Revisiting the Delaware Flip

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From the perspective of a UK company raising venture capital, one of the most significant differences between UK and US investors is in their choice of holding company in which to invest.

Early-stage (Seed and Series A) US venture capitalists often insist they will invest in a UK or other non-US company only if the company “flips” its corporate structure and establishes a US (typically Delaware) holding company. US investors are familiar with Delaware corporations and aren’t necessarily inclined to change the model, especially given the volume of homegrown US companies seeking investment. In particular, we regularly see certain US accelerators deem non-US companies too early-stage to warrant special treatment.

However, US investors require UK companies to execute a Delaware flip less frequently in connection with a Series B or later financing. US growth-stage investors generally are willing to accept the incremental complexity and cost of investing into a UK limited company (unless the US fund’s internal rules prohibit investments in non-US companies).

We addressed these dynamics in a 2015 article, noting that high US corporate tax rates were leading some early-stage US investors to reconsider their traditional insistence on a Delaware flip as a condition for investment.

The recent reduction of the US federal corporate tax rate from 35 percent to 21 percent, and our subsequent conversations with UK founders and US investors regarding the impact of these tax changes, suggest it’s time to revisit some of the arguments for and against the Delaware flip.

The arguments for the Delaware flip

Before addressing various pro-flip arguments, it’s important to note that irrespective of the holding company’s nationality, UK companies seeking early-stage funding typically need a significant US presence (e.g., a US-based founder) and/or US traction to attract a lead US investor. In other words, a US holding company often is a necessary – but not sufficient – condition for US investors to lead a Seed or Series A financing. We previously addressed that dynamic here.
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Besides the incremental complexity and cost, an argument early-stage US investors commonly make against investing in UK companies relates to employee equity. Shares in certain types of US companies (such as C corporations organized in Delaware) can provide US taxpayers with tax advantages that don’t extend to shares in a UK company. In particular, the US tax code’s [Qualified Small Business Stock (QSBS) exemption](#) can help employees of successful early-stage companies protect up to $10 million (or 10 times cost basis, whichever is greater) from US federal income taxes on the sale of shares held for more than five years. As a result, UK companies doing business in a highly competitive labor market such as Silicon Valley will be at a disadvantage relative to companies who can offer potential employees equity in a US company.

Another argument often advanced is that proactively executing a Delaware flip (i.e., before signing a term sheet requiring a flip as a condition of closing the round) reduces friction with potential US investors.

Early-stage UK companies should be wary of conceding this point. Paying outside advisors to execute a Delaware flip without the certainty of an immediate capital infusion can impair the company’s financial health. Further, once a UK company flips into a US holding company, there’s usually no going back; the “Delaware backflip” from a US company into a UK holding company (also known as an “inversion” transaction) can have undesirable US tax consequences.

Rather, UK founders willing to flip for the right US investor and the right deal terms should simply make their position known to any potential US investor raising concerns about investing into a UK holding company; there’s no need to flip at the preliminary discussion stage. With careful tax planning, a UK limited company usually can execute a Delaware flip at any point in its life cycle without incurring UK tax. Accordingly, there’s little downside to waiting until the flip is absolutely necessary.

Similarly, if a US Seed investor willing to lead a round in a UK company is concerned about the willingness of US Series A investors to lead a future round, the UK company can postpone the flip and assure potential Series A investors that it will flip if eventually necessary.

**The arguments against the Delaware flip**

The decision to execute a Delaware flip is virtually always investor-driven. If a UK company requires a US company for operational or commercial reasons (e.g., to hire US employees or contract with US counterparties), a US subsidiary should suffice. A more thorough discussion of the considerations associated with forming a US subsidiary can be found [here](#).

If a US investor requires a Delaware flip as a condition of investment, the relatively high US corporate tax rate is a counter-argument – although a less-compelling one given the 2018 changes to the US tax code. The current US corporate tax rate approaches 26 percent (federal plus state); by comparison, the UK corporate tax rate is 19 percent. This means that a Delaware flip potentially subjects a larger share of a UK company’s global profits to the higher US tax rate, while also adding greater tax complexity. Although tax may not be a material consideration in a
company’s early years, in its later stages the ability to pay less tax on non-US-sourced profits may make a UK holding company structure more attractive.

A more immediate consideration is the out-of-pocket cost of a Delaware flip transaction. The tax and legal advisory fees can run into the tens of thousands of dollars, particularly if the company has completed prior fundraising rounds and needs to consider numerous competing shareholder interests. In those instances, UK companies typically will need sophisticated advice to address the impact of the flip on UK tax incentive programs such as SEIS and EIS.

While these short-term and long-term costs are more palatable when the Delaware flip results in the completion of a funding round, UK companies need to ensure the amount invested and value added by the US investor justify those costs.

An additional consideration associated with having a US parent company is the potential chilling effect of the Committee on Foreign Investment in the United States (CFIUS) on non-US investment into US companies.

As of November 2018, non-US investors making equity investments into many US companies will be required before closing to file their investments with CFIUS. The updated rules require non-US investors to provide CFIUS the opportunity to review investments into a wide range of US businesses - including those that develop, make, or test "critical technologies" - and to evaluate national security risks associated with those investments. Penalties for failing to make a mandatory filing may be as much as the total investment in question, and parties can be forced to divest their investment.

More on CFIUS filing requirements [here](#).

**The Delaware flip and non-UK companies**

An early-stage US investor’s willingness to invest in UK companies doesn’t necessarily suggest the investor will invest in companies formed in other countries. Many US investors view a UK holding company as a strong “second choice” option, and other jurisdictions present real and perceived challenges and risks they often are unwilling to address.

Further, the UK tax dynamics discussed above are specific to the UK. A non-UK company should consider obtaining home market tax advice early in its life cycle if US investment and a Delaware flip are likely outcomes; in some countries, the longer the company waits to flip, the larger the potential tax bill.

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When presented with the question “to flip or not to flip,” UK and other non-US companies need to be pragmatic and make an informed judgment call based on thoughtful discussions with their potential US investors, lawyers and other advisors. Often there is no simple right or wrong
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answer, and founders should carefully evaluate the particular US investor, the specific deal terms, and the short-term and long-term implications for the company, its employees, and its existing investors.

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