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Delaware Franchise Tax: Don't Panic!

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What is Franchise Tax?

A franchise tax is a government tax charged by states to businesses organized in that state. A state charges companies for the privilege of doing business in that state. Simple, right?

It's not! Different states calculate the tax you owe using different methods. Many startups are incorporated in Delaware,[1] which has a pretty unique way of both calculating the amount of franchise tax you owe and of conveying that information to you. Let's look at how they do it, and how you can save some money.

Authorized Shares Method and Assumed Par Value

Delaware uses two different methods to calculate the amount of franchise tax you owe: the authorized shares method (based on the number of shares you have authorized) and the assumed par value method (based on the value of your company's assets). Delaware's default is the **authorized shares method**, which is often much, much more expensive than the assumed par value calculation. It is the calculation they use when sending their annual franchise tax notifications.

The **authorized shares method** uses the number of shares you have authorized[2] in your Charter. It calculates your tax owed based on a sliding scale, starting at $175 for 5,000 or fewer authorized shares and increasing $85 for each additional ten authorized shares. Most startups authorize a large number of shares for things like issuing equity grants to employees, which leads to a large tax burden under this calculation method. As an example, if you've authorized 10 million shares, you'd owe around $75,000 in franchise taxes.

Compare this to the **assumed par value method**, which uses a formula based on both your issued and outstanding shares and your company's gross assets.[3] This calculates a "par value" per share. Since most startups don't have a large amount of assets, the tax burden will be much lower. **Most importantly, you are only required to pay the lower of the two calculations.**

An Example

We don't need to go deep into the math, but let's assume you have an early stage company with 10 million authorized shares, a par value of $0.0001 per share, 5 million of which have been issued to the founders, and $1 million in assets. Under the authorized shares method you'd owe $85,165. But under the assumed par value method you would owe only $800.00. Yes, you read that right! Delaware typically would send a bill for $85,165, but actually you only owe $800.00.

Don't Panic

So don't panic when you get your Delaware franchise tax notice in the mail. The franchise tax notice you receive from Delaware probably uses the authorized shares method. But you can often save a lot of money using the assumed par value calculation. Call your lawyer and make sure you're paying the right amount.

Coda: File Your Annual Reports!

Your company's annual report in Delaware is due on or before March 1 each year. It must be filed online. Failure to file the annual report can result in a penalty of $200 plus interest, and if you don't pay you will fall out of good standing in Delaware. This can cause problems with contracts and future financings.

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[1] The typical reason lawyers give for this is that Delaware has a very well-developed set of corporate laws and an effective court system to adjudicate them. More generally, most corporate lawyers, regardless of where they're located, will have some expertise in Delaware law, and incorporating in Delaware serves as a signal to third parties (like VC funds) that you're planning for growth.

[2] Remember that "authorized" refers to the number of shares you *may issue*, as opposed to outstanding shares, which is the number you have *already issued*.

[3] Using your "Total Gross Assets" from your Tax Form 1120, Schedule L.

Christopher Poe is an attorney at Wyrick Robbins. His practice focuses on startups, helping businesses of all sizes and in all stages of development, from organization to exit. He assists startups with financings, including angel and venture fundings, and advises them on securities issues.

The purpose of this brief is to provide general information, and it is not intended to provide, and should not be relied upon as, legal advice. The actual tax rates and calculation methods used by the State of Delaware may be changed (they made some changes to their payment amounts just

last year), so you should go to the Delaware Secretary of State's website to confirm their requirements. They also have a useful calculation spreadsheet that you can access here.