

10 questions: Australian flips to the US

By Joel Cox

1. What is a US flip?

A "flip" is a restructure whereby a company in one country (the existing startup) interposes a new head company in another country (headco) between it and its existing shareholders, to change the location of the head entity. The result of the flip is that the existing shareholders exchange their current interests in the existing startup for identical interests in the headco, and the existing startup becomes a wholly owned subsidiary of the headco.

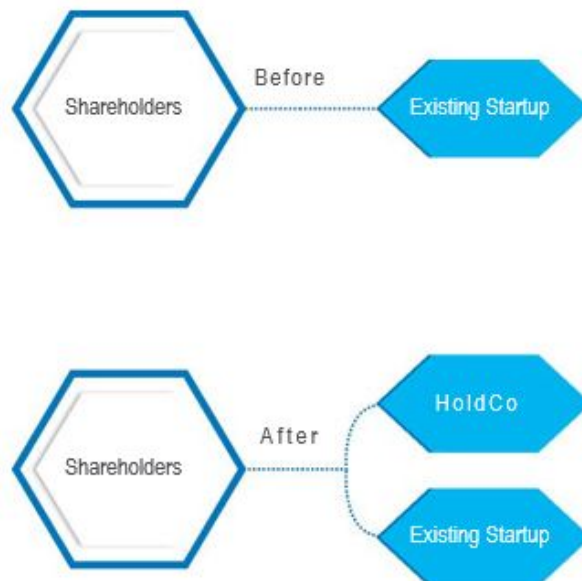
In Australia, we most commonly see flips to the United States, given the importance of that market to many startups. Singapore and the UK are also common flip destinations.

Why undertake a flip?

- To obtain funding from an investor in another jurisdiction: a flip is a common restructure that Australian-domiciled fast-growth companies undertake in order to attract funding from US-based institutional venture capital funds. US investors generally prefer to invest in a US head company.
- To focus the company's operations on a foreign market: moving the headquarters of a company to another market is a clear step toward operational expansion. Often, a flip coincides with a business plan to increase activities in the US and the flip assists this process (eg, the business now has a US entity to do such things as employ staff, lease an office and issue shares under an employee share scheme options).
- To take advantage of US intellectual property development concessions: Australia has attractive research and development incentives; however, these are being scaled back, and the US has recently introduced a concessional rate for royalties on intellectual property developed in the US.
- To enable the head company of the group to easily contract with parties based in a foreign market: many US companies (and banks) prefer to contract with US companies rather than foreign ones.

3. What are the key steps?

1. Incorporate the holdco (generally a Delaware structure is used)
2. Existing shareholders of existing startup enter into a stock exchange agreement with holdco
3. Existing shareholders are issued shares in holdco



4. How should I structure my legal team?

Prudent companies call on experienced tax and corporate advisors, preferring those able to provide service across all affected jurisdictions.

Generally in a US flip involving an Australian entity, the US lawyers take care of the incorporation of the holdco and draft the US documents, including the bylaws and other incorporation documents relating to the holdco, as well as any US financing documents (if there is an investment taking place post-flip). Australian lawyers draft the resolutions needed in the share exchange and undertake the analysis of tax consequences for the shareholders involved in the flip.

Using a single firm active in both jurisdictions creates efficiencies, streamlines management and simplifies the fee process.

5. When is the best time to do the flip?

Assuming the flip is being undertaken to gain access to a US investor, it should occur just before the investment in the US is made. We do not see any significant benefit in doing this earlier, because US investors increasingly understand the flip process and are not concerned about having it as a condition precedent to investment.

6. What are the Australian tax consequences?

Ordinarily, the exchange of shares in a flip would give rise to capital gains tax for the shareholders in the existing startup as they are disposing of a capital gains tax (CGT) asset (being their shares). However, there are a number of CGT rollovers available for flips:

- Division 615 rollover
- Subdivision 124-M rollover

Rollover relief

Broadly, the effect of rollover relief is that:

- Options cannot be subject to Division 615 rollover relief
- Capital gains of shareholders triggered as a result of the flip are ignored at the time the Flip occurs and
- The cost base, for CGT purposes, of the replacement equity transferred or issued to shareholders (ie, shares in holdco) is equal to the cost base of the original equity (ie, shares in the existing startup), so that any unrealized capital gain is deferred/preserved, and CGT is only triggered when the shareholders later dispose of their replacement shares.

In effect, rollover relief results in a deferral of tax (if any), rather than a full exemption.

Obtaining rollover relief is generally voluntary for shareholders, in that they must elect for the non-inclusion of the capital gain on the occurrence of the flip. This election is made through the completion of their income tax returns in a manner that is consistent with applying the rollover (ie, no formal election is required to be made or filed with the ATO and the election is effectively made by the non-inclusion of a capital gain).

7. What are the key conditions for rollover relief?

The conditions for rollover relief are different depending on which one applies. Where both Division 615 and Subdivision 124-M rollovers apply, the Tax Act provides for a "tie breaker" rule giving priority to Division 615.

Following are some of the key conditions that must be satisfied for each of the types of rollover relief (this list is not exhaustive):

Division 615 rollover

- The shareholders must dispose of all of their shares in the existing startup to the holdco in exchange for shares in the holdco and nothing else
- Each shareholder's percentage interest and market value of shares in the holdco must be the same as it was in the existing startup just before the flip and
- After the flip, the shareholders of the existing startup must own all of the shares in the holdco, or another shareholder (ie, the original holdco shareholder) can hold 5 shares or less in the holdco, provided those shares are of nominal value.

Subdivision 124-M rollover

- The existing startup shareholders exchange a like interest in the existing startup for a corresponding interest in the holdco (ie, share for share, or option for option)

- The exchange must result in the holdCo becoming the owner of at least 80 percent of the voting shares of the existing startup
- The arrangement is one in which at least all owners of voting shares in Existing Startup could participate and
- The arrangement is one in which participation is available on substantially the same terms for all of the owners of interests of a particular type in the existing startup.

8. How long does a flip take?

Depending on the complexity of a company's cap table, and the commercial drivers and decisions for the flip, the time to complete can vary.

Given the potentially adverse consequences of not obtaining rollover relief, care must be taken to ensure that the rights and interests held in the existing startup are replicated in the holdco, which can be complicated by the existence of options, preference shares and convertible notes on the cap table of the existing startup.

Additionally, where there is an investment pre-flip or post-flip (or both!), more parties are involved in the process and investors will generally want to review the flip documents to ensure that they are not adversely affected. The review of the documents by multiple parties can add considerable time to the process.

We expect a reasonably straightforward flip with a post-flip investment to take four to six weeks from start to finish.

9. What if the company has Employee Share Scheme Shares/Options on issue?

Employee Scheme Options and Shares (ESS or ESOP) can be a further complicating factor in a flip because these shares, unlike normal shares, may be subject to vesting restrictions and specific tax rules about the timing of their taxing point (one of which can be disposal).

Options can be rolled over under a Subdivision 124-M rollover, and like with shares, the same offer must be made to all option holders.

Given the ESS rules contained in the Australian Tax Act, even if rollover relief is obtained under Subdivision 124-M, there may be other tax consequences for the option holders. For example, the disposal of an option in the flip may result in a taxing point on the option in a tax-deferred plan, or contravene the three-year holding period in a startup plan.

Accordingly, the ESS rules contain its own version of rollover relief to ensure that adverse tax consequences do not arise (ESS rollover).

Where ESS rollover is obtained, the new options issued will be effectively treated as a continuation of the old ones. Accordingly, it is imperative that the ESOP adopted in the US mirror the prior Australian plan – this can involve some finessing!

10. Are there any other important considerations?

There may be wider implications of a flip, both tax and otherwise.

Potential tax consequences that should be considered in due course include:

- Franking credits will not be available to shareholders post-flip – generally startups who do flips are not anticipating paying dividends and rather are focused on capital gains, which alleviates this as an issue
- Shares held on revenue account by an existing shareholder may have different tax consequences
- R&D tax concessions – you should consider the impact on this and
- International tax issues including transfer pricing on any payments made to the intellectual property holding entity post-flip.

In addition, should the Ausco hold interests in Australian land, stamp duty may arise as a result of a flip.

Other considerations include:

- The potential need to assign contracts from the existing startup to the holdco
- The issue of the replacement shares in the holdco to the shareholders will be subject to the Corporations Act disclosure requirements and the relevant exemptions will need to be satisfied to ensure that a prospectus does not need to be prepared and lodged
- Shareholder protections under the Corporations Act will not apply to the headco; rather, Delaware law will apply – a new investor rights agreement and voting agreement may be needed and should adapt US best practice
- Preparing the relevant agreements between the existing startup and holdco to enable them to operate in both jurisdictions and
- Preparing Australian shareholders regarding their US compliance obligations.

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