The Delaware Franchise Tax Trap for Section 1045 QSBS Rollovers

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One of the key requirements of Section 1202 is that the business issuing qualified small business stock (QSBS) must be a domestic (US) C corporation.[1] The issuer of replacement QSBS must also be a domestic (US) C corporation when a taxpayer sells QSBS and elects to roll proceeds from the sale over into replacement QSBS under Section 1045.

Many corporate start-ups are organized in Delaware, including corporations organized in connection with issuing replacement QSBS. The bias toward Delaware corporations is a reflection of the familiarity of founders, investors and advisors with Delaware corporate law (the Delaware General Corporate Law) and the state's experienced judiciary. But while there are certainly attractive aspects to using Delaware corporations, business owners must be familiar with Delaware's annual corporate franchise tax.

Delaware imposes an annual franchise tax on corporations organized in Delaware. Business owners who don't understand how the franchise tax is calculated can be surprised by high tax bills. The potential for an excessive Delaware franchise tax bill is particularly acute when business owners rely on commercial providers of organizational documents that routinely default to a large number (often 10 million or more) of authorized shares, which unfortunately can lay the groundwork for excessive franchise tax obligations.

Many start-ups, including most corporations organized using commercial document vendors, default to 10 million authorized shares. The reason why founders choose to organize a corporation with 10 million rather than 10,000 authorized shares for a closely-held corporation is generally expressed as the favorable "optics" associated with larger numbers. While holding one out of 100 shares outstanding is the same percentage-wise as holding 100,000 out of 10 million outstanding shares, there is a widely held belief that investors and employees are happier when they hold a larger number of shares. While the point of this article is not to

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dispute that premise, the problem is that a large number of authorized shares creates potential supersized annual Delaware franchise tax obligations.

Takeaways from this blog:

- Defaulting to millions of authorized shares creates a potential tax trap for the unwary, sometimes leading to supersized Delaware annual franchise tax bills.
- Founders should take note that corporate filing services and commercial entity formation vendors often default to using a certificate of incorporation authorizing 10 million shares.
- Taxpayers forming corporations for the purpose of rolling proceeds over under Section 1045 are particularly at risk for an excessive Delaware franchise tax because these corporations are routinely organized with significant amounts of money that will be included in the corporation's "total assets."
- Business owners must be aware of the multiplier effect of Delaware's "assumed part value capital method" formula. If a Delaware corporation is organized with a large number of authorized shares and has significant "total assets," it is imperative that the number of issued shares either be the same as the number of authorized shares or close to it in order to avoid a potentially excessive franchise tax liability resulting from the peculiar multiplier effect included in the franchise tax calculation.
- Two ways of reducing the Delaware franchise tax burden are to either (i) start with a lower number of authorized shares (e.g., 10,000), or (ii) make sure that the number of issued and authorized shares are substantially the same so that the franchise tax will be $400 per million in "total assets."
- Founders and advisors should review authorized and issued share counts before closing a Section 1045 rollover or relying on off-the-shelf or commercial vendor incorporation documents.

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- Delaware's franchise tax can be avoided by organizing the corporation outside of Delaware.

How Delaware's franchise tax is calculated.

An annual franchise tax obligation is imposed on all corporations organized in Delaware. The franchise tax is calculated using either the "**Authorized Shares Method**" or the "**Assumed Par Value Capital Method**."[2] A Delaware corporation with a modest number of authorized shares (e.g., 10,000) would generally use the Authorized Shares Method for calculating the franchise tax and would typically owe a modest annual franchise tax. If the corporation has millions of authorized shares, calculating the franchise tax using the Authorized Shares Method would result in a significant annual franchise tax liability – ***with 10 million authorized shares, the annual franchise tax would be $85,165***. Under those circumstances, business owners generally calculate the Delaware franchise tax using the second method—the Assumed Par Value Capital Method.

If a corporation has issued all of its authorized shares (whether that number is 1 million, 10 million or 100 million), the annual franchise tax calculated using the Assumed Part Value Capital Method will be $400 per million dollars of "total assets." The Assumed Par Value Capital Method typically won't result in a significant franchise tax liability for created start-ups because they typically start life with few assets, but the annual franchise tax increases significantly as the corporation's "total assets" grow.

When a corporation is organized and funded for the purpose of rolling over proceeds from original QSBS into replacement QSBS under Section 1045, the franchise tax liability of $400 per million dollars of "total assets" will be a significant number from the outset. If there is a spread between the issued and authorized shares, the corporation's franchise tax due can grow exponentially.

To illustrate a trap for the unwary, if a founder rolls over $5 million in QSBS sales proceeds under Section 1045 in exchange for 10,000 shares of stock where the corporation has 10 million authorized shares, the corporation would have a $200,000 (the maximum)

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annual Delaware franchise ($0.0001 par value) tax bill using the Assumed Par Value Capital Method. See the table below for the step-by-step calculation under the Assumed Par Value Capital Method.

Step 1	Assumed Par Value Per Share $5 million investment /10,000 issued shares = $500/share
Step 2	Assumed Par Value Capital $500 x 10 million authorized shares = $5 billion
Step 3	Franchise Tax (5 billion / 1 million) x $400 = lesser of (i) $2 million or (ii) $200

The "good news" is that this corporation would end up only owing $85,165 in Delaware franchise taxes if the tax is calculated using the first method—the Authorized Shares Method. Delaware automatically applies the method that yields the lower tax—but "lower" can still mean shockingly high. Taxpayers rolling over QSBS gains are often stunned to learn that a Delaware corporation can generate an $85,165 annual franchise tax bill purely as a function of capitalization mechanics.

How to avoid excessive Delaware franchise tax liabilities.

Excessive Delaware franchise tax liabilities can be avoided by issuing all of a corporation's authorized shares, or at least keeping the number of issued shares as close as possible to the number of authorized shares. Even using this approach will not avoid a significant franchise tax liability if the corporation has both significant "total assets" and authorized shares. Under those circumstances, the only way to reduce the Delaware franchise tax burden is to work with a smaller number of authorized shares so that the corporation can calculate a more modest franchise tax using the Authorized Shares Method. If a corporation has 10,000 authorized shares, the annual franchise tax liability is $250, regardless of the corporation's "total assets." Obviously, this approach can work for some closely-held corporations but not for corporations with a larger group of stockholders or public

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companies.

Should business owners consider incorporating outside of Delaware?

Delaware's annual franchise tax issue is avoided if the corporation is organized elsewhere. If business owners believe that Delaware's advanced body of corporate law, its "pro-management" tilt, and the bias toward Delaware corporations among venture capitalists and other investors are not relevant, consideration should be given to organizing in other states such as Wyoming or the founder's home state.[3] Taxpayers rolling significant proceeds into newco-corporations under Section 1045 might save a meaningful amount of tax dollars by incorporating outside of Delaware. If the corporation is initially organized outside of Delaware, the door remains open to redomicile the corporation if Delaware's benefits become relevant.[4]

A more detailed explanation of how Delaware's annual franchise tax is calculated.

Delaware provides two methods for calculating the annual franchise tax. The **Authorized Shares Method** and the **Assumed Par Value Capital Method**. Delaware will send corporations a preliminary calculation of the annual franchise tax liability based on the corporation's authorized shares, and management can then go to the Delaware franchise tax website and recalculate the tax using the Assumed Par Value Capital Method if that method results in a lower tax bill. The Delaware government website page addressing the calculation of Delaware franchise taxes is located at: https://corp.delaware.gov/frtaxcalc/

Authorized Shares Method

Under the Authorized Shares Method, the Delaware franchise tax is driven entirely by the number of authorized shares—not assets—and authorizing millions of shares can produce a five-figure tax bill before the company earns a dollar. The table illustrates how to calculate the Delaware franchise tax based on the Authorized

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Shares Method.

Up to 5,000 Authorized Shares	$175
5,001 – 10,000 Authorized Shares	$250
Each additional 10,000 Authorized Shares	$85 per 10,000 au

Using the Authorized Shares Method, the annual franchise tax is $8,665 for 1 million authorized shares (1 million – 10,000)/10,000 x $85) + $250) and $85,165 for 10 million authorized shares (10 million – 10,000)/10,000 x $85) + $250). Keeping the number of authorized shares low (e.g., 5,000 or 10,000) will result a modest annual franchise tax.

Assumed Par Value Capital Method

Founders of venture-backed start-ups often find it beneficial to authorize at least several million shares. The certificates of incorporation produced by certain incorporation services routinely default to 10 million authorized shares. If several million shares are authorized, the franchise tax will usually be calculated using the Assumed Par Value Capital Method. Founders should note that authorizing millions of shares can result in a substantial franchise tax burden if the corporation has significant "total assets." Corporations organized to issue replacement QSBS under Section 1045 will typically start with millions of dollars of "total assets." The maximum annual Delaware franchise tax liability is $200,000.

Calculation of the franchise tax using this method requires first pulling the corporation's "total assets" number from the federal corporate return (Form 1120, Schedule L). As illustrated above, the first step is to divide the "total assets" amount (e.g., assume $5 million) by the corporation's issued shares. For example, if the corporation's "total assets" are $5 million and the corporation has 10 million authorized ***and issued*** shares, the corporation's "assumed par value" would be $0.50 per share ($5 million of assets /10 million shares). This $0.50 per share assumed par value amount would then be multiplied by the corporation's 10 million authorized shares to determine the corporation's "assumed par value capital" – in this case $5 million (10 million x $0.50 = $5 million). The resulting $5 million in assumed par value capital is then divided by 1 million (5

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million /1 million = 5), and the resulting amount is then multiplied by $400. Here the annual franchise fee would be $2,000 (5 x $400 = $2,000).

Using the same formula outlined in the preceding paragraph, if the corporation has $2 million in total assets, and 10 million authorized ***and issued*** shares, the annual franchise tax would be $800. If the corporation's "total assets" remain minimal, the franchise tax should be $400 if the corporation has the same number of authorized and issued shares. If significant amounts of cash are contributed to the start-up (e.g., in a Section 1045 transaction), the initial annual franchise tax calculated using the Assumed Par Value Capital Method could be significant (generally $400 per million dollars of "total assets"). If the corporation relies on the Assumed Par Value Capital Method for calculating the franchise the tax, the corporation's annual franchise tax burden will increase as its "total assets" increase.

* * *

When it comes to the Delaware franchise tax, default incorporation documents can quietly turn routine planning into a five-figure annual cost. Taxpayers rolling over QSBS gains should remember that Delaware franchise tax surprises are almost always self-inflicted—and entirely avoidable with thoughtful capitalization. The danger zone arises when (1) total assets are high, and (2) issued shares are far lower than authorized shares.

Please contact the authors, Scott Dolson or Brian Masterson, if you want to discuss any Section 1202 and Section 1045 issues by video or teleconference. You can also visit the **QSBS & Tax Planning Services page** to learn more about our team and read our latest insights and analysis.

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[1] References to "Sections" are to sections of the Internal Revenue Code of 1986, as amended.

[2] The annual franchise tax assessment is based on the "authorized shares" method. The minimum tax for the Assumed Par Value Capital Method of calculation is $400. The total tax will never be less than $175, or more than $200,000. Corporations owing $5,000

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or more make estimated payments with 40% due June 1st, 20% due by September 1st, 20% due by December 1st, and the remainder due March 1st.

[3]Wyoming doesn't impose a tax on business income and there is no corporate tax return to file in Wyoming. Other states will tax a Wyoming corporation's business income apportioned to those states. Wyoming also imposes an annual report license tax equal to the greater of $60 or $60 for every $250,000 of assets located and employed in Wyoming. No license tax is imposed on assets located and employed outside of Wyoming.

[4] Redomiciling the corporation would fall within the scope of a Type F tax-free reorganization. See the article "*Conversions, Reorganizations, Recapitalizations, Exchanges and Stock Splits Involving Qualified Small Business Stock (QSBS)*."

More Tax Planning & QSBS Resources

- Rolling QSBS Gains Under Section 1045? Don't Ignore Working Capital
- Planning for the Sale of Qualified Small Business Stock (QSBS)
- Revisiting the Choice of Entity Decision After OBBBA's 2025 Tax Law Changes | Part 1
- Exploring Section 1202's Active Business Requirement
- Substantiating the Right to Claim QSBS Tax Benefits | Part 2
- Substantiating the Right to Claim QSBS Tax Benefits | Part 1
- To Be Clear…LLCs Can Issue Qualified Small Business Stock (QSBS)
- Advanced Section 1202 (QSBS) Planning for S Corporations
- Finding Suitable Replacement QSBS – A Section 1045 Primer
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 1
- Guide to Converting Partnerships (LLCs/LPs) into C Corporation Issuers of QSBS – Part 2

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- Structuring the Ownership of QSBS – Is There a Role for Roth IRAs?
- Dealing with Excess Accumulated Earnings in a Qualified Small Business – A Section 1202 Planning Guide
- Section 1202 (QSBS) Planning for Sales, Redemptions and Liquidations
- Can Stockholders of Employee Staffing Companies Claim Section 1202's Gain Exclusion?
- QSBS Guidebook for Family Offices and Private Equity Firms
- Conversions, Reorganizations, Recapitalizations, and Stock Splits Involving QSBS
- Navigating Section 1202's Redemption (Anti-churning) Rules
- A Section 1202 Walkthrough: The QSBS Gain Exclusion
- A SPAC Merger Primer for Holders of Qualified Small Business Stock
- Determining the Applicable Section 1202 Exclusion Percentage When Selling QSBS
- Selling QSBS Before Satisfying Section 1202's Five-Year Holding Period Requirement?
- Part 1 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045
- Part 2 – Reinvesting QSBS Sales Proceeds on a Pre-tax Basis Under Section 1045

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