TOPIC THREE - DELAWARE NO MORE (TAX-WISE)

Delaware is universally considered the go-to destination for establishing a US C-corp. The reasons are well-documented – robust case-law, no state income tax, anonymity of director and officers. Now however the holy grail status of Delaware has been challenged.

To many founders the recent judgement of the Delaware Chancery Court that invalidates Elon Musk's pay package is a sign that Delaware has too long a reach into a corporation's internal affairs in favor of protecting the rights of minority stockholders. Aside from Tesla, other prominent public companies that have recently or in the process of leaving Delaware for Nevada include TripAdvisor, X (formerly Twitter) and TransPerfect. The stated reasons for leaving Delaware are absence of clarity on Chancery Court decisions and a perceived Court bias in preserving minority stockholder rights. Ironically the large majority of companies have the opposite view, which is that the extensive body of Delaware caselaw establishing and defining the business judgement rule protects the decisions and actions of officers and directors when taken prudently.

Nonetheless, the iron grip that Delaware has had as the preferred US jurisdiction in which to domicle corporations is now being questioned and is open to re-examination. Another factor contributing to this reexamination of where to domicle a company is the impact of the Pandemic and the physical relocation of companies and staff to lesser-cost, lower tax and more business friendly states such as Texas, Nevada and Florida. Up to now institutional investors startups to incorporate in Delaware as a condition to funding, mainly as a risk-mitigation measure to protect investor-directors. Whether this condition continues is unknown. Perception of whether a state is business friendly is subjective in many respects, but what can be objectively compared are the corporate tax rates or formulations among the states. On that measure Delaware tax must be considered. Here's how the major low corporate tax states line up:

Delaware Franchise Tax: Delaware allows corporations to calculate franchise tax in two ways.
The ***Authorized Shares Method*** uses the number of authorized shares to determine the franchise tax due. Corporations with 5,000 or less authorized shares pay a franchise tax of $175 plus (i) an additional $85 for the first 5,000 shares in excess of the initial 5,000 (i.e., 5,001 – 10,000 shares) and (ii) another $85 for each 10,000 shares. The maximum tax under this method is $200,000. The capital base of many startups consists of between 10M-15M authorized shares at the time of formation in order to keep the per share price low and allow for the optics of granting a large amount of shares as incentive equity compensation to new hires. This capital base increases with each new round of financing as companies grow. If the Authorized Shares Method is applied, Del tax could be substantial.

The ***Assumed Par Value Method*** is an alternative. Under this method (i) the gross assets of a company are divided by the number of outstanding shares, (ii) multiplied by the number of authorized shares, (iii) rounded up to the next $1M of gross assets, and (iv) applied to a franchise tax rate of $400 per $1M. The key variables under this method are a company's gross asset value and the authorized but unissued shares. Startups with a low gross asset value less than $500K will typically pay the franchise tax of $400. However for companies with a gross asset value above $5M the franchise tax may be in the range of $2K per year. Tax on more mature companies may range between $5K-$10K per year.

Alternatives.
The following states have lower corporate tax and also apply the business judgement rule to protect officers and directors:

1. Texas applies a gross receipts tax. As of January 1, 2024, businesses (i) with less than $2.47M in annual gross receipts pay no state tax and (ii) those with gross receipts ranging from $2.47M up to $20M pay 0.331% of the gross receipts. For businesses with gross receipts in excess of $20M, the tax rate on ranges from 0.375% for retail and wholesale businesses to 0.75% for others.

2. Wyoming has no business taxes. There is no income tax, no franchise tax or any other form of business levies in the State. Wyoming is notable for enacting friendly and flexible laws and regulations for companies in the cryptocurrency sector but does not have extensive caselaw on fiduciary matters.

3. Nevada has no income tax and no franchise tax. But like Texas imposes a gross receipts tax on companies with gross annual revenue exceeding $4M. The tax rate is low ranging between 0.05% to 0.3% depending on the sector of the business.

4. Florida has a corporate income tax rate. Of 4.445% applied to adjusted federal taxable income. However, for businesses operating entirely outside of Florida, the state does not levy corporate income tax on their earnings, though filing obligations remain. This makes Florida a potentially attractive option for businesses considering incorporation locations, particularly for those with operations primarily beyond the state's borders.

Topic References:

1. While this Reuters article details a recent Delaware lawsuit against Tesla, it also highlights potential drawbacks of the Delaware Chancery Court for some businesses (https://www.linkedin.com/pulse/delaware-judge-invalidates-elon-musks-56-billion-tesla-pay-32zsc)
2. This is the official Delaware Division of Corporations website with detailed information on Delaware's franchise tax structure, a key factor driving companies to consider alternative states (https://support.stripe.com/questions/how-to-pay-delaware-franchise-tax-online)
3. Texas Secretary of State's website provides information on incorporating a business in Texas, showcasing its business-friendly tax laws compared to Delaware (https://direct.sos.state.tx.us/help/help-corp.asp?pg=fee)
4. Florida Department of State's website highlights the advantages of incorporating in Florida, including potential tax benefits compared to Delaware (https://incparadise.net/florida/advantages-incorporating-business-florida/)
5. Nevada Secretary of State's website offers information on incorporating a business in Nevada, another state known for its tax-friendly environment for businesses (https://www.nvsos.gov/sos/businesses/start-a-business/limited-liability-company)