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news alert

Delaware Franchise Taxes Are Around the Corner

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If you are a Delaware corporation, you likely received a notice from the Secretary of State of Delaware informing you that your company's Annual Report and franchise tax payment are due by **March 1, 2020**. These notices are sent to the corporation's registered agent. You are still required to file an Annual Report and pay the franchise tax even if your corporation never engaged in business or generated revenue. Delaware requires these to be submitted online.

There are two ways to calculate your Delaware franchise taxes (the Authorized Shares Method and the Assumed Par Value Capital Method). Delaware defaults to calculating its franchise taxes owed by using the Authorized Shares Method, which almost always results in a higher tax liability for startups with limited assets. However, by using the Assumed Par Capital Value Method, startups are often able to **significantly** lower their franchise tax burden.

For example, a typical early-stage startup corporation with: (i) 10 million authorized shares of stock; (ii) 9 million issued shares of stock; (iii) a par value of $0.0001; and (iv) gross assets of $100,000, would result in the following franchise tax obligations under the different methods:

- $85,165 under the Authorized Shares Method
- $400 under the Assumed Par Value Capital Method

If you are incorporated in Delaware, but conducting business in another state, you must be qualified to do business in that state – meaning, you might be subject to that state's franchise tax (if any) as well. For example, a Delaware corporation doing business in Texas must still register for a foreign qualification to conduct business in Texas ($750 filing fee), submit a Texas annual Franchise Tax Report (due by **May 15** of each year), and pay the associated tax.

Texas franchise taxes are based on an entity's margin (unless filing under an EZ computation), and are calculated based on one of the following ways:

- total revenue times 70 percent;
- total revenue minus cost of goods sold (COGS);
- total revenue minus compensation; or
- total revenue minus $1 million (effective Jan. 1, 2014).

See below for a detailed breakdown and explanation of the different methods. Delaware also provides a Franchise Tax Calculator to assist you in estimating your franchise taxes.

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Method 1 – The Authorized Shares Method (DEFAULT)

Under this Method, franchise taxes are based on the number of ***shares*** a corporation is ***authorized*** to issue in its certificate of incorporation as of December 31st.

STEP 1: First 5,000 Authorized Shares (or less) is taxed at $175 (minimum franchise tax under this Method)

$$\text{If corporation has less than 5,000 Authorized Shares, then Franchise Tax is \$175}$$

STEP 2: Next 5,000 Authorized Shares is taxed an additional $75

$$\text{If corporation has between } 5{,}000 - 10{,}000 \text{ Authorized Shares, then Franchise Tax is \$250}$$

STEP 3: If corporation has 10,001 or more Authorized Shares:

(a) Take $175 (from STEP 1) + $75 (from STEP 2) = $250; and

(b) Add an additional $85 for every additional 10,000 Authorized Shares (or portion thereof) – with a $200,000 maximum Franchise Tax under this Method

STEP 3 FORMULA (includes both parts 3(a) and 3(b):

$$\frac{\#\text{ Authorized Shares} - 10{,}000}{10{,}000} \times \$85 + \$250 = \text{Total Franchise Tax owed}$$

Example Calculation:

Under this Method, a corporation with 10,000,000 Authorized Shares, pays $85,165 in Franchise Taxes:

STEP 1: 10,000,000 Authorized Shares > 5,000 Authorized Shares, so first 5,000 Authorized Shares incurs a franchise tax of $175

Total Franchise Tax after this STEP 1 is $175

STEP 2: Next 5,000 Authorized Shares incurs an additional $75

Total Franchise Tax after this STEP 2 is $250

STEP 3:

(a) Take $175 (from STEP 1) + $75 (from STEP 2) = $250; and

(b) $\frac{10{,}000{,}000 - 10{,}000}{10{,}000} \times \$85 + \$250 = (999 \times \$85) + \$250 = \$84{,}915 + \$250 =$ **$85,165** (**Total Franchise Tax** owed under this Method)

Method 2 – The Assumed Par Value Capital Method

Under this Method, franchise taxes are based on ***all Issued Shares***, ***Authorized Shares***, and ***Total Gross Assets*** (as reported on U.S. Form 1120, Schedule L).

STEP 1: **Assumed Par Value:**

Find your corporation's **Assumed Par Value** by dividing your Total Gross Assets by the total shares your corporation has issued:

$$\frac{\text{Total Gross Assets}}{\text{Total Issued Shares}} = \textbf{Assumed Par Value}$$

STEP 2: Real Par Value:

Find your corporation's **Actual** or **Real Par Value** of your corporation's shares by looking at your corporation's certificate of incorporation.

STEP 3: **Assumed Par Value Capital:**

Calculate your corporation's **Assumed Par Value Capital** by comparing the STEP 1 value (Assumed Par Value) to the value in STEP 2 (Real Par Value), and then doing either:

(a) If your corporation's STEP 1 value (Assumed Par Value) is greater than its STEP 2 value (Real Par Value), then multiply STEP 1 by your Authorized Shares:

$$\text{If STEP 1 (Assumed Par Value)} > \text{STEP 2 (Real Par Value), then:}$$

$$\text{Assumed Par Value} \times \text{Authorized Shares} = \textbf{Assumed Par Value Capital}$$

or

(b) If your corporation's STEP 1 value (Assumed Par Value) is less than or equal to its STEP 2 Value (Real Par Value), then multiply STEP 2 by your Authorized Shares:

$$\text{If STEP 1 (Assumed Par Value)} \leq \text{STEP 2 (Real Par Value), then:}$$

$$\text{Real Par Value} \times \text{Authorized Shares} = \textbf{Assumed Par Value Capital}$$

STEP 4: If your value from STEP 3 (Assumed Par Value Capital) is more than $1,000,000 – then round it up to the next million (leave as-is if under $1,000,000)

For example:

If STEP 3 (Assumed Par Value Capital) value is $1,500,700, round the Assumed Par Value Capital amount up to $2,000,000.

If STEP 3 (Assumed Par Value Capital) value is $978,000, then keep the Assumed Par Value Capital amount as $978,000.

STEP 5: **Franchise Tax Amount:**

Take the result from STEP 4, divide it by 1,000,000, and then multiply it by $400. If Franchise Tax Amount is less than $400, round up to $400; if more than $400, then keep as-is:

$\frac{\text{STEP 4}}{1{,}000{,}000} \times \$400 =$ **Total Franchise Tax** owed (with a $400 minimum franchise tax under this Method)

If different classes of shares have different par values, then, if and as applicable, you would calculate Steps 3(a) and 3(b) for each class of share, add the results in order to get the aggregated Assumed Par Value Capital Amount, and then proceed with the rest of steps as listed.

Example Calculation:

For example, a typical startup with 10,000,000 Authorized Shares of stock, with a par value of $0.0001, that has issued 9,000,000 shares, and has gross assets of $100,000, under this model, might have a franchise tax calculation look like:

STEP 1: **Assumed Par Value:**

Find your corporation's **Assumed Par Value** by dividing your Total Gross Assets by the total shares your corporation has issued:

$$\text{Assumed Par Value} = \frac{\text{Total Gross Assets}}{\text{Total Issued Shares}} = \frac{100{,}000}{9{,}000{,}000} \cong \$0.01$$

STEP 2: Real Par Value:

Find your corporation's **Actual** or **Real Par Value** of your corporation's shares by looking at your corporation's certificate of incorporation.

Here, the Real Par Value is $0.0001

STEP 3: **Assumed Par Value Capital:**

Calculate your corporation's **Assumed Par Value Capital** by comparing the STEP 1 value (Assumed Par Value) to the value in STEP 2 (Real Par Value), and then doing either:

STEP 1 value (Assumed Par Value) is $0.01

STEP 2 value (Real Par Value) is $0.0001

Because STEP 1 ($0.01) > STEP 2 ($0.0001), we follow STEP 3(a), and multiply STEP 1 by Authorized Shares:

STEP 3(a): $\text{Assumed Par Value} \times \text{Authorized Shares} = \text{Assumed Par Value Capital}$

$$\text{Assumed Par Value Capital} = \$0.01 \times 10{,}000{,}000 \cong \$111{,}111.111$$

STEP 4: If your value from STEP 3 (Assumed Par Value Capital) is more than $1,000,000 – then round it up to the next million (leave as-is if under $1,000,000)

Because STEP 3 (Assumed Par Value Capital) is $111,111.111 and is not more than $1,000,000, we leave it as-is for STEP 5.

STEP 5: **Franchise Tax Amount:**

Take the result from STEP 4, divide it by 1,000,000, and then multiply it by \$400. If Franchise Tax Amount is less than \$400, round up to \$400; if more than \$400, then keep as-is:

$$\text{Franchise Tax Amount} = \frac{\text{STEP 4}}{1{,}000{,}000} \times \$400 = \frac{\$111{,}111.111}{1{,}000{,}000} \times \$400 \cong \$\,44.44$$

Because this Franchise Tax Amount (as calculated) is less than the minimum tax allowed under this Method, the **Total Franchise Tax Amount** will be increased to **\$400.**

As you can see, the Assumed Par Value Capital Method is significantly more complicated than the Authorized Share Method; however, it can drastically reduce your corporation's franchise tax obligation. In the examples above, the same corporation with 10,000,000 Authorized Shares is obligated to pay **\$85,165** under the **Authorized Shares Method** (default method used by Delaware), compared to just **\$400** under the **Assumed Par Value Capital Method**.
