



SPONSOR: Rep. Hudson & Sen. Marshall

HOUSE OF REPRESENTATIVES

141st GENERAL ASSEMBLY

HOUSE BILL NO. 567

AN ACT TO AMEND TITLE 30 OF THE DELAWARE CODE RELATING TO DELAWARE TAXES.

BE IT ENACTED BY THE GENERAL ASSEMBLY OF THE STATE OF DELAWARE (Three-fifths of all members elected to each house thereof concurring therein):

1           Section 1. Amend § 1106(b), Title 30 of the Delaware Code, by adding a new paragraph "(9)" to read as follows:

2                       "(9) The amount of any refund of Delaware State income taxes imposed under this Chapter, to the  
3           extent shall be included in federal adjusted gross income for the tax period."

4           Section 2. Amend § 1635, Title 30 of the Delaware Code, by designating existing § 1635 as Subsection (a) of  
5           said Section and adding to said Section a new Subsection "(b)" to read as follows:

6                       "(b) in the case of an electing small business trust as defined in § 1631(e) of the Internal Revenue Code  
7           [26 U.S.C. § 1631(e)] there shall be added to the amount calculated pursuant to Subsection (a), to the extent not  
8           otherwise included in such amount, the taxable income of the portion of the trust consisting of S corporation  
9           stock that is treated as a separate trust pursuant to § 641(c) of the Internal Revenue Code [26 U.S.C. § 641(c)]."

10          Section 3. Amend § 1636(a), Title 30 of the Delaware Code, by striking said subsection in its entirety and  
11          substituting in lieu thereof a new "§ 1636(a)" to read as follows:

12                       "(a)(1) Allowance of deduction. Except as provided in paragraph (2), a resident estate or resident trust  
13                       shall be allowed a deduction against the taxable income otherwise computed under Chapter 11 of  
14                       this Title for any taxable year for the amount of its federal taxable income, as modified by § 1106  
15                       of this Title, which is, under the terms of the governing instrument, set aside for future  
16                       distribution to nonresident beneficiaries.

17                       (2) Electing small business trusts. No deduction shall be allowed the nonresident beneficiaries of an  
18                       electing small business trust as defined in § 1631(e) of the Internal Revenue Code [26 U.S.C. §  
19                       1631(e)] for the taxable income of the portion of the trust consisting of S corporation stock that is

20 treated as a separate trust pursuant to § 641(c) of the Internal Revenue Code [26 U.S.C. §641(c)]  
21 and to the extent that it constitutes income derived from sources within Delaware."  
22 Section 4. Section 1 of this Act confirms the operation of the personal income tax law since its  
23 inception. Sections 2 and 3 of this Act shall be effective for tax periods commencing after December 31, 1996.

#### SYNOPSIS

Section 1 retroactively corrects an unintentional omission from the law of an adjustment to the calculation of taxable income. Federal law requires that refunds of State income taxes claimed as a deduction in a prior year be included in federal taxable income. Since Delaware does not allow a deduction for Delaware income taxes paid, there should be no adverse consequence to Delaware taxpayers for receiving a refund of State taxes deducted on the federal return, nor has the Division of Revenue ever applied the law so as to create those consequences. This Act makes the statutes consistent with the manner in which the State personal income tax has been administered both presently and historically.

Sections 2 and 3 resolve an ambiguity regarding the interaction of Delaware and federal law. Under federal law, for tax years beginning after December 31, 1996, a trust may elect to be an "electing small business trust" (IRC § 1631(e)(1)). An electing small business trust ("ESBT") is permitted to own stock in a Subchapter S corporation. The portion of an electing small business trust that consists of stock of one or more S corporations is treated as a separate trust in computing the tax attributable to S corporation stock held by the trust (IRC § 641(c)). The income of the separate "S portion" is taxed at the highest rate imposed on trusts.

Section 2. Under Delaware law, the starting point for calculating the tax on a trust is the amount of taxable income shown on the taxpayer's federal income tax return (Form 1041). The Internal Revenue Service did not materially redesign its tax return in response to the 1996 amendment to the tax code. Instead, without specific statutory direction, the instructions for IRS Form 1041 tell the taxpayer to separately calculate the tax on the S portion of an ESBT and then combine that tax with the tax calculated on the remainder of the trust income. To the left of the box for entry of the combined tax on the return the taxpayer is instructed to make an interline notation "Sec. 641(c)". The result is that the S portion is taxed for federal purposes at the highest rate, but it is not included in the amount of taxable income of the trust reported on line 22 of the return. Because of the way the Internal Revenue Service instructs taxpayers to calculate the tax on the S portion of an ESBT, some taxpayers contend this income is not taxable in Delaware. Section 1 of this Bill will clarify the intent of the Delaware Revenue Code to tax income received by an electing small business trust from its interest in an S corporation to the extent it constitutes Delaware source income.

Section 3. One principle of the Delaware Tax Code is that income derived by residents and non-residents from the businesses or tangible property in this State shall be subject to a fair tax. The 1996 amendment to the federal law now permits certain trusts (ESBTs) to own interests in S corporations. The S corporations may, in turn, operate businesses and own tangible property in Delaware. Section 2 of this Bill provides that trusts electing to be treated as an ESBT are not permitted a deduction that benefits only non-resident beneficiaries of income derived from the indirect ownership of businesses and tangible property in Delaware.