State of Delaware

Tax Preference Report 2005 Edition

Department of Finance

Division of Revenue

EXECUTIVE SUMMARY

This Report, required by §8305(6), Title 29, Delaware Code, assesses the impact of tax preferences on the personal income tax, corporate income tax, motor fuel/special fuel tax, and public utility tax codes.

Tax preferences are no different from additional state spending in terms of their budgetary implications and thus are sometimes referred to as "tax expenditures." A reduction in revenues has the same fiscal impact as a direct expenditure of equal magnitude -- both consume finite public resources. Since the last Tax Preference Report was issued in 2003, Delaware has created or expanded four tax preferences, bringing the total covered by this report to 46, and increasing the growth of State expenditures on tax preferences.

Tax preferences are often established to pursue public policies that are not directly related to the tax system itself. For example, the tax-exempt status of employer-provided health insurance is primarily a health care policy that is administered through the tax system. In these cases, the effectiveness of a tax preference should be subject to the same cost-benefit analysis that direct expenditures undergo.

Using cost-benefit analysis to evaluate tax preferences is more difficult than for comparable direct expenditures. The analysis must also weigh how the policy affects the tax system through which it operates. For example, the impacts of such policies are often in conflict with the goals of an "ideal" tax system. The proliferation of tax preferences can, if left unchecked, undermine the fairness of a tax system, erode the tax base, distort private economic incentives, and generate unnecessary complexity within the tax code.

Given their budgetary and policy equivalence to direct expenditures, the burden they may place on the tax system, and the upward trend in their use, tax preferences represent a significant component of Delaware's fiscal environment. As such, it is important that this report receive serious attention from State policy makers.

ACKNOWLEDGMENTS

Rebecca Goldsmith, of the Department of Finance's Office of Research and Analysis, performed the preponderance of analysis used in this Report.

The Division of Revenue also appreciates the assistance, analysis and contributions of the staff of the Delaware Economic Development Office, Department of Natural Resources and Environmental Control, Delmarva Power Delivery, Motor Fuel Tax Administration, the Delaware Transit Corporation and the State Lottery Office.

The revenue estimates and judgments expressed herein, however, are ultimately those of the Division of Revenue.

Patrick Carter
Director of Revenue

TABLE OF CONTENTS

INTRODUCTION

Legislative Background

Title 29, Delaware Code, §8305(6) requires that the Division of Revenue, under the supervision of the Secretary of Finance, prepare biennial reports that estimate the fiscal impact of all newly enacted and existing tax preferences within selected revenue sources. Reports are due in each odd-numbered year. This ninth Tax Preference Report is submitted to meet the requirements of that provision for Calendar Year 2005.

Only during the last thirty five years has the importance of tax preferences on government revenues been formally acknowledged by the federal and state governments and systematic analysis of their revenue impact been required. The reporting of tax expenditures was incorporated into the federal budget process through the enactment of the *Congressional Budget and Impoundment Act* (CBIA) in 1974. CBIA requires the President to report on tax expenditures in the budget and requires Congressional committees to provide tax expenditure estimates for each tax bill that they report. Legislators, therefore, have begun to recognize the costs associated with tax expenditures and have taken initial steps to bring such spending under traditional budget scrutiny.

Delaware has taken similar steps to analyze preferences within its tax system. In November 1986, a tax preference report was submitted to meet the requirements of the original legislation. The report was the State of Delaware's first published effort to identify tax preferences arising from provisions of the Delaware Code. The second report, which the Department of Finance submitted to the General Assembly in November 1988, fulfilled the legislation's more comprehensive requirements by analyzing the impact of all State and federal tax preferences on Delaware revenues. Pursuant to Senate Bill No. 284 of the 136th General Assembly, beginning with the third Tax Preference Report -- published in November 1993 -- the reports have had a significantly narrower focus. Like the more recent reports, this ninth Delaware Tax Preference Report examines statutory tax preferences within the categories of personal income tax, corporate income tax, motor fuel/special fuel tax, and public utility tax. Because no federal tax preferences are analyzed, more specific analyses of Delaware tax preferences are possible than in the second, more broadly focused report.

Purpose of the Tax Preference Report

The "Declaration of Policy" set forth in §8305(6)(a) acknowledges that state governmental policy objectives may be achieved through direct expenditures and indirectly through the use of tax preferences. Unlike direct expenditure programs, however, tax preferences do not receive regular review or require annual appropriations.

As such, preferences may remain in place indefinitely, with no review of their effectiveness and no system to monitor their cost. The primary purpose of this Report is to identify all tax preferences within specified revenue sources, and assess them quantitatively and qualitatively.

A comprehensive review of tax preferences has value in its own right. Without thorough, long-term reviews, tax policy often becomes overly focused on immediate, short-term problems. In such an environment, more fundamental government goals may fall by the wayside. For example, day-to-day tax policy issues often involve the analysis of a single tax preference designed to address a particular perceived need. When viewed in isolation, a tax preference may have considerable merit and be motivated by the best of intentions. But ad hoc preferences incrementally add to the complexity of the tax code and may threaten its fairness, distort decision-making, and gradually erode the tax base. Before long, the fundamental objectives of a tax system -- equity, efficiency, simplicity and adequacy -- may become compromised.[1]

Periodic review is necessary because time can dramatically alter the complexion of tax preferences. Tax breaks for a select and small group of people can grow quickly into expensive entitlements as demographic and/or economic conditions change. Conversely, tax preferences can lose their usefulness if the income or business conditions on which the preference is based change over time.

Tax preference reports are useful tools in the annual budget process. They offer insight into revenue losses that could be slowed, allowing budget shortfalls to be closed without resorting to tax increases or direct expenditure cuts. The incorporation of tax preference reports directly into the budget process would enhance the visibility of these fiscal options.

The purpose of this report, however, is not to propose specific policy alternatives, but rather to assist the tax policy debate in the State of Delaware by objectively highlighting the potential advantages and disadvantages of various tax preferences. It is our hope that this report will help facilitate discussion of current tax preferences and the role they play in the tax system.

Components of the Tax Preference Report

As per the requirements of §8305(6), this report provides the following information for each of the four designated tax types:

[1] See the section of this Report entitled "Incrementalism" below.

1. A description of each tax preference, its statutory basis, and its purpose.

2. An estimate of the revenue loss to the state, or one of its subdivisions, caused by each tax preference for the last fiscal year (FY 05), and the estimated revenue loss caused by each tax preference for the current fiscal year (FY 06).

3. An assessment of whether each tax preference is the most fiscally effective means of achieving the purpose for which it was enacted, and whether or not each tax preference has been successful in meeting the purpose for which it was enacted.

4. An assessment of whether each tax preference benefits those taxpayers originally intended to benefit from it and, if not, a listing of those who do benefit.

5. A statement of any unintended or inadvertent effects, benefits, or harm caused by each tax preference, including whether each tax preference conflicts with any other state laws, regulations, or policies.

Definition of "Tax Preference"

An essential step in preparing tax expenditure reports is defining the term "tax preference." A provision of the tax code that one onlooker considers to be grossly unfair can be a provision that another observer considers absolutely equitable and fair.

Nevertheless, most commentators agree that a tax preference: 1) provides a benefit only to taxpayers; 2) operates through specific statutory provisions of the tax code; and 3) depends on certain criteria, such as age, income source, or expenditure decisions that not all taxpayers meet. In general, then, tax expenditures are tax code provisions that narrow the tax base or give credits to certain groups of taxpayers. The federal government uses the following definition, originally found in §3(a)(3) of the *Congressional Budget and Impoundment Act*:

> "those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or other deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."

The tax base for both the federal and State income tax is "net income" in the case of corporate income tax, or "adjusted gross income" in the case of personal income tax. In either case, the base equals gross income less certain costs associated with earning income. Not all subtractions from "net income" can be called tax preferences. For example, costs of earning income are often deductible, but not considered tax preferences. These expenses are deductible by all taxpayers, so no preferential treatment occurs.

In addition, certain features of the tax code are considered to be integral parts of its basic structure and thus, are not considered tax preferences, even though they are subtractions from net income: among them, differential rates based on income level, the standard deduction, and personal exemptions. Only exceptions to these basic tax rules can be properly identified as tax preferences.

In defining "tax preference," this Report uses the following operational guidelines found in §8305(6):

> " 'Tax preference' means any law of the United States or of the State of Delaware which exempts, in whole or in part, certain persons, income, goods, services or property from the impact of established taxes, including, but not limited because of a failure of enumeration, to those devices known as tax deductions, tax exclusions, tax credits, tax deferrals, and tax exemptions. Tax preferences shall not include variations in the rate of income tax...standard deductions...or personal exemptions. [2]"

Review of Tax Preference Terminology

Tax systems are frequently evaluated according to several commonly accepted criteria and fundamental goals. Tax preferences should be assessed in the same terms, since they directly affect how well the basic tax system achieves these goals. These criteria characterize a system's: (i) ability to raise revenues in a reliable manner, known as *adequacy and stability*; (ii) fairness in terms of the distribution of the tax burden, known as *horizontal equity* (i.e., treating equals equally) and *vertical equity* (treating unequals fairly based on their ability-to-pay); (iii) ease of administration, enforcement, and return preparation, known as *simplicity*; (iv) amount of interference with individual decision-making, known as *economic efficiency*; and (v) potential to promote (or hinder) *economic growth*.

---

[2] The personal exemption was replaced by a personal credit effective January 1, 1996.

Adequacy and Stability

The impact of tax preferences on government revenues is the most obvious way that tax preferences affect the tax system. In fact, the term "tax expenditures" is often used interchangeably with "tax preferences" to indicate their negative effect on revenues. Producing steady revenues, even in economic downturns, is one of the most important roles of any tax system. Tax preferences affect the adequacy of tax systems because they narrow the tax base and reduce the liability of certain groups of taxpayers, thereby reducing the ability of a tax system to raise revenue in a *stable* and *reliable* manner through alternating economic cycles. Tax preferences linked to certain income sources or investment activities increase revenue instability because taxpayers can change their economic behavior in unpredictable ways.

A related concept, which is often discussed in connection with adequacy, is the *elasticity* of a particular revenue source. Tax elasticity refers to the percentage change in revenue attributable to a one-percent change in the income of taxpayers. Revenue sources are often assigned an elasticity value and rated accordingly. For example, an elasticity of 0.5 would mean that a one-percent change in income would result in a 0.5 percent change in tax revenue.

Elasticity is an important consideration in evaluating tax systems because it is desirable to have revenue sources in place which keep pace with inflation and the demand for public services. In most instances, an elasticity of at least 1 is desired -- this implies that a one percent increase in income will produce a one percent increase in tax revenue. The reader should note that, within a given revenue source, tax stability and sufficient tax elasticity are often difficult to achieve simultaneously (i.e., the more elastic a revenue source, the less stable and predictable it is likely to be). For this reason, a state's mix of taxes (or its "revenue portfolio") should be composed of a number of taxes allowing for proper balance between revenue growth and stability. For additional information on the tradeoff between the evaluative criteria discussed in this section, please refer to the summary below.

Horizontal Equity

Horizontal equity means that, all other things being equal, taxpayers with similar ability-to-pay should have similar net tax burdens. Generally speaking, for tax purposes, equal ability-to-pay is defined in terms of equal income. But income does not always equate with ability-to-pay. For example, if "Taxpayer A" and "Taxpayer B" have the same level of income, but "Taxpayer A" spends two-thirds of her income on unavoidable medical expenses, "Taxpayer A" has less ability-to-pay than "Taxpayer B." Horizontal equity, therefore, does not necessarily imply one set of rules for all. Tax rules can be adjusted to take account of special circumstances and thereby maintain horizontal equity. The problem is determining *which* special circumstances justify special treatment for tax purposes. These special circumstances are typically unavoidable, catastrophic expenses that a taxpayer faces involuntarily. Large, voluntary, and common expenses are not usually considered in ability-to-pay calculations because of their controllability. When it is legitimate to deviate from a common definition of income, criteria defining these cases should be outlined, and tax preferences evaluated with respect to them.

Vertical Equity

Vertical equity is the principle that tax burdens should be distributed "fairly" among taxpayers with different abilities-to-pay. Vertical equity is a subjective concept that, at its core, is essentially a value judgement. Among policy makers and academics, however, there is general agreement that the tax system should not be regressive; i.e., that those with lower incomes should not pay a larger proportion of their income in taxes than do those with higher incomes. Some tax preferences are clearly intended to benefit low-income groups.

The intent of these preferences, with respect to their effect on tax burdens is different from horizontal equity. Tax preferences that improve horizontal equity are intended to equalize the tax treatment between individuals with similar incomes by recognizing differences in ability to pay. Typically, tax preferences that seek to address vertical equity are designed to increase the tax system's progressivity by reducing the tax burden on lower-income taxpayers relative to those with higher incomes. To the extent that they are successful, proponents of increased progressivity may claim that the tax preference improves vertical equity. However, several of Delaware's tax preferences provide significant tax benefits to middle- and upper-income taxpayers even though they were ostensibly established for the purpose of improving vertical equity.

Simplicity

Simplicity in tax systems is valued because it allows for lower taxpayer and administrative costs and enhances compliance with tax laws. Tax preferences may take the form of deductions, exemptions, credits, and exclusions, many of which make tax forms more difficult to understand, more time-consuming, and harder to complete accurately. Entitlement to special deductions often requires special recordkeeping by taxpayers and additional verification by revenue agents. Conversely, simple tax systems offer reduced administrative and collection costs due to their transparent, straightforward definition of taxable income.

Simplicity can affect voluntary and involuntary compliance rates. The more deductions and subtractions that taxpayers make on their returns, the greater the possibility that they will make inadvertent mistakes in calculating their liability. Tax simplification can increase voluntary compliance rates. Fewer deductions and credits (which often are difficult to verify in the absence of an audit) provide fewer opportunities to shelter income. Reducing the number of tax preferences reassures taxpayers that other citizens are "paying their fair share" and enhances their willingness to comply voluntarily.

Economic Efficiency

An efficient tax system should be as neutral as possible with respect to economic decision-making. This requires that resources be allocated where they will receive the highest expected return. Tax preferences may interfere with economic decision making and, therefore, erode *economic efficiency*, because they explicitly favor certain allocative decisions over others.

Not only does society lose resources by limiting tax payments from certain taxpayers, but tax preferences also may shift economic resources towards less productive uses. Tax preferences can cause resources to be allocated where they can receive the most favorable tax treatment rather than where they can produce the goods and services most in demand by consumers, or earn the highest economic return.

Economic Growth

Many tax preferences are based on the argument that they will promote economic development by encouraging businesses to locate in Delaware or to invest in existing Delaware enterprises. Tax preferences can increase tax revenues if they attract investments that enlarge the economy. Whether preferences *do* enhance economic growth is up to question. On the downside, tax preferences may actually become growth impediments if they cause other, non-preferred activities to pay higher taxes. Higher rates impede economic growth because they reduce the after-tax return available on investments.

Other Criteria

Tax preferences are often established for reasons other than improving the tax system, and so should be measured against criteria in additional to those listed above. Many preferences are designed to provide incentives to certain investment activities or to serve specific constituencies, and not to enhance revenues or simplify tax administration. In these cases, the tax system is simply being used as a mechanism to achieve other public policy goals. For example, the purpose of some business tax credits is to increase business investment in certain industries, locations, or production methods, such as expenditures on pollution abatement equipment. Clearly, these external policy goals must be recognized in any assessment of a tax preference. The primary questions in these cases is whether the tax preference actually causes the behavioral change that society desires, and if another mechanism (aside from the Tax Code) is more appropriate in achieving the desired goal.

<u>Summary</u>

One final point to keep in mind is that, in practice, there is a tradeoff between these different criteria. For example, efforts to improve horizontal equity by instituting new tax deductions or credits to insulate taxpayers from unavoidable expenditures may erode simplicity. Tax structures designed to produce a more progressive distribution of tax burdens may violate the principal of economic efficiency. A tax system cannot achieve each of these goals to the same degree simultaneously. Ideally, these fundamental goals are balanced in a way that reflects the desires of state taxpayers as expressed through their elected representatives.

Readers will likely form more fundamental questions as they read this report. To list a few:

(i) Should the tax system go beyond its basic role of raising government revenues? If so, what are these roles?

(ii) If the tax code is being used to address a certain societal problem, would direct governmental expenditures or the imposition (or removal) of government regulations better address the problem?

(iii) To what degree should tax preferences be held to the traditional standards of tax administration (i.e., adequacy, equity, efficiency, and simplicity), even if a tax preference was not created for tax policy purposes?

Methodology -- Measurement of Revenue Impacts

The revenue impacts of Delaware tax preferences are analyzed using a variety of sources and techniques. Estimates of losses in the personal income tax system rely primarily on databases that includes information from both state and federal personal income tax forms for Delaware residents. Because Delaware has a relatively small number of taxpayers, in many instances the Division of Revenue can analyze data for all resident and non-resident taxpayers, rather than resort to statistical samples of the population. The relatively small number of taxpayers, combined with modern relational database software packages, allows substantially more accurate analyses of the impacts of specific tax preferences on individual income tax revenues than might otherwise be possible. These advances in computing capacity overcome the analytic limitations of the early tax preference reports.

Other sources of information for this report include computerized data for corporate income and other tax sources; published and unpublished Department of Finance reports and fiscal notes; data and reports from other government agencies and private institutions; and, where necessary, direct sampling of Delaware tax returns.

Readers should be aware of several limitations with respect to the Report's fiscal impact calculations:

(i) Except where noted, revenue loss estimates for each tax preference are calculated in static terms without accounting for behavioral effects that may result from the elimination or modification of a specific tax preference. This limitation is most significant with respect to business tax credits, whose primary purpose is to encourage behavioral change (e.g., different patterns of business investment).

(ii) Revenue loss estimates are calculated separately for each tax preference. No assessment has been made of the cumulative effect of a number of tax preferences on lost revenues. Interrelationships between different tax preferences can result in situations where changing one preference has implications for the revenue loss estimates of other preferences. This limitation is most apparent with respect to tax preferences for the elderly. The elderly may claim up to four different, non-means-tested tax preferences. Due to Delaware's graduated rates structure, the revenue effect of claiming four tax breaks simultaneously is not necessarily the same as the sum of its parts. For example, an elderly couple that qualifies for three tax preferences may avoid any tax liability by taking only one of the three preferences available to them.[3]

(iii) Revenue estimates assume no change in the taxpayer's decision to itemize deductions or to take the standard deduction. If several preferred itemized deductions were eliminated, more taxpayers would possibly claim the standard deduction instead. As a result, the revenue impacts of other itemized deductions would fall. Conversely, elimination of the additional standard deduction for the

[3] See the section of this Report entitled "Incrementalism" below.

elderly might cause an increase in itemized deductions, which would affect the fiscal impact of other tax preferences.

(iv) The fiscal impact of a particular provision only examines the revenue losses related to a specific tax covered in this Report. This is significant for several of the business tax credits, which may be taken against taxes other than corporate income tax or public utility taxes. For example, while a firm may have no corporate income against which to claim credits, it may claim the credits against the gross receipts tax, which is not covered in this Report.

(v) Economic performance directly affects these revenue loss estimates, especially those for corporate income tax preferences. For example, in economic downturns, corporations may not have any taxable income due to net losses. Corporations with no liability cannot claim the tax credits to which they may be entitled. As such, estimates of tax expenditures depend on the predictability of changes in taxable income that result from changes in the national economy.

(vi) Changes in the Federal tax or regulatory system can also affect the revenue loss estimates for Delaware tax preferences. This is because changes at the Federal level may induce behavioral changes that affect the State revenues.

Despite these limitations, this Report's revenue loss estimates do provide useful information on the relative size and growth of various tax preferences. The estimates can show how widely a tax preference is being used and indicate the revenue implications associated with its repeal or modification.

Limitations of the Tax Preference Report -- Incrementalism

One of the shortcomings of the approach taken by this report (the examination of individual preferences within specific revenue categories) is that, in some instances, it fails to adequately convey the implications which can result from the cumulative effect of different tax preferences. The incremental nature with which some preferences develop can have unintended consequences on taxpayers and state revenues. Due to the efforts of state policymakers, Delaware has for the most part avoided this problem. Two areas where incrementalism has raised concerns are the complexity of the "Blue Collar Jobs

Act" credits and personal income tax preferences based on age. The discussion below deals with personal income tax preferences based on age. [4]

Over the past forty years, public policy makers at all levels of government have implemented proposals aimed at improving the welfare of elderly citizens. The creation of Medicare and indexing Social Security benefits are among the most notable federal policies of the last forty years aimed at assisting the elderly. Like other states, Delaware has enacted several personal income tax preferences to assist elderly taxpayers.

Evaluated individually, the unintended implications inherent in many of these preferences (see the Personal Income Tax section below) may not have sufficiently outweighed the perceived benefits to prevent their enactment. Taken together, however, serious equity implications can arise. Because elderly taxpayers can utilize more than one of these preferences at a time, the combined effect of these preferences can result in dramatically different tax treatment of individuals with the same ability to pay.

Cumulative Effect of Non-means Tested Preferences

An illustration of the equity problems caused by the cumulative effect of these tax preferences can be seen in the following example. Consider the following two households:

	Household A	Household B
Family of :	4	2
Both Spouses Age:	35	65
Number of Children:	2	0
Both Spouses Work:	Yes	No
Total Household Income:	**$74,400**	**$74,400**

"Household A" receives its income exclusively from wages and interest, while "Household B" receives its income primarily from Social Security and pension income. The differences in sources of income between these two households will have a dramatic impact on their tax liability.

[4] For a more detailed discussion of the problems associated with the incremental development of "Blue Collar Jobs Act" credits, please refer to Items 2.08, 2.09, 2.11 and 2.12 in the Corporate Income Tax section below.

Household A

	Husband	Wife
Pension:	$0	$0
Interest:	$500	$500
Dividends:	$0	$0
Wages:	$36,700	$36,700
Social Security:	$0	$0
Total Income:	**$37,200.00**	**$37,200.00**

Household B

	Husband	Wife
Pension:	$20,000	$20,000
Interest:	$7,200	$7,200
Dividends:	$0	$0
Wages:	$0	$0
Social Security:	$10,000	$10,000
Total Income:	**$37,200.00**	**$37,200.00**

In computing taxable income, each spouse in Household A can reduce his/her taxable income by $3,250 (a total of $6,500 - the amount of the standard deduction). In contrast, the couple in Household B, because of the sources of their income and their age, can eliminate taxable income almost completely. This reduction represents the exclusion of Social Security benefits, the pension and eligible retirement income exclusion, the low-income elderly exclusion, the standard deduction and the additional standard deduction for persons 65 and over. (See table below.)

Tax Liability Comparison

Two-earner Family of Four v. Two Taxpayers Over 65				
	Household A		Household B	
Type of Income	Husband	Wife	Husband	Wife
Total Income	$37,200	$37,200	$37,200	$37,200
Wages	$36,700	$36,700	$0	$0
Social Security Exclusion	$0	$0	-$10,000	-$10,000
Pension Income	$0	$0	$20,000	$20,000
Dividend Income	$0	$0	$0	$0
Interest Income	$500	$500	$7,200	$7,200
Total Pension/Retirement Income	$0	$0	$27,200	$27,200
Pension Exclusion	$0	$0	-$12,500	-$12,500
Delaware AGI	$37,200	$37,200	$14,700	$14,700
Standard Deduction	-$3,250	-$3,250	-$3,250	-$3,250
Additional Standard Deduction	$0	$0	-$2,500	-$2,500
Taxable Income	$33,950	$33,950	$8,950	$8,950
Gross Tax Liability	$1,497	$1,497	$220	$220
Personal Credit	-$330	-$110	-$110	-$110
Additional Personal Credit	$0	$0	-$110	-$110
Child Care Credit	$0	-$250	$0	$0
Net Liability	$1,167	$1,137	$0	$0
Total Household Liability	**$2,304**		**$0**	

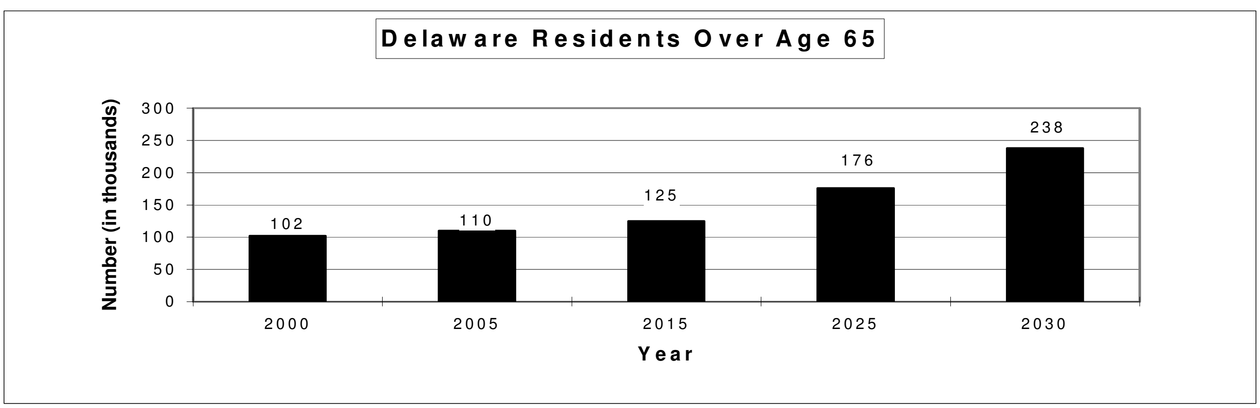
In the end, Household A has a gross liability of $2,994 which is reduced to $2,304 through the use of four $110 personal credits, and the child care credit.[5] Household B, on the other hand, has $440 in gross liability. This liability, however, is completely eliminated because the couple in Household B qualifies for four $110 personal credits – two regular credits plus two additional credits for persons age 60 or over. The retirees in Household B, despite having the same income and no dependents, pay no income tax, while the working family of four owes the state over $2,300.

This example is not unrepresentative of the radically different tax treatment of similarly situated taxpayers possible through the cumulative effect of non-means tested tax preferences.

Long-Term Effect on State Revenues

In addition, the cost of these preferences is expected to increase dramatically in future years. Early in the next century, the percentage of the population over age 65 is expected to increase dramatically as the baby boom generation begins its transition into retirement. This will significantly increase the cost of these tax preferences as more and more elderly taxpayers become eligible to benefit from them.

As can be seen in the table below, the number of Delaware residents over 65 is expected to increase to approximately 238,000 by the year 2030 -- a *134 percent increase* over 2000. The percentage of all Delawareans over age 65 is expected to increase from approximately 13 percent in 2000 to almost 24 percent in 2030.



Source: U.S. Census Bureau (http://www.census.gov/population/projections/summaryTabB1.xls)

[5] This couple can use four personal credits -- one personal credit for each spouse and one for each dependent.

LIST OF DELAWARE TAX PREFERENCES

<u>Personal Income Tax</u>

1.01 Low-Income Elderly Exclusion

1.02 Exclusion of Pension and Eligible Retirement Income

1.03 Exclusion of Taxable Social Security Benefits

1.04 Exclusion of Benefits Received Through the Travelink Program

1.05 Exclusion of Delaware Lottery Winnings

1.06 Additional Standard Deduction for the Blind or Persons Age 65 or Over

1.07 Charitable Mileage Deduction

1.08 Additional Personal Credit for Persons Age 60 and Over

1.09 Volunteer Firefighter's Tax Credit

1.10 Child and Dependent Care Expense Tax Credit

1.11 Tax Credits for New Business Facilities, New Employees, Qualified Investments, and Green Industries

1.12 Military Action Exemption

1.13 Extension of Filing Deadline for Military Personnel Serving in a Combat Zone

1.14 Exemption for Early Retirement Distributions Used for Education

1.15 Exemption for Trusts Established as “Designated” or “Qualified” Settlement Funds

1.16 Land and Historic Resource Tax Credit

1.17 Historic Preservation Tax Credit

1.18 Earned Income Tax Credit ★

<u>Corporate Income Tax</u>

2.01 Exemption of Investment Holding Companies and Firms Managing Intangible Investments of Mutual Funds

2.02 Exemption of Foreign Sales Companies

2.03 Exemption of Foreign Sales Service Companies

2.04 Exemption of Export Trading Companies

2.05 Deduction of Interest from Affiliated Companies

2.06 Handicapped Accessibility Deduction

2.07 Neighborhood Assistance Credit

2.08 Credits for Creation of Employment and Qualified Investments in Business Facilities

2.09 Credits for Creation of Employment and Qualified Investments in Targeted Areas

2.10 Credits for Mitigation of Commuter Traffic During Peak Travel Periods

2.11 Green Industries Tax Credits

2.12 Credits for Development of "Brownfield" Sites

2.13 Research and Development Tax Credit

2.14 Land and Historic Resource Tax Credit

2.15 Historic Preservation Tax Credit

Motor Fuel/Special Fuel Tax

3.01 Exemption for Ambulances, Veterans' Group Vehicles, and Volunteer Fire Companies

3.02 Refund for Certain Non-Road Vehicles

3.03 Exemption for Special Fuels

Public Utility Tax

4.01 Exemption for Corporations Reorganizing Under Provisions of the Bankruptcy Code

4.02 Exemption of Electricity Used in Certain Manufacturing Processes

4.03 Refunds for Firms That Qualify for New Business Facilities Credit

4.04 Rate Reduction for Electricity used by Manufacturing Firms, Agribusiness and Food Processing Firms[6]

4.05 Rate Reduction for Gas Used by Manufacturing Firms

4.06 Exemption for Electricity used by Automobile Manufacturing Firms

4.07 Exemption for Gas used by Automobile Manufacturing Firms

4.08 Rate Reduction for the Provision of Cable Television Services

4.09 Exemption for Electronic Pager Service

★ New or recently implemented preference

[6] In previous Reports, this item had been broken out into two separate categories -- one for manufacturers and another for agribusiness/food processors.

DELAWARE TAX PROVISIONS NOT INCLUDED

The following items are listed in the Delaware Code in a manner similar to other tax preferences detailed in this report. Many of the items meet the criteria used to define a tax preference, which are highlighted above. However, these tax preferences have been excluded from the report for the reasons noted below.

Personal Income Tax

1. Modification for Fiduciary Adjustment
   Title 30, Delaware Code, Chapter 11, §1106(c).

   Rationale for exclusion from report:
   This modification is viewed as an appropriate adjustment to determine net income and, as such, should not strictly be defined as a tax preference.

2. Deduction of Interest or Dividends on U.S. Government Obligations
   Title 30, Delaware Code, Chapter 11, §1106(b)(1).

   Rationale for exclusion from report:
   This modification is required by the Supremacy Clause of the U.S. Constitution.

3. Deduction for Wages Paid for Which New Jobs Tax Credit is Claimed
   Title 30, Delaware Code, Chapter 11, §1106(b)(5).

   Rationale for exclusion from report:
   This provision is not technically a tax preference because a deduction is allowed for all wages paid, even when the taxpayer elects the federal preference of taking a credit for the same wages.

4. Credit for Income Taxes Paid to Another State
   Title 30, Delaware Code, Chapter 11, §1111.

   Rationale for exclusion from report:
   This credit avoids double taxation of Delaware residents.

5. Favorable Tax Treatment of Distributions from Qualified Tuition Savings Plans
Title 14, Delaware Code, §3483.

Rationale for exclusion from report:
This is a preference authorized under the federal Internal Revenue Code (IRC). Under §529 of the IRC, qualified distributions from such plans are taxed at the rate applicable to the beneficiary, not the contributor. State taxpayers benefit by virtue of Delaware's "piggybacking" on the federal tax system.

6. Deduction of Health Insurance Costs Paid by Self-Employed Persons
Title 30, Delaware Code, Chapter 11, §1109(a)(2)(b)

Rationale for exclusion from report:
This preference allows a State income tax deduction for amounts spent on health insurance over and above that which is allowed as a deduction on the taxpayer's federal return. Beginning in Tax Year 2003, the federal exclusion increased to 100% of qualified expenses and effectively eliminated any benefit associated with Delaware's "preference."

Corporate Income Tax

1. Deduction for Interest Received from U.S. Government Securities
Title 30, Delaware Code, Chapter 19, §1903(a)(3).

Rationale for exclusion from report:
This deduction is required by Constitutional provision.

2. Deductions for Gains or Losses From Sale of U.S. Government Securities
Title 30, Delaware Code, Chapter 19, §1903(a)(4).

Rationale for exclusion from report:
These deductions are required by Constitutional provision.

3. Deduction for Wages Paid For Which New Jobs Tax Credit is Claimed
Title 30, Delaware Code, Chapter 19, §1903(a)(6).

Rationale for exclusion from report:

As with the personal income tax exemption, this provision is not technically a tax preference because a deduction is allowed for all wages paid, even when the taxpayer elects the federal preference of taking a credit for the same wages.

4. Exemption of Foreign Interest, Dividends, and Royalties
Title 30, Delaware Code, Chapter 19, §1903(a)(1).

Rationale for exclusion from report:
These sources are not included due to Constitutional limitations.

5. Exemption for Homeowners' Associations
Title 30, Delaware Code, Chapter 19, § 1902(b)(17)

Rationale for exclusion from report:
These entities are not considered part of the base of the tax, and therefore the exemption is not defined as a tax preference.

Motor Fuel/Special Fuel Tax

1. Motor Fuel Tax and Special Rates
Title 30, Delaware Code, Chapter 51, §5110(c), §5132.

Rationale for exclusion from report:
This provision is not regarded as a tax preference because different tax rates are applied to technically different tax bases.

2. Exemption for Sales of Gasoline to the U.S. Government or Any of Its Subdivisions
Title 30, Delaware Code, Chapter 51, §5111.

Rationale for exclusion from report:
This exemption is required by Constitutional provision.

3. Exemption for Sales of Gasoline to Anyone Protected by the Interstate Commerce Clause
Title 30, Delaware Code, Chapter 51, §5111.

Rationale for exclusion from report:
This exemption is required by Constitutional provision.

4. Exemption for Sales of Gasoline to Delaware or Any of Its Subdivisions
Title 30, Delaware Code, Chapter 51, §5111.

Rationale for exclusion from report:
This exemption avoids the state needlessly taxing itself.

5. Exemption for Sales of Special Fuels to the U.S. Government or Any of Its Subdivisions
Title 30, Delaware Code, Chapter 51, §5133.

Rationale for exclusion from report:
This exemption is required by Constitutional provision.

6. Exemption for Sales of Special Fuels to Delaware or Any of Its Subdivisions
Title 30, Delaware Code, Chapter 51, §5133.

Rationale for exclusion from report:
This exemption avoids the state needlessly taxing itself.

7. Exemption of Fuel Used and All Vehicles of Any Other State Government Which Reciprocates
Title 30, Delaware Code, Chapter 51, §5133.

Rationale for exclusion from report:
This exemption is required by Constitutional provision.

Public Utility Tax

1. Exemption for Electricity, Gas and Telephone Sales and Services to Residential Users
Title 30, Delaware Code, Chapter 55, §5506(e).

Rationale for exclusion from report:
These users are not considered part of the base of the tax, and therefore the exemption is not defined as a tax preference.

2. Exempt Tax Receipts Received From the Sale of Public Utilities to the State of Delaware or Any of Its Subdivisions
Title 30, Delaware Code, Chapter 55, §5506(d).

Rationale for exclusion from report:
This exemption avoids the state needlessly taxing itself.

3. Exempt Internet Access Charges from Public Utility Tax
Title 30, Delaware Code, Chapter 55, § 5502

Rationale for exclusion from report:
This preference is effectively authorized under Delaware's own Tax Code. Authorization of this exemption became effective for Delaware taxpayers on January 1, 2005. As of November 1, 2005, however, an update to federal law effectively replicated Delaware's provision thereby eliminating any benefit associated with Delaware's "preference."

A SUMMARY OF TAX PREFERENCE CHANGES SINCE 2003

The adoption of new, and expansion of existing tax preferences has not abated since the publication of the last Tax Preference Report in 2003. In the intervening two years, the General Assembly spent resources on the creation, implementation, or expansion of nine tax preferences. Below is a summary of the legislative changes affecting tax preferences since the completion of the 2003 Report.

Tax Preferences Created
Personal Income Tax:

- Earned Income Tax Credit (EITC)

  Established a non-refundable Delaware Earned Income Tax Credit equal to 20% of the Federal EITC.

Tax Preferences Expanded

Personal Income Tax:

- Historic Preservation Tax Credit

  Expanded the annual allocation from $3 million to $5 million.

- Volunteer Firefighters Tax Credit

  Increased the tax credit for volunteer firefighters and ambulance or rescue service members or auxiliary members from $300 to $400 and eliminated the requirement that active members provide proof of expenditures in the performance of their service.

Corporate Income Tax:

- Historic Preservation Tax Credit - *see above for further detail*

- Research and Development Tax Credit

  Extended Sunset date from December 31, 2005 to December 31, 2010.

Tax Preferences Eliminated
None.

PERSONAL INCOME TAX

- <u>Statutory Provision</u>

  Title 30, <u>Delaware Code</u>, Chapter 11.

- <u>Collection/Administrative Agency</u>

  The Department of Finance, Division of Revenue, administers this tax.

- <u>General Liability</u>

Resident

Every resident of Delaware must file a personal income tax return whenever such resident:

(a) Is required to file a federal tax return; or

(b) Has adjusted gross income (after modifications) that exceeds the maximum filing thresholds. The maximum filing thresholds for each filing status are listed below:

(BEGINING TAX YEAR 2000)

AGE/STATUS	FILING SINGLE	MARRIED FILING A JOINT RETURN (1)	MARRIED FILING SEPARATE	FILING AS A DEPENDENT ON ANOTHER PERSON'S RETURN
Under 60	$9,400	$15,450	$9,400	$5,250
60 to 64	$12,200	$17,950	$12,200	$5,250
65 and over OR Blind	$14,700	$20,450	$14,700	$7,750
65 and over AND Blind	$17,200	$22,950	$17,200	$10,250

(1) This dollar amount represents a taxpayer's individual Adjusted Gross Income, NOT a total combined with anyone else.

Every resident must report all income earned during the taxable year to Delaware, regardless of the source.

Nonresident

Every nonresident must file a tax return to report all income earned within the State. This includes only income attributable to employment or personal services performed in Delaware, or to the ownership or disposition of any interest in real or tangible personal property in Delaware (i.e., wages, business income (or losses), capital gains (or losses), rents and royalties, partnerships, farm income and any other income derived from a Delaware source). Interest, dividends and pensions, even if attributable to Delaware employment, are excluded.

Nonresidents calculate their liabilities as if they were residents except that nonresidents' final liabilities are prorated according to their ratio of Delaware source income to total income.

Part-Year Resident

Part-year residents have the option of filing as a resident or a nonresident. By filing as a nonresident, final liability is reduced because it is prorated according to the taxpayer's ratio of Delaware source income to total income. Filing a resident return, however, allows the taxpayer to make use of certain tax credits (e.g., the child care credit) not available to nonresidents. If large enough, these tax credits can produce a final liability that is lower than that which may be obtained by filing as a nonresident.

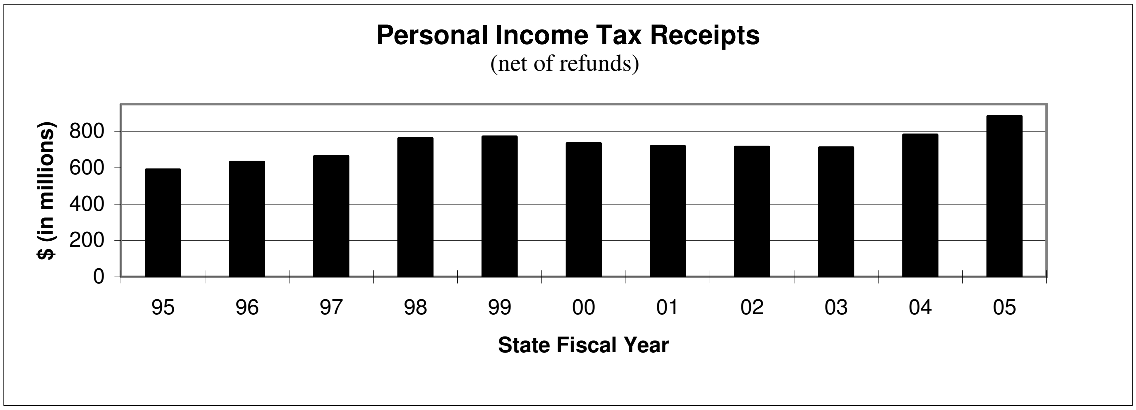
- Tax Rates

For Tax Years 2000 and after, taxable income is assessed at the following rates:

If Taxable Income is Greater Than:	But Less Than:	Tax Liability is Calculated As:	Plus:	On Taxable Income Over:
$0	$2,000	$0.00	0.00%	$0
$2,000	$5,000	$0.00	2.20%	$2,000
$5,000	$10,000	$66.00	3.90%	$5,000
$10,000	$20,000	$261.50	4.80%	$10,000
$20,000	$25,000	$741.50	5.20%	$20,000
$25,000	$60,000	$1,001.00	5.55%	$25,000
$60,000		$2,943.50	5.95%	$60,000

- Tax Receipts, net of refunds (millions of dollars)

Fiscal Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total ($)	588.6	631.4	662.7	761.3	770.6	732.8	718.3	713.7	710.3	781.2	882.5



- Tax Preferences

The following items have been identified as personal income tax preferences within the Delaware Code:

1.01 Low-Income Elderly Exclusion

1. Statutory Provision
   Title 30, Delaware Code, Chapter 11, §1106(b)(2).

2. Description
   The law provides for exclusions from gross income to persons who meet certain qualifications. If a taxpayer is single, or married and filing separately, the law allows an exclusion of $2,000 to any person:

   (a) Who is totally and permanently disabled, or who is 60 years of age or older;
   (a) Whose earned income for the year is less than $2,500; and
   (b) Whose Delaware adjusted gross income (before this deduction) does not exceed $10,000.

   A husband and wife filing a joint return are entitled to an exclusion of $4,000 if the following conditions are met:

(a) Each is at least 60 years of age, or totally and permanently disabled;
(b) Their total earned income in the taxable year is less than $5,000; and
(c) Their Delaware adjusted gross income (without reduction of this exclusion) does not exceed $20,000.

3. Estimated Revenue Loss

FY 05: Negligible[1]
FY 06: Negligible

4. Assessment

The purpose of this provision is to allow elderly or disabled taxpayers with low income to exclude a portion of their income from taxes. Because certain forms of income are not included in this means test, some higher-income elderly taxpayers may qualify for this preference. Conversely, elderly taxpayers who rely primarily on wage income may not qualify for this exclusion even though they otherwise meet the definition of "low-income."

5 . Inadvertent Effects

This provision suffers from a number of defects, which at the time of its original enactment appear to have been overlooked. As the size and scope of other tax preferences expanded, these defects became more important.

The eligibility means test is poorly designed, resulting in an application of tax relief that follows no rational pattern. Though ostensibly targeted to help "low-income" elderly taxpayers, in practice, this provision was nearly as likely to help middle- and high-income taxpayers as it was to help the poor. For example, the fact that the income of a taxpayer's spouse is not taken into consideration in determining eligibility means that well-to-do couples enjoy a "low-income" tax preference simply because their income is highly skewed between husband and wife. Some low-income elderly taxpayers were denied relief (elderly wage earners, for example) simply because the composition of their income did not conform the statute's requirements. Finally, the deduction was "all or nothing." If the taxpayer met the means test, the full deduction was awarded. If the taxpayer exceeded the means test amount by one penny, he or she received nothing.

For taxpayers age 60 and over, recent events have rendered this tax preference practically useless. Other elderly tax preferences have expanded to such an extent that, beginning in tax year 2000, all taxpayers meeting this provision's

[1] Defined as less than $10,000.

eligibility requirement and using the standard deduction have already been removed from the tax rolls.

Taxpayers who choose to itemize their deductions may still benefit from this provision, provided their itemized deductions are less than the standard deduction amount. Low-income taxpayers who would make such a choice are rare and most likely are the spouse of a high-income taxpayer who makes use of most or all of the couple's itemized deductions. Because all of this provision's intended beneficiaries age 60 and over will no longer be paying any tax, policymakers should seriously consider its elimination or limit its application to disabled taxpayers.

Modifying the provision's means test to be more inclusive would merely result in the extension of tax relief to middle- and upper-income elderly taxpayers. If policymakers desire such a result, it could be more efficiently achieved through other simpler and less arbitrary means.

1.02 Exclusion of Pension and Eligible Retirement Income

1. Statutory Provision
   Title 30, Delaware Code, Chapter 11, §1106(b)(3).

2. Description
   Certain amounts of income received as pensions from employers or meeting the definition of "eligible retirement income" are excludable from Delaware taxable income. This exclusion is limited to $12,500 a year for taxpayers 60 years and older.[2]

   As defined in §1106(b)(3)b.2(B) of Title 30, eligible retirement income includes:[3]

   - Distributions from qualified retirement plans defined under §4974 of the Internal Revenue Code (IRC);
   - Distributions from cash or deferred arrangements described in §401(k) of the IRC;
   - Distributions from government deferred compensation plans described in §457 of the IRC;

---
[2] This amount was increased from $5,000 to $12,500 effective January 1, 2000.
[3] The definition of "eligible retirement income" was expanded to include Capital Gains, effective January 1, 2000.

- Dividends;
- Capital Gains;
- Interest; and,
- Net Rental Income

Taxpayers under 60 years of age may exclude up to $2,000 of pension income per year. These taxpayers may not exclude eligible retirement income.

3. Estimated Revenue Loss
FY 05: $31.5 million
FY 06: $33.5 million

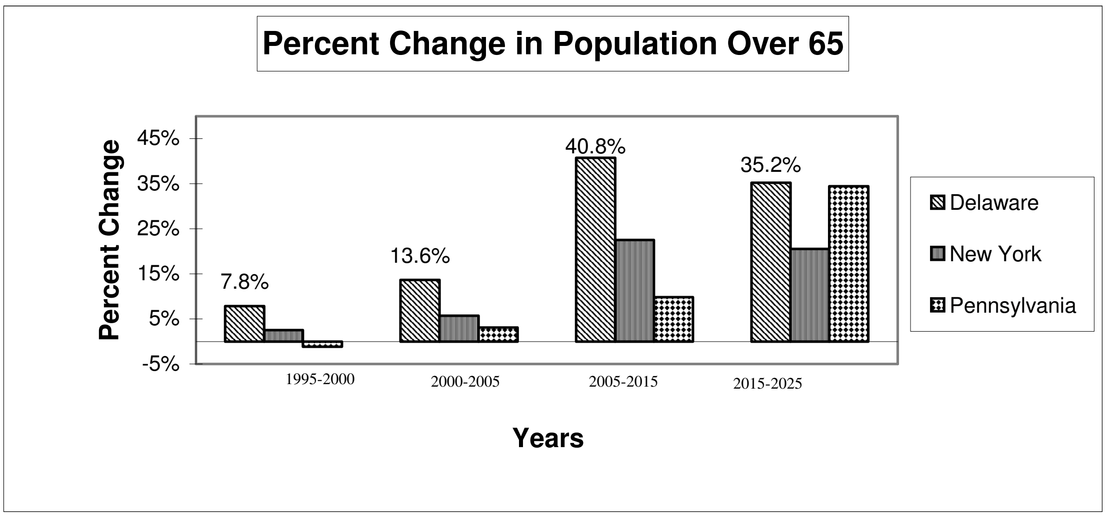
4. Assessment
In contrast to the low-income elderly exclusion, the pension exclusion is not means-tested. Any taxpayer with pension or eligible retirement income is entitled to claim this tax preference, regardless of his or her ability-to-pay. The purpose of this provision is to provide a tax reduction to recipients of pension or eligible retirement income; it clearly serves only the intended group.

5. Inadvertent Effects
Delaware's progressive income tax rate structure implies that any non-means-tested, lump-sum exclusion from taxable income -- such as the pension and eligible retirement income exclusion -- provides a larger tax benefit to higher-income taxpayers than to lower-income taxpayers. For example, "Pensioner A" has $112,500 in income, $100,000 in taxable income once the exclusion is taken. This exclusion provides Pensioner A with a $744 reduction in tax liability ($12,500 x 0.0595). "Pensioner B" has $20,000 in income, $12,500 in taxable income once the exclusion is taken. Because Pensioner B is subject to a lower marginal tax rate, the same $12,500 deduction reduces Pensioner B's tax liability by only $578 ($10,000 x .048 + $2,500 x.039), significantly less benefit than for the high-income Pensioner A.

With respect to other states in the region, Delaware's maximum pension exclusion of $12,500 may appear to be relatively small. New York allows a maximum pension exclusion of $20,000 (complete pension exclusion for federal, state, and military pensions).[4] Pennsylvania provides 100% exclusion for public and private pension benefits.[5] Some observers, therefore, argue that in the absence of such preferences, taxpayers will migrate to states such as

[4] New York Statutes - Article 22, §612(c)(3-a)
[5] Pennsylvania Statutes - Article III, §7301(d)(iii)

New York and Pennsylvania simply because of their favorable tax treatment of retirement income. There is some anecdotal evidence to support this claim, however, demographic data suggest that it is not a major phenomenon. For example, the U.S. Bureau of the Census estimates that the number of Pennsylvania and New York residents over 65 will rise by 10% and 23%, respectively, between the years 2005 and 2015. (See chart below.) Similarly, the number of Delawareans over 65 is expected to increase by nearly 41% during this same period.



Source: U.S. Census Bureau (http://www.census.gov/population/projections/state/stpjage.txt)

This suggests that factors other than the tax treatment of retirement income have a more profound impact of the locational decisions of retirees. Another real possibility is that the combined impact of Delaware's many retirement tax preference are, in fact, very competitive relative to other states in the region.[6]

Proponents of tax preferences for the elderly argue that an increased elderly concentration provides an economic stimulus, especially with respect to service markets. Unless tax preferences for the elderly are significant enough to generate a net increase in tax revenues, then the direct revenue losses imply that marginal tax rates have to be higher than they would be without the preferences in order to generate the same revenues. The effect of elderly preferences, therefore, may be to reduce taxes for taxpayers over age 60 at the

[6] Delaware has distinct advantages over neighboring states with respect to property and sales taxes. For the majority of retirees, Delaware's tax burden is *lower* than that of surrounding states.

cost of increasing taxes for wage earners (whose labor supply decisions are most responsive to changes in after tax wages). Proponents also argue that tax relief based on age is justified because these taxpayers have, after a lifetime of tax paying, paid their "fair share" and at some point deserve relief.

Critics of tax preferences based solely on age disagree with these points for several reasons. Due to the growth in benefit payments and longevity after retirement, many government programs for the elderly are paying significantly more to beneficiaries than the recipients ever paid into the system in taxes. Estimates show, for example, that current Social Security recipients will receive many times more in benefits than they and their employers paid into the Social Security system. Because elderly services have grown in cost and total quantity, it takes longer for a person to pay a "fair share" than it did 30 years ago. Another concern is that some exclusions may be taken by persons still in the workforce. This pension exclusion, for example, allows workers who begin to draw a pension at, say, age 45 to exclude $2,000 of income from taxation while other similarly situated taxpayers get no such break.

Finally, preferences that depend only on age or income source are not as closely linked to ability-to-pay as they were at their inception, when persons over age 60 were the poorest segment of society (see discussion below). All the elderly preferences, except the low-income exclusion, can be used to reduce liability for even the wealthiest taxpayers as long as they meet the age requirement.

While the extension of eligibility to other sources of retirement income has improved the horizontal equity problems of this preference *among taxpayers over 60*, there are still some equity concerns. [7] When compared to income or other ability to pay considerations, age is a fairly arbitrary criterion on which to establish a tax preference. It could be argued that the horizontal equity problems of this preference between taxpayers over and under 60 years of age have been aggravated by this recent change. For example, consider two hypothetical taxpayers with $1,000 in pension income and $3,500 in other eligible retirement income. "Taxpayer A" is 59 years old, while "Taxpayer B" is 61. Assuming both taxpayers have the same ability to pay, Taxpayer A can only exclude $1,000 while taxpayer B can exclude $4,500. Not only is taxpayer A's exclusion capped at $2,000 in the aggregate, it is limited to traditional pension income. For taxpayers under 60 without pension income, no exclusion is allowed.

[7] The exclusion of pension income alone resulted in more favorable tax treatment for taxpayers whose income is derived from a pension, rather than other forms of retirement income.

As the following table shows, the rate of poverty among the elderly is now below the rate for the general population. In 1970, 24.6% of those age 65 and over lived under the federal poverty level. By 2003, the proportion had dropped to 10.2%.

Percent of Population Below Federal Poverty Level
2003 *

Under 18	17.6%
18-24	16.5%
25-34	12.8%
35-44	9.6%
45-54	7.6%
55-59	8.2%
60-64	9.7%
65+	10.2%
Overall Rate	**12.5%**

* Source: CPS Annual Demographic Survey, March 2004 Supplement (http://pubdb3.census.gov/macro/032004/pov/new01_100_01.htm)

The rate of poverty is significantly lower for the elderly than for children and young adults. As the elderly are statistically no more poor than any other age group in society, a single age test may, on the whole, benefit taxpayers who do not need relief under any legitimate interpretation of ability-to-pay.

Of equal concern is the group of taxpayers (elderly wage earners who must continue to work to make ends meet) who are ignored by this provision. Because wages are not eligible for the deduction, the working poor elderly receive no assistance.

While there is certainly a significant proportion of the elderly population with income below federal poverty levels, policymakers might need to consider whether government support should more properly continue to be based on age rather than on need and/or ability-to-pay.

1.03 Exclusion of Taxable Social Security Benefits

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1106(b)(4).

2. Description
For purposes of federal income taxation, recipients of Social Security benefits or Railroad Retirement Board payments who have modified adjusted gross income from all sources above a "base amount" of $25,000 ($32,000 for taxpayers who file jointly) are taxed on a portion of these benefits. This taxable portion is the lesser of 50% of the Social Security benefits received, or 50% of a taxpayer's "combined" income over the "base amount." Combined income is 50% of these benefits plus adjusted gross income plus any tax-exempt income or income earned from a foreign country or U.S. possession which is excluded from federal gross income. If a taxpayer's income exceeds $34,000 ($44,000 if married, filing jointly), the lesser of 85% of Social Security benefits or 50% of the combined income above the base amount is included in federal adjusted gross income.

(A complete description of the federal tax code provision relating to social security can be found in the IRS publication "Publication 915 Social Security and Equivalent Railroad Retirement Benefits")

3. Estimated Revenue Loss
FY 05: $17 million
FY 06: $18 million

4. Assessment
The purpose of this provision is to provide a tax reduction to Social Security and Railroad Retirement Board benefit recipients. This exclusion clearly offers a benefit to those for whom the exclusion was written.

5. Inadvertent Effects
Like the exclusion for certain forms of pension income (Item 1.02), this provision is not a means-tested tax preference; higher-income taxpayers are eligible for, and benefit more from, this provision than do lower-income taxpayers. As a result, much of the preceding discussion of the pension exclusion is also valid with respect to this exclusion of federal benefits. Despite the fact that this tax relief is provided to Social Security and Railroad Retirement Board recipients because, as a group, they are perceived as being in need, taxpayers who do not fit this generally accepted perception of being in need may also receive benefits.

Moreover, Delaware's exclusion of federally taxable Social Security and Railroad Retirement Board benefits effectively removes a federal means test which is designed to limit the preferential tax treatment of such income to those most in need. Only taxpayers over certain income thresholds are required to include such benefits in federal gross income. By definition, only taxpayers who have income above these relatively high thresholds benefit from the exclusion of federally taxable Social Security or Railroad Retirement Board benefits.

1.04 Exclusion of Benefits Received Through Travelink Program

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1106(b)(6).

2. Description
Individual income taxpayers may exclude from taxable income $100 per month in benefits received under the State's Travelink traffic mitigation program (to the extent that the taxpayer included these benefits in calculating federal adjusted gross income).

3. Estimated Revenue Loss
FY 05: Negligible, Likely to be less than $35,000
FY 06: Negligible, Likely to be less than $35,000

4. Assessment
This component of the Travelink Program supplements the business tax incentives also available through this program. (See Item 2.10 below.) The fiscal impact of the personal income tax exclusion is dependent upon employer response to these more prominent business tax credits. Participation in the program has traditionally been low.

5. Inadvertent Effects

   The Travelink Program's benefits should accrue to those intended, i.e., employers and employees that participate in traffic mitigation efforts. Nonetheless, neither the threat of federal regulation nor these tax credits seem to have encouraged workers to reduce the number of single-occupant trips they make.

   Significant participation, however, remains unlikely as larger phenomena (e.g., the price of gasoline, availability of desired mode of public transportation) will probably continue to exert a larger influence on commuting decisions.

1.05 Exclusion of Delaware Lottery Winnings

1. Statutory Provision

   Title 29, Delaware Code, Chapter 48, §4817.

2. Description

   For Delaware personal income tax purposes, all income received from Delaware Lottery winnings is excludable.

3. Estimated Revenue Loss [8]

   FY 05: $8.0 million
   FY 06: $3.0 million

4. Assessment

   The rationale for excluding lottery winnings from personal income tax is that the exclusion serves as a promotional vehicle for the Delaware Lottery and, therefore, enhances State revenues. However, whether the added ticket sales and video lottery play that may result from the exclusion compensate for the revenue loss it causes is not known. If additional ticket sales and video lottery play *do not* offset the revenue loss, there appears to be no justification for maintaining preferential tax treatment for this source of income -- a violation of horizontal equity principles. If there *is* a clear net revenue gain, then the benefits -- in terms of additional state revenues -- must be assessed against the loss of horizontal equity.

5. Inadvertent Effects

   None noted.

[8] The estimated fiscal impact in FY 05 is largely due to one, large powerball jackpot. In calculating these estimates, an adjustment was made to account for the deduction for gambling losses.

1.06 Additional Standard Deduction for the Blind or Persons Age 65 or Over

1. Statutory Provision
   Title 30, Delaware Code, Chapter 11, §1108(b).

2. Description
   Taxpayers who are at least 65 years of age (or blind), and who do not itemize their deductions, are entitled to an additional standard deduction of $2,500. Non-itemizers who are at least age 65 *and also* blind may claim an additional standard deduction of $5,000.

3. Estimated Revenue Loss
   FY 05: $2.5 million
   FY 06: $2.7 million

4. Assessment
   The purpose of this provision is to provide a tax reduction to persons who are blind and/or at least 65 years old. The provision's benefits reach only those for whom it was intended.

5. Inadvertent Effects
   As is the case with the exclusion of pension income (see Item 1.02 above) and the exclusion of taxable Social Security income (see Item 1.03 above), this provision is not means-tested. With respect to this preference's age criterion, many of the same issues that arise with other non-means-tested preferences for the elderly arise here as well. For example, the additional standard deduction benefits many higher-income taxpayers who have no need for tax relief on ability-to-pay grounds, but who qualify solely because of their age.

   By definition, an additional standard deduction is not available to taxpayers that itemize their deductions. Because taxpayers that take the standard deduction typically have lower incomes, it may be argued that this additional standard deduction primarily benefits lower-income taxpayers. But many taxpayers in this age group no longer have mortgage interest deductions, making them less likely to itemize, even if they are middle or high-income taxpayers.

   One component of eligibility for this preference (that a person be blind) may violate horizontal equity in that other disabilities do not entitle taxpayers to claim an additional $2,500 or $5,000 standard deduction, even though they may more severely compromise the taxpayer's ability-to-pay.

1.07 Charitable Mileage Deduction

1. Statutory Provision
   Title 30, Delaware Code, Chapter 11, §1109(a)(2)(a).

2. Description
   Federal law permits a person who uses his/her automobile to perform voluntary service for a charitable organization to claim an itemized deduction for a portion of those expenses. Under Delaware law, this additional itemized deduction is calculated by subtracting the permissible federal rate for automobile mileage (currently 14 cents per mile) from the amount State employees may claim for work-related use of their vehicles (31 cents effective July 1, 2000).

3. Estimated Revenue Loss
   FY 05: Less than $50,000
   FY 06: Less than $50,000

4. Assessment
   Though small, this preference does confer an element of recognition on those individuals who have to drive in order perform voluntary services for charitable organizations. The benefits of this provision go to those intended and do not produce a large fiscal loss. As an itemized deduction, however, the provision does not benefit those taxpayers who use their vehicles for charitable purposes but who take the standard deduction.

   Another concern arises from the fact that only one type of charitable activity (i.e., driving) is singled out for favorable tax treatment.

5. Inadvertent Effects
   None noted.

1.08 Additional Personal Credit for Persons Age 60 and Over

1. Statutory Provision
   Title 30, Delaware Code, Chapter 11, §1110(b)(2).

2. Description
Taxpayers who are age 60 and over are entitled to claim an additional non-refundable personal credit. Married taxpayers who file jointly receive an additional $110 credit if only one of the couple is age 60 or more, and an additional $220 if the both persons meet this age test.

3. Estimated Revenue Loss
FY 05: $6.0 million
FY 06: $6.4 million

4. Assessment
The purpose of this provision is to reduce tax liability for persons age 60 and over. Only persons who meet this age test can receive this extra credit, thus ensuring that the provision serves only the intended beneficiaries.

   The switch from an extra personal exemption, to an extra non-refundable personal credit for persons over 60 eliminated the regressivity inherent in the additional personal exemption. The value of the tax credit (which reduces tax liability dollar for dollar) is the same for taxpayers in all income ranges.

5. Inadvertent Effects
As discussed above (see items 1.02 and 1.06), age is a relatively arbitrary criterion on which to grant favorable tax treatment. This preference suffers from the same drawbacks as other nonmeans-tested tax breaks for the elderly in that taxpayers with the same ability-to-pay receive different tax treatment based solely on age (a violation of horizontal equity).

   Moreover, high-income elderly taxpayers receive benefits that are not available to younger taxpayers with substantially less ability to pay (a violation of vertical equity).

1.09 Credit for Expenses Incurred by Active Volunteer Firemen, Fire Company Auxiliary Members or Members of Volunteer Ambulance or Rescue Service

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1113.

2. Description
The provision allows Delaware residents who are active emergency service volunteers to claim a $400[9] credit against their income tax otherwise due. In order to qualify for the credit, a person must be:

(i) an active volunteer firefighter on call to fight fires on a regular basis; and
(ii) a voting member of a Delaware volunteer company; or
(iii) a voting member of a Delaware fire company auxiliary; or
(iv) an active member of a Delaware volunteer ambulance or rescue service.

2. Estimated Revenue Loss
FY 05: $2.0 million
FY 06: $2.1 million

3. Assessment
The purpose of this credit is to help defray the costs incurred by emergency service volunteers in performing their duties. This is clearly a worthy goal. A fundamental issue in assessing this provision, though, is whether goals like this one are most appropriately addressed through the tax code. As an alternative, the State could make additional direct annual grants to volunteer fire companies to defray volunteers' expenses equal to the estimated revenue loss that this preference creates.

This approach would avoid an additional complication of the tax code and would simplify administration as the State could work with a manageable number of fire companies rather than reviewing claims by thousands of volunteer firefighters on their tax returns.

4. Inadvertent Effects
None noted.

1.10 Child Care and Dependent Care Expense Credit

1. Statutory Provision
IRC Section 21.
Title 30, Delaware Code, Chapter 11, §1114.

[9] The amount of this credit increased from $300 to $400 as of January 1, 2004 (74 Del. Laws c. 422).

2. <u>Description</u>
This non-refundable credit is equal to 50 percent of the federal child and dependent care credit allowed for a given taxpayer. The federal credit[10] amount is determined by applying a percentage (between 35% and 20% depending on the size of adjusted gross income) to qualifying expenses (a maximum of $3,000 for one child, or $6,000 for two or more children). For taxpayers with federal adjusted gross incomes over $43,000, the maximum credit is 20 percent of qualifying expenses.

Married couples filing joint federal but separate Delaware returns are limited to applying the credit to the tax liability of the spouse with the smaller taxable income. The credit can be taken for payments made to a relative for child care, provided that the relative is not claimed as dependent on the taxpayers return and is not the taxpayers child under the age of 19.

3. <u>Estimated Revenue Loss</u>
FY 05: $5.7 million
FY 06: $5.9 million

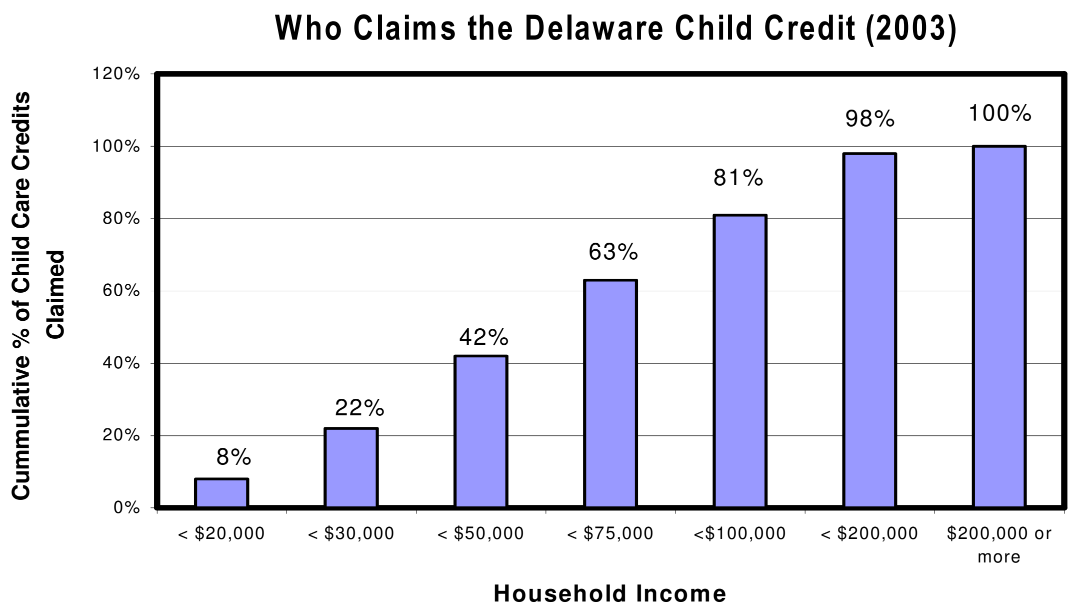
4. <u>Assessment</u>
This credit is intended to encourage the expansion of the State's workforce, particularly for entry-level positions, by removing a major obstacle to employment for many potential workers. A significant number of job seekers are single parents in search of relatively low-wage jobs.[11] For these individuals, the high cost of child care is not affordable on the potential wages. The credit, therefore, is intended to offset a significant barrier to entry into the labor force. The degree to which an annual tax subsidy -- often received in the form of a refund -- is likely to make lower wage jobs economically feasible for parents entering the labor market is debatable.

As can be seen in the following chart, in 2003 nearly 58 percent of the child care credits claimed by Delaware families were claimed by families with Delaware Adjusted Gross Incomes of more than $50,000. As such, it seems clear that a substantial portion of the benefits of this preference accrue to families with moderate and more abundant means.

---

[10] The Federal Economic Growth and Tax Relief Reconciliation Act of 2001 increased the maximum credit rate to 35% (from 30%) and increased the maximum qualifying expense to $3,000 (from $1,200) for one child and $6,000 (from $4,800) for two or more children in 2003.

[11] The IRC also allows the credit to be claimed for persons who are physically or mentally unable to take care of themselves (e.g., a spouse or parent), and claimed as a dependent on the taxpayer's return.



A credit for child care expenses can be viewed as consistent with a definition of taxable income that excludes costs associated with earning income.[12] As such, some observers may not regard the provision as a tax preference. Such a view does not mesh with the fact that some costs of earning income, such as work apparel and commuting expenses, are not deductible. Regardless, if child care expenses were to be considered non-preferential as a cost of earning income, then this provision should be structured as a deduction from taxable income, not as a credit.

5. Inadvertent Effects
None noted.

1.11 Tax Credits for Creation of Employment, Qualified Investments in Business Facilities, and Green Industries

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1115.

[12] This line of reasoning is used to justify a host of deductions against both personal and corporate income taxes for costs incurred in the earning process (e.g., the federal deduction for home office expenses, the federal deduction for business meals).

2. Description
The law offers tax credits for any eligible taxpayer who is not subject to the corporate income tax under the same terms as those discussed below for items 2.08, 2.09, and 2.11. Resident shareholders in eligible S Corporations are entitled to a proportionate share (based on the percentage of ownership in the organization by the taxpayer) of the credits listed. The credits are limited to 50% percent of the tax owed multiplied by the taxpayer's share of distributable income of the S Corporation.

3. Estimated Revenue Loss
FY 05: $500,000 - $700,000
FY 06: $500,000 - $700,000

4. Assessment
This provision simply extends the credits available under the corporate income tax and gross receipts tax to those eligible taxpayers who are subject to the personal income tax (e.g., S corporations). These personal income tax credits raise the same issues as the investment tax credits discussed later in this Report's corporate income tax section. For example, the credits may be too small to generate a significant incentive to increase investments in the intended industries and locations. Many businesses and individuals may be receiving tax reductions for investments and improvements that they would have undertaken anyway in the absence of the credits. For a full discussion of these issues, please refer to Items 2.08 and 2.09 below.

5. Inadvertent Effects
As mentioned above, since its inception, the Blue Collar Jobs Credits has been expanded several times and is sometimes identified as a program in which this incremental approach may have resulted in unanticipated shortcomings. Please refer to Items 2.08, 2.09, and for a full discussion of possible inadvertent effects.

1.12 Military Action Exemption

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1171.

2. Description
Income earned by U.S. Armed Forces personnel while on active duty who die from disease or injuries incurred while serving in a combat zone is exempt

from the personal income tax. Unpaid outstanding tax liabilities of such individuals are forgiven.

Additionally, income earned by U.S. Armed Forces personnel located outside the United States who die in "terroristic or military actions" is exempt from the personal income tax.

3. Estimated Revenue Loss
FY 05: Negligible
FY 06: Negligible

4. Assessment
This preference reaches its policy objectives in a fiscally effective manner. Even though the recent years have seen U.S. forces deployed in large numbers, the cost of this preference remains low. This is true because:

(1) Delaware is a small state and, as such, its citizens constitute only a small fraction of the total military compliment;

(2) Members of the armed forces have latitude in determining their "home of record." A significant number chose states like Texas and Florida, which do not levy income taxes; and

(3) Compared to other wars, for example World War II, Korea and Vietnam, the number of casualties suffered in recent years has been relatively small.

Barring a major military engagement, war, or terrorist action overseas resulting in a much larger number of casualties, the cost of this preference will remain negligible.

5. Inadvertent Effects
None noted.

1.13 Extension of Filing Deadline for Military Personnel or Support Staff Serving in a Combat Zone

1. Statutory Provision
Title 30, Delaware Code, Chapter 3, §376.

2. Description
Military personnel who serve in a combat zone (pursuant to Section 112 of the IRC) are permitted to file their income tax returns up to 195 days after leaving the combat zone.

3. Estimated Revenue Loss
FY 05: Negligible
FY 06: Negligible

4. Assessment
Delaware's General Assembly implemented this provision in response to Operation Desert Storm. Legislators recognized the practical difficulty of requiring military personnel to file a State personal income tax form while actively engaged in an overseas military operation.

This item is the fiscally most effective means of achieving its purpose and benefits those intended. The resulting impacts on final payments and refunds are minor. This provision is included as a tax preference because, in those cases in which a payment is due with the final return, the filing deadline extension is, in effect, a tax deferral. While the deferral of final payment may amount to an interest-free loan from the State to the taxpayer, it is likely that reservists' wage withholding levels were not adjusted to compensate for lower earnings during military service. Thus, this filing deadline extension may actually result in the deferral of refund checks.

5. Inadvertent Effects
None noted.

1.14 Exemption for Retirement Distributions Used for Education

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1106(b)(8).

2. Description
This preference allows an exemption from taxable income for early distributions from qualified retirement and deferred compensation plans, provided that the distribution is used in the same tax year to pay for books, tuition or fees at an institution of higher education. This exemption is available so long as the distribution is used to pay for costs incurred by the

taxpayer receiving the distribution, or any of the taxpayer's dependents under the age of 26.

3. Estimated Revenue Loss
FY 05: $1.0 million – $1.5 million
FY 06: $1.0 million – $1.5 million

4. Assessment
The purpose of this exemption is to provide parents of college age children with an additional alternative for funding their child's education. It is based on the assumption that the saving rate among families for their children's college education is insufficient. It is difficult to isolate this provision's impact, however. It is likely, though, that, given all the financial considerations that affect college-funding decisions, this provision's impact is minimal.

For example, consider a taxpayer in the 28.0% federal tax bracket. In the absence of this provision, this taxpayer would face a combined state and local marginal tax rate on early distributions from retirement plans of 33.95% (28.0% federal income tax rate + 5.95% state income tax rate). By allowing an exclusion for state tax purposes, the marginal rate facing this hypothetical taxpayer is reduced to 28.0% (a 21.2% reduction -- 5.95%/28.0%). The degree to which such a reduction increases the use of retirement funds for higher education costs is uncertain.

Federal tax law changes adopted over the last several years also make it unclear how successful this preference has been in achieving its stated goal. For example, provisions of the *Taxpayer Relief Act of 1997* eliminated the 10% penalty for early withdrawals from Individual Retirement Accounts used for qualified higher education expenses.[13] On the other hand, a number of other tax preferred, higher education savings vehicles are now available to taxpayers (e.g., Education IRAs).

5. Inadvertent Effects
According to the IRS, 85% of deductible contributions to Individual Retirement Accounts are made by people with adjusted gross incomes of $30,000 or more.[14] As such, this program may not benefit those most in need of assistance with higher education costs to the same degree as those with

[13] However, the eligible education costs for the use of these funds is not consistent between the federal and State programs. Delaware policy makers should consider aligning the eligible education expenses for this program with similar federal programs to avoid taxpayer confusion.
[14] IRS Statistics of Income Bulletin, -- Individual Income Tax Returns, Tax Year 2000.

more money invested in retirement funds (and, presumably, with larger incomes).

Additionally, to the extent that the program does encourage the use of retirement funds for higher education costs, the amount available for distribution after retirement is reduced. Because the income from qualified distributions from tax deferred retirement vehicles is included in adjusted gross income, the use of retirement funds for higher education costs could reduce the amount available for retirement and the tax revenues these funds would generate.

1.15 Exemption for Trusts Established as "Designated" or "Qualified" Settlement Funds

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1133(d).

2. Description
This provision exempts from Delaware income taxes the earnings of trusts that are recognized as "designated" or "qualified" settlement funds under Section 468B of the IRC. Generally speaking, these types of settlement funds are established to satisfy claims arising out of tort, breach of contract, injury, death, property damage or violation of the law. *Designated* settlement funds may only be established by courts. *Qualified* settlement funds may be established by any government agency or instrumentality.

Section 468B(b)(3) of the IRC exempts "qualified payments" to a designated settlement fund (defined as money or property transferred to a fund pursuant to a court order) from the fund's gross income. Treasury Regulations Section 1.468B-2 exempt "amounts transferred to the qualified settlement fund...to resolve or satisfy a liability for which the fund was established" from gross income. As such, trust income for state tax purposes would, in the absence of this provision, include any income other than transfers to pay claims (i.e., interest income from fund assets).

3. Estimated Revenue Loss
FY 05: Unknown
FY 06: Unknown

4. Assessment
This preference is intended to further Delaware's reputation as a leader in the financial services sector. Since these funds are established by agreement between plaintiffs and defendants in civil cases, the prospect of taxation in Delaware would make it very likely that the parties to a suit would seek to establish such a fund outside the state. The Department is not aware of any funds currently existing in Delaware, but the aim of this preference is to encourage their formation here. How successful this preference will be in achieving its intended purpose is unknown.

5. Inadvertent Effects
None noted.

1.16 Land and Historic Resource Tax Credit

1. Statutory Provision
Title 30, Delaware Code, Chapter 18, §§ 1801 -- 1807.

2. Description
This preference allows an income tax credit for permanent gifts of land or interest in land to public agencies and qualified private non-profit charitable organizations. Lands that qualify must either:

    (1) meet the criteria for Open Space established by the Delaware Land Protection Act;

    (2) Consists of natural habitat for the protection of Delaware's unique and rare biological and natural resources; or,

    (3) Protect Delaware's important historic resources.

The tax credit is based on 40% of the appraised fair market value of the gift. The amount of credit that can be claimed is limited to $50,000. In any one tax year, the credit claimed cannot exceed the tax due, but unused portions of the $50,000 credit can be carried forward for up to five (5) consecutive years. The credit became available on January 1, 2000.

3. Estimated Revenue Loss [15]
FY 05: $21,000
FY 06: $10,000 - $30,000

[15] The maximum amount that can be awarded in any one year can not exceed $1 million.

4. Assessment

The goal of this tax preference is to encourage land conservation and historic preservation by providing an income tax preference for the donation of lands to the State or qualifying conservation organizations.

It can be argued that the State will have limited control over the types of land donated and the location of such land (subject to limitations discussed above) and absolutely no control over the timing of such donations.

As an alternative, the State could make outright purchases of properties deemed desirable for conservation. This approach would avoid an additional complication of the tax code and restore some degree of control and predictability to land conservation efforts.

To date, it appears as though this preference has been unsuccessful in accomplishing its goal. During the five years in which this program has been in place, less than $400,000 in credits have been granted to fewer than fifteen taxpayers. Given the ten-year life of this program and the $10,000,000 credit cap, at this rate is likely that less than 10% of potential credits granted for preservation will ever be applied for or allocated. As a consequence, it appears that the program's impact on land use in Delaware will be inconsequential.

5. Inadvertent Effects:

In effect, through the adoption of this preference, the State is attempting to address a perceived market failure, namely, the loss of open space. Like many business development incentives, a common criticism of awarding tax breaks for conservation efforts is that, in many instances, the desired behavior would have occurred in the absence of the tax break. That is, many of the land-owners who choose to participate in this program may have never contemplated developing their land. In such instances, this provision acts as a "bonus" and not as an incentive that actually changes behavior.

Whether the value of preserving open space exceeds the benefits of allowing market forces to permit development according to the lands' "highest and best" use is debatable. It is clear, however, that open space preservation efforts could influence real estate markets by increasing housing prices in certain areas.

1.18 Historic Preservation Credit

1. Statutory Provision:

Title 30, Delaware Code, Chapter 18 §§1813.

2. <u>Description:</u>
Under this provision, a person who wishes to repair, or otherwise preserve a historic property may apply to the State Office of Historic Preservation, for a partial credit for qualified expenditures.

To qualify for the credit, an individual must first submit a rehabilitation proposal to the Office of Historic Preservation to ensure that the restoration, when completed, would meet federal and state guidelines. Credits would be granted on a first come-first serve basis, not to exceed $5 million[16] in any one fiscal year. Moreover, $100,000 of the credits awarded in a given fiscal year must be reserved for distribution to qualified resident curators.

Upon project completion, a State Preservation Office must certify that the end product conforms to federal and state requirements. Once certified, the Division of Revenue or the Office of the State Bank Commissioner will determine the appropriate value of the tax credit to be issued. Personal/corporate income or bank franchise tax credits may be valued at:

- 20% (30% in the case of low income housing) of qualified expenditures made in the rehabilitation of any certified historic property eligible for a federal tax credit under §47 of the Internal Revenue Code (income producing properties), or

- 30% (40% in the case of low income housing) of qualified expenditures made in the rehabilitation of any certified historic property not eligible for a federal tax credit under §47 of the Internal Revenue Code (non-income producing properties).

Rehabilitative efforts taking the following forms do not qualify for the Historic Preservation Credit:

1) The acquisition of real property or interest in real property,

2) Additions to existing structures when the square footage of all additions is greater than or equal to 20% of the total square footage of the historic portion of the property,

[16] The annual credit allocation was increased from $3 million to $5 million from Fiscal Year 2006 onward.

3) Paving or landscaping costs that exceed 10% of the total qualified expenditure,

4) Sales and marketing costs, or

5) Expenditures not properly charged to a capital account, or, in the case of owner occupied property, would not be charged to a capital account if the owner were using such property in a trade or business.

This credit became available as of July 1, 2000, though the first claim against income or bank franchise taxes could not be claimed until July 1, 2002. Currently, this preference is scheduled to expire on June 30, 2010, unless otherwise extended by the General Assembly.

3. Estimated Revenue Loss[17]
FY 05: $90,000
FY 06: $100,000 - $350,000

4. Assessment:
The intention of this provision is to encourage private sector participation in maintaining and preserving the State's historic structures. However, since no public purpose is required for participation in this program, it is possible that the benefits enjoyed from this credit could accrue to relatively few, and most likely wealthy, individuals. Credits could be issued for renovations conducted on privately owned homes located in isolated areas. In instances like this, the individuals (all state taxpayers) ultimately subsidizing the historic renovation would be unable to even view that for which their tax dollars have paid. Recent experience, however, has proven that businesses account for the majority of those qualifying to take this credit..

Additionally, it is unlikely that individuals with insufficient means to undertake renovations would be motivated by this tax incentive. As such, it is possible that this credit may act more as preservation subsidy than as a preservation incentive.

Because this preference is administered on a first-come, first-serve basis, it would also be possible for funds which should have been allocated to the state's most important historic resources to instead, be diverted to other, potentially less worthy, properties. Moreover, this method of allocation may cause equity concerns given that there is no restriction on the amount of tax

[17] Claims against tax credits may not be taken until approved projects are completed.

credit than can be granted to any one taxpayer. Consequently, one taxpayer could receive the entire $5 million dollar credit allotment in any given year.

5. Inadvertent Effects:
As previously mentioned, aside from the resident curator provision there is nothing preventing one large taxpayer from receiving the remainder of the credits available in any given fiscal year. Such allocation of the credit may actually hinder preservation efforts by causing individuals who would have otherwise begun historic rehabilitation to postpone projects until the credit is once again available. Additionally, equity concerns are a likely consequence of credit monopolization.

1.18 Earned Income Tax Credit

1. Statutory Provision:
Title 30, Delaware Code, Chapter 11 §§1117.

2. Description:
Federal law permits certain low-income individuals with earned income, meeting adjusted gross income thresholds, to take a refundable Earned Income Tax Credit (EITC). For tax years beginning January 1, 2006, Delaware taxpayers who qualify to take the federal EITC will be permitted to take a non-refundable State tax credit equal to 20% of the federal amount.

3. Estimated Revenue Loss[18]
FY 05: $0
FY 06: $0

4. Assessment:
EITC advocates consider this credit to be an important tool in fighting poverty. Since 1975, the federal Earned Income Tax Credit has essentially worked as a income subsidy, which is delivered through the tax code and which targets the working poor. Unlike traditional welfare programs, because the EITC rewards work, proponents contend that it encourages socially beneficial behavior.

5. Inadvertent Effects:
The Federal EITC's generosity and refundability make it one of the Internal Revenue Code's most abused preferences. Although Delaware has attempted to limit the State's exposure to abuse by issuing only non-refundable credits, the Division of Revenue will likely experience a higher than average rate of fraud on returns claiming an EITC. As

[18] The first credits are to be taken against tax year 2006 liabilities. As such the fiscal impact of this new credit is likely to appear during FY 07, when CY 06 income tax returns are filed.

such, the administration of an effective low-income subsidy may come at a high price. Not only will the higher likelihood of fraud increase the overall administrative burden but it may expose the Division of Revenue to claims of "unfairly targeting the poor" due to a potential audit focus on low-income returns.

CORPORATE INCOME TAX

- Statutory Provision

  Title 30, Delaware Code, Chapters 19 and 64.

- Collection/Administrative Agency

  The Department of Finance, Division of Revenue, administers this tax.

- General Liability

  Every domestic and foreign corporation doing business in Delaware is required, unless specifically exempt by law, to file a corporate income tax return regardless of the amount of its gross income or its taxable income. Corporations that maintain a statutory office in Delaware but that do not conduct business within the State are not required to file a corporate income tax return.

  Taxes for Delaware purposes are computed on whatever share of the corporation's federal taxable income is allocated and apportioned to Delaware. Delaware taxable income does not include interest on obligations of the United States, the State of Delaware, or its subdivisions. Dividends, interest, and royalties of foreign corporations that qualify for a foreign tax credit for federal purposes are excluded from Delaware taxable income. Additional deductions are allowed for any wages eliminated as a deduction in the calculation of the federal Jobs Credit and certain expenditures on building renovations that improve accessibility for handicapped persons.

  Income from rents and royalties, patents and copyright royalties, gains and losses from the sale or other disposition of real and tangible personal property, and from interest is allocated directly to the states where the property is physically located or the transactions took place, reduced by the applicable related expenses.

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

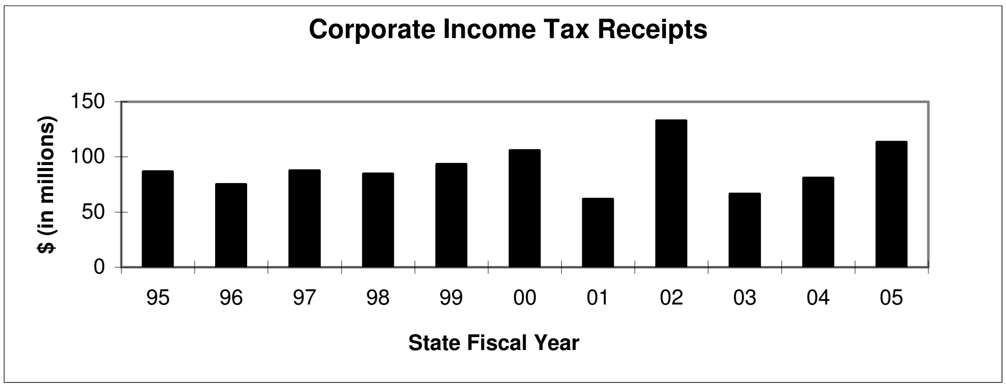
$$\frac{\text{Property Ratio + Salary Ratio + Sales Ratio}}{3} = \text{Apportionment Ratio}$$

- Tax Rate

8.7% of taxable income

- Tax Receipts, net of refunds (millions of dollars)

Fiscal Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total ($)	86.8	75.1	87.6	84.8	93.3	106.0	61.8	133.0	66.3	81.0	113.9



- Tax Preferences

The following items have been identified as corporate income tax preferences within the Delaware Code:

2.01 Exemption of Investment Holding Companies and Firms Managing Intangible Investments of Mutual Funds

1. Statutory Provision
   Title 30, Delaware Code, Chapter 19, §1902(b)(8)

2. Description
   Investment holding companies and corporations whose activities within this State are confined to the maintenance and management of the intangible investments of corporations or business trusts registered as investment companies under the Investment Company Act of 1940 are exempt from the corporate income tax.

3. Estimated Revenue Loss
   FY 05: Unknown
   FY 06: Unknown

4. Assessment
   This provision is designed to spur economic development in the State. The tax preference is intended to strengthen the State's reputation as a major financial center, and to signal to the financial community that Delaware is a progressive state in terms of liberalizing its financial regulatory environment. Originally, this exemption applied only to investment holding companies. On July 1, 1990, this provision was extended to include corporations that invest the funds of a mutual fund.

   Eligible firms file only information returns, establishing their eligibility for the exemption and, therefore, do not have to file a corporate income tax return. This makes an accurate assessment of the revenue impact of this provision little more than guesswork. As investment holding companies are established in Delaware primarily because of this tax exemption, it is likely that, given the inherent mobility of intangible assets, many of them would leave the State if the exemption were repealed or narrowed significantly. However, no data exist by which the Division of Revenue could make its own estimate of the revenue loss generated by this exemption.

5. Inadvertent Effects
   None noted.

2.02 Exemption of Foreign Sales Corporations

1. Statutory Provision
   Title 30, Delaware Code, Chapter 19, §1902(b)(11).

2. Description
   Corporations that qualify as foreign sales corporations (FSC's) under the federal Internal Revenue Code (IRC) are exempt from corporate income tax. An FSC is a non-U.S. corporation, established by a single U.S. exporter, or jointly by a group of U.S. exporters (a "shared" FSC), to export U.S. goods and services abroad.

   The Federal preference was dissolved by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (H.R. 4986), effective October 1, 2000. Short-term transition rules allow existing FSCs to continue these benefits through

December 31, 2001. Long-term benefits are also extended to long-term lease transactions, which will be allowed to maintain FSC tax benefits over the life of the lease.

3. Estimated Revenue Loss
FY 05: Unknown, Likely to be $0
FY 06: Unknown, Likely to be $0

4. Assessment
The primary rationale for exempting FSCs is to promote export opportunities for small- and medium-sized Delaware businesses. Such businesses face significant export barriers in the form, for example, of complex foreign legal and administrative requirements. By eliminating the tax liability on goods and services exported using an FSC, it may be argued that such barriers are more likely to be overcome, and Delaware's exports enhanced.

Historically, few firms claimed this exemption and, although FSC's were not required to file tax returns, analysts concluded that the provision cost the State little in terms of foregone revenue. Analysts also concluded that the exemption probably did little to improve Delaware's export base.

5. Inadvertent Effects
None Noted.

2.03 Exemption of Foreign Sales Service Corporations

1. Statutory Provision
Title 30, Delaware Code, Chapter 19, §1902(b)(12).

2. Description
Delaware exempts from its corporate income tax any corporation whose primary business is the sale of services to FSCs through the end of calendar year 2001. The Federal FSC Repeal and Extraterritorial Income Exclusion Act of 2001 will prohibit further use of this preference.

3. Estimated Revenue Loss
FY 05: Unknown, Likely to be $0
FY 06: Unknown, Likely to be $0

4. Assessment
This preference is also intended to encourage export growth and promote international trade by exempting FSSCs from corporate income tax. Like

FSCs, FSSCs only have to file information returns that prove their eligibility for the exemption--they do not have to file a corporate income tax return. Historically, very few firms have made use of this provision and it is very likely that this remains the case, especially in light of its repeal at the federal level.

As with the previous preference, the World Trade Organization found that such rules were effectively illegal export subsidies and encouraged the repeal of this preference.

5. Inadvertent Effects
None noted.

2.04 Exemption of Export Trading Companies

1. Statutory Provision
Title 6, Delaware Code, Chapter 74, §7401-§7404.
Title 30, Delaware Code, Chapter 19, §1902(b)(13).

2. Description
Any corporation that qualifies as an export trading company under federal law is exempt from corporate income tax. To qualify, a company must have an office in Delaware and, subject to the rules and regulations of the Delaware Economic Development Office, perform export trade services. In making its eligibility determinations, the Delaware Economic Development Office must consider:

(i) whether the firm's basic aim is to encourage and expand export trade;
(ii) whether its activities contribute significantly to encouraging export trade;
(iii) whether the exemption will serve as a significant incentive and aid in encouraging export trade; and
(iv) whether export trade opportunities will be expanded.

3. Estimated Revenue Loss
FY 05: Unknown, but likely to be negligible[1]
FY 06: Unknown, but likely to be negligible

4. Assessment
Although this provision was intended to promote export trade by Delaware corporations, very few firms have claimed the exemption since the provision

[1] Defined as less than $10,000.

became law in 1985. Historically this provision has gone largely unused. DEDO officials question its usefulness. As this provision is so little used, it seems reasonable to suggest that policymakers examine alternative methods of promoting Delaware's export trade.

This exemption appears to have provided no real impetus to the expansion of Delaware's export base. But this fact should not be misinterpreted to imply that these provisions are cost-effective approaches to export promotion. The cost is low, but the effectiveness appears to be minimal as well. Such provisions serve to further complicate the Delaware tax code, and could increase revenue losses if other factors cause exports to boom.

5. Inadvertent Effects
None noted.

2.05 Deduction of Interest from Affiliated Companies

1. Statutory Provision
Title 30, Delaware Code, Chapter 19, §1903(a)(2)

2. Description
Delaware allows firms (creditors) to deduct the amount of interest income (including discount) that they earn on inter-corporate obligations (usually in the form of advances, loans, or similar contractual transactions). In order to qualify for this deduction, the following requirements must be met:

(i) the debtor and creditor corporations are subject to taxation under Delaware law; and
(ii) the debtor corporation does not claim a deduction for such interest payments in determining its entire net income for Delaware corporation income tax purposes.

3. Estimated Revenue Loss
FY 05: Likely to be Negligible*
FY 06: Likely to be Negligible*

* Accounts for a very high probability of a sweeping behavioral effect. See discussion in Assessment, below.

4. Assessment
The corporate income tax deduction for interest from affiliated corporations allows related companies to shift interest income and related expenses among

members of a group that is eligible to file a federal consolidated return. The rational behind this provision is consistent with the idea behind the exemptions for investment holding companies (Item 2.01) and designated or qualified settlement funds (Item 1.16). By creating a tax advantage for the management of inherently mobile intangible assets, such as inter-company obligations, Delaware enhances its reputation as a financial center and may also produce a secondary effect in the form of relatively small employment gains for Delaware's financial and legal communities. Because the ease with which intangible assets could be moved from Delaware is so great, it is clear that a tax incentive's impact on the decision to locate such assets in Delaware is critical.

In fact, many argue that a business's decision to "locate" intangible assets in Delaware occurs solely due to the tax incentive. Unlike tangible business assets (e.g., a production or research facility), the location of intangible assets is not dependent upon the quality of public infrastructure, access to markets, a well-trained pool of labor, or quality of life considerations. In the event of its repeal, the vast majority of the intangible assets covered under this provision would leave the State drastically reducing any revenue loss estimate produced on a static basis.

When the deduction was enacted in 1957, Delaware permitted corporations to elect to file consolidated returns. Since most corporations at that time filed consolidated returns, there was little or no revenue impact resulting from the shift of income among related companies. Starting on August 1, 1971, however, corporations were not permitted to file consolidated returns and now must file a separate return for each corporation conducting business within Delaware. Interest may be excluded from State taxation to the extent that the creditor corporation (i.e., the corporation that receives the interest income) conducts a greater percentage of its business in Delaware than the debtor corporation (i.e., the corporation that pays the interest on its debt).

Affiliated finance companies (AFCs) present a special case under this tax preference. By purchasing receivables from their affiliate or "core business" (a large retailer, for example), the AFC acts as a creditor for its affiliate. The affiliate (retailer), usually has a very small apportionment percentage because sales in Delaware make up only a small part of its market. The AFC, however, usually has a very high apportionment percentage (frequently 100%). Therefore, the interest on a large loan from an AFC to the core business is often sufficient, when deducted from the AFC's net income, to totally eliminate its tax liability. The AFC's primary function is to enhance the financial position of the core business; correspondingly, large loans are not uncommon. It is evident that this preference is the reason behind the establishment of AFC's in Delaware. The fact that so many AFC's were established in Delaware in response to this provision suggests that its elimination would cause many or all AFC's to move to other states.

As mentioned above, estimates of the revenue loss for this tax preference are confounded by unknown market responses to a change in this tax law. Although the elimination of this provision could cause a temporary, short-term increase in revenues, firms likely would move these operations out of the State as quickly as possible, erasing any long-term revenue gain.

5. Inadvertent Effects
None noted.

2.06 Handicapped Accessibility Deduction

1. Statutory Provision
Title 30, Delaware Code, Chapter 19, §1903(a)(6).

2. Description
Delaware offers a deduction from corporate income tax equal to the expenses that a corporation incurs (not to exceed $5,000) in a renovation project to remove design features in a building that restrict the full use of the building by physically handicapped persons. The term "building" means a building or structure, located in Delaware and open to the general public. This definition includes sidewalks, curbing, driveways, and entrances connected with, or related to, the use of the building structure. Also qualifying for the deduction are expenditures incurred in the removal of architectural barriers or physical design features for the purpose of making the building more accessible to, or usable by, handicapped individuals.

3. Estimated Revenue Loss
FY 05: Negligible
FY 06: Negligible

4. Assessment
The relatively low utilization of this deduction suggests that it is insufficient to encourage firms to undertake costly renovations. This is true despite the fact that the deduction may be claimed in addition to a deduction on depreciation for renovation projects. Moreover, corporations are also allowed to expense up to $15,000 of capital costs (in lieu of depreciation) to remove architectural and transportation barriers to handicapped individuals under §190 of the

federal IRC, which is adopted by Delaware law. As such, corporations may receive a Delaware tax benefit of up to $435 (8.7% of the capital project up to $5,000) in addition to expensing or depreciating the capital investment.

Small businesses may also claim the federal "disabled access tax credit" -- a credit equal to 50 percent of "eligible access expenditures" as exceed $250 (as defined under Section 44 of the IRC), but not exceeding $10,250. To be eligible, a small business must have gross receipts of less than $1 million, or no more than 30 full-time employees.

Despite these federal and state inducements, very few companies have responded to them. The primary policy tool in promoting handicapped accessibility is the Americans with Disabilities Act (ADA). Enforcement of the ADA depends primarily upon private lawsuits brought by persons who claim that a business is non-compliant. If companies respond to the threat of such lawsuits, then the number of businesses that claim these deductions could grow. Nonetheless, it is unlikely that these tax benefits alone will offer much incentive for firms to make their buildings accessible. The value of these benefits, capped at $435 for each firm, pales in comparison to the costs of actually performing accessibility improvements. For these reasons, it appears that utilization of this tax benefit will remain inconsequential and that this provision will do little to achieve its intended purpose. Moreover, as with other tax incentives that parallel regulatory provisions, it is unclear that the State should simultaneously subsidize actions that are mandated by other laws.

5. Inadvertent Effects
   None noted.

2.07 Neighborhood Assistance Credit [2]

1. Statutory Provision
   Title 30, Delaware Code, Chapter 20, Subchapter I, §2001-§2006.

[2] Previously the Neighborhood Assistance Deduction.

2. Description

Businesses that invest in community development programs approved by the Director of the Delaware Economic Development Office and the Tax Appeal Board are entitled to a tax credit equal to fifty percent (50%) of the amount invested by a business firm in a program or in a Community-Based Development Organization. The size of the tax credit is limited to the lesser of 50% of a firm's qualifying investment or $100,000. The aggregate amount of tax credits awarded in any one year may not exceed $500,000.

The term "Neighborhood Assistance" encompasses business contributions to neighborhood organizations, Community Development Corporations, Community-Based Development Organizations, or which fund the following activities: job training or education for individuals not employed by the business firm, community services, crime prevention, housing, or economic development in an impoverished area.

3. Estimated Revenue Loss

FY 05: $0
FY 06: Less than $25,000

4. Assessment

The goal of this credit is to encourage Delaware businesses to invest in job training, education, crime prevention, and other community services in designated impoverished areas. The credit offered for neighborhood assistance is allowed in addition to the deduction for any amounts qualifying as charitable contributions. Corporations can therefore reduce their tax liability by over 50% percent of any amount (subject to the aforementioned limits) that they contribute to neighborhood assistance programs and to charitable organizations.

Prior to tax year 2000, this incentive was a less valuable deduction of which few firms made use. The expansion of the deduction into the current Neighborhood Assistance Credit, was implemented January 1, 2000, in an attempt to encourage greater program participation. However, it is not clear that these program enhancements will increase the success of the program. The inability of this provision to elicit business participation in the past, rather than demonstrating that the value of the preference is insufficient, more likely demonstrates that the tax consequences of corporate giving are far from the only consideration involved in the selection of the type of corporate charity. In addition to charitable objectives, corporate charity is also motivated by business considerations. Though exceptions may exist, generally speaking, charitable activities which resonate with a firm's customers, management and shareholders[3] are probably more likely to receive funding than other causes which lack similar appeal but happen to provide a larger tax break. Corporate giving, to the extent that it occurs within impoverished areas, is no exception; it occurs because it provides benefits to both the neighborhood and the firm.

To the extent that the traditionally scant use of this deduction demonstrates an inherent "disconnect" between the goals of corporate charitable efforts and the very real needs of impoverished areas, there may be very little chance that any reasonably constructed tax incentive will provide meaningful support to these communities. If policymakers conclude that the present level of support (both public and private) for these communities is inadequate, it seems apparent that other, more reliable, funding mechanisms (e.g., a direct appropriation) would be preferable to the current deduction or the enhanced version thereof.

To the extent that firms do take this deduction in the future, and are motivated by the factors discussed above rather than the tax benefits of giving, the credit may represent a bonus for actions that would have taken place in its absence.

5. Inadvertent Effects
None noted.

2.08 Tax Credit for Creation of Employment and Qualified Investments in Business Facilities (Blue Collar Jobs Act)

1. Statutory Provision
Title 30, Delaware Code, Chapter 20, Subchapter II §2010, §2011.

2. Description
Any corporate taxpayer that makes a qualified investment ($200,000 or more) and that hires five or more qualified employees ($40,000 per employee) is entitled to receive a tax credit. Eligible corporations receive credits of $400 for each qualified employee and $400 for each $100,000 invested, not to exceed fifty percent of their tax liability in a given year. Unused credits may be carried forward. Qualified activities are defined as:

   1. Manufacturing;
   2. Wholesaling;
   3. Scientific, agricultural or industrial research development or testing;
   4. Computer processing, or data preparation and processing services;

[3] For example, support for the arts, or support for medical research efforts.

5. Engineering services;
6. Consumer credit reporting services, including adjustment and collection services and credit reporting services;
7. Telecommunications services;
8. Aviation services;
9. Non-custom computer software;
10. Any combination of the activities described above; or
11. The administration, management or support operations (including marketing) of any activity described above.

Instead of five employees and $40,000 of investment, telecommunication service businesses are required to hire at least 50 qualified employees and make a minimum investment of $15,000 per qualified employee (with a minimum aggregate investment of $750,000, rather than $200,000).

In July 1997, the application of these credits was expanded. The requirement that a taxpayer make a qualifying investment *and* employ the requisite number of new employees in the same tax year was loosened. The two events now need to occur within the same 12-month period.

An alternative investment tax credit of $300 per $100,000 of investment is available in cases where the qualified investment is at least the greater of $1 million, or 15% of the unadjusted basis of the qualified facility. The alternative credit is to be used by manufacturers, wholesalers or aviation service firms who do not meet the ordinary requirements for investment credits (i.e., the required number of new employees).

Eligibility for corporate income tax credits also means firms become eligible for gross receipts and public utility tax breaks.[4] Unused credits may be carried forward for use in future tax years.

The cost of this preference, like the tax itself, tends to fluctuate considerably from year to year. As a consequence, as corporate profits have increased in recent years, so too, has the cost of this preference.

Unless the program is extended, no new credits will be allowed for investments that occur on or after January 1, 2007.

---

[4] A related type of investment credit can be used against the bank franchise tax (5 Del. C., Chapter 11, Section 1105(d)-(f)).

3. Estimated Revenue Loss [5]
FY 05: $2.4 million
FY 06: $2.5 - $5.0 million

4. Assessment
The first goal of these credits is to promote job creation and investment in Delaware by giving employers incentives to hire additional full-time employees or to expand business facilities. The second goal is to offer an incentive to firms that are considering whether to locate a facility in Delaware. Whether a $400 credit per $100,000 of investment offers enough incentive for firms to expand is an open question, but appears improbable. In the absence of increased demand for a firm's products or services, the promise of a relatively small tax subsidy will make little difference in the expansion decision.

These credits also attempt to create a competitive environment to attract new business to Delaware. State development officials have indicated that these credits serve a useful role as a marketing tool in recruiting new businesses to Delaware. On the margin, the existence of tax credits may tip a firm's location decision in Delaware's favor. Further, the credits may have value if they portray Delaware as being committed to economic development.

In general, though, the impact of taxes on business location decisions is often of secondary importance to other elements of a State's business climate. Access to markets, labor skill and supply, and infrastructure quality are typically more important considerations in a business's location decision. It is often unclear whether tax credits are a critical element, without which a firm would have chosen to locate elsewhere, or if they merely serve as a bonus to firms that would have chosen a particular state regardless of the credit. The size of the incentives suggests that they are unlikely to have a significant impact on businesses' location decisions. Despite this, proponents argue that such credits must be offered for businesses to even consider Delaware as a potential location. Even if the credits are not *the* deciding factor in the location

[5] This estimate only includes the fiscal impact of this provision with respect to the corporate income tax. No assessment is made of the extent to which these credits will be claimed against other eligible taxes. Given this limitation, the fiscal impact estimate does not reflect the full impact of this provision on state revenues. It also excludes any "dynamic" revenue effect the credit may have (i.e., economic improvements resulting from the credit which offset some of its cost). For example, to the extent that the qualified investment in new facilities and employees increases a firm's productivity (and profits) corporate income tax receipts -- and other state tax receipts -- could increase. Establishing and quantifying a causal effect, however, would be tenuous at best.

decision, they may be of enough importance to retain. They may even be considered a cost of doing business for State development efforts.

This provision has been modified incrementally over a number of years, and is the basis for other credits against corporate income and other taxes (see items 2.09, 2.11 and 2.12). This “layer-upon-layer” development, however, has compromised the potential benefits of these credits by making the entire program unwieldy for development officials and confusing for prospective participants. The credits are only useful as a marketing tool for development officials to the extent that they can be understood and effectively utilized. As such, consideration should be given to streamlining the complex system of business tax credits now in place.

An assessment of the fiscal impact of the credits depends on the ability to identify those business decisions that were influenced by the credits and those that were not. Fiscal impacts could then be calculated for both sets of decisions and weighed against each other. No data exist that would allow such a comparison to be conducted. The fiscal impacts of these provisions are therefore calculated on a static basis, with no assessment of the potential positive behavioral responses to the incentives.

5. Inadvertent Effects

These credits may indeed serve as a useful promotional tool for State development officials. But there is an equally strong probability that most firms are simply "rewarded" with a bonus for actions that they would have taken without the existence of a credit, rather than “earning” a credit for actions that would not have occurred without them.

Moreover, as mentioned above, a series of incremental changes have made the program extremely complex, potentially compromising any positive effects the credits may have. Consideration should be given to streamlining the existing program.

2.09 Tax Credit for Creation of Employment and Qualified Investments in Targeted Areas (Blue Collar Jobs Act)

1. Statutory Provision
   Title 30, Delaware Code, Chapter 20, Subchapter III §2020-§2023.

2. Description
   This provision allows employers engaged in qualified activities (as defined in §2010 -- see above) an extra credit of $250 (for a total credit of $650) for each additional full-time employee, and an extra credit of $250 (for a total of $650) for each $100,000 investment in qualified facilities located in "targeted areas" (as defined in §2020), in addition to the credits allowable under §2011 above.

   A related credit of $400 (the amount for investment in qualified facilities) is allowed for facilities engaged in "commercial or retail activity" within targeted areas. *Commercial activities* (as defined in §2020(3)) include all services except: amusement conductor, amusement park operator, auctioneer, automobile race operator, bowling alley operator, circus exhibitor, entertainment agent, finance or small loan agency, floor show operator, health spa or health club, junk dealer, motion picture theater, outdoor music festival promoter, pawnbroker, pool table operator, public bath keeper, salvage yard operator, and self-service laundry or dry cleaner. *Retail activities* (as defined in §2020(4)) include all retail trade except: eating and drinking places, automobile sales, or providing recreation or entertainment. Facilities meeting this expanded definition in targeted areas are treated as if they qualified for the credit described above in 2.08.

3. Estimated Revenue Loss [6]
   FY 05: See Item 2.08 above
   FY 06: See Item 2.08 above

4. Assessment
   These credits were established to further encourage economic development and employment in certain underdeveloped areas of the State, and to create a business environment that is competitive with other states in the region. It is likely that some of the financial benefit of these credits accrues to firms that would have made the same investments anyway. In many cases, the use of

---

[6] This figure is included in the fiscal impact estimate for tax credits for the creation of employment and qualified investment in business facilities (Item 2.08). The information available to the Division of Revenue did not allow for the separate impact of these provisions to be broken out.

credits does not reflect desired behavioral change induced by the tax benefit, but rather shows decisions are often of secondary importance to other elements of a state's business climate (e.g., access to markets, the skill and cost of labor, infrastructure, etc.). Given the size of the incentives and the characteristics of the targeted areas, they seem unlikely to have a significant impact on locational decisions of businesses.

5. Inadvertent Effects
Certain qualifying firms may be benefiting from a tax relief for actions that were largely unrelated to the existence of tax incentives.

2.10 Tax Credits for the Mitigation of Commuter Traffic During Peak Travel Periods (Travelink Credits)

1. Statutory Provision
Title 30, Delaware Code, Chapter 20, Subchapter IV, §2030-§2036.

2. Description
Employers that participate in a Travelink program certified by the Delaware Department of Transportation are entitled to a tax credit equal to 10 percent of the developing, implementing, and maintaining the Travelink program, or up to $250 for each employee taking part in traffic mitigation efforts. In addition to the corporate income tax, businesses may take the credits against the gross receipts tax, bank franchise tax, insurance premium tax, or public utility license fee. The total amount of credits that may be authorized in any one year may not exceed $100,000.

3. Estimated Revenue Loss [7]
FY 05: Negligible
FY 06: Negligible

4. Assessment
The 1990 Federal Clean Air Act Amendments (CAA) required states to develop regulations to reduce commuter traffic. To comply, Delaware drafted the employee commute options (ECO) regulations mandating that employers with 100 or more employees develop commuter plans to reduce the use of single-occupant vehicles.

---

[7] As is the case with the credits described in items 2.08 and 2.09, these credits may be claimed against one of several taxes. The fiscal impact estimate for corporate income tax may, therefore, underestimate the full impact of this provision.

For a brief period while Delaware was in the process of developing its ECO regulations, it appeared that Travelink would become a very costly program. Travelink's tax credit would have been eligible for all firms meeting a regulatory mandate. In this sense, there would have been no doubt that a tax credit would have been a bonus rather than a true incentive.

After Delaware had drafted its ECO regulations, however, the provisions of the CAA that mandated employee commute options programs were overturned by an act of Congress. ECO programs are now voluntary.

In the absence a regulatory mandate, the Travelink program continues to go largely unused. The Travelink program was expanded under legislation adopted during the first session of the 140th General Assembly. It is possible that these program enhancements may someday increase participation in the program. Significant participation, however, remains unlikely as more important phenomenon (e.g., the price of gasoline, availability of desired mode of public transportation) will probably continue to exert a larger influence on commuting decisions.

5. Inadvertent Effects
None Noted.

2.11 Green Industries Tax Credits

1. Statutory Provision
Title 30, Delaware Code, Chapter 20, Subchapter V, §2040-§2045.

2. Description
The "Green Industries" provisions allow tax credits in the categories listed below:

(i) §2041 provides a $400 credit for each full 10 percent of waste reduction by manufacturers that voluntarily reduce the weight of wastes reported under the Toxic Release Inventory by at least 20% (50% for non-TRI chemicals). The credit may be taken in the year the waste reduction is achieved and in each of the four succeeding years provided the waste reduction is maintained.

(ii) §2042 provides a $250 credit (for a total of $650) for firms that:

- Make use of recycled materials or materials removed from Delaware's solid waste stream for 25% of their raw materials;
- Satisfy the eligibility requirements of the Blue Collar Jobs Act under §2011; and
- Use the materials in a qualified facility (as defined in §2011). If the facility is located in a targeted area, then the credit may be claimed on top of the additional credits under §2021, for a total credit of $900.

(iii) §2043 provides a $250 credit (for a total of $650) for firms that:

- Process waste materials removed from Delaware's solid waste stream for resale as raw materials to manufacturers;
- Satisfy the eligibility requirements of the Blue Collar Jobs Act under §2011; and
- Devote the qualified investment entirely to the processing and resale of waste materials. If the facility is located in a targeted area, then the credit may be claimed on top of the additional credits under §2021, for a total credit of $900.

(iv) §2044 provides a $250 credit (for a total of $650) for firms that:

- Collect materials for recycling and distribute recycled materials;
- Satisfy the eligibility requirements of the Blue Collar Jobs Act under §2011; and
- Devote the qualified investment entirely to the collection of materials for recycling and distribution of recycled materials. If the facility is located in a targeted area, then the credit may be claimed on top of the additional credits under §2021, for a total credit of $900.

These credits are exclusive of one another. No taxpayer may claim credits under more than one section. However, credits may be carried forward for four years in the case of toxic waste reduction (i.e., (i) above), and nine years in the case of recycling activities (i.e., (ii) - (iv) above).

3. Estimated Revenue Loss [8]
FY 05: See item 2.08 above
FY 06: See item 2.08 above

4. Assessment
Since the inception of the program in 1992, this credit has gone virtually unused.

The goal of the Green Industry Credits is to encourage waste reduction among Delaware manufacturers and to provide incentives for the collection, processing, and use of recycled materials. Source reduction credits depend solely on the level of a firm's capital investment in pollution control equipment and on its compliance with an established waste reduction standard. In contrast, the eligibility for the recycling credits depends not only on performance of one of three separate activities, but also on achievement of the job creation and capital investment requirements specified in the Blue Collar Jobs Act.

The qualification requirements for Green Industry recycling credits ensure a low probability that a firm in a specific industry would qualify in any given year. The likelihood that a firm coming from an unestablished industry, as many recycling ventures are, and qualifying for these credits is even more remote. Further diminishing the qualification prospects is the fact that the new firms that may be eligible for the Blue Collar Jobs credits are rarely immediately profitable. Because of this, they have no corporate income tax liability and are often small enough to be exempt from payment of the gross receipts tax. The offer of a non-refundable tax credit is irrelevant to a firm without any tax liability.

The fiscal impact of the Green Industries Credit Program should therefore continue to be negligible. Unfortunately, the impact is negligible, because *very few companies are using them*, not because they are inexpensive. It may be that the

[8] As is the case with the credits described in items 2.08, 2.09, and 2.10, these credits may be claimed against one of several taxes, the fiscal impact estimate for corporate income tax may underestimate the full impact of this provision. However, the importance of this consideration is diminished given the low level of participation in the program.

credits simply represent too small an incentive to encourage the scale of behavioral change necessary to qualify for them. It may also be the case that, for the foreseeable future, the demand for recycled products is simply not sufficient to justify investment under any circumstances. Many recycling industries are still in a fledgling stage of development, suffering from large expenses, uncertain demand for recycled products, and a fluctuating supply of valuable recyclable materials. Given this adversity, expanding the Blue Collar Jobs Act has not provided a significant incentive for firms to enter the recycling business. Similarly, the "source reduction" credit is too small to cause a significant behavioral response. A business that invests $50,000 in capital equipment and reduces its chemical use by 20%, receives a tax credit of $800 per year for five years, just 8% ([$800x5]/$50,000) of its capital costs.

5. Inadvertent Effects

Like many of the other tax preferences that intend to encourage behavioral change, it seems likely that the Green Industry credits will reward behavior which takes place *regardless of the credits*. Prior to the enactment of these credits, in 1988, Delaware firms invested an estimated $12.5 million in capital acquisitions and improvements for pollution abatement purposes. Firms invested these resources without any financial encouragement from the State. As with other such credits, the Green Industries Credits serve as a bonus for actions that occur without regard to the availability of credits.

However laudable the goals of economic development, job creation, and environmentally friendly activities, the Green Industries Credits are not achieving those aims. Other policy tools (e.g., direct grants of equivalent amounts, or regulatory mechanisms) might better serve these goals.

This preference is linked to the Blue Collar Jobs program (see (ii) - (iv) above). As such, it has amplified the inherently complex nature of state business tax credits, making it more difficult for state officials to administer them, and for prospective participants to understand and benefit from them.

2.12 Credits for Development At "Brownfield" Sites and Facilities

1. Statutory Provision

Title 30, Delaware Code, Chapter 20, §2011(l).
Title 30, Delaware Code, Chapter 20, §2021(d).

2. Description

Seeking to encourage the redevelopment of underutilized real property known as "brownfields," the General Assembly created an additional investment tax credit in June 1995. These properties are typically abandoned properties where some residual environmental contamination may still exist, or where fears of cleanup liability may be preventing re-use of the land. Piggybacked on the Blue Collar Jobs Act credits, the "brownfield" credits attempt to encourage redevelopment of these lands by offering reduced license fees and tax credits for firms that invest in these properties. Tax credits worth $650 for each qualified employee and $650 for each $100,000 in qualified investment in "brownfield" sites are now available. The value of these credits grows to $900 per qualified employee or $900 for each $100,000 in qualified investments if the "brownfield" is also located in a "targeted" area, as defined under §2020.

3. <u>Estimated Revenue Loss</u>
FY 05: $0
FY 06: Likely to be $0

3. <u>Assessment</u>
Since the inception of this program in 1995, this program has gone unused.

As with the Green Industry Credits, the "brownfield" credits may not offer enough incentive to outweigh the large potential cleanup liabilities that investment in, or ownership of, these properties may entail. Moreover, it is clear that the firms that would actually fund and oversee a brownfield clean up (i.e., those that specialize in environmental remediation or real estate development) typically are not the firms that would meet the Blue Collar Jobs Act employment, investment and qualified activity requirements. As mentioned above, Brownfield credits can only be awarded if the firm first qualifies for the Blue Collar Jobs Act credits.

Further diminishing the qualification prospects is the fact that otherwise eligible firms may not be initially profitable. Because of this, they have no corporate income tax liability and are often small enough to be exempt from payment of the gross receipts tax. The offer of a non-refundable tax credit is irrelevant to a firm without any tax liability within the foreseeable future.

This preference is linked to the Blue Collar Jobs program (see above). As such, it has amplified the inherently complex nature of state business tax credits, making it more difficult for state officials to administer them, and for prospective participants to understand and benefit from them.

5. Inadvertent Effects
Like many the other tax preferences that try to encourage behavioral change, it seems likely that the "brownfields" credits, if ever used, would reward some behavior which takes place, *regardless of the credits*. Despite the laudable goals of economic development, job creation, and environmentally friendly activities, it remains to be seen if these new credits will lead to redevelopment of "brownfields."

2.13 Research and Development Tax Credit

1. Statutory Provision
Title 30, Delaware Code, Chapter 20, §§2070-2075.

2. Description
This preference, adapted from similar federal tax provisions allows a credit against tax for qualified research conducted within Delaware. The statewide cap on such credits is $5 million per year, to be granted first in December 2001, with regard to tax year 2000 expenses. Whenever statewide application exceed $5 million, receipts are to be allowed pro rata according to the approved amount so that the total approved credits do not exceed $5 million. This preference will sunset in 2010.[9] Unused credits may not be carried back, but may be carried forward fifteen years.

The cost of this preference, like the tax itself, tends to fluctuate considerably beneath the $5 million annual cap. As a consequence, as corporate profits have increased in recent years, so too, has the cost of this preference.

3. Estimated Revenue Loss
FY 05: $1.2 million - $2.0 million
FY 06: $2.0 million - $5.0 million

4. Assessment
The purpose of this preference is to enhance Delaware's reputation as a home for research intensive firms (e.g., pharmaceutical and biotechnology firms). Like all business tax incentives, it is difficult to isolate that portion which actually results in "new" economic activity from that part which merely serves

[9] House Bill 56 during the 142nd General Assembly extended the sunset date from December 31, 2005, to December 31, 2010.

as a bonus to firms that would have engaged in the desired activity in the absence of the incentive. Because the Research and Development Credit is used by many firms that already had significant research and development activity in Delaware prior to its enactment, it is likely that a large portion of the provision's costs does nothing to add to the level of research and development conducted in Delaware. On the other hand, as may be the case with the Blue Collar Jobs Credits, the Research and Development Credits may be considered an unavoidable cost of doing business for states, like Delaware, that hope to compete successfully in the area of high-tech economic development.

5. Inadvertent Effects
None noted.

2.14 Land and Historic Resource Tax Credit

1. Statutory Provision
Title 30, Delaware Code, Chapter 18, §§ 1801 -- 1807.

2. Description
This preference allows an income tax credit for permanent gifts of land or interest in land to public agencies and qualified private non-profit charitable organizations. Lands that qualify must either:

(1) meet the criteria for Open Space established by the Delaware Land Protection Act;

(2) Consists of natural habitat for the protection of Delaware's unique and rare biological and natural resources; or,

(3) Protect Delaware's important historic resources.

The tax credit is based on 40% of the appraised fair market value of the gift. The amount of credit that can be claimed is limited to $50,000. In any one tax year, the credit claimed cannot exceed the tax due, but unused portions of the $50,000 credit can be carried forward for up to five (5) consecutive years. The credit became available on January 1, 2000.

3. Estimated Revenue Loss
FY 05: Refer to Section 1.17
FY 06: Refer to Section 1.17

4. <u>Assessment</u>
This credit may not be effective in motivating some corporate donors. Tax credits only benefit those firms that have a tax liability. Due to fluctuations in net corporate income, some firms may have little or no tax liability and, therefore, would have little incentive to take advantage of the credit.
For further discussion, refer to Section 1.17.

5. <u>Inadvertent Effects</u>:
Refer to Section 1.17.

2.15 Historic Preservation Credit

1. <u>Statutory Provision:</u>
Title 30, Delaware Code, Chapter 18, §1813.

2. <u>Description</u>
Under this provision, a person who wishes to repair, or otherwise preserve a historic property may apply to the State Office of Historic Preservation, for a partial credit for qualified expenditures.

To qualify for the credit, an individual must first submit a rehabilitation proposal to the Office of Historic Preservation to ensure that the restoration, when completed, would meet federal and state guidelines. Credits are to be granted on a first come-first serve basis, not to exceed $5 million[10] in any one fiscal year. Moreover, $100,000 of the credits awarded in a given fiscal year must be reserved for distribution to qualified resident curators.

Upon project completion, a State Preservation Office must certify that the end product conforms with federal and state requirements. Then the Division of Revenue or the Office of the State Bank Commissioner will determine the appropriate value of the tax credit to be issued. Personal/ Corporate Income tax or Bank Franchise tax credits may be valued at:

- 20% (30% in the case of low income housing) of qualified expenditures made in the rehabilitation of any certified historic property eligible for a federal tax credit under §47 of the Internal Revenue Code (income producing properties), or

- 30% (40% in the case of low income housing) of qualified expenditures made in the rehabilitation of any certified historic property not eligible for

[10] The annual credit allocation was increased from $3 million to $5 million from Fiscal Year 2006 onward.

a federal tax credit under §47 of the Internal Revenue Code (non-income producing properties).

Rehabilitative efforts taking the following forms would not qualify for the Historic Preservation Credit:

1) The acquisition of real property or interest in real property,

2) Additions to existing structures when the square footage of all additions is greater than or equal to 20% of the total square footage of the historic portion of the property,

3) Paving or landscaping costs that exceed 10% of the total qualified expenditure,

4) Sales and marketing costs, or

5) Expenditures not properly charged to a capital account, or, in the case of owner occupied property, would not be charged to a capital account if the owner were using such property in a trade or business.

This credit became available as of July 1, 2000, though the first credits could not be claimed until July 1, 2002. Currently, this preference is scheduled to expire on June 30, 2010, unless otherwise extended by the State Legislature.

3. Estimated Revenue Loss:[11]
FY 05: $0
FY 06: Negligible, Likely to be $0

4. Assessment:
For a more complete discussion, refer to analysis in Section 1.18

5. Inadvertent Effects:
Refer to analysis in Section 1.18

[11] With the exception of credits owned by individuals (see section 1.18), all remaining Historic Preservation Credits appear to be owned by financial institutions. As such, there are approximately $14 million in credits available to immediately offset Bank Franchise Tax liabilities. Given the transferability of these credits, at any time the credits may be conveyed to corporate taxpayers and then used to immediately reduce corporate income tax liabilities.

MOTOR FUEL/SPECIAL FUEL TAX

- Statutory Provision

  Title 30, Delaware Code, Chapter 51.

- Collection/Administrative Agency

  The Department of Transportation, Motor Fuel Tax Administration, administers this tax.

- General Liability

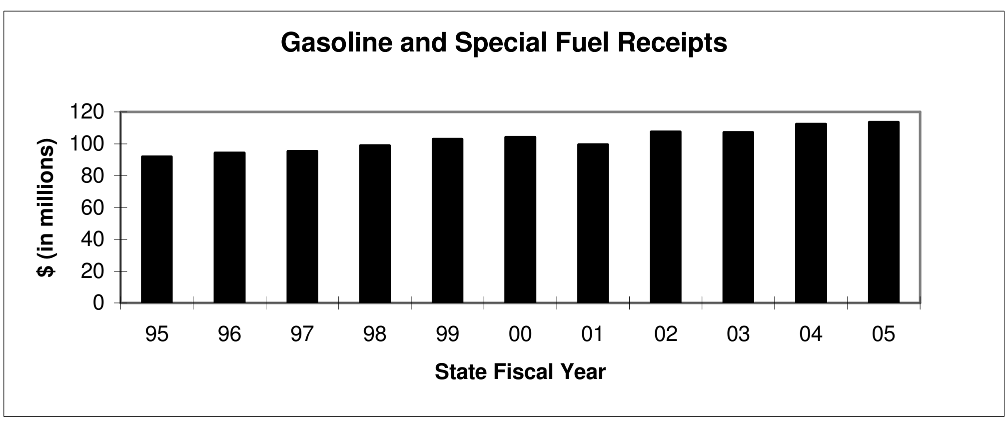
  Delaware imposes an excise tax on each gallon of gasoline sold or used in the state. The tax is collected by and paid to the state by licensed distributors. An excise tax is also imposed on the retail sale or use of special fuel, which includes all combustible gases and liquids suitable for propulsion of motor vehicles, except fuels that are determined to be gasoline or gasohol. The special fuel tax is collected by and paid to the state by licensed suppliers, users, and/or dealers.

- Tax Rates

  The excise tax rate is 23 cents per gallon of gasoline and 22 cents per gallon of special fuel, sold or used in the state.

- Tax Receipts ($ millions)[1]

Fiscal Year:	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total ($):	91.9	94.4	95.5	98.8	103.0	104.2	99.4	107.7	107.3	112.4	113.7



[1] Figures are for gasoline and special fuel receipts

- Tax Preferences

The following items have been identified as motor fuel tax preferences within the Delaware Code:

3.01 Motor Fuel Tax Exemptions

1. Statutory Provision
Title 30, Delaware Code, Chapter 51, Subchapter I, §5111(a)(5)

2. Description
This provision exempts gasoline sold to volunteer fire companies, veterans groups, and civic ambulance companies from the motor fuel tax.

3. Estimated Revenue Loss
FY 05: $20,000
FY 06: $20,000 - $25,000

4. Assessment
Whether the tax code is the most appropriate policy tool to provide public support for these activities is open to question. It can be argued that the exemption is justified given that these organizations perform quasi-public service functions, that the State (or one of its political subdivisions) would otherwise provide.

5. Inadvertent Effects
None noted.

3.02 Motor Fuel Tax Refunds

1. Statutory Provision
Title 30, Delaware Code, Chapter 51, Subchapter I, §5120(a).

2. Description
This provision allows for a refund of motor Fuel taxes in the following circumstances:

   - Gas sold for use in stationary engines, tractors, motor boats, aircraft, and any other vehicle or machine that does not utilized public highways; or

   - Gas sold to operators of a taxicab business with a base of operations in Delaware.

3. Estimated Revenue Loss
FY 05: $277,000
FY 06: $285,000

4. Assessment
As the motor fuel excise tax is perceived as a road use tax, the exemption of fuel in off-highway vehicles and machines is considered to be legitimate. One may question, however, the exemption for taxicabs, as they clearly use public roads and highways.

5. Inadvertent Effects
None noted.

3.03 Special Fuel Exemptions

1. Statutory Provision
Title 30, Delaware Code, Chapter 51, §5133(a)

2. Description
The special fuel tax shall not apply to special fuel sold and delivered to and used by the following persons:

- The United States or any governmental agency thereof;
- The state and every political subdivision thereof;
- And volunteer fire companies in any of their official vehicles and veterans' or civic organizations in their ambulances when such ambulances are provided on a volunteer basis.

3. Estimated Revenue Loss
FY 05: $740,000
FY 06: $725,000 - $750,000

4. Assessment
The rationale for exempting special fuels used by eligible vehicles is consistent with the exemption of such vehicles from the motor fuels tax. Please refer to the discussion in Items 3.01 and 3.02.

5. Inadvertent Effects
None noted.

PUBLIC UTILITY TAX

- Statutory Provision

  Title 30, Delaware Code, Chapters 33, 41 and 55.

- Collection/Administrative Agency

  The Department of Finance, Division of Revenue, administers this tax.

- General Liability

  Firms that provide steam, gas, electric, telephone, telegraph, cable television services are subject to provisions in the public utility tax code. Except for cable television services, receipts from sales to residential users are exempt from this tax. A separate license tax is based on gross receipts of businesses that produce steam, gas, or electricity; and a another license tax is imposed on the owners and operators of telephone and telegraph lines, based on the length and total miles of line, wire and/or number of transmitters within the State of Delaware. The tax does not apply to firms that utilize radio or satellite signals to provide services similar to those subject to the tax.

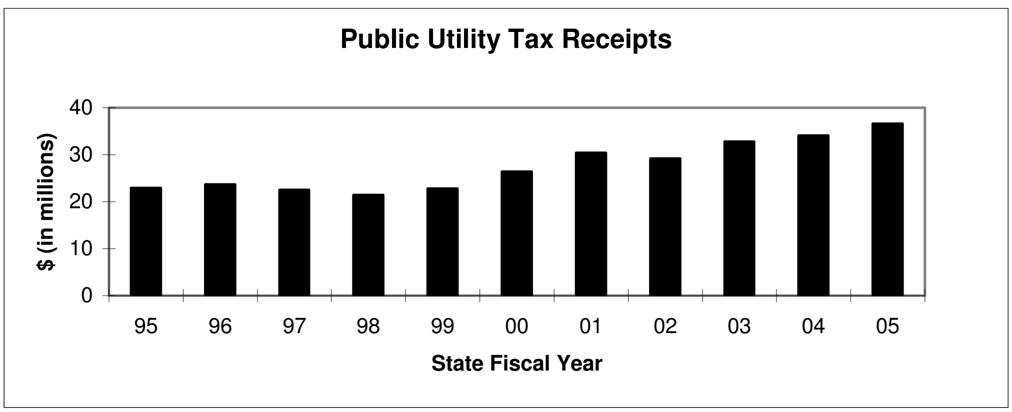
- Tax Rates

UTILITY	TAX RATE	PAYMENT DATES
Electricity Distribution	4.25% of gross receipts from non-residential users. 2% of gross receipts from manufacturers, food processors and agribusinesses. Sales to automobile and certain other types of manufacturers are exempt.	Returns and payment due on or before the 20th day after the end of each calendar month.
Gas Distribution	4.25% of gross receipts from non-residential users. 2% of gross receipts from manufacturers, food processors and agribusinesses. Sales to automobile are exempt.	Returns and payment due on or before the 20th day after the end of each calendar month.
Intrastate Telephone & Telegraph Services	4.25% of gross receipts from non-residential users	Returns and payment due on or before the 20th day after the end of each calendar month.
Telegraph	\$ 0.60 per mile of the longest wire in DE \$ 0.30 per mile of the next longest wire in DE \$ 0.20 per mile for every other wire owned, maintained or operated within DE.	Returns and reporting the number of miles of wire and transmitters are due June 1st and tax payments are due by June 15th.
Telephone	\$ 0.60 per mile of the longest wire in DE \$ 0.30 per mile of the next longest wire in DE	Returns and reporting the number of miles of wire and transmitters are due June 1st

UTILITY	TAX RATE	PAYMENT DATES
	$ 0.20 per mile for every other wire owned, maintained or operated within DE. $ 0.25 for each telephone transmitter within DE	and tax payments are due by June 15th.
Cable Television Distribution	2.125% of gross receipts	Returns and payment due on or before the 20th day after the end of each calendar month.
Electricity and Gas Manufacturing and Production	0.1 % (one mill) on each dollar of gross receipts from the production of gas or electricity. Municipalities are exempt.	Returns and payments are due on the first Monday of May.

- Tax Receipts (millions of dollars)

Fiscal Year:	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total ($):	22.9	23.7	22.5	21.4	22.8	26.4	30.4	29.2	32.8	34.1	36.6



- Tax Preferences

The following items have been identified as public utility tax preferences within the Delaware Code:

4.01 Public Utility Exemption for Corporations Reorganizing Under Provisions of the Bankruptcy Code

1. Statutory Provision
   Title 30, Delaware Code, Chapter 55, §5506(f)

2. Description
The public utility tax on gas and electricity is exempted for 36 consecutive months for any corporation which is a debtor in possession in a reorganization proceeding under Chapter 11 of the United States Bankruptcy Code.

3. Estimated Revenue Loss
FY 05: Unknown, but likely to be negligible [1]
FY 06: Unknown, but likely to be negligible

4. Assessment
This exemption is intended to assist ailing Delaware firms that are deemed to be extremely important to the state economy. This exemption could result in a significant revenue loss if given to one or more firms that are a large electricity consumer. No firms are known to have claimed this exemption over the course of the last several years, and none is expected to do so in the near future.

5. Inadvertent Effects
None noted.

4.02 Exemption of Electricity Used in Certain Manufacturing Processes

1. Statutory Provision
Title 30, Delaware Code, Chapter 55, §5506(g)

2. Description
Gross receipts from electricity used in electrolytic (decomposition of a chemical compounds using an electrical current), electroarcthermal (steel production using electric arcs for heating), or air separation manufacturing processes (separation of air into its component parts by electric charge) are exempt from the public utility tax.

3. Estimated Revenue Loss
FY 05: $620,000
FY 06: $600,000 - $700,000

4. Assessment
This preference attempts to strengthen the competitive position of certain Delaware manufacturers relative to neighboring states by assisting specific

[1] Defined as less than $10,000.

types of firms that use large amounts of electricity in production. How successfully this tax preference meets its objective is unknown. Currently, three firms in Delaware qualify for this exemption.

5. Inadvertent effects
None noted.

4.03 Refunds of Public Utility Tax to Firms That Qualify for the New Facilities Business Credit Program

1. Statutory Provision
Title 30, Delaware Code, Chapter 55, §5507

2. Description
Any firm that is eligible for tax credits under the Blue Collar Jobs Act (as defined under Title 30, Section 2011(a)) is also entitled to receive for five years a rebate of 50 percent of the public utility tax that it owes on the operation of new or expanded enterprises.

3. Estimated Revenue Loss [2]
FY 05: less than $50,000
FY 06: less than $50,000

4. Assessment
This program was implemented as a component of the Blue Collar Jobs Act in order to enhance the business climate for the State's manufacturers. For a full discussion, please refer to Item 2.08, 2.09, 2.11 and 2.12 in the corporate income tax section above.

5. Inadvertent effects
None noted.

4.04 Rate Reduction for Electricity Used by Manufacturing, Agribusiness and Food Processing Firms

1. Statutory Provision
Title 30, Delaware Code, Chapter 55, §5502(b)(2)

---

[2] This estimate can vary significantly from year-to-year as claims for refunds from a handful of major energy-using firms can widely change the total amount of refunds.

2. Description
This provision lowers the tax rate for all manufacturers in the State who do not qualify for the electrochemical manufacturing exemption discussed above (see Item 4.02). Effective September 30, 1994, the public utility tax on electricity sold to Delaware manufacturers was reduced to 2 percent, down from the previous 4.25 percent rate. The General Assembly extended this preferential rate to electricity used by agribusinesses and food processors, effective January 1, 1995.

3. Estimated Revenue Loss

FY 05: $1.4 million
FY 06: $1.2 million - $1.5 million

4. Assessment
This preference attempts to strengthen the competitive position of Delaware's manufacturers relative to neighboring states by assisting firms that use large amounts of electricity in production. How successful this tax preference is in its purpose is unknown. For firms using significant amounts of electricity in the production process, overall power rates may be much more important than the 2.25 percentage point reduction provided by this provision in determining if the State's utility rates are affordable and competitive. While this provision provides a 53 percent reduction in rates (4.25 - 2.0% = 2.25%, 2.25% / 4.25% = 53%), the savings in terms of overall cost for electricity is small (only 2.16 percent). For example, consider a firm that spends $10,000 annually on electricity. The savings provided by this provision are calculated as follows:

Cost Savings From Utility Rate Reduction

Amount spent on electricity (before taxes):	**$10,000**	
Amount spent on electricity under 4.25% rate:	**$10,425**	($10,000 * 1.0425)
Amount spent on electricity under 2.0% rate:	**$10,200**	($10,000 * 1.02)
Difference:	**$225**	($10,425 - $10,200)
Percent Reduction:	**2.16%**	($225 / $10,425)

A flaw of broad, industry-based preferences such as this is that firms obtain tax relief solely because they fall under a definition of "manufacturing." Such a criterion misses the point that firms in other industries may actually be larger power users, or in more competitively precarious positions, but nonetheless do not meet the statutory definition.

5. Inadvertent effects
Enacting a public utility tax preference for a single sector of the economy may, in the long-run, cause firms in that industry to lag in the introduction of more energy-efficient production technologies. Although, given the relatively small benefit provided by this preference, this outcome seems unlikely.

Additionally, providing a preference for firms in one sector of the economy may create an incentive for other firms to construe their activities in such a way that they meet the legal requirements for eligibility. For some firms, non-substantive changes to their activities and/or accounting practices can create a basis for claiming entitlement to benefits. To the extent that they are successful, the cost of this provision is increased with no concomitant increase in benefits. Such preferences may also increase administrative costs in enforcing narrowly defined eligibility standards.

4.05 Rate Reduction for Gas Used by Manufacturing Firms

1. Statutory Provision
Title 30, Delaware Code, Section §5502(b)(2)

2. Description
This provision reduces the public utility tax rate on receipts from natural gas consumed by manufacturers, agribusinesses and food processing firms to 2.0% effective January 1, 1998.

3. Estimated Revenue Loss
FY 05: $190,000
FY 06: $200,000 - $300,000

4. Assessment
Generally speaking, the same assessment of the rate reduction for receipts from electricity consumed by manufacturers (see item 4.04) can be applied to this preference. However, an evaluation of this preference must also take into account that a rate preference for electricity consumed by manufacturers existed for several years prior to the enactment of this provision. As such, a rate differential existed between electricity and gas used in manufacturing

processes. To the extent that these inputs could be substituted, manufacturers had a tax induced incentive to favor electricity in the production of goods over natural gas. By eliminating the rate differential, the economic decisions of manufacturers for inputs in the production process will be less distorted by tax code provisions.

5. Inadvertent effects
See item 4.04.

4.06 Exemption of Electricity Used By Automobile Manufacturers

1. Statutory Provision
Title 30, Delaware Code, Chapter 55, §5506(j)

2. Description
This provision exempts automobile manufacturers from paying the public utility tax on electricity that they use in vehicle production.

3. Estimated Revenue Loss
FY 05: $200,000
FY 06: $200,000 - $250,000

4. Assessment
Noting the large "multiplier effect" that automobile plants have on Delaware's economy, the General Assembly added this provision in the spring of 1995. Automobile Manufacturers are critical Delaware employers. As the relative size of the manufacturing industry shrinks, lower tax rates offer an cost incentive for plants to remain in Delaware. How successful this tax preference is in achieving its purpose is, however, unknown. While this provision likely provides only a minor benefit to auto manufacturers, it demonstrates a visible commitment by the state to this sector of the economy.

A flaw of broad, industry-based exemptions like this one is that firms pay no public utility tax solely because they make automobiles. Such a criterion does not recognize that firms in other industries may actually be larger power users, or in more competitively precarious positions, but nonetheless do not qualify simply because they are not favored industries.

5. Inadvertent effects
Enacting a public utility tax preference for a single sector of the economy may, in the long-run, cause firms in that industry to lag in the introduction of more energy-efficient production technologies. Given the relatively small benefit provided by this preference, however, this outcome seems unlikely.

4.07 Exemption of Gas Used By Automobile Manufacturers

1. Statutory Provision
Title 30, Delaware Code, Chapter 55, §5506(j)

2. Description
This provision exempts automobile manufacturers from paying the public utility tax on gas that they use in vehicle production.

3. Estimated Revenue Loss[3] [4]
FY 05: $50,000
FY 06: $50,000 - $100,000

4. Assessment
Generally speaking, the same assessment of the exemption for receipts from electricity consumed by automobile manufacturers (see item 4.06) can be applied to this preference. However, an evaluation of this preference must also take into account that an exemption for electricity consumed by automobile manufacturers existed for several years prior to the enactment of this provision. As such, a rate differential existed between electricity and gas used in this manufacturing process. To the extent that these inputs could be substituted, manufacturers had a tax induced incentive to favor electricity in the production of automobiles over natural gas. By eliminating the rate differential, the economic decisions of automobile manufacturers for inputs in the production process will be less distorted by tax code provisions.

5. Inadvertent effects
See Item 4.06

---

[3] Utilities are collection agents and as such, the Department of Finance relies on the utilities to provide background data for this estimate. Several of the utilities were unable to provide DOF with detailed information with respect to this preference.

[4] The fiscal impact estimate for this item represents the cost difference between the complete exemption for automobile manufacturers and the reduced rate for other manufacturers (see Item 4.05). In the absence of this preference, receipts from automobile manufacturers would be subject to a rate of 2%.

4.08 Rate Reduction for the Provision of Cable Television Services

1. Statutory Provision
Title 30, Delaware Code, Chapter 55, §5502(b)(3)

2. Description
This preference imposes a rate of 2.125% (as opposed to 4.25% for other services defined as public utilities[5]) on the provision of cable television communications, commodities and services. The legal incidence of this tax falls on entities distributing cable television services within the State of Delaware.

3. Estimated Revenue Loss
FY 05: $4.0 million
FY 06: $4.3 million

4. Assessment
Although it can be debated as to whether this provision is appropriately included in this report as a tax preference, it is treated as such because it taxes one type of public utility service (cable television) differently from others, and it meets the definition of a tax preference found in 8305(6) of Title 29.[6] Moreover, as the focus of this report is meant to be as inclusive as possible, an argument can be made to include this item.

The goal of this preference is to reduce the tax differential between the provision of cable television and other television services not subject to the public utility tax (e.g., Direct Broadcast Satellite [DBS] services). Firms providing traditional cable television services in Delaware are subject to the public utility tax, while satellite and wireless cable providers are not.

In recent years, satellite television services have been becoming increasingly popular. To the extent that household have increased their consumption of DBS services based on tax cost considerations, this preference should help level the playing field and mitigate any inefficiency caused by the rate

---

[5] See Title 30, Delaware Code, §5501(1) for a listing of commodities and services defined as "public utilities."

[6] The definition of a "tax preference" found in §8305(6) describes a preference as a tax code provision that (among other things) "...exempts, in whole or in part, certain persons, income, goods, *services* or property from the impact of established taxes..." The federal definition speaks more directly to the issue by defining a tax preference as "a preferential rate of tax."

differential. It is unknown, however, the extent to which other features of DBS services (e.g., improved sound and picture quality, larger number of available channels) may influence households' consumption of these services.

5. Inadvertent effects
None noted.

4.09 Exemption for Electronic Pager Service

1. Statutory Provision
Title 30, Delaware Code, Chapter 55, §5501(6)

2. Description
This provision excludes electronic pager service from the public utility tax.

3. Estimated Revenue Loss
FY 05: Unknown
FY 06: Unknown

4. Assessment
This exemption differentiates electronic pager service from other types of telecommunications service. While traditional electronic pagers had limited utility (providing little more than a return telephone number), advances in telecommunications technology have greatly enhanced the features available through pagers. For example, electronic pagers now provide a variety of information beyond a return number, including written messages from the paging entity. In addition, cellular telephone technology has advanced significantly, providing additional features (including paging features) to cell phones.

In fact, growth in cellular phone service has severely damaged the traditional paging service providers. In recent years, dozens of paging service companies have merged and three of the nations ten largest have declared bankruptcy.[7]

As this technology advances, and the lines separating the different types of telecommunications technologies is further blurred, policy makers and tax administrators need to be aware of the issues that can be created by tax code provisions. For example, when confronted with "bundled services" (e.g., voice, paging, and internet access) delivered via a cellular phone, officials

---

[7] Wow-com.com: News Daily, "Pager Industry in Crisis as Customers Turn to Cellular Phones," April 24, 2001.

attempting to administer this exemption may need to wrestle with the question of what portion of the cellular phone bill is derived as a result of the paging service. If providers find that the additional record-keeping needed to break out the pager component of a "bundled service" bill costs more than the potential tax saving permitted by this provision, then one would expect that few firms would use this preference and its fiscal impact would be minimal.

5. Inadvertent effects
   None Noted.