Tax Treatment of SAFEs

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SAFEs, or Simple Agreements for Future Equity, which were introduced by Y-Combinator in 2013, are a popular investment instrument in early-stage startup financings.[1] Y-Combinator intended for SAFEs to be a simple investment instrument requiring minimum negotiation.[2] However, from a tax perspective, the treatment of SAFEs is not so simple.

Background: Common SAFE Terms

Startups often perceive SAFEs as preferable to (i) convertible debt, as SAFEs do not bear interest or have maturity dates and convert only in the event of an equity financing or company sale, and (ii) at the earliest stages, a priced equity round because they believe that SAFEs minimize costs and complexity. Additionally, some investors embrace SAFEs over convertible debt because they desire equity upside rather than debt-protection downside. While not the focus of this article, and notwithstanding the foregoing, startup companies should fully understand the impact that SAFEs may have on their cap table post-conversion. Savvy early-stage investors are generally aware of what their post-conversion ownership of the company will be after the SAFEs convert. Founders should always do the post-conversion math at the time that they issue the SAFEs to avoid surprises months or even more than a year later, when the conversion or liquidity event actually occurs.[3] Perceptions and impact aside, the basic SAFE terms are as follows: The investor pays a purchase price for the SAFE. If there is an equity financing following the purchase of the SAFE, the company automatically issues the investor a number of shares of preferred stock that varies depending on the structure of the SAFE and its conversion mechanics. SAFEs commonly have a valuation cap and/or a discount and they convert into equity at a price per share based on the valuation cap and/or discount. For example, if the SAFE contains a valuation cap, then there is a cap on the conversion price (i.e., it cannot be higher than the price per share based on the valuation cap). If there is a discount, the investor typically can choose whether to take advantage of the better of the discount price or the valuation cap price.

If there is a liquidity event before conversion of the SAFE, the investor can often choose to receive a cash payout equal to the purchase price of the SAFE (reduced if there is not enough cash to pay all investors in full) or equity. If the company dissolves while the SAFE is outstanding, the company will return the investor's purchase price (reduced where the assets cannot support full repayment to creditors and investors - presumably SAFEs come after debt and ahead of equityholders,

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[1] *See* http://blog.ycombinator.com/announcing-the-safe-a-replacement-for-convertible-notes (accessed 4/20/2018) and http://www.ycombinator.com/documents/ (accessed 4/20/2018).
[2] *Id.*
[3] *See* Edward Zimmerman, "The Damaging Shortcuts Entrepreneurs Take When Raising Money," *The Wall Street Journal* (April 30, 2018) ("There's no doubt that the SAFE and KISS documents are faster and cheaper–when the deal first closes. Unfortunately, that's not the case over time. In SAFEs, KISS documents and convertible notes, often the unresolved issues and the issues that everyone relegates to side letters can make the next fundraising effort more complicated and more expensive, sometimes resulting in relationship-damaging negotiations at a time when the company is doing well.").

though this too may be an open issue). As a result, SAFE holders appear largely in it for the upside, as they will likely write off their investment in the company in a down scenario and will not have rights as a creditor.

While the terms of the SAFEs appear to make clear that they are not debt instruments, the correct tax treatment of a SAFE is an open issue and is often a complexity of a SAFE overlooked by investors and companies alike at the time of sale. Depending on the terms of the SAFE and the facts and circumstances relevant to its issuance, a SAFE should be treated as either equity or a variable prepaid forward contract from a U.S. federal income tax perspective.

A SAFE Should Not Be Treated as Debt for Tax Purposes

Classic debt instruments call for the payment of principal at a fixed point in time and bear interest at an arm's-length rate. Classic equity instruments, on the other hand, give the investor the right to share in profits of the underlying business but no right to withdraw the investment made to acquire the instrument; rather, the investment is subject to the risks of the business. Many instruments bear indicia of both debt and equity. For example, in certain circumstances, convertible debt may be treated as equity for tax purposes.[4] However, it seems clear that a SAFE should not be treated as debt for U.S. federal income tax purposes. which is consistent with Y-Combinator's initial intent in creating the SAFE as an alternative to convertible debt.[5]

In determining whether an instrument is debt or equity for U.S. federal income tax purposes, a number of factors are taken into consideration by the IRS and the Tax Court. Specifically, factors that have been considered include (1) whether there is a fixed maturity date and schedule of payments; (2) whether there are interest payments, and if such interest payments are at a fixed interest rate; (3) whether there is a right to enforce payment of principal and interest; (4) whether there is a contingency on the obligation to repay; (5) whether there is subordination or preference to debt of the company; (6) the debt-to-equity ratio of the company; (7) whether the instrument converts into equity of the company; (8) the relationship between holdings of stock in the company and holdings of the instrument in question; (9) the names given to the instrument (e.g., if the parties call the arrangement debt); and (10) the intent of the parties.[6] No single factor is controlling or decisive in determining whether an instrument is debt or equity for tax purposes; however, the absence of a fixed maturity date for the repayment of a sum certain often precludes debt status for an instrument.[7] A creditor's return is based on the time value of money, whereas an equity holder profits from growth of the company. Where an instrument gives the investor the right to participate in the growth of the business, the instrument may be treated as equity even if called "debt." For example, the IRS has found convertible debt to be treated as equity where the likelihood of conversion of the debt into common stock was very high.[8]

With respect to a SAFE, the investor lacks the primary advantages of being a creditor. There is no fixed maturity date, the investor lacks the unconditional right to repayment of the purchase price or interest, there are generally contingencies on the right to any repayment on or conversion of the instrument, and the investor would be subordinated to any debt of the company. Moreover, it is clear that the parties intend the instrument to not constitute debt for tax and nontax purposes.

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[4] For example, convertible debt may be treated as equity when the company issuing such debt is an early-stage company and at the time of issuance it is unlikely that it would be able to repay the debt without a later investment that would allow the debt to convert.
[5] *See* http://blog.ycombinator.com/announcing-the-safe-a-replacement-for-convertible-notes/ (accessed 4/20/2018) and http://www.ycombinator.com/documents/ (accessed 4/20/2018).
[6] *See, e.g., Roth Steel Tube Co. v. Comm'r*, 58 A.F.T.R.2d 86-5808, 86-5811 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987); *Estate of Mixon v. United States*, 30 A.F.T.R.2d 72-5094, 72-5098-99 (5th Cir. 1972); *Fin Hay Realty Co. v. United States*, 22 A.F.T.R.2d 5004, 5005-06 (3d Cir. 1968); Revenue Ruling 83-98, 1983-2 C.B. 40. *See also* Section 385(b). Unless otherwise noted, all Section references herein are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.
[7] *See Farley Realty Corp. v. Comm'r,* 5 A.F.T.R.2d 1646, 1649 (2d Cir. 1960) ("Numerous cases have held that the absence of a fixed maturity date is a critical factor weighing against a corporate taxpayer's claim that a debtor-creditor relationship existed between it and its payee.").
[8] Revenue Ruling 83-98, 1983-2 C.B. 40 (finding convertible notes to be equity rather than debt for tax purposes where the instrument would convert to equity unless the stock price dropped more than 40 percent).

A SAFE Should Be Treated as a Derivative or Equity for Tax Purposes

If a SAFE is not debt for tax purposes, then what is it? Depending on the terms and circumstances surrounding issuance of the SAFE, it seems likely that a SAFE should be treated as either a prepaid forward contract or a current equity grant. As discussed further below, in most cases, the usual treatment should be as a prepaid forward contract.

SAFE as a Prepaid Forward Contract

A forward contract is an executory contract pursuant to which the buyer agrees to purchase from the seller a fixed quantity of property at a fixed price in the future. With a variable prepaid forward contract ("VPFC"), the buyer pays the seller the purchase price at the time the contract is entered into rather than on the date of delivery of the property, and a variable amount of property is transferred at closing of the contract. A SAFE resembles a VPFC contract, as the investor is purchasing the equity (in cash or by providing services) pursuant to a contract with a contractually specified quantity of property, which varies depending on the circumstances, to be delivered later in time.

Generally, the "seller" of property pursuant to a prepaid forward contract is not treated as selling the property underlying the contract on the date the contract is entered into. Instead, the property is not considered "sold" until that property is delivered. A prepaid forward contract is therefore an open transaction, with tax consequences delayed until the transaction is closed (i.e., the date that the property is delivered).[9] Accordingly, if a SAFE is treated as a VPFC, the investor's purchase of the SAFE from the company should not be a taxable event for the investor or the company. The prepayment is treated as an advance deposit, without immediate tax consequences.[10] When the stock is received pursuant to the SAFE, there should not be a taxable event for either the investor or the company.[11] The investor will have a basis in the stock received equal to the prepayment amount,[12] and the holding period of the investor in the stock begins when the stock is received pursuant to the terms of the SAFE (which means the holding period for "qualified small business stock" treatment under Section 1202 starts at that time).[13] Upon disposition of the stock, the investor should recognize capital gain or loss equal to the difference between the prepayment and the amount realized on the sale of the equity.[14]

The IRS has held that a VPFC will be respected as a VPFC rather than treated as a sale of the underlying stock as long as the taxpayer (1) received a fixed amount of cash, (2) simultaneously entered into an agreement to deliver on a future date a number of shares that varied significantly based on the value of the shares on the exchange date, (3) pledged the maximum number of shares deliverable under the agreement, (4) retained an unrestricted legal right to substitute cash or other shares for the pledged shares, and (5) was not economically compelled to deliver the pledged shares on the contract's maturity date.[15] The IRS' conclusion that the taxpayer had not sold the shares at the time the forward contract was entered into and that instead the forward contract should be treated as a VPFC was primarily based on a few factual determinations, including that the seller retained all dividend and voting rights and the taxpayer was not required to deliver the pledged shares to the counterparty. In the typical SAFE arrangement, the company receives a fixed amount of cash and simultaneously enters into an agreement to deliver on a future date a number of shares or an amount of cash that varies significantly based on the value of the shares on the settlement date. Further, until

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[9] *Lucas v. North Tex. Lumber*, 281 U.S. 11 (1930); *Virginia Iron Coal & Coke Co.*, 37 B.T.A. 195 (1938), *aff'd*, 99 F.2d 919 (1938), *cert. denied*, 307 U.S. 630 (1938).
[10] Rev. Rul. 78-182, 1978-1 C.B. 265.
[11] Section 1032(a). *See* Chief Counsel Advice Memorandum 201025047 (3/22/2010).
[12] Section 1012(a).
[13] For more on these issues, see Ed Zimmerman and Brian A. Silikovitz, "Gimme Shelter: VC-Backed M&A Tax Strategies for QSBS/1202," *Forbes* (July 18, 2016) (hereafter, Zimmerman & Silikovitz Forbes QSBS).
[14] Section 1001.
[15] Rev. Rul. 2003-7, 2003-1 C.B. 363. *See also* IRS LMSB Coordinated Issue Paper on Variable Prepaid Forward Contracts Incorporating Share Lending, LMSB-04-1207-077 (Feb. 6, 2008).

the shares are delivered, the investor does not have any dividend or voting rights with respect to those shares. Accordingly, the benefits and burdens of ownership of those shares likely have not been transferred to the investor.

SAFE as an Equity Grant

The more likely or certain it is (based on the circumstances surrounding the SAFE's issuance) that the SAFE will convert into shares of stock, the stronger the support for treating the SAFE as an equity grant. For example, if the SAFE is issued at a time when equity financing (and therefore conversion) is substantially certain to occur very soon after its issuance, the issuance of the SAFE more strongly resembles the receipt of equity rather than a derivative.

If the SAFE is received for purchase price and treated as an equity grant, the investor's holding period in the stock underlying the SAFE would begin on the date the investor purchased the SAFE. This is one benefit of upfront equity treatment, which can become particularly relevant, depending on timing, if an investor is seeking to qualify the stock as "qualified small business stock" to obtain an exemption from taxation on gain when such stock is sold under Section 1202 or even long-term capital gains.[16]

Y-Combinator designed SAFEs to be fast and simple documents. The complexities are, however, likely to arise or be detected after, rather than before or during, the issuance of the SAFE. As discussed in this article, a complexity often overlooked by investors (and companies alike) is the tax treatment of SAFEs. Unless a SAFE is treated as upfront equity, investors purchasing SAFEs instead of equity are delaying (and potentially forfeiting as a result of that delay) the commencement of the capital gains clock (one year) and the "qualified small business stock" clock (five years), which could mean forgoing substantial tax benefits. Investors and issuers should discuss the tax treatment of receipt of a SAFE based on the particular circumstances in which the SAFE was issued. Although it seems clear that a SAFE should not be treated as debt for tax purposes, it is beneficial for a SAFE holder to understand upfront the treatment of the SAFE for tax purposes, as it can affect the character of the gain on disposition of the stock underlying the SAFE.

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[16] For more on these issues, see Zimmerman & Silikovitz Forbes QSBS, cited in footnote 11, and Edward Zimmerman and Brian Silikovitz, How Startup Founder Stock Often Triggers Unnecessary Personal Tax Hits, *Forbes* (Jan. 6, 2015).

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