

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 reduction of the US federal corporate tax rate from 35 percent to 21 percent, the increase in the UK corporate tax rate to 25%, and our subsequent conversations with UK founders and US investors regarding the impact of these tax changes, weigh in favor of revisiting 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 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 US 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 long-term 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 US corporate tax rate has been less of an issue since changes to the US tax code in 2018. The current US corporate tax rate approaches 26% (federal plus state); from April 2023, the main UK corporate tax rate is 25% percent (although in the short term some companies considering flipping will still be benefiting from the lower rates available to companies with less than £250,000 of profits). So the headline rates on profits are not far apart, but a Delaware flip potentially subjects the business to [greater tax complexity](#). Although tax may not be a material consideration in a company's early years, in its later stages a UK holding company structure or having the group's ultimate holding company in a third jurisdiction may be more attractive.

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More immediate considerations are the out-of-pocket cost of a Delaware flip transaction and ensuring the flip transaction can be executed without incurring tax charges. The legal and tax 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. While these 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.

In particular, UK companies often will need advice to address the impact of the flip on UK tax incentive programs such as the Seed Enterprise Investment Scheme (SEIS) and Enterprise Investment Scheme (EIS). With careful planning and execution, it is possible to structure the flip transaction so that the UK company's existing SEIS and/or EIS shareholders enjoy continued SEIS and/or EIS tax relief treatment after the flip. The most important considerations in maintaining SEIS and/or EIS treatment, and ensuring no tax charges are crystallised on the flip for non-SEIS or EIS investors, include:

- *Pre-clearance from HMRC.* Confirmation from HMRC of the UK company's application for clearance under section 138 of the Taxation of Chargeable Gains Act 1992 (TCGA 1992) must be received. Pre-clearance from HMRC will not be granted if the flip is not done for genuine commercial reasons or if it forms part of any scheme or arrangement for the purpose of avoiding tax. In general, so long as the UK company flip to the US is for the purpose of obtaining US investment or to make the company more manageable with US employees or commercial partners - and not for avoiding UK tax - the flip should be treated as being for genuine commercial reasons.
- *Mirror Rights.* After the flip, the former shareholders of the UK company become stockholders of the new US company. The shareholders of the UK company must be issued shares in the US company that "mirror" the rights of the shares of the UK company they are exchanging in the flip transaction. The US company's shares also must be issued to the shareholders in the same proportions that were held in the UK company.
- *Permanent Establishment.* As with any SEIS/EIS investment, the company must maintain a UK "permanent establishment" during the three-year qualifying period from the last SEIS/EIS investment, *i.e.*, the three-year period beginning from the last date shares were issued that qualify for SEIS/EIS relief and ending on the later of: (1) the third anniversary of that share issue; or (2) the third anniversary of the date that the trade that was funded by that share issue first commenced. The fact that other group companies, including the former UK top company, have a UK permanent establishment is not sufficient for this purpose - the UK permanent establishment needs to belong to the new Delaware holding company.

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

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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 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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