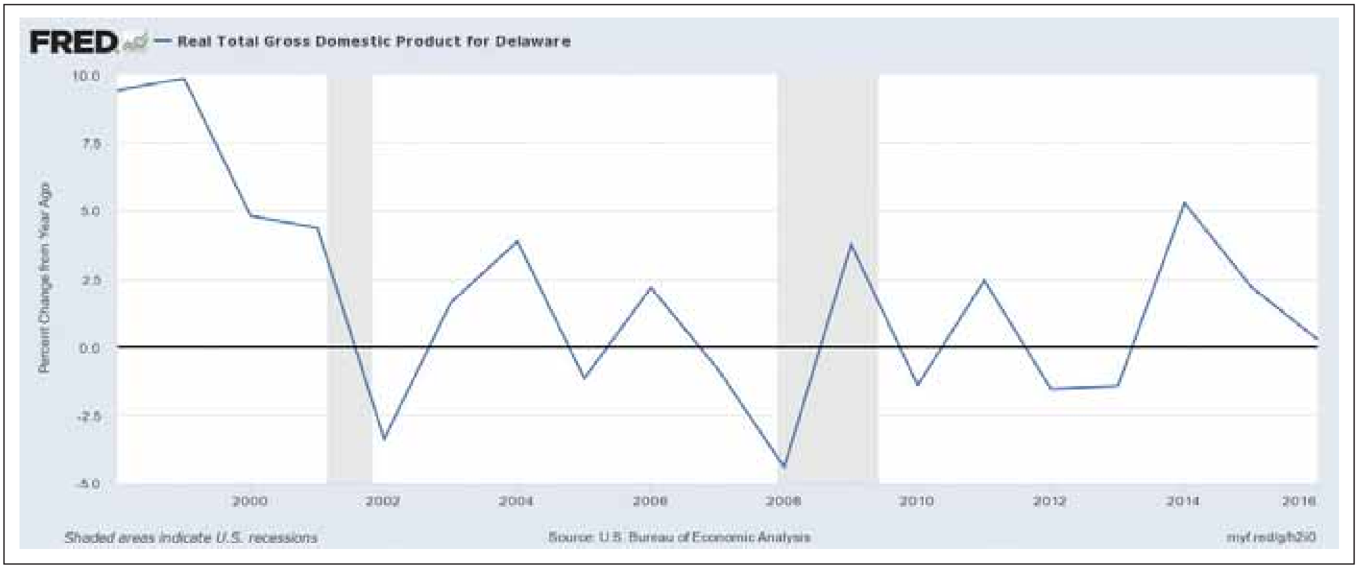
In order to balance the budget, spending in other categories was constrained. State employees received no or small raises for several years. Higher education spending actually fell -1.4% during the decade. Many state governments have made the difficult decision that in order to fund growth of spending for Medicaid, college students or their families will pay a greater share of the cost of their education, as they will reap the benefits of a higher income during their careers.

Any analysis of fiscal health also must consider future obligations, as these will necessitate reduced spending or higher taxes in future years. Debt issues, borrowing to fund capital spending, will require future repayment, thus requiring future taxes or reduced spending. Also, pension obligations for state employees must be funded. If not, future funding requires additional taxes or constrained spending.

Currently Delaware's bonds have a triple-A rating from all three ratings agencies. This is the best rating possible, and for this the state government should be commended. Still, debt burdens have increased during the past decade. The dollar amount of debt and inflation-adjusted-debt per person have both increased.

The best depiction of the debt burden is that it has increased from 3.02% of personal income in 2006 to 4.17% of Delaware personal income in 2016. While debt has increased, more rapid growth of personal income would have offset much of the growth in indebtedness.

Nationally, many state and local governments face a crisis resulting from underfunding of employee retirement benefits. Compared to most states, Dela-


FRED
Real Total Gross Domestic Product for Delaware
Percent Change from Year Ago
Shaded areas indicate U.S. recessions
Source: U.S. Bureau of Economic Analysis
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Real Total Gross Domestic Product for Delaware
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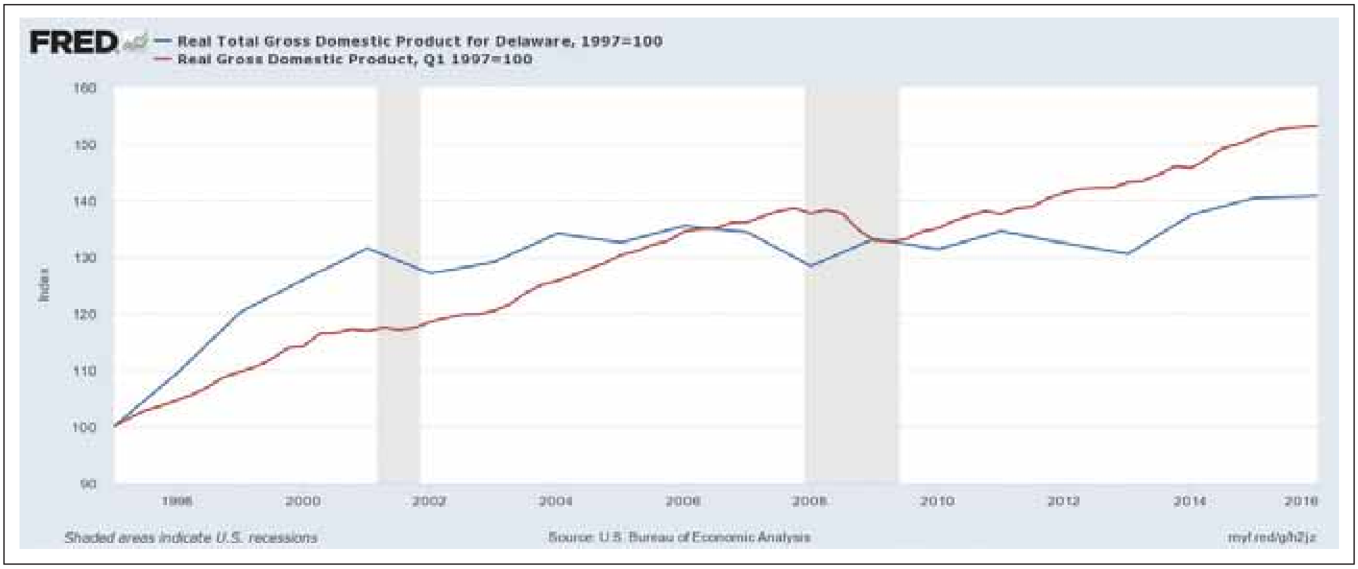

FRED
Real Total Gross Domestic Product for Delaware, 1997=100
Real Gross Domestic Product, Q1 1997=100
Index
Shaded areas indicate U.S. recessions
Source: U.S. Bureau of Economic Analysis
myf.red/g/h2jz

ware's employee pensions are relatively well funded at 84.1%. This ranks Delaware among the best-funded pension plans. Still, Delaware's employee pension program was overfunded (103.1%) as recently as 2008.

An example from a neighboring state is telling. In 2001, Maryland's state employee pensions were 102.2% funded — actually overfunded. Today Maryland's plans are 65% funded, ranking it near the bottom of states. Deferring funding can quickly accumulate into a serious problem.

Overall, Delaware's fiscal health is respectable. The most concerning issue is the slow rate of growth. For example, if Delaware personal income growth had equaled U.S. personal income growth between 2006 and 2016, with the same average tax take from personal income, total state general fund revenue would have been 8% higher.

Delaware' growth slowdown began before the Great Recession. From 2000 through 2008, Delaware's dollar GDP grew at an annual rate of 2.65%. From 2008 through 2016, Delaware's GDP has grown at a 3% annual rate.

> If Delaware personal income growth had equaled U.S. personal income growth between 2006 and 2016, ... total state general fund revenue would have been 8% higher.

It is easier to identify a problem than to find a solution. During the two decades following the passage of the Financial Center Development Act (FCDA), Delaware experienced exceptionally fast growth.[5] Subsequently, growth has slowed markedly.

The FCDA was an exercise in deregulation, not an industrial policy attempting to pick winners. South Dakota in 1980, followed by Delaware in 1981, enacted legislation eliminating usury laws and allowing bank holding companies to establish subsidiary operations with each state. The credit card industry was targeted, but no specific firm.

Imagine if Delaware had attempted a credit-card industrial policy. J.P. Morgan would have been an obvious choice. But would anyone have targeted the credit card subsidiary of a troubled Maryland bank operating in a former drug store in a strip mall on Ogletown Road? Yet MBNA grew to a giant in the credit card industry, before Bank of America acquired it.

Targeting specific firms is problematic. The state spent over $100 million in incentives and infrastructure improvements to attract AstraZeneca to Delaware. Initially many well-paying employees moved to Delaware, but the number of workers has declined significantly and AstraZeneca's future in Delaware is uncertain.

Bloom Energy has failed to generate the expected employment, yet the cost in electric bills has been high. Fisker was never a good bet. No foreign auto company that established production in the U.S. has entered a highly-unionized area. Not surprisingly, Fisker's operations in Delaware never materialized.

Any plans to encourage growth need to recognize that incentives matter. The rapid population growth in Sussex County is due, in large part, to favorable tax treatment of retirees' income, low property taxes, vibrant beach communities and a major highway connection.

Delaware should also repair its tarnished reputation. Aggressive pursuit of abandoned property using a methodology that corporations consider dubious makes the state a less attractive location.

> Developing a positive climate, as did the FCDA, is likely to result in greater success than attempting to attract specific firms with lucrative incentives.

When developed nations criticize small principalities and island nations for operating offshore financial centers that serve as tax havens and vehicles for money laundering, the retort is that Switzerland, the British Channel Islands and Delaware in the United States serve the same functions. Federal authorities are currently investigating over 200 Delaware LLCs for possible fraudulent activities.[6]

After two decades of rapid growth powered by the FCDA, Delaware has experienced almost two decades of slow growth. To restore growth to a normal rate, the state should ensure that its business climate welcomes business development, both large and small. Developing a positive climate, as did the FCDA, is likely to result in greater success than attempting to attract specific firms with lucrative incentives.

Reforming tax laws and finding new sources of revenue are also possibilities. But new taxes and tax rates must not be punitive. Creating a stable economic environment is imperative. Controlling

See **Root Causes**
continued on page 27

FEATURE

Richard J. A. Popper and
Vincent C. Thomas

How the Federal Tax Law Will Impact Delaware

With state taxes linked to federal rules, changes in Washington have a direct effect on local citizens.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 was enacted into law. This Act is hereafter sometimes referred to as "the Bill."

The changes made by the Bill to the Internal Revenue Code of 1986, as amended (the "Code"), are sweeping and numerous. Many articles, news stories and pamphlets have been written and published that detail the changes implemented by the Bill. The purpose of this article is not to summarize or explain those changes, but rather to explain the legislation's effect on the State of Delaware and its taxpayers.

Delaware, like many states, has a state income tax that piggybacks on federal income tax, with modifications. This is true of both the Delaware personal income tax[1] and the Delaware corporate income tax.[2] Accordingly, whenever the income tax provisions of the Code are amended, the amendments are likely to have an effect on the State of Delaware.

Congress rarely considers the impact of income tax changes on state revenues. This forces the states to react — and often makes states look bad when they have to pass legislation that may be perceived as a tax increase, even if the legislation is merely intended to preserve the status quo in tax revenues.

The Bill is perhaps more burdensome than most, since its enactment occurred at the end of a calendar year, with only a handful of days before it took effect.

Many of the Bill's provisions change the amount of deductions of certain types of business expenses by limiting the amount of current deductions, by eliminating them, or by increasing them, as noted below. Many provisions of the Bill also change individual income tax deductions, some of which are noted below.

The Delaware Department of Finance has the ability to analyze the aggregate of individual and corporate income tax returns filed in the state to estimate how this type of change will affect Delaware's coffers, and is no doubt performing that analysis. The authors of this article do not have access to that type of information and therefore cannot predict whether the overall effect of these changes will increase or decrease Delaware's 2018 income tax. However, our state, unlike the federal government, must operate under a balanced budget, so changes to Delaware law may be inevitable.

Section 11001 of the Bill, which changes federal income tax rates, will have no effect on the State of Delaware income tax, since the Delaware Code defines its own set of rates. One might initially think that section 11011 of the Bill, which adds new Code section 199A, will have a potentially significant impact on Delaware tax revenues. This is the provision that permits individuals and pass-through entities to claim a deduction of up to 20 percent of certain qualified business income.

The Delaware Code defines taxable income as "the federal adjusted gross income as defined in the laws of the United States as the same are or shall become effective for any taxable year with the modifications and less the deductions and personal exemptions provided in this subchapter." [3]

However, new Code section 199A(e) states that "taxable income shall be computed without regard to the deduction allowable under this section." Because this deduction is one not enumerated in the Code as being allowed in computing "adjusted gross income," the Division of Revenue is likely to take the position that this deduction will not effectively flow through for Delaware State income tax purposes because it will not effectively reduce federal adjusted gross income.

Section 11021 of the Bill, which increases the standard deduction under section 63 of the Code for 2018 through 2025, will have no direct effect on Delaware income tax collections, since the Delaware Code has its own definition of standard deduction, and permits itemizing for State income tax purposes even when a taxpayer does not do so for federal income tax purposes.

However, section 11041 of the Bill, which eliminates the deduction of personal exemptions allowed by section 151 of the Code for years 2018 through 2025, by redefining the exemption amount as zero, could have a significant effect on Delaware income tax. The Delaware Code specifies the amount of a resident's personal tax credit as $110 for each personal exemption to which such individual is entitled for the taxable year for federal income tax purposes, plus an additional

Section 13001 of the Bill, which reduces the corporate income tax rate to 21 percent, will have no direct effect on the Delaware corporate income tax, which specifies its own rate.

$110 for each resident individual aged 60 or older.[4]

It is, at minimum, arguable that the federal statutory language that makes the exemption amount zero effectively eliminates the Delaware personal credit. The Code statutory language, however, probably means that the Delaware Division of Revenue will interpret the Delaware Code to mean that the personal tax credit is still in force.

An individual's total deduction for state and local taxes previously was unlimited in amount, but now will be limited to $10,000 ($5,000 for married taxpayers filing separately).[5] Many higher-income Delaware taxpayers pay Delaware income tax, ad valorem property tax, and in some cases Wilmington city wage tax, which together exceed the threshold. This change will increase the resident's federal income tax liability unless deductions were already limited by other reasons, such as the phase-out of itemized deductions or the alternative minimum tax.

The change will not always increase the Delaware income tax liability, however, since the state income tax itself is not deductible for Delaware state income tax purposes.[6] For example, a Delaware resident who pays $7,000 in Delaware state income tax, $4,000 in property taxes, and $1,000 in Wilmington City wage tax, both under present and future law will not be able to deduct the state income tax on his Delaware state income tax return, and will only have $5,000 in other state taxes, which should still be deductible.

On the other hand, a Delaware resident who pays $12,000 in property taxes alone, as well as any amount in state income tax plus $1,000 in Wilmington City wage tax will have the $13,000 deduction reduced to $10,000 on his Delaware income tax return.

Section 11061 of the Bill doubles the federal estate tax exemption from $5,000,000 to $10,000,000, indexed for cost of living increases, for 2018 through 2026. The Delaware estate tax exemption tracks the federal exemption.[7] However, since Delaware's estate tax has been repealed effective for decedents dying on or after January 1, 2018, this change has no effect on Delaware.[8]

Section 13001 of the Bill, which reduces the corporate income tax rate to 21 percent, will have no direct effect on the Delaware corporate income tax, which specifies its own rate. However, changes such as in section 13101, increasing the expensing deduction from $500,000 to $1,000,000 in section 179 and changes in certain depreciation schedules, will flow through to Delaware corporate, partnership and individual returns in a way that will reduce Delaware taxable income.

Do you want to hire a tax attorney or a CPA to help you figure all this out? If it is not a trade or business expense, the tax professional's fee that you pay will no longer be deductible, since under section 11045 of the Bill, miscellaneous itemized deductions will no longer be allowed for 2018 through 2025. Previously, fees for tax planning expenses were deductible as a miscellaneous itemized deduction under Code section 67.

Happy New Tax Year! ◆

NOTES

1. 30 *Del. C.* §1101 *et seq.*
2. 30 *Del. C.* §1901 *et seq.*
3. 30 *Del. C.* §1105
4. 12 *Del. C.* §1110
5. Section 11042 of the Bill, Section 164(b) of the Internal Revenue Code.
6. 2 *Del. C.* §1109(a)(1)a.
7. 12 *Del. C.* §1501(3)c.
8. 81 Del. Laws ch. 52 (2017).

Robert Perkins

State Finances: Promote Growth, Control Spending

Faced with an unsustainable mismatch between revenue and expenses, policy-makers need to chart a new economic path for Delaware.

The state received some good news when the Delaware Economic and Financial Advisory Council projected that Delaware will have an extra $87.6 million for the upcoming fiscal year — a welcome improvement for a General Assembly confronted with a $350-million budget deficit just a year before.

That's the good news. The bad news is that the state still faces fundamentally shaky finances driven by unreliable and unpredictable revenue sources and ever-ballooning health, education and public employee expenses.

Gov. John Carney used his 2018 State of the State Address to call on lawmakers to come together in a bipartisan manner to tackle the biggest challenges facing the state. And fewer challenges are bigger than state finances that continue to threaten Delaware's long-term growth and stability.

Now policy-makers must summon the political will needed to rise to these challenges, which can be difficult in an election year. But it is not impossible — and this is the time for the General Assembly to lay the groundwork for a stronger and more sustainable Delaware economy.

The Delaware Business Roundtable believes the state must take a two-pronged approach toward strengthening Delaware's economy and shoring up the state's finances: aggressively promoting sustainable growth while strategically managing spending.

First, promoting growth. Gov. Carney and the General Assembly took an important first step last year with the creation of the Delaware Prosperity Partnership, a landmark achievement in the future economic development efforts for the state.

The Delaware Prosperity Partnership creates a public-private economic development entity designed to encourage entrepreneurship and attract new business to the state. For the first time, Delaware government, employers and academia are formally cooperating to create a culture of growth, investment and entrepreneurship as we work to expand the state's economy by attracting jobs, talent and capital investment.

Arguably the most important start-up in Delaware, the Partnership has a strong Board of Directors and John Riley, a former head of the Delaware Economic Development Office under then-Governor Tom Carper, has been named Interim CEO. A national search for a permanent CEO is underway.

This public-private partnership concept was at the center of the Roundtable's Delaware Growth Agenda — a strategic framework for pursuing a new long-term approach to economic development in Delaware that makes the state a global magnet for leading-edge technologies, talent and investment.

In addition to recommending the creation of the Delaware Prosperity Partnership, the Growth Agenda urged state policy-makers to strengthen the state's approach to business development by:

Promoting Entrepreneurship

The plan calls for the state to focus higher education spending on potential growth areas — most notably finance, health care, science and technology, engineering and entrepreneurship programs. By changing our approach to how we invest higher education dollars, we will ensure they are going to areas the can build a stronger, more economically diverse Delaware.

Strengthening the Business Climate

Delaware must take significant steps to improve its business climate, including ensuring the state's infrastructure meets the needs of a 21st-century economy. Lawmakers took another step forward last session when the General Assembly approved the modernization of the Coastal Zone Act. In addition, the plan calls for improving the state's public education system by implementing the strategic recommendations contained in the "Student Success 2025" report published by the Vision Coalition of Delaware; and taking a leadership role in helping to facilitate more efficient development and permitting processes at the local and county levels.

By building on the Delaware Prosperity Partnership and continuing to promote growth, state leaders will help identify, attract and retain the next generation of employers in Delaware. This will strengthen and grow the economy while providing badly needed revenues that will help stabilize state finances.

Taken together, these numbers are nothing less than a recipe for disaster. The growth rates are simply unsustainable, especially for a state the size of Delaware.

As we seek to strengthen the economy, however, we must not lose sight of the need to rein in spending and ensure Delaware is using taxpayer dollars as prudently, effectively and efficiently as possible.

One area where Delaware falls short on this score is in public employee benefits. A 2015 study by the Delaware Public Policy Institute found that the state could save between $260 million and $720 million if state government operated like a private business when it comes to employee benefits.

The study concluded that the total average compensation for state employees is significantly higher than Delaware private sector workers with similar education and experience — driven entirely by the health, pension and retiree health benefits packages that taxpayers provide state workers. State government employees receive a benefits package that ranges from 53 to 102 percent more generous than those earned by private sector workers, more than offsetting salaries that are 12.4 percent lower than similar private sector employees.

What does that mean in real dollars? Delaware state government employees bring home total compensation packages ranging from $88,530 to $97,197 a year. That's 8.5 percent to 23.3 percent more than their private sector counterparts ($78,814).

The generous benefit packages are readily apparent on the health care front. The state paid 87 to 96 percent of health insurance premiums for roughly 122,000 individuals covered by the state plan in 2015, according to the report. "Put in terms of the ratings used in the Affordable Care Act Marketplaces — bronze, silver, gold and platinum — the average GHIP plan would qualify as 'platinum' coverage," the report concluded.

This is significantly more generous than the typical private sector plan. In fact, the DPPI report states that private employers in the South Atlantic region generally paid about 78 percent of costs for single-employee health coverage and 64 percent of costs for family health coverage.

This approach has real consequences. All told, the cost of providing health coverage to state employees is projected to reach $1 billion by 2020. Coupled with growing Medicaid expenses, health care costs comprise more than 25 percent of the state budget — and cost more than $2 billion a year, including federal funding.

Of course, health care spending is not the only area that is growing at a breakneck pace. Consider:

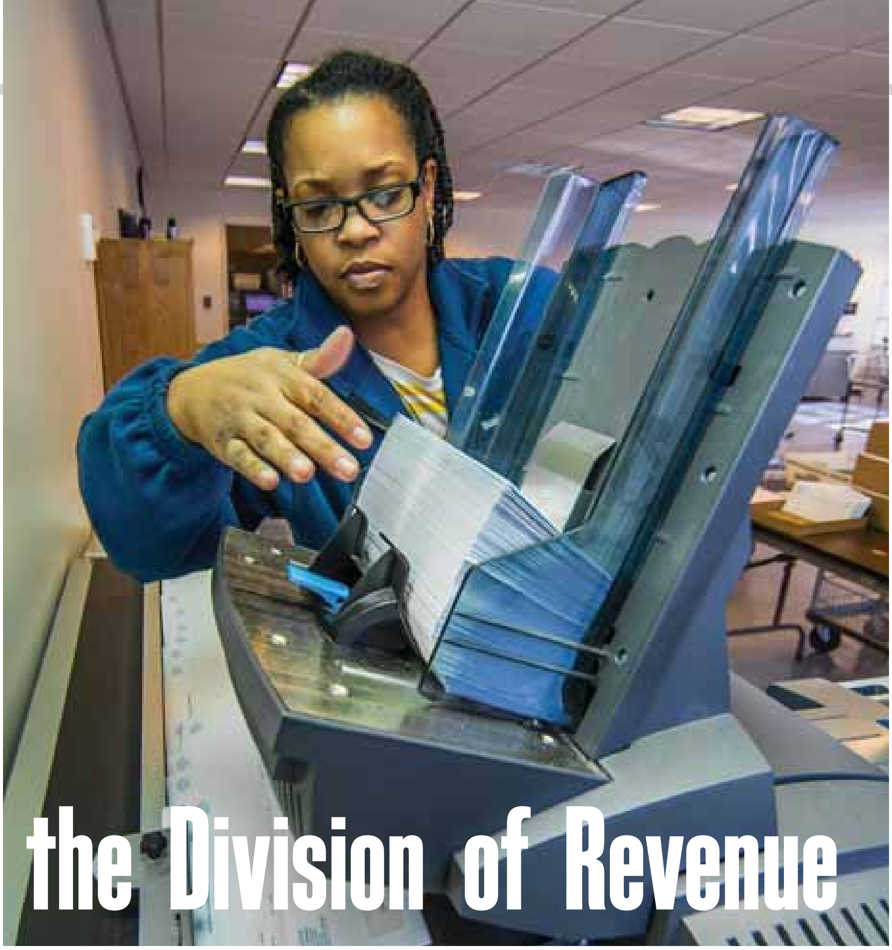
- The operating budget of $1.4 billion for school districts and the Department of Education made up 34 percent of the state's budget — up 27 percent from 2007, according to the Governor's Office.
- Government contributions for the Delaware State Employees' Pension Plan have risen six-fold since 2001.

Taken together, these numbers are nothing less than a recipe for disaster. The growth rates are simply unsustainable, especially for a state the size of Delaware — even in an improving economy.

The General Assembly must gather the political will to work with Gov. Carney to achieve meaningful reforms and real savings as soon as possible. They must be politically brave to ensure the state's budget house is in order, both for today and for years to come. ◆

FEATURE

Jennifer Hudson



The View From the Division of Revenue

Delaware's new Revenue Director reviews her division's mandate, processes, challenges and opportunities.

I was appointed to serve as the Director of the Delaware Division of Revenue last October and the months since have passed in a blur. Much of what I have been involved with has been administrative, not policy-related, as I have been learning how the Division operates.

When I was asked to write this article about Delaware's revenue, my mind was blank. What about the Division of Revenue would be interesting to the readers of *Delaware Lawyer*?

The truth is, I'm a bit of a tax nerd and one of the rare people who gets excited when talking about taxes. In the recent months, I have learned that the Division of Revenue is a multi-faceted, dynamic organization with qualified, dedicated employees who are focused on providing the best possible service to taxpayers of the State of Delaware.

I am hopeful that through this article you will learn just a little bit more about Revenue — an agency that is in a position to touch the lives of every Delawarean, whether because we administer your taxes or because we collect the money that funds the State's operations.

The Division of Revenue is part of the Department of Finance that is tasked with administering nearly all of the taxes imposed under Delaware law. This includes the personal and corporate income taxes, the license fee and gross receipts taxes, the realty transfer tax, scrap tire fees, alcohol and tobacco taxes, and public accommodation taxes — essentially all the taxes that are imposed pursuant to Title 30 of the Delaware Code.

Revenue is also involved in processing many of the tax credits and incentives that are permitted. These include credits that promote preservation of historic properties and economic development incentives provided for research and development, new capital investment in property located in the State, and for employers who hire or retain Delaware employees.

Revenue does not administer property taxes (which are handled at the municipal and county level in Delaware), the corporate and LLC franchise taxes (which are administered by the Division of Corporations in the Department of State), or the bank franchise taxes (which are administered by the Office of the State Bank Commissioner).

Revenue processes many of the tax returns filed by Delaware taxpayers and collects nearly two-thirds of Delaware's annual general fund revenue. On average, Revenue collects more than $5 million a day throughout the year. That number increases dramatically during tax season and may exceed the $20-million mark on any given day. Revenue also processes between $250 and $300 million of taxpayer refunds annually.

Other government agencies, including the IRS, other state agencies and revenue agencies for other states, frequently request that Revenue assist them to collect outstanding balances, whether by having Revenue manage the entire collection process or only by having Revenue set off tax refunds.

Revenue has three offices, located in Wilmington, Dover and Georgetown, each of which has a public service area that is open to the public. Through our public service offices, we provide answers to tax questions, make paper tax forms available, accept returns for filing and payments to be credited, and process payments for lottery tickets.

Our personnel answer hundreds of calls from taxpayers and practitioners each day to respond to both specific and general inquiries. As practitioners, please do not ask Revenue's personnel to talk with you about an account without a power of attorney on file. We are bound by strict tax confidentiality provisions in Title 30, and discussing a taxpayer record without appropriate written permission is a misdemeanor.

We have more than 215 people working to ensure that Delaware's tax system is properly administered, that returns filed with the Division of Revenue are processed properly and efficiently, and that we are responsive to the inquiries we receive daily on behalf of Delaware's citizens and businesses.

I truly believe that the Revenue staff is our greatest asset. Many of the people in Revenue have worked here for decades and have many years of institutional knowledge, making them one of the greatest resources available both to me as the new Director and to our customers.

While we are still evaluating the effect of the federal legislation, we may need to issue updated withholding tables for employers, and it is likely that we will have to modify many of our tax forms.

If you have an opportunity to work with Revenue and you see something that Revenue personnel have done well, please tell us. We welcome the opportunity to recognize individuals who provide excellent service to our constituents, but we do not know that you have received outstanding service unless you say something. At the same time, because we are striving for continual improvement, if there is something we can do better, please let us know that too.

Title 30 of the Delaware Code sets forth in great detail those penalties and interest that apply in various circumstances, including for late payment, failure to timely file a return, or failure to make estimated payments, as well as the statutory protections and processes available to all taxpayers.

Anyone who has concerns about an assessment or a denied refund may challenge Revenue's position by filing a protest with the Tax Conferee, a statutorily-created administrative appeals office. The Conferee's office handles approximately 2,500 protests each year. These range from relatively-straightforward requests for abatement of penalty and interest to complicated challenges to Revenue's interpretation of the provisions of Title 30.

The Conferee's determinations may be challenged in front of the Tax Appeal Board ("TAB"), a quasi-judicial, independent panel of five members appointed by the Governor. The TAB meets once a month to manage the cases filed by taxpayers to challenge the Notices of Determination issued by the Conferee. These cases are typically presented to the TAB on a fully-stipulated factual record and the TAB issues legally-reasoned opinions as to the propriety of Revenue's determinations. Revenue will often rely on these decisions to interpret provisions of Title 30 in later audit cases.

TAB decisions may thereafter be appealed to the Delaware Superior Court and the Delaware Supreme Court.

When the Delaware legislature makes changes to Delaware's tax regime, as happened at the end of the last legislative session, the Division of Revenue must ensure that we update the affected forms and systems to incorporate those changes. As another article in this edition notes, federal tax change will affect Delaware's taxpayers and Delaware's revenue estimates. The tax bill will likely have an impact on the Division of Revenue, as well, because the starting point for income tax reporting in Delaware is each taxpayer's federal adjusted gross income.

While we are still evaluating the effect of the federal legislation, we may need to issue updated withholding tables for employers, and it is likely that we will have to modify many of our tax forms to incorporate new federal rules.

In addition to those changes necessitated by federal tax reform and legislative changes at the state level, Revenue also feels the impact of changes made by the Internal Revenue Service. In September 2016, the IRS issued an update to Publication 1075, which provides the information security requirements with which all agencies that have access to federal tax information must comply. These requirements are complicated and mandate certain technology improvements, additional background checks for all employees, periodic vendor audits, and other best practices for a tax-processing agency.

The computer systems in place at Revenue have been lovingly referred to as being held together with chewing gum and baling wire. We operate more than 100 different programs across four different platforms to process the returns we receive. Interestingly, Revenue administers those types of taxes listed above across all these programs, meaning that many tax types are administered on multiple platforms. For example, the system to issue a new business license is different than the system used to renew a business license, which is different from the system used to receive and process gross receipts taxes (which are effectively three related taxes).

Because of the age of our systems and the fact that they do not all communicate with one another, our personnel must manually balance the deposits made every day (those multiple million-dollar numbers noted above) to ensure that the deposits correspond to the credits entered into taxpayer accounts within the Revenue Accounting System.

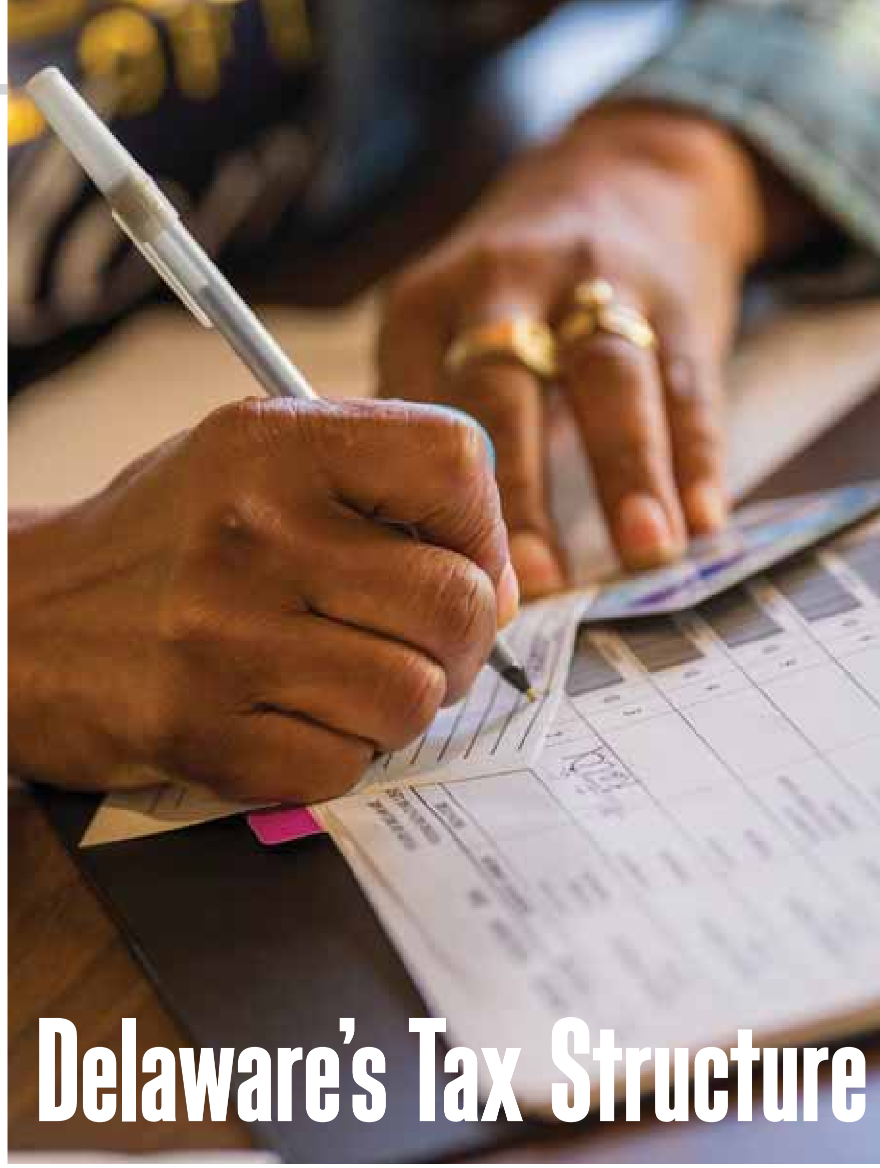
We would like to better leverage technology to help Revenue process returns and ensure appropriate tax reporting by all taxpayers. As a result, one major goal of the new administration is the modernization of the entire tax processing platform with an integrated system. This will be a major undertaking that is still in the investigation and development stages (we recently issued a Request for Information soliciting feedback on existing systems). We are hopeful that an investment in technology will help Revenue provide better service to all of our constituents.

Finally, to all practitioners in Delaware — we invite you to be an active participant in what we do. Title 30 includes many complicated provisions and we are not always aware of things that might be inconsistent or difficult to interpret. If you see something that you think could be done better or differently, we invite you to let us know.

Similarly, if you think that Delaware's taxpayers could benefit from regulatory or administrative guidance, or if you have encountered processes that you think are unnecessarily complicated and could benefit from simplification, please tell us.

My email is Jennifer.Hudson@state.de.us and I look forward to hearing from you. ◆

Chuck Durante



Rethinking Delaware's Tax Structure

Policy-makers need an open mind as they strive to develop tax policies that are progressive, reasonably fair and sufficient to fund government obligations.

State taxation has become increasingly harsh. Developments beyond the reach of governors and legislators have made the ideal of progressive taxation more elusive.

Theodore Roosevelt argued a century ago — amplifying the views of Andrew Carnegie and Adam Smith — that taxation should fall most heavily on those who can best bear it: "I believe in a graduated income tax on big fortunes, and … a graduated inheritance tax on big fortunes."

Within a decade, he won the debate. A constitutional amendment, passed unanimously in the Senate, authorized the income tax. Congress enacted the estate tax at the behest of Southern and Western lawmakers, anxious that the cost of preparedness for overseas war not be borne by farmers, tradesmen and workers.

These progressive federal taxes have given a rare break to Americans of modest means. Almost every other tax takes proportionately more from the poor and middle class. Through tariffs on imports, excise taxes on liquor, fishing poles and crankcase fluid, sucker taxes on cigarettes and lucky numbers, bridge tolls, auto tag fees, sales taxes and FICA, most taxes are regressive, falling most heavily on those with stagnant incomes.

State governments especially rely on regressive taxes and fees. The mandate that a state's budget be balanced every year means that states must rely on safely recurring sources like sales tax and bridge tolls, since income taxes are cyclical, and estate tax revenue spasmodic.

Delaware has historically been able to extract revenue less regressively than most states. Yet, its modestly progressive tax structure will be difficult, although not impossible, to preserve, due to changes in federal law, mobility of capital and the creativity of other states.

Three factors have helped Delaware taxpayers pay less tax than their neighbors.

The first factor was oval-shaped. Through the first half of the 20th century, the Three Cousins — Pierre, Alfred and Coleman du Pont — personally financed many of Delaware's schools, highways and other public institutions with their share of gunpowder profits derived worldwide.

A generation later, a corporate income tax was instituted, with the acquiescence of the state's chemical industry. Schools and highways were financed from Lucite, Lycra and Tyvek. Meanwhile, the ability to deduct state taxes against high federal rates permitted state personal income tax brackets unimaginable today — topping at 14 percent in the 1960s, 18 to 19 percent in the 1970s.

Second, much of Delaware's other revenue came from elsewhere. The business world incorporates here, bringing many ancillary benefits. Credit card holders make monthly payments to Delaware banks. The state was a decade ahead of the field in legalizing one-armed games of chance. Half of all inheritance tax revenue came from out-of-state beneficiaries.

Third, Russ Peterson established the Cabinet form of government, but Pete du Pont showed how to make it work. His most important legacy was financial discipline, backed with structure and attitude, which enabled Delaware to ascend from the nation's worst credit risk in 1977 to one of the best, and stay at that level even during turbulent times. Thrifty with its spending, creative in collecting money, the state managed never to adopt a sales tax.

That legerdemain is more difficult now. The geysers of revenue that emerged after 1980 — gambling, bank franchise tax and unclaimed property — have reached or passed their peak, while traditional income tax sources had to be changed.

The state's revenue needs, however, have not peaked. "Cutting government revenue" means either cutting programs or deficit spending. The facile claim that "the state has a spending problem" doesn't explain which programs are to be ended, what erosion in social services is desirable, or which schools should lose their librarians.

> If the new [tax] law's unusual features cause a windfall, the state should guard against the two likely impulses: to spend the extra money immediately, or use the short-term bonanza as an excuse for permanent tax cuts.

Rather, the state will have to be more resourceful than ever — and its residents braced to pay more — if the state is to maintain its top-line revenue. The recently-discovered revenue streams are not annuities. Unclaimed property comes to Delaware due to a 6-3 Supreme Court decision. Because the 1993 case applied federal common law rather than a constitutional principle, it could be reversed at any time by Congress, where Delaware is outnumbered. The bank franchise tax rests on a compact industry that could operate with equal efficiency elsewhere. State lottery proceeds shrank as Pennsylvania and Maryland tiptoed into the casino business. Corporate franchise tax revenue appears safe for now, but in an era where aimless "disruption" is considered a virtue, complacency is not recommended.

Taxes are not intended to be fun. But, they can be reasonably fair and not cause harmful side-effects as they raise the revenue needed for the common mission of an organized society. Here are some suggestions for the state's policy-makers, and those who wish to influence them.

Personal Income Tax

Delaware's personal income tax tops out at 6.6 percent on taxable incomes of $60,000, with liberal income-splitting rules. Pennsylvania, whose constitution mandates a flat rate, taxes all income at 3.07 percent, with no deductions. Maryland's brackets reach 4.75 percent at $3,000, then 5.75 percent for a couple with taxable income of $300,000. New Jersey's rates reach 6.37 percent at $75,000 and 8.97 percent at $500,000.

- The double-figure rates of an earlier generation are impractical. State taxes were once deductible against federal rates that could reach 70 percent, and people needed to live near their work. Both factors have changed irrevocably.
- Having a flat tax for taxable income above $60,000 creates perceptions. Legislators may have to decide whether the perception of those making $65,000 or of those making $650,000 is more important.
- The state should not adopt abrupt or gimmicky responses to the new federal tax law, a monstrosity that gives bar napkins everywhere a bad name. Rather, the state should take the long view, in the expectation that this law will have a short life and be shredded within four years. If it's not, there will be more serious problems, like benzene in the Brandywine and oceanfront views in Georgetown.
- If the new law's unusual features cause a windfall, the state should guard against the two likely impulses: to spend the extra money immediately, or use the short-term bonanza as an excuse for permanent tax cuts. Both choices were made in the last 20 years, each looking poor in hindsight.

Corporate Income Tax

To address a major revenue crunch as its population and needs boomed, Delaware adopted a corporate income tax in 1958, based on the portion of a corporation's overall payroll, property and sales that are located here. In 2016, the formula was changed to one where the tax is based solely on sales within the state. The change reduced the tax of major employers but was no giveaway. The traditional formula, in universal use 60 years ago, has been abandoned by every other Eastern state. Corporate income tax will remain important, but it can drop by as much as 50 percent during recessions.

Gross Receipts Tax

A low, broadly-based tax on businesses, gross receipts tax receipts climb with inflation, resist recessions and provide stability. It raises 6 percent of state revenue — more during economic doldrums. That sounds smaller than it really is. Gross receipts tax raises more than corporate income tax, cigarette tax and liquor tax, combined. It exceeds all personal income tax raised from Kent County.

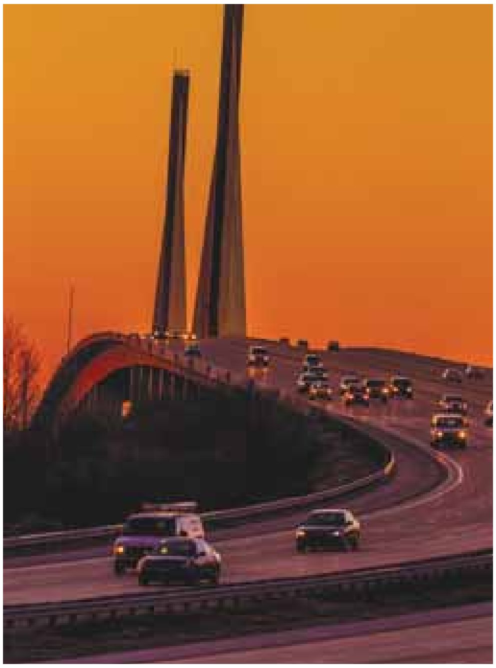
The tax is stable and low (0.72% for retailers, 0.384% for service providers, 0.18% for manufacturers). That's one penny on a $3 bottle of milk. (Compare that to 18 cents of sales tax in neighboring states.) The tax is easy to administer. The return is filed on the proverbial post card. It exempts businesses grossing less than $1.2 million per year ($15 million for manufacturers).

The tax has been imposed on retailers since 1871, and was three times higher in 1925 than now. In the 1975 revenue crisis, leading to a February walkout by teachers over an undelivered pay raise, the General Assembly adopted a reform long proposed by Rep. Jim McGinnis, to expand the gross receipts tax to include services, as well as goods. The revised tax stabilized the state's finances, and McGinnis was handily elected lieutenant governor a year later.

Should a tax be imposed on a business, whether or not it makes a profit? Motorists pay bridge tolls even if they're broke. Families pay income tax whether they have increased their net worth or slid deeper into debt.

As Bill Remington wrote here in 2004, after 25 years as an advisor to nine Secretaries of Finance of both parties, the last 10 as Director of Revenue:

"A fair tax should be proportionate to the taxpayer's ability to pay. To be considered fair, a tax should be proportionate to benefits received from the taxing



government. Neither criterion is easily applied. Though it is often argued that the gross receipts tax fails the first criterion, it is not clear this is true. The ability of a business to pay any expense is in fact roughly proportionate to its sales, since the existence of receipts from sales is the basic source of the ability to pay expenses. The fact that those making business decisions have made decisions or presented them in such a way that certain taxes are compared with profits determined after other costs (including executive compensation and depreciation) are taken into account is an artifact of presentation, not necessarily of the ability to pay.

"Second, though it may be difficult to determine the value of the benefits a business, including a business running a net current loss, receives from public services (like the education of its workforce and their children, police protection of the place of employment and of employees), it is clear the value is not zero. Once it is established the value is not zero, it seems like proportionality to gross income is not a terrible measure, if the measure is in any case inevitably arbitrary."[1]

Is the gross receipts tax ultimately passed on to the consumer? No evidence suggests so. Interstate retailers price their goods regionally, across state lines. Local merchants charge what the market will bear, and don't reduce price just because a cost has dropped. Do you know any lawyers who reduced their fees, or merchants who cut the cost of toothpaste, when the General Assembly lowered the gross receipts tax from 2005 to 2009?

Pension Exclusion

Tax exemptions should have sound policy basis. Those with identical income should be taxed similarly, unless there are compelling reasons to do otherwise. Delaware's exemption of the first $12,500 of pension income has no basis in public policy except inertia. The population eligible for this exclusion — anyone over 60, even if not retired — is growing, needlessly shorting the income tax and shifting the cost of government to younger tax-payers.

Property Tax

Delaware property taxes rank fifth lowest in the nation, slotted between Louisiana and South Carolina. If rates were doubled, Delaware would be at the national midpoint, and still well below Pennsylvania and New Jersey.

Of equal importance, reassessment is overdue. Delaware property taxes are based on appraisals that are, depending on the county, 32 to 44 years old. No property tax boost would be accepted based on these rickety valuations. Reassessment would cause some homeowners' taxes to rise, and an equal number to decline, but overall must be revenue-neutral.[2] Most importantly, it would realign tax liability with the real world.

Not to reassess shifts the tax burden from Bethany to Seaford, from Middletown to Dunlinden Acres – in effect, causing an annual transfer of wealth in the other direction. "Property tax is a form of wealth tax," observed Bill Chandler in an interview while still Chancellor. "Property taxes are based on a value that is a measure of wealth, an ability to pay. But by assessing a property today according to a value as if it had been built in 1974, you are grossly understating that wealth. This creates an inequality in tax payments that is difficult to reconcile in any notion of fairness."[3]

Every state and county legislator knows reassessment is overdue, and has been told as much by task forces that have recommended it. As Ed Ratledge of University of Delaware noted in these pages six years ago, reassessment could permit many functions now left to school districts to be addressed on a coherent statewide basis.[4]

Realty Transfer Tax

Last summer's increase from 3 to 4 percent was a bludgeon, but the real impact of the tax is not in Brookside or Rodney Village. Flippers, investors and vacation home buyers are the real target. The sale of a $2-million strip shopping center will now yield $80,000 — in a transaction where the seller is likely avoiding income tax entirely by a tax-deferred exchange, a stratagem that can be employed endlessly until the seller dies, the basis is stepped up, and no gain is ever recognized.

Washingtonians brag that they avoid the real estate transfer tax by titling their Rehoboth cottages in LLC's, which they sell in transactions that don't require recording. Actually, that loophole was closed in 1986, and our smug Bay Bridge visitors might soon encounter audits.

> Like most states, Delaware was robbed of its estate tax by an ill-considered provision in the 2001 tax act. Included among its upper-income sugar plums was a time bomb for states.

Sales Tax

The Land of Tax-Free Shopping seems to have less allure than just 10 years ago. Over a dozen vacant storefronts greeted my semiannual visit to the Concord Mall last summer and anchor tenant Sears was as desolate as Connie Mack Stadium on a chilly September night.

Since suggestions of a state tax were whispered in the 1970s, small retailers, big business and labor have united in opposition. But if fewer people drive to Delaware to save the 6 percent, because Internet retailers provide free delivery and skip the sales tax, how important is the absence of a sales tax?

Patience is in order. Long-discussed federal legislation, or cases percolating through federal courts, might lead to a requirement that large Internet retailers collect sales tax, whether or not they have bodies and bricks in the vendee's state. Such a change would restore the advantage of in-person shopping in Delaware, once again rendering verboten any discussion of a Delaware sales tax.

Medicaid

There is no less edifying sight than the scurrying of middle-aged children to contort their aging parents' affairs so that the children can inherit property while the state pays for their long-term custodial care.

Delaware regulations actually restrict the Division of Social Services from recovering the Medicaid costs it has expended for long-term care to two sources: a patient's probate estate and real estate. This requires the state to pay nursing home costs for solvent seniors who have created trusts to exploit this loophole.

Many other states have addressed this problem by including trusts, life estates and similar vehicles within Medicaid recovery. Delaware must confront whether this growing subsidy to the non-indigent should remain a priority.

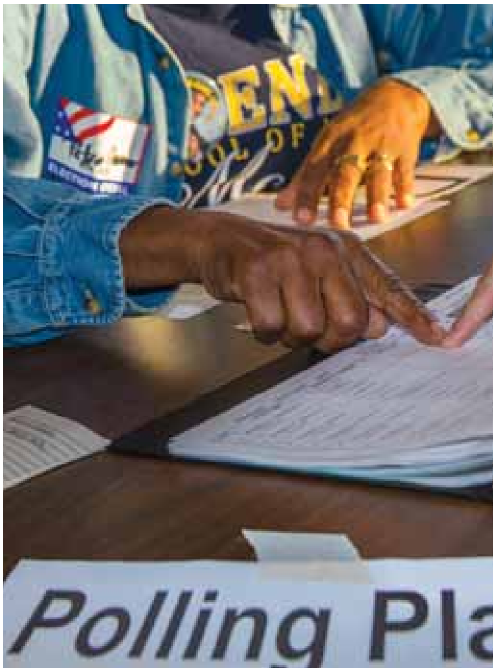
Estate Tax

Like most states, Delaware was robbed of its estate tax by an ill-considered provision in the 2001 tax act. Included among its upper-income sugar plums was a time bomb for states: it changed the state death tax credit into a deduction, immolating 75 years of sensible policy designed to prevent state-shopping. The state death tax credit painlessly shifted estate tax revenue, assessed by the federal government, to state governments, without costing their residents a dime. For most states, it was the only progressive element in their tax laws.

Elimination of the credit launched a race to the bottom. States eliminated their death taxes, since they were no longer painless, being only deductions, not dollar-for-dollar credits. Delaware did so, but in 2009, during the Great Recession, reinstated the tax.

Did this increase out-migration that hurt the state? There's no data, although there has been vigorous argument by anecdote. Since Willis Carrier developed air conditioning in 1902, retirees have moved to Florida, where the constitution prohibits a state income tax and the ballparks host spring training.

Because estate tax revenue is spasmodic in a small state, it was almost inevitable that the tax would be again repealed, as happened last summer, as part of the bargaining for an increase in the franchise tax.



If in the 2021 tax bill, the Federal government revives the state death tax credit, Delaware should change how it treats the estate tax revenue. Just as a well-advised heir treats an inheritance as a legacy to be preserved, and not spent within 12 months, the state should consider devoting all estate tax receipts to an endowment fund for projects that require a massive one-time investment. Important initiatives could be considered, not swiftly dismissed because "the money's not there." Such a proposal was introduced 50 years ago by GOP Reps. Laird Stabler Jr. and George Hering.

Divestiture Fund

There's precedent to hold tax receipts in an endowment fund. When DuPont had to divest its General Motors stock in 1961-63, Delaware received $29 million, manna that would never recur, which the General Assembly placed into a special fund to be used only for major capital expenses.

In the 1970's, though, it was regularly tapped by legislatures under control of both parties as a last-minute patch for the operating budget, and finally emptied by 1976. After 40 years of incorporating sound fiscal management into its culture, the state should have learned better. It should again create such a reservoir, fund it with non-recurring tax revenue, maintain it with discipline and use it prudently.

Three-Fifths Rule

After a decade of successive financial calamities, the General Assembly adopted a constitutional amendment, proposed in 1978 by Gov. du Pont, a Republican, and Lt. Gov. McGinnis, a Democrat, to require a three-fifths majority in both legislative chambers to adopt or increase a tax.

Although Republican Senators Dan Weiss and Andy Knox saw practical problems with the proposal, designed to make tax increases more difficult and prevent what du Pont described as "midnight raids," the amendment rolled with scant opposition, part of the modernization of the State's financial practices, gaining hearty acceptance from a public weary of whiplash from hastily-conceived tax legislation, and generally chary of taxes in the Proposition 13 era.

The ensuing professionalization of state revenue management, the establishment of the Delaware Economic and Finance Advisory Council and the rainy day fund, regularized procedures for the Joint Finance Committee, and the collegial, result-oriented process known as the Delaware Way, proved enormously successful, yielding consistent AAA bond ratings for over a generation.

Yet, the three-fifths rule does not prevent last-minute legislation. It simply adds new tools to the combatants in June negotiations. Too much legislation is still made on June 30, often after last call. The principal effect of the three-fifths rule is to tilt the field in favor of the defense. Fiscal shortfalls can be used as hostage for issues unrelated to budget or finance.

Potential mischief arises in ways that didn't exist in a prior, less polarized era. In the 1970s, last-minute negotiations could be oafish — expansion of the Delaware Supreme Court to five members was delayed by four years because of a legislator's pique over a failed bill to benefit asphalt contractors — but not ideological. The parties overlapped then. When the three-fifths rule was adopted, most of the state Senate's liberals were Republicans.

In 2017, though, the arguments no longer center on paving contractors. In effect, last spring's discussion in the legislature had sounds of, "You want a tax increase? Then we want something back on environmental regulation, labor law or social legislation."

The three-fifths rule, if misused in the contention of an ideology-polarized era, could lead to late-night damage not envisioned by its original proponents.◆

NOTES

1. William M. Remington, *Delaware's Tax System in a Digital Age*, Delaware Lawyer, vol. 22, no. 3, p. 19.

2. State law permits property tax revenue to increase by 15 percent in the first year after reassessment, to cover the cost, but must return to its prior level thereafter. 9 *Del. C.* § 8002.

3. Reid Champagne, *A Mess to Reassess,* Delaware Today, August 2008.

4. Edward C. Ratledge, *Delaware's Revenue Portfolio*, Delaware Lawyer, vol. 30, no. 2, p. 12.

Root Causes

continued from page 13

spending is also essential. Spending programs that will require higher future taxes can be as damaging to the business climate as high taxes today.

In the end, tax policy alone is not the answer to the state's fiscal challenges. Responsible, productive spending policies and recreating a pro-growth climate are the true solutions to the challenges the state faces. ◆

NOTES

1. All Delaware and United States economic data are taken from the Federal Reserve Bank of St. Louis' Federal Reserve Economic Data web site: https://fred.stlouisfed.org/.

2. This difference is greater than indicated by the raw data, as certain components of personal income, such as interest on federal bonds, Social Security benefits and a part of pension income, are not subject to Delaware income tax and yet are fully or partially taxed at the federal level.

3. All Delaware budget data is from the 2016 *Delaware Fiscal Notebook*.

4. In July 2017, legislation was enacted increasing various taxes and fees, including the corporate franchise tax and the property transfer tax.

5. Butkiewicz, James L. and Latham III, William R. "Banking Deregulation as an Economic Development Tool" *Southern Economic Journal*, April 1991, pp. 961-74., and Abrams, Burton A. and Butkiewicz, James L. "Deregulation for Development: A Tale of Two States" 2009, University of Delaware Department of Economics Working Paper, study the growth effects of the FCDA.

6. *Wilmington News Journal*. "Who is behind Delaware LLCs?" December 3, 2017. 1E, pp. 1,3.

David H. Williams

OF COUNSEL: George C. Hering, III

As the State addresses important options in taxation and budgeting, this is an appropriate time to revisit a senior member of the bar who helped Delaware navigate similar choices a half-century ago, leaving a lasting impact.

George C. Hering, III has deep roots in Delaware, and at Morris James LLP. George grew up in Wilmington and graduated from Tower Hill, where he was a three-sport captain. He attended Dickinson College and Dickinson School of Law. Two years of service in the Army's Counter Intelligence Unit interrupted his law school education. In 1959, George joined what is now Morris James, where he worked until his retirement in 2000.

In 1931, George's father, George Clark Hering, Jr., and John J. Morris, Jr. co-founded the firm now known as Morris James LLP. The firm had a foot in both political camps. George's father was active in the Republican Party, including serving as State Chairman. John Morris was a Democrat who also was active in politics, and served two terms as the United States Attorney for the District of Delaware. Albert W. James joined Hering and Morris in 1932. James, a prominent Republican, served as President of Wilmington City Council, Mayor of Wilmington from 1940-1945, and was elected Attorney General of Delaware in 1945.

Given his father's active role in politics, the legacy of political activity on the part of the other partners of the firm, and his own service as a U.S. Senate page while a teenager, it is not surprising that in 1964 George dove into a central role in a group known as the Active Young Republicans of Wilmington. This group spearheaded the rejuvenation of a party decimated in the 1964 election.

Named the city's Outstanding Young Man of the Year by the Wilmington Junior Chamber of Commerce in 1965, George was elected to the Delaware House of Representatives in 1966, and was immediately elected Speaker of the House. Over the next few years, the Republican resurgence included electoral victories for Mike Castle, Laird Stabler, Jr., Hal Haskell, Bill Roth, Pete du Pont and Russell Peterson's election as Governor in 1968.

In his years in the House, George led the enactment of transformative legislation. Most notably, the commission form of government was replaced by the cabinet structure and the Coastal Zone Act of 1971 was adopted, banning heavy industrial development on Delaware's coastline. The Coastal Zone Act was highly controversial, particularly within the business community, at the time it was debated and enacted.

George also was an advocate of financial reform and clean government. He led the adoption of the first rules requiring registration of lobbyists. He proposed campaign finance limits, a strengthened legislative council and a victims' compensation fund. He proposed that fiscal notes be attached to bills whose costs exceed $50,000. In the wake of the fiscal emergency of 1971, caused by faulty revenue estimates, he asked that the state establish an independent revenue-forecasting board. Each of these reforms was ultimately adopted.

After serving in the House of Representatives for six years, continuing to practice law while serving in office, and branching out to an active role nationally as a delegate to Presidential Nominating Conventions, George's wife, Fairfax, understandably asked George to step back from his political career in order to devote more time to raising their five children. George turned his focus to his family and building his law practice.

When he retired from the legislature, a *Wilmington Morning News* editorial expressed hope that he would return, saying, "He's the best kind, the type needed for [public life]." He retained a presence in Dover, chairing the transition team for Governor-elect Pete du Pont in 1976, and serving as rate counsel for the Public Service Commission during a turbulent era. In private practice, he migrated from a general practitioner to an emphasis on Trusts and Estates.

George continued his commitment to public service by serving on the Board of the YMCA, as a Trustee of Dickinson College, a Vestryman at Trinity Episcopal Church and a Trustee of Tower Hill. Late in his career, George also served as Chairman of the Kalmar Nyckel Foundation, and was instrumental in raising the funds to build the *Kalmar Nyckel*, which was completed in 1997. It is the last ship launched in Wilmington, a city that has launched more than 10,000 ships over its history. ◆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