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Jumping the Pond – The „Delaware Flip“ for German Tech Companies

Although the German venture capital market has seen significant increase of ticket size and overall investment volume over the past few years, German tech companies seeking a larger venture capital investment to continue further development of their business model frequently have to turn to US venture capitalists to secure larger tickets – over the last few years, the presence of US-based VC investors willing to invest in German growth companies therefore has increased substantially, especially in connection with mid- to later-stage financing rounds (Series B/C or later).

Given the fast-growing venture capital market in Germany and the advanced status of the business models and the often rapid growth of such German portfolio companies, we observe that US investors are generally more prepared to accept the incremental complexity and cost of investing into a German limited company (Gesellschaft mit beschränkter Haftung – GmbH) unless the US fund's internal rules prohibit investments in non-US companies.

However, it's important to note that German companies seeking early-stage funding from US investors regularly need a significant US presence and/or at least an initial US traction for their business model. In particular, early-stage (Series Seed/Series A) US-based venture capitalists often insist on investing in a German target company only if the company "flips" its corporate structure and establishes a US holding company, typically a Delaware C-corporation (hereinafter "US-Newco"). Especially given the volume of home-grown US companies seeking investment, US investors are inclined to invest in familiar corporate structures and portfolio companies with its offices not too far from the corporate seat of the US fund in order to ensure efficient control and supervision of the portfolio company. In particular, we continue to see certain US accelerators deem non-US companies too early-stage to warrant special treatment.

On the flipside, executing a "Delaware Flip" can have substantial advantages for fast-growing German tech companies at all stages of corporate development.

A Implementing the Flip

Before addressing these pro-flip arguments, it is important to briefly review the main pathways for a German GmbH to set up a US presence through a Delaware corporation.

1 Parallel Structure

In order to create a US-based business unit out of an existing German GmbH, one possible common approach would be to retain the existing shareholder structure of the German GmbH and implement a cash capital increase through the US-NewCo with capital contributions from the relevant US investors and, as the case may be, the existing investors. In this scenario, the US-NewCo would only serve the purpose of collecting fresh money and no transfer of assets from the German GmbH to the US-NewCo (which may entail activating hidden assets and corresponding adverse tax effects) would be required.

However, such parallel structure will most likely conflict with the US investor's intention to create a unified corporate governance, allowing for effective control of the portfolio company through the US-NewCo (only). The same would obviously be true for the mere formation of a US subsidiary of the German GmbH which is frequently incorporated for operational purposes only.

Typically, a US venture capitalist would insist on a lean and simple corporate structure as similar as possible to a US standard corporate structure which facilitates follow-up investments, trade sales or IPO's without triggering extensive due diligence of future investors or acquirers of the US-NewCo.

2 Contribution of GmbH-Shares into US-NewCo

The more common approach is that the existing shareholders of the German GmbH acquire shares in the US-NewCo pro rata to their current shareholding in the German GmbH against contribution of the shares held by the respective shareholders in the German GmbH which in turn results in the German GmbH becoming a wholly-owned subsidiary of the US-NewCo. Such structure enables the US investor to provide funds directly to the US-NewCo against issuance of new shares in the US-NewCo without being tangent to the business operations of the German GmbH.

B Advantages of a Delaware Flip

Expanding their market presence and traction to the US market by way of a flip into a Delaware corporation generally provides enormous potential for scalability and (further) rapid growth as the portfolio company will be able to tap into a far larger market, to benefit from a very active venture capital scene with significantly higher investment ticket sizes and to gain access to the US public capital markets in general.

Besides the incremental complexity and cost, an argument early-stage US investors commonly make against investing in German companies relates to employee equity: Shares in a Delaware C corporation can provide US taxpayers with tax advantages that don't extend to shares in a German limited 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, German companies doing business in a highly competitive labour market such as Silicon Valley will be at a disadvantage relative to companies who can offer potential employees equity in a US company. If a Delaware flip is consummated, it is therefore important to include any existing employee incentive program such as a VSOP or phantom stock program in the flip (e.g. by exchanging existing virtual stock appreciation rights in the German GmbH into such rights in the US-NewCo for the new employees of the US-NewCo).

Another argument often raised 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.

However, executing a Delaware flip without the certainty of an immediate capital infusion can impair the company's financial health. Further, once a German GmbH flips into a US holding company, there's usually no going back; the "Delaware backflip" from a US company into a German holding company (also known as an "inversion" transaction) can have undesirable US tax consequences. Therefore,

founders should execute the flip only at the point in time it is absolutely necessary for soliciting US investors and/or the further development of the business model and the execution of the flip should be directly linked to the envisaged equity investment by the relevant US investor.

C Potential Risks involved in a Delaware flip

It should be noted that a Delaware flip is almost exclusively executed upon request of the relevant US investors – whereas, if a German limited company requires a US company exclusively for operational or commercial reasons (e.g., to hire US employees or contract with US counterparties), the formation of a direct US subsidiary would suffice in most cases. This means the Delaware flip is a process imposed on the German GmbH by investors. To that end, it is vital for US investors and founders alike to be aware of potential (legal, tax and economic) risks and disadvantages a Delaware flip may entail for a German GmbH. company, there's usually no going back; the "Delaware backflip" from a US company into a German holding company (also known as an "inversion" transaction) can have undesirable US tax consequences. Therefore, founders should execute the flip only at the point in time it is absolutely necessary for soliciting US investors and/or the further development of the business model and the execution of the flip should be directly linked to the envisaged equity investment by the relevant US investor.

1 US Tax Implications

The US-NewCo would be subject to a higher aggregate US corporate tax rate of close to 26 percent (federal plus state); by comparison, the German federal corporate tax rate is approximately 15.8 percent (although it is important to note that the averaged aggregate tax burden of a German GmbH is approx. 29.8 percent and therefore may be significantly higher than for a US corporation following the 2018 US tax reform). This means that a Delaware flip potentially subjects a larger share of a German GmbH's global profits to the higher US corporate tax rate, while also adding greater tax complexity since the German GmbH as a subsidiary of the US-NewCo is now a so-called "controlled foreign corporation (CFC)" and needs to be included in the US tax statement of the US-NewCo pursuant to sec. 5471 Internal Revenue Code (IRC), although, due to the German-US double taxation treaty, income of the German GmbH will still be taxed in Germany. Moreover, rather extensive reporting and accounting obligations apply with respect to the German GmbH now being a CFC.

It should be noted that the contribution of shares in a German GmbH into a US-NewCo itself is not subject to tax since sec. 351 IRC stipulates that the contribution of property into a company whose share capital is, following the transaction, held by the contributing (former) shareholder of the German GmbH does not lead to any taxable profit but is considered a tax-neutral "exchange".

An additional consideration associated with having a US-NewCo as a holding company is the 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 to file their investments with CFIUS before closing. 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.

2 German Tax Implications

Executing a Delaware flip may have two substantial adverse tax implications from a German perspective: The contribution of shares in the German GmbH into a US-NewCo is essentially regarded as a transfer of shares to a foreign entity and therefore, the privilege of book value-transfers for share swaps applicable to comparable share transfers to a German entity is therefore not applicable. To that end, the Delaware flip may trigger capital gains tax, whereas the taxable capital gains are equal to the delta between the fair market value of the GmbH-shares at the point in time of the Delaware flip and the historical acquisition costs for such shares. Typically, the German tax office would calculate the fair market value for the GmbH-shares on the underlying most current pre-money valuation of the German GmbH on which the Delaware flip (or even the corresponding equity investment by the relevant US investor) is based, leading to capital gains for the former shareholders of the German GmbH. However, it should be noted that, if the relevant former shareholder of the German GmbH is a limited liability company or a corporation (as it is usually the case for investors and founder vehicles alike), 95% of the capital gains are tax-exempted, leading to an effective capital gains tax of approx. 1.5 percent.

Moreover, the Delaware flip may have a significant adverse effect on losses carried forward of the German GmbH. Typically a fast-growing tech company has a significant amount of losses carried forward which are normally credited against any taxable profits of the German GmbH and therefore constitute an important tax asset for the German GmbH. However, losses carried forward will become fully forfeited within five years if more than 50% of the shares in the German GmbH are sold or otherwise transferred to a third party. Although since 2016 there is now the possibility of applying for a continuous use of such losses carried forward as tax assets despite a transfer of the majority of shares to a third party, it remains rather uncertain under which circumstances such application would be approved by the tax office in case of a Delaware flip.

Therefore, contemplating a Delaware flip of a German GmbH should always include a thorough assessment of the legal and economic impact of potential tax risks as well as, to the extent required, due consultation with the competent tax authorities prior to implementing the flip transaction itself.

3 Transaction Costs

A more immediate consideration is the out-of-pocket cost of a Delaware flip transaction. The German and US 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. While these short-term and long-term costs may partly be compensated by the fact that – ideally – the Delaware flip is closely linked to a further equity financing round, the relevant company and the US investor should jointly assess whether the amount invested and value added by the US investor justify those costs and tax risks.

In conclusion, executing a Delaware flip can bear significant advantages for fast-growing German tech companies intending to attract larger US investors and gain further traction in the US. Given the complexity and costs of such transaction, the execution of the flip should be closely linked to a further equity funding of the company. Moreover, the potential German and US tax risks and further implications need to be carefully assessed and – if possible – mitigated prior to execution.

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Dr. Christian Gahr is a member of our Practice Area Corporate, M&A and Capital Markets. He primarily advises both national and international investors and growth companies with a focus on technology and innovation on Venture Capital transactions. His practice further includes advising on M&A transactions, corporate structuring as well as stock corporation law issues.

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