

Tax

April 9, 2019

Potentially Improved Tax Treatment of the New Post-Money SAFE

By **Lesley P. Adamo**

In September 2018, Y-Combinator released new (post-money) SAFE forms, which contain more equity-like features than do the traditional (pre-money) SAFE forms. This Client Alert updates and serves as a companion to our Lowenstein Sandler LLP Client Alert of July 12, 2018, regarding the tax treatment of those SAFEs that follow the traditional form.

Summary

SAFEs, or Simple Agreements for Future Equity, which Y-Combinator introduced in 2013, are a popular investment instrument in early-stage startup financings.¹ In September 2018, Y-Combinator released new SAFE forms (Post-Money SAFEs) which, as discussed below, modify the traditional SAFE forms (Pre-Money SAFEs) in a number of ways. From a tax perspective, the Post-Money SAFE forms contain more equity-like features than do the Pre-Money SAFE forms, increasing support for “equity” tax treatment from the date of grant for those SAFEs that are Post-Money SAFEs, while the taxing authorities are more likely to view Pre-Money SAFEs as variable prepaid forward contracts (which results in Pre-Money SAFEs being treated as open transactions for tax purposes). More specifically, Post-Money SAFEs provide holders with rights to receive both the same consideration as shareholders in a liquidity event and also the right to receive dividends. Moreover, the forms for

the new Post-Money SAFEs contain explicit language addressing the treatment of such Post-Money SAFEs as common stock for tax purposes.

Post-Money SAFE Forms versus Pre-Money SAFE Forms

Post-Money SAFEs are intended to provide greater clarity as to the precise effect of the issuance of a SAFE on ownership of stock in the target company.² Specifically, the SAFE holder’s ownership is measured after all SAFE money is taken into account but before there is a dilutive priced round converting the SAFEs (e.g., Series Seed or Series A). The form Post-Money SAFE also removes the “pro rata” right for a SAFE holder to purchase a pro rata portion of preferred stock in the round of financing following the round in which the SAFE converts (although a form side letter is provided if the parties desire this feature).

The holder of a Post-Money SAFE has the right to a dividend payment when a cash dividend is paid on outstanding shares of common stock. Additionally, the Post-Money SAFE clarifies that in a liquidity or dissolution event, the SAFE is explicitly intended to operate like standard non-participating preferred stock so that the SAFE holder’s right to receive its cash-out amount is junior to the payment of any outstanding indebtedness or creditor claims, on par with

¹ See <http://blog.ycombinator.com/announcing-the-safe-a-replacement-for-convertible-notes/> (accessed 3/27/2019) and <http://www.ycombinator.com/documents/> (accessed 3/27/2019).

² See <http://www.ycombinator.com/documents/> (accessed 3/27/2019).

payments for other SAFEs and/or preferred stock,³ and senior to payments for common stock. Likewise, the SAFE holder's right to receive its conversion amount (the amount the SAFE holder would receive on an as-converted to common stock basis) is on par with payments for common stock and other SAFEs and/or preferred stockholders who are also receiving amounts on an as-converted to common stock basis.

Lastly, the Post-Money SAFE provides an acknowledgment from the parties that for U.S. federal and state income tax purposes, the SAFE is intended to be characterized as common stock and that the parties agree to treat the SAFE consistent with such tax characterization.

Support for the Treatment of Post-Money SAFEs as Equity

As discussed in our *Client Alert of July 12, 2018*, depending on the terms and circumstances surrounding the issuance of the SAFE, it seems likely that a SAFE should be treated as either a prepaid forward contract or current equity grant.⁴ As compared with the Pre-Money SAFE, the Post-Money SAFE contains features that give further support to its treatment as stock for tax purposes.

In determining whether a contract should be treated as transferring ownership of the underlying equity for tax purposes, the key question is whether the benefits and burdens of ownership of the underlying equity have transferred.⁵ How the parties treat the transaction is one consideration in making that determination.⁶ The Post-Money SAFE forms contain explicit language regarding the intended treatment of the SAFE as common stock, and the language of the form more generally conforms to tax treatment as

equity. Additionally, the right to dividends is another factor often key to determining whether there has been an ownership transfer of stock.⁷ The Post-Money SAFE gives the investor dividend rights, a feature missing from the Pre-Money SAFE. Lastly, the Post-Money SAFE is intended to provide greater certainty, or less variability, as to the investor's actual percentage ownership of underlying stock.⁸ That uncertainty has increasingly become a problem we see in deals as founders and investors try to get a clear understanding of who owns how much of the company when seeking to determine the desired valuation and investment round size in a subsequent funding.

Benefits of Treatment of Post-Money SAFE as Equity

Y-Combinator apparently intends that the Post-Money SAFE be treated as equity from the date of grant. The treatment of a SAFE as equity from the date of grant benefits investors by starting the holding period in the stock underlying the SAFE at the time the investor purchases the SAFE. If a SAFE is treated as common stock, its purchase by an investor starts the investor's clock on ownership of such stock for purposes of the beneficial long-term capital gains rate (one year) and "qualified small business stock" qualification (five years), which could result in substantial tax benefits.⁹ Because of the differing forms of SAFE (e.g., pre-money versus post-money, including negotiated terms), investors and companies alike should review the intended SAFE investment with their advisors to understand up front the treatment of their SAFE for tax purposes.

**Acknowledgements to Robert Krieger, law clerk at Lowenstein Sandler LLP, for his contribution to this alert.*

³ There would, of course, be issues to resolve in terms of the order of payment if there are one or more series of preferred stock outstanding that are junior or senior.

⁴ See our [previous article](#) for a more in-depth discussion of the tax analysis underlying such determination and the conclusion that, like the Pre-Money SAFE, the Post-Money SAFE should not be treated as debt for tax purposes.

⁵ *Anshutz Company v. Commissioner*, 664 F.3d 313 (10th Cir. 2011); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981).

⁶ *Id.*

⁷ *Id.* See 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).

⁸ Notably, there are some factors indicative of equity ownership that are not present where a SAFE is used, including voting rights, passage of legal title of the underlying stock, and greater certainty as to actual percentage of stock ownership (i.e. there is some variability still present above what is generally the case where there is a preferred stock round).

⁹ 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).

Contact

Please contact the listed attorney for further information on the matters discussed herein.

LESLEY P. ADAMO

Partner

T: 646.414.6974

ladamo@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

This Alert has been prepared by Lowenstein Sandler LLP to provide information on recent legal developments of interest to our readers. It is not intended to provide legal advice for a specific situation or to create an attorney-client relationship. Lowenstein Sandler assumes no responsibility to update the Alert based upon events subsequent to the date of its publication, such as new legislation, regulations and judicial decisions. You should consult with counsel to determine applicable legal requirements in a specific fact situation. Attorney Advertising.