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Client Alert: Delaware Franchise Taxes

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Everyone told you to incorporate in Delaware. Podcast hosts, industry blogs, your co-founder, your lawyer, your college roommate, your dogwalker – they all said that when it comes to incorporating your startup, Delaware is the place to be. Now, you're staring at a notice saying that your company owes tens of thousands of dollars in state franchise taxes, and you're ready to reach for the panic button. Sound familiar?

Don't worry – you're not alone. Every year, countless new business owners receive notices from Delaware informing them of an upcoming franchise tax payment that seems impossibly huge. Luckily, there is an easy solution available.

What are franchise taxes, and how are they calculated?

Franchise taxes are required to be paid on an annual basis by all Delaware corporations. Payment of franchise taxes entitles the payor to do business in Delaware and to utilize the Delaware state court system. The amount of franchise tax assessed for a given company is intended to be proportional to the size and complexity of the company – this means that for most early-stage companies, the amount assessed will be the state minimum for corporations: $400. So, what's going on with this crazy estimate?

There are two basic methodologies for calculating Delaware Franchise Tax: the Authorized Shares Method, and the Assumed Par Value Capital Method. The Authorized Shares Method is based on the number of shares that your company is authorized to issue pursuant to its Certificate of Incorporation. Since startups generally authorize a large number of shares at formation (ten million is typical) in order to accommodate founder share issuances and equity incentive plans, using the Authorized Shares Method to calculate franchise tax can result in an assessment that is wildly excessive in light of the actual size and complexity of the business.

The Assumed Par Value Capital Method, on the other hand, calculates franchise tax based on the par value of the company's shares (usually a fraction of a cent per share), the ratio of shares actually issued vs. authorized, and the company's actual assets. This method paints a clearer picture of the size and complexity of the company, and therefore allows for a far more precise calculation of the franchise tax owed.

The Authorized Shares Method is the default calculation for purposes of these notices because at the time the notice is generated, Delaware has no idea what your assets are. But the important thing to remember is: it's just an estimate. You're not stuck with it.

What do I do?

Recalculate! Head over to the Delaware Secretary of State's franchise tax filing page. Log in using your Business Entity File Number, and click "File Annual Report". Scroll down to the Stock Information section, and fill in your company's total Issued Shares, Gross Assets, and Asset Date (the last day of the year you are filing taxes for). Click "Recalculate Tax", and boom! You should see a drastic reduction in your Amount Due.

Proceed thrugh the remaining steps in the online form, fill in your company's payment information, and submit. Congratulations! You are now done filing your annual franchise taxes.

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