

Cross-border funding for startups: top questions founders should ask

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When preparing for a cross-border financing round, there are several important decisions to make. While there is no one-size-fits-all approach to this process, there are common questions Canadian startups often have when planning to raise capital from U.S. investors. Here are our answers to the frequently asked questions many founders have.

Should the investment be made in a Canadian or U.S. entity?

The investment can be made in either.

You're not required to have a U.S. company to raise funds from investors there—however, startups will often incorporate in both Canada and the U.S. if they plan to do business in both countries. However, the investment will go into the parent entity (often the Canadian entity for a startup headquartered in Canada). While there are no rules regarding which of these entities should receive the capital, investments are usually made at the parent company level.

Corporate law in Canada is very similar to Delaware corporate law (the jurisdiction of choice for most U.S. startups), so if you do decide to incorporate in the U.S., it is usually advised to incorporate in Delaware.

Can you change the location of your parent company at the time of fundraising?

Yes, you can change the parent company's jurisdiction at the time of a funding round; however, it is best to do so before there is significant value in the company so that you can avoid adverse tax consequences. Tax implications can include receiving a decision that you now owe a lump sum tax payment from your startup's new parent country.

Additionally, if a Canadian company with Canadian shareholders wants to reorganize so that it has a U.S. parent company, then the Canadian shareholders will be subject to tax for the increase in value of their shares when they exchange the Canadian company shares for those in the U.S. company. This tax will be applicable regardless of whether these shareholders sell their shares.

If you're considering making the flip, it is important to do so as early as possible before your cap table and operations grow. As your company matures and engages more businesses and stakeholders, undertaking a reorganization will become more costly and increasingly complex.

What are other tax implications from cross-border fundraising?

The good news is that many cross-border tax-related issues, such as withholding taxes and PFIC status, have been addressed by changes to the laws in both Canada and the U.S., which means there are less obstacles involved in both cross-border business and fundraising.

Scientific Research and Experimental Development tax credits

If you want to receive the Canadian reimbursable and enhanced Scientific Research and Experimental Development (SR&ED) tax credits, your company needs to be a Canadian-controlled private corporation (CCPC). At a high level, this requires your company to be incorporated in Canada and cannot be controlled by nonresidents. The rate for enhanced reimbursable SR&ED credits is 35% federally for qualified expenditures, and each province has additional reimbursable tax credits for CCPCs. However, as the startup grows, the availability of SR&ED tax credits can be diminished—startups sometimes factor this timing into any contemplated reorganization to maximize their potential SR&ED claims. Although it may be possible to implement corporate structures that allow a company to access enhanced SR&ED credits with a U.S. parent company, this structuring can be complex and costly.

Qualified Small Business Stock and Corporations

On the investor side, U.S. shareholders won't be able to access capital gains exemptions under the Qualified Small Business Stock (QSBS) regime if investing in a Canadian entity. This may impact how attractive they see your startup as an investment. On the other hand, Canadian shareholders will not be able to access the lifetime capital gains exemptions for Qualified Small Business Corporations (QSBC) if the shares are held in a U.S. corporation.

Should the investment price be set in U.S. or Canadian dollars?

The price of shares and options can be set in either U.S. or Canadian dollars, regardless of where your parent company is. However, using multiple currencies can create accounting complications. You should therefore select one currency and be consistent for future issuances.

Where should you hold your intellectual property?

It is generally recommended that startups hold their intellectual property (including U.S. patents) outside of the U.S. due to higher U.S. corporate tax rates and the difficulty of moving IP outside of the country at a later date. For these reasons, Canada is generally preferable as an IP holding jurisdiction.

Are there differences in deal documents?

The Canadian Venture Capital & Private Equity Association (CVCA) publicly shares model venture capital documents, which are based on the U.S. National Venture Capital Association (NVCA) model documents. This helps contribute to some consistency and similarity across deal documents whether you are receiving investment in your Canadian or

U.S. entity.

What works best for each startup can be complicated. It is important to obtain advice from your legal, accounting and other advisers with expertise in dealing with cross-border funding.

To discuss these issues, please contact the author(s).

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

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