Cross-Border Angel Investment Opportunities

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US angel investors can find attractive investment opportunities if they are prepared to reach outside the US borders. Talented teams with world-leading tech are available, the costs of building a startup are typically much lower (especially for technical talent) than in the US, valuations frequently are considerably lower, and governmental grants and incentives may also help to mitigate risk. Consequently, on a risk-adjusted basis, it can make a lot of sense for US angels to invest outside of the United States.

However, there are key differences between angel investing in US startups and investing outside of the United States. Investors will want to obtain appropriate advice, preferably from advisors who are familiar with both US investor expectations and non-US markets.

Areas that warrant investigation include the following (and this is by no means an exhaustive list):

1. Entrepreneurial experience.
2. Local market opportunities.
3. Availability of follow-on financing.
4. Local legal and corporate governance considerations.
5. Tax considerations.

Additionally, US business angels may find that investing, at least initially, through cross-border angel syndicates may help them become comfortable with some of the less familiar aspects of investing outside the United States.

Startup Entrepreneurial Experience

Forming and operating a "lean startup", and scaling it internationally, involve special skills. These skills are learned, and first-time entrepreneurs are likely to make mistakes that they will not make in their subsequent ventures, particularly if they lack an ecosystem of experienced mentors. Founder experience issues are global, and apply to US startups as well as foreign startups.

However, the US benefits from a deeper cadre of entrepreneurs who have built and exited prior startups. This experience is very useful even if the prior startups were unsuccessful; investors hope that something has been learned from the prior experience.

Most non-US markets have fewer entrepreneurs that have exited startups and are looking to build or scale new ones. This deficit is particularly important when a startup is looking to scale.

Conversely, however, entrepreneurs that have successfully built and scaled startups in many non-US markets are likely to have done so in circumstances that are significantly less supportive than those enjoyed by US entrepreneurs. In particular, startup entrepreneurs outside the United States have probably needed to accomplish more with less – they could well have bootstrapped to a later stage. Running very leanly is more likely to be part of the DNA of non-US entrepreneurs.

In any case, business angels investing in non-US startups will need to consider whether the startup is likely to be able to attract the talent that it needs to develop and scale the business, and whether the surrounding ecosystem will provide sufficient support to the startup in doing so. If not, investors will want to consider whether they, or others they can bring to the table, can compensate for the lack of local support.

Local Market Opportunities

It may seem obvious that the success of non-US startups is likely to depend, at least in the first instance, on opportunities in their local markets. While other markets, such as those in the US, may ultimately be more attractive, non-US founders are unlikely to have the necessary skills to develop foreign markets except with support from experienced cross-border personnel, and they are unlikely to afford such talent at early stage.

Consequently, any investor assessment of a non-US startup requires an understanding of the markets in which the startup is likely to operate initially. In particular, the investor will need to consider whether customers in those markets are likely to be (i) receptive to doing business with a startup (this may be significantly more difficult in some markets than in the US, particularly for b2b businesses) and (ii) interested in what the startup is selling.

Follow-on Financing

A key underpinning for angel investment in the US is the existence of a robust venture capital financing market that provides follow-on financing. Modern venture capital in the US has developed over a substantial period of time, even if one only looks back over 40 years to the beginnings of Silicon Valley.

Additionally, a set of practices in respect of valuation and dilution have become "market"; these support the continued engagement of founders in their companies, potentially through multiple rounds of financing. In particular, experienced US investors understand the risks associated with excessive dilution of founders in early rounds of financing.

In contrast, there is not a similar history of venture capital finance in most markets outside the US, and market norms differ. While US-style VC's can now be found through the world, non-US VC markets generally are not as deep as those in the US, nor is there always the same understanding of the need to maintain appropriate incentives for founders.

The lack of robust VC communities is particularly important at early stage (say, pre-Series B), since most early stage VC investment is local. Early stage VC's want their startups nearby to provide network, experience and oversight, and also so that they can better understand the geographic market that they are pursuing. As a result, startups in some markets may secure early seed funding from business angels and then find themselves in a "financing valley of death" when they need later stage seed or Series A funding.

Consequently, angel investors in non-US startups need to consider the likely sources of follow-on funding, their own willingness to follow on, and whether they can potentially play a helpful role in assisting companies to secure the next round of funding.

Law, Regulation and Corporate Governance

It goes without saying that legal and regulatory regimes and corporate governance standards vary substantially from country to country. The regimes in common law countries like the UK, Ireland, Canada, Israel, Australia and New Zealand may seem broadly familiar to US angels; in particular, corporate governance provisions are likely to be at least as protective of investors as similar provisions in the US. Legal regimes in some civil law jurisdictions may be more surprising for US investors, and constituencies other than investors, such as employees, may play broader roles than US investors might expect. The differences in legal and regulatory regimes are even wider where the home jurisdiction is an emerging market or developing country, and startups may face pressures that they would not face in the US.

Even in developed countries, however, provisions governing such matters as employment and insolvency may have an impact that US investors do not expect. For example, employees are highly likely to have contractual and statutory rights beyond those applicable in the United States. Similarly, insolvency regimes differ, and directors of startups operating in the zone of insolvency (a common position for startups) may owe duties to creditors that expose them to civil or event criminal liability. As a result, startups that run short on funding may face greater pressures to shut down quickly than they would in the US.

Conversely, legal and regulatory regimes in some countries may be easier for a startup to navigate than those in the US. In particular, the US federal system, with regulation (and tax) at multiple levels (federal, state, local), imposes significant compliance burdens. For example, in the financial services (fintech) space, the US regulatory morass associated with regulation by multiple federal and state agencies subjects regulated startups to high costs; other jurisdictions, such as the UK, are innovation-friendly and may be easier places to build a regulated fintech business. Some non-US jurisdictions also may choose to impose lighter compliance burdens on early stage companies and other small businesses than on larger ones, whereas a "one size fits all" approach is more common on the US.

The underlying point, however, is that a business angel investing outside of the United States needs to get broadly comfortable with the legal, regulatory and governance

regimes that apply to (i) his or her investment and (ii) the startup in which the investment is made.

Tax

Consideration of tax issues by US business angels must take account of both US tax and tax (including social charges) in the local jurisdiction. Additionally, angels need separately to consider (i) their own tax position as investors and (ii) the tax position of the startup and its business.

US Tax

US angels making cross-border startup investments need to address, in particular, two areas of potential US adverse tax treatment. Angels should obtain professional tax advice in respect of both, and the provisions are complex. However, there are solutions.

The discussion below is intended to flag issues for discussion with tax advisors rather than provide tax advice.

CFC. Non-US companies that are more than 50% US owned by 10% or greater US shareholders are potentially subject to the controlled foreign corporation (CFC) provisions of the US tax code. 10% or greater US shareholders in CFC's are subject to tax under these provisions. The federal tax changes enacted by the Congress in 2017 complicated this analysis by taking into account value as well as vote in applying the 50% and 10% tests.

Additionally, the Congress enacted changes that are misleadingly-labelled as addressing Global Intangible Low Tax Income (GILTI), but in substance impose a global minimum tax. The GILTI provisions are too complex to address here but potentially result in a 10% or greater US shareholder in a CFC paying tax on income of the investee company on a pass-through basis even though no dividend has been paid.

The CFC rules include constructive attribution provisions that deem persons to own equity owned by family members or through intervening entities or options. Further, new constructive attribution rules can result in brother-sister non-US corporations in a group that includes a US subsidiary being deemed to be CFC's even where the top holding company is not a CFC.

A US investor that owns 10% or more of a CFC is subject to additional US tax filing obligations on an annual basis.

The bottom line is that a US angel generally will want to avoid circumstances where his or her ownership in a startup equals or exceeds the 10% threshold unless the angel has gotten sophisticated tax advice. It may be prudent to consider including special restrictions in convertible instruments (convertible preferred stock, convertible debt, simple agreements for future equity (SAFEs) etc.) to cap the investor's percentage ownership interest by vote and by value.

PFIC. Non-US startups that have predominantly passive income or assets may fall within the classification of passive foreign investment companies, known as PFIC's. Specifically, a startup will be a PFIC if at least 75% of its gross income is passive income (eg, from investments) or at least 50% of its assets are of the type that produce passive income (eg, interest, dividends or capital gains). While PFIC status is determined at the company level, the tax imposed on a PFIC shareholder applies at the individual shareholder level. Moreover, the PFIC provisions are intended to apply only if the shareholder is **not** a 10% or greater shareholder in a CFC (ie, the two regimes are designed to be mutually exclusive).

The PFIC tax provisions were designed to prevent Americans from deferring tax on investments in offshore passive vehicles, such as foreign mutual funds. Startups are not intended to be passive, but there is a risk that they may fall within the PFIC bright line tests. In particular, pre-revenue startups risk falling afoul of the PFIC income or asset tests (for example, as a result of depositing investor payments in interest-bearing accounts). The problem is compounded because once a company is classified as a PFIC it can retain that classification forever in respect of a US investor who held his or her shares in a year in which it was a PFIC (although curative actions are possible).

Investors in startups that may be classified as PFIC's will want to consider addressing the issue by filing a Qualified Electing Fund (QEF) election with the US Internal Revenue Service, which is an election by a US investor to include its proportionate share of the PFIC's income and gain in the US investor's own tax return on a current basis. This may particularly make sense since, in a startup context, little if any tax is likely to be due in connection with the election. The startup should be asked to provide the information (about its income and capital gains) required for the investor to make the annual filings required in connection with the QEF election. These filings are only required (and any PFIC-related tax is only due) in years in which the startup is a PFIC.

US tax and the "Delaware flip"**.** US angels may be tempted to try to avoid PFIC and CFC issues by insisting that the foreign startup put in place a Delaware holding company to receive their investment. Indeed, less sophisticated foreign entrepreneurs may welcome such a proposal.

However, a "Delaware flip" simply shifts the burden of dealing with US international tax complexities from the angels to startup founders that are likely to be ill-equipped (either from a monetary or advisory standpoint) to deal with them.

Consequently, it often is undesirable for a non-US company to put in place a US holding company until, at a minimum, it has secured at least several million dollars of investment (and, of course, unless and until it otherwise makes business sense). Thus, while a "Delaware flip" may make sense at some point, particularly if the startup's business and sources of investment are likely to become US-centric, it is counterproductive for angels to pressure the startup to flip prematurely for their own convenience.

Local (Non-US) Taxation

Angels also need to ask about the tax position in the jurisdictions where the startup is headquartered or has operations. This is relevant from two standpoints: (a) the tax regime (including, in particular, social charges) that the startup itself faces; and (b) any tax issues associated with local taxation upon a disposition of the angel's interest in the company. However, the latter is, in many cases, not likely to be a problem for US investors in jurisdictions with which the US has a tax treaty.

In respect of the startup and its own taxation, there is a wide variation both in levels of corporate income tax but also in levels of social charges (national insurance/social security etc.). Corporate income tax is less likely to be a major factor at early stage, but social charges may have a significant effect on the cost of scaling a startup.

Some jurisdictions, such as the UK and Ireland, are relatively benign, and provide a startup-friendly environment. Indeed, they may provide special tax incentives for startups, such as favorable tax treatment of founders and employee option holders, research & development tax credits, and special incentives for investors (which may not always be useful for foreign investors).

Other countries, however, such as some continental European jurisdictions, impose very high levels of social charges (even as much as 40% of salary). These charges impose substantial early stage costs as startups seek to scale.

Conclusion

US business angels who are prepared to invest internationally can find outstanding opportunities that they may not find in the United States. It is no longer the case (if it ever was) that the best startups can only be found in the US. That being said, US business angels face additional challenges in assessing, and investing in, non-US startups, and it is essential to secure appropriate advice from those familiar with these challenges.

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This discussion is not intended to provide legal or tax advice, and no legal, tax or business decision should be based on its contents. If you have any questions or comments, feel free to contact robert.mollen@friedfrank.com or via LinkedIn here.

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