IS IT SAFE TO USE A S.A.F.E.?

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Tags
C.L.E.
Contract
Convertible Debt
Debt vs. Equity
Forward Contract
O.I.D.
Original Issue Discount
Prepaid Variable Forward
Q.S.B.S.
S.A.F.E.
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Y Combinator

INTRODUCTION

In 2013 a new investment scheme was introduced to the world by Y Combinator, a well-established start-up companies accelerator. A Simple Agreement for Future Equity ("S.A.F.E.") allows a company to receive funds in exchange for an obligation to issue shares in the future, if and when a fundraising round, a liquidity event, or an I.P.O. occurs. Due to its the relatively simple nature for capital-raising, the S.A.F.E. became very popular among start-up tech companies.

The S.A.F.E. does not properly fit into any of the usual categories of investment vehicles, such as debt or equity, and there is much ambiguity as to the proper characterization of A S.A.F.E. for U.S. tax purposes.

Earlier this year, the Israeli Tax Authority ("I.T.A.") published its position on taxing a S.A.F.E. The I.T.A.'s position is not the main focus of this article, but it evoked the interesting question of how should a S.A.F.E. be characterized for U.S. Federal income tax purposes. Interestingly enough, the I.R.S. has not yet published any guidance on point.

THE MECHANICS OF A S.A.F.E.

A S.A.F.E. typically refers to a financing arrangement under which an investor tenders an agreed amount to a company, in exchange for the company's obligation to issue stock (typically preferred stock) at a later time. At the signing of the S.A.F.E., the specific date on which shares will be issued and the price per share at time of issuance are unknown. Instead, the parties typically agree on the following mechanics:

- Shares will be issued upon a future financing round, a change in control, an initial public offering, or a dissolution (a "Triggering Event").
- The price-per-share will be determined based on the company's valuation on the Triggering Event date, subject to a valuation cap or a specified discount.

If the parties agree on a valuation cap, the stock value at the time of conversion is limited to a maximum amount.[1] This mechanism protects the investor's rights by

[1] To illustrate, the investor invests $200,000 in a company under the S.A.F.E. and the parties agree that the value of the company will be capped at $2 million. This means that the investor will receive 10% of the company's stock at the time of a Triggering Event, even if the Triggering Event takes place when the company is evaluated at $4 million. Without the cap on value for conversion purposes, the investor would have received shares reflecting 5% of the company.

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ensuring that the investor's price per share does not rise too high causing the number of shares issued to fall below an acceptable amount. The alternative mechanism designed to protect the investor's rights is granting the investor a pre-determined discount for the future shares.[2] The discount alternative imposes no limitation on the investor's future price per share, but it ensures that such a price will be a better price relative to the price in the next financing round.

The S.A.F.E. is relatively straightforward to create and implement. The parties do not need to evaluate the company's stock, negotiate interest payments, or subject the agreement to certain conditions or restrictions that typically apply to debt instruments. This presents a significant benefit to the company because it is able to raise additional funds quickly and easily in the future. The investor derives its own advantages, mainly the opportunity to benefit from an upside of the company's shares after the time the S.A.F.E. is signed.

Nonetheless, a S.A.F.E. presents its own set of disadvantages, as well. The Triggering Event might never occur, and the investor might lose the entire investment. Repayment rights typically kick in only upon the company's dissolution and, in any event, they are junior to the rights of creditors. The S.A.F.E. investor might also incur losses if a Triggering Event occurs, but the company's valuation is lower than was expected at the time of funding the S.A.F.E. These are typical risks of equity owners.

Another significant disadvantage is the lack of clear taxing rules, thereby creating a level of uncertainty for both parties to the S.A.F.E. arrangement. In the absence of specific taxation rules, a common approach to quantifying expected tax consequences is to equate a new instrument such as the S.A.F.E. to a type of instrument that it resembles most, and for which established taxing rules exist.

This raises the main question that remains unanswered, except perhaps, to a limited extent, in Israel. In what category does the S.A.F.E. fit? The possible alternatives include debt, stock, warrants and forward contracts. Below is a short discussion on each of these alternatives.

DEBT?

There is a large body of case law identifying several key factors that point to the status of an instrument as debt, rather than equity, based on common law principles.[3] Those factors include, *inter alia*,

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2 For example, if the parties agree on a 20% discount and the price per share at the closing of the Triggering Event is $10, the price per share offered to the S.A.F.E. investor is only $8. As a result, a S.A.F.E. investor who invested $200,000, and should have received 20,000 shares based on a price of $10, will receive 25,000 shares (200,000 ÷ 8 = 25,000).

3 See, for example, *Indmar Products Co. v. Commr.*, 444 F.3d 771, (6th Cir. 2006); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986), *affg.* T.C. Memo 1985-58; *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972)); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); and *Laidlaw Transp., Inc. v. Commr.*, T.C. Memo 1998-232.

- the borrower's repayment obligations, typically with a schedule of payments;
- a fixed maturity date;[4]
- stated interest payments;
- the borrower's preferred rights on dissolution
- credit worthiness of the borrower, measured for example based on the debt-equity ratio;
- no rights of conversion into equity are granted to the borrower;
- documentation and the title of the instrument refer to a debt instrument; and
- the parties' intent to treat the instrument as debt.

"The S.A.F.E. does not meet the above factors and therefore lacks the essential indicia of a debt."

The weight given to any factor varies from case to case, indicating that the answer depends on all the facts and circumstances that are present.[5]

The S.A.F.E. does not meet the above factors and therefore lacks the essential indicia of a debt. The company is not obligated to repay the S.A.F.E. amount and there is no maturity date. There is also no obligation to pay any interest. The S.A.F.E. holder's rights are usually junior to those of any creditor and the legal documents typically clarify that the parties did not intend to create a debt instrument. Therefore, the common view is that a S.A.F.E. should not be treated as a debt instrument for tax purposes.[6]

Convertible loan agreements ("C.L.E.s") are debt instruments that give the holder the right to convert the debt instrument into an equity security. Despite their hybrid nature, they are typically treated as debt for U.S. tax purposes until converted to stock.[7] It follows that, since a S.A.F.E. should not be treated as debt, a S.A.F.E. should not be treated as a C.L.E. In fact, the S.A.F.E. was originally designed by Y Combinator to avoid having C.L.E. characteristics.[8]

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[4] See *Farley Realty Corp v. Commr.*, 279 F.2d 70 (2nd Cir. 1960): "Numerous cases have held that the absence of a fixed maturity date is a crucial factor weighing against a corporate taxpayer's claim that a debtor-creditor relationship existed between it and its payee." *Laidlaw Transp., Inc. v. Commr., supra, (*citing *Estate of Mixon v. U.S., supra).*

[5] *John Kelley Co. v. Commr.*, 326 U.S. 521 (1946); Notice 94-47, 1994-1 C.B. 357.

[6] See, *e.g.*, Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS,'* Tax Notes, May 7, 2018, p. 831; L.P. Adamo, Tax Treatment of S.A.F.E.s, Lowenstein Sandler Client Alert..

[7] See, for example P.L.R. 201517003, cross-refencing to H.R. Rep. No. 105-220, at 524 (1997): "This appears to indicate a Congressional preference for treating convertible debt instruments as valid debt in most cases." However, where it is substantially certain that the holder will receive stock, the instrument is presumed to be equity and interest deduction will not be allowed. See also Code §163(l). The conversion of the debt into equity is also not a taxable event because it is a mere exercise of rights embedded in the security under its own terms. Treas. Reg. §§1.1272-1(e) and, 1.1275-4(a)(4).

[8] See here.

Interestingly, the I.T.A. did not preclude the possibility of characterizing a S.A.F.E. as a debt instrument in its announcement. The I.T.A. clarified that, unless certain specified conditions are met, a S.A.F.E. may be categorized as debt and the discount given to the investor upon conversion of the S.A.F.E. into stock, may be treated as taxable interest income, similar to the concept of original issue discount ("O.I.D.") under Code §1272.[9] The I.R.S. is not expected to adopt a similar approach because the S.A.F.E. does not meet any of the factors that serve as an indication of debt. Even if S.A.F.E. could be viewed as debt, no taxable O.I.D. would exist under Code §1272 because an option to convert debt into equity is ignored for purposes of determining O.I.D. income.[10]

EQUITY?

Based on the debt vs. equity analysis that has been developed by the courts, an instrument that is disqualified as debt is typically recharacterized as equity. Under certain circumstances, instruments may be classified as equity even if labelled by the parties as debt when the likelihood of conversion is very high at the time of issuance.[11] For example, in one Technical Advice Memorandum ("T.A.M.") published by the I.R.S. discussing subordinated loan agreements,[12] a company issued non-interest-bearing notes with no maturity date. The investor had no right to force any repayment, and his repayment rights on a dissolution of the company were subordinated to the creditors' rights. In addition, the lender was the only shareholder of the company and the company was thinly capitalized. In the circumstances, the notes were found to be equity for income tax purposes. In addition, "deep in the money" stock options have been traditionally treated as equity.[13]

Hybrid Nature

The S.A.F.E. resembles equity in several aspects. Like some of the instruments discussed in the cases mentioned above, a S.A.F.E. is signed with the view that it will be converted into stock. It bears no interest and has no maturity date. The S.A.F.E. investor has no right to force repayment and his repayment rights upon dissolution are junior to the creditors' rights. Lastly, the S.A.F.E. investor is not required to pay any strike price, which causes the conversion option to be viewed as deep in the money.

In addition, a S.A.F.E. investor's gain or loss is subject to the company's success and profits, much like the holder of an equity instrument.[14] If the company's value goes up and it undergoes a successful financing round, the investor will gain significantly on the conversion of the S.A.F.E. by receiving discounted shares. However,

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9 Any S.A.F.E. arrangement that will not meet the conditions outlined by the I.T.A. will be examined and its classification for Israeli tax purpose will be determined based on all facts and circumstances.

10 Treas. Reg. §1.1272-1(e).

11 See, for example, Rev. Rul. 83-98. There, the parties agreed that the debt would be converted into equity unless the stock price dropped by more than 40%. See also Bozkurt and Bauer, A Bridge Between Debt and Equity: Taxation of Bridge Convertibles.

12 T.A.M. 2004180008.

13 Rev. Rul. 82-150.

14 *U.S. v. Title Guarantee & Trust Co.*, 133 F2d 990, 993 (6th Cir. 1943).

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if the company is unsuccessful and fails in raising any funds, the investor might end up losing the investment without receiving any stock or any other compensation.

Based on the above, it is not improbable that a S.A.F.E. will be classified by the I.R.S. as equity (more accurately, preferred stock). Some practitioners have already expressed their views that the S.A.F.E. is a type of equity instrument.[15]

On the other hand, equity generally reflects an ownership interest in a corporation. Some commentators explained that ownership concepts for tax purposes are not coterminous with concepts of legal ownership. Rather, tax ownership is based on the three attributes:

- Legal ownership
- Possession (including the right to use the property or to derive any current income from the property)
- The right to derive any appreciation and to suffer any depreciation in the value of the property[16]

A S.A.F.E. holder does not fully meet any of these attributes. First, the S.A.F.E. investor does not legally own any shares in the company. Secondly, the S.A.F.E. investor has no possession or any right to use the corporation's property (no voting rights) and has no right to derive any current income from the property (no dividend rights). Finally, a S.A.F.E. investor may derive only limited appreciation or depreciation in the value of the company.[17] In comparison, holders of traded options on shares or commodities enjoy the right to appreciation and suffer the burden of losses in value, but are not considered to own the underlying shares or commodities. If such rights and risks were determinative, all equity swaps, options, forward contracts, and other derivatives would effect an immediate transfer of tax ownership because they all shift the risk of appreciation or loss in value.[18]

Again, with reference to the stated position of the I.T.A., a S.A.F.E. is viewed in Israel as a mere upfront payment for future issuance of the company's stock, provided

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[15] In an American Bar Association Section of Taxation letter to the I.R.S. dated June 9, 2023, on identified issues to be addressed in the I.R.S. 2023-2024 priority guidance plan, one commentator asked guidance concerning the classification of a S.A.F.E. as a second class of stock for purposes of Code §1361(b)(1)(D) regarding S-Corporations that are a form of pass-through entities for U.S. individuals.

[16] Dolan, Dabrowski, Massed & Tretiak, U.S. Taxation of International Mergers, Acquisitions, and Joint Ventures (Thomson Reuters/Tax & Accounting, 1995, with updates through May 2023) (online version accessed on Checkpoint (www.checkpoint.riag.com)) para 23.03[1].

[17] If the corporation's value appreciates, the S.A.F.E. investor may benefit from a limited and predetermined discount on issuance of future shares. Similarly, if the value depreciates, the S.A.F.E. investor is not exposed to unlimited risks. In case of dissolution, the S.A.F.E. investor will have priority over the common stockholders. In that respect, see B. Bittker & J.S. Eustice, Federal Income Taxation of Corporations and Shareholders, (Thomson Reuters/Tax & Accounting, 7th ed. 2015 with updates through July 2023) para. 4.05[1][a], explaining that equity is the " * * *unlimited claim to the residual benefits of ownership and an equally unlimited subjection to the burdens thereof."

[18] Dolan, Dabrowski, Tretiak & Massed, *supra*, n.16, para 23.03[1].

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that certain criteria specified in the I.T.A.'s announcement are met. If the I.R.S. were to adopt a similar approach, the S.A.F.E. would be considered an executory contract that is completed only on the passage of the legal title in the shares at the time of closing the transaction.[19] These types of contracts, where the buyer is paying an upfront amount for property to be delivered at a future settlement date, are typically referred to as forward contracts. Forward contracts are discussed in greater detail, below.

Tax Implications

If the S.A.F.E. is treated as stock, no taxable event is expected to be recognized by the investor[20] or the company[21] at the time the S.A.F.E. is signed and funds are advanced to the company. The conversion of the S.A.F.E. into stock might trigger gain unless the conversion meets the requirements of Code §1036 (regarding stock-for-stock exchanges of shares of the same corporation) or Code §368(a)(1)(E) (regarding recapitalizations) and nonrecognition treatment applies.[22]

If the S.A.F.E. is treated as stock, and nonrecognition treatment applies to the conversion of the S.A.F.E. into company stock, the investor's holding period in the stock would relate back to the date the investor purchased the S.A.F.E. This may become relevant in two respects:

- If the investor sells the shares of stock acquired in connection with the conversion of the S.A.F.E., the holding period would relate back to the date the S.A.F.E. transaction was entered. The starting date would not begin with the conversion, and for that reason, favorable tax rates for long-term capital gains could be achieved without having to wait an additional 12 months.[23]
- If the investor seeks to have the stock qualified small business stock ("Q.S.B.S.") allowing an exemption from taxation on gain under Code §1202 when the stock is sold,[24] the Q.S.B.S. must have been held for at least five years prior to the sale. Where the Q.S.B.S. in a corporation is acquired solely

19 In determining whether a sales contract is executory, some courts have focused on whether legal title to the underlying goods passes. (*Commr. v. Segall*, 114 F.2d 706 (6th Cir. 1940). Executory contracts are open transactions that are taxed only upon closing, at the time when an unconditional liability of the buyer is created. See, *Lucas v. North Tex. Lumber*, 281U.S. 11 (1930).

20 At the time the investment is made, no realization is expected on the part of the investor.

21 Code §1032(a).

22 For more detail on the proposition that conversion of a S.A.F.E. into stock may be treated as recapitalization under Code §368(a)(1)(E), see Damsky, *Pigeon-holing the 'S.A.F.E.' and 'KISS,' supra* note 6., at page 833.

23 The tax rate that applies to long-term capital gains is 20%. See Code §1(h)(1)(D). In contrast, short term capital gains are subject to the same tax rates that apply to ordinary income and may reach 37%. In both cases, Net Investment Income Tax (N.I.I.T.") of 3.8% would be imposed. See Code §1411.

24 Code section 1202 provides for a tax exemption on a sale of certain corporate stock received in an original issuance from a qualified small business. The exemption is capped at the greater of (i) gain not exceeding $10 million and (ii) 10 times the aggregate adjusted bases of Q.S.B.S. issued by such corporation and disposed of by the taxpayer during the taxable year. A business is considered "small" if the gross assets of such corporation do not exceed $50 million any time prior to or immediately after the issuance of stock.

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through the conversion of other stock in the same corporation, the holding period for the other stock is taken into account in determining the start of the five-year holding period.[25] This is commonly known as "tacking" of holding periods.

A WARRANT?

Very broadly, a warrant is a noncompensatory option, which is an option issued not in consideration for the performance of services. A S.A.F.E. is similar to warrant, except that a S.A.F.E. does not include a price per share, it has no strike price, and it does not provide an option on whether to exercise or not.

In light of these differences, it is unlikely that the S.A.F.E. will be categorized as an option, mostly because the I.R.S. and the courts have narrowly construed the meaning of an option for tax purposes. Most significantly, where the investor's ability to exercise an option is contingent on the occurrence of events outside the investor's control, an option status is typically not available.[26] Since a S.A.F.E. is contingent on the occurrence of a future financing event, it will not be surprising if the I.R.S. position is that the S.A.F.E. not treated as a warrant. Moreover, a S.A.F.E. does not require payment of an exercise price, which means that it is deep in the money. There is authority that deep in the money options should be treated as either stock[27] or a forward contact.[28]

Tax Implications of a Warrant

If the S.A.F.E. is categorized as a warrant, the company issuing the warrant will have no taxable income on the receipt of the initial payment, which will be treated as an option premium[29] or prepaid exercise price.[30] Issuance of the stock upon conversion of the S.A.F.E. should also not be a taxable event.[31]

The investor's holding period in the stock is expected to start on the date of exercise. The shares of stock must be held for 12 months and one day in order for an investor to benefit from long-term capital gains treatment when the underlying stock is sold.[32] This is also true for purposes of the Q.S.B.S. exemption.[33] As a result, the treatment of a S.A.F.E. as a warrant may be significantly less favorable to the treatment as shares, which was discussed above.

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[25] Code §1202(f).

[26] See, Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS'*, Tax Notes, *supra* note 6, and the cross-references made there to Rev. Rul. 68-801; P.L.R. 8936016; M.A. Stevens, The Tax Treatment of Contingent Options, Tax Notes, January 27, 2004; *Saviano v. Commr.*, 80 T.C. 955 (1983).

[27] Rev. Rul. 82-150; P.L.R. 9747021.

[28] Rev. Rul. 80-238; *Progressive Corp. and Subsidiaries v. U.S.*, 970 F.2d 188 (1992); FSA 956.

[29] *Virgina Iron Coal & Coke Co. v. Commr.*, 37 B.T.A. 195 (1938).

[30] Code §1032.

[31] Rev. Rul. 78-182.

[32] Rev. Rul. 88-31; *Helvering v. San Joaquin Fruit & Investment Co.*, 297 U.S. 496 (1936).

[33] H.R. Rep. No. 103-111, 1993-3 CB 163 (July 1993).

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A FORWARD CONTRACT?

Forward Contract

The Code defines a forward contract as a "contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price."[34] In simple words, a forward contract is typically an agreement to sell agreed property for an agreed price at an agreed date in the future.[35]

The S.A.F.E. does not fit into the foregoing definition of a forward contract because neither requirement is met. The number of shares to be issued is unknown as is the price and the date.

Prepaid Variable Forward Contract

A Prepaid Variable Forward Contract ("P.V.F.C.") is a special type of a forward contract, under which the investor pays a purchase price to the seller at the time the agreement is entered into, in exchange for the seller's obligation to deliver a variable quantity of stock at the closing of the contract.

"There is no bright line demarcation between a P.V.F.C. and a stock purchase agreement."

A P.V.F.C. is an attractive arrangement because it allows stock owners to manage equity risk by providing protection against price decreases and get up-front liquidity with no current tax liability, while also allowing them to profit to some extent from price increases.

The S.A.F.E. resembles the P.V.F.C. in that in both arrangements, the investor is making a prepayment at the signing in exchange for a variable amount of shares at the closing. The main difference between the P.V.F.C. and the S.A.F.E. is that a P.V.F.C. typically has an agreed-upon settlement date, whereas the settlement date for the S.A.F.E. will occur only upon a future financing event. Nevertheless, such a distinction should not preclude a S.A.F.E from being treated as a type of P.V.F.C., especially in light of a recent Tax Court case that suggests that an uncertain settlement date might not invalidate forward contract status. In *McKelvey v. Commr.,* [36] the court held that an amendment of the delivery date under the P.V.F.C. was not a taxable event. In comparison, the I.R.S. has treated a significant option extension as a taxable event.[37]

There is no bright line demarcation between a P.V.F.C. and a stock purchase agreement. In Rev. Rul. 2003-7, the I.R.S. ruled that an agreement made by a shareholder to deliver a variable amount of shares on an agreed-upon future date, will be respected as a V.P.F.C. rather than a stock sale where the execution of the agreement does not effect a sale of the underlying shares. The shareholder-seller pledged the underlying shares to the buyer by placing them with a third-party trustee, but the shareholder retained the right to vote the shares, receive dividends, and substitute cash or other shares for the pledged shares on the delivery date. The I.R.S. further noted that the result might have been different had greater limitations been placed on the rights retained by the shareholder in the pledged shares.

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34 Code §1259.

35 See, the Joint Committee on Taxation, *Present Law and Analysis Relating to the Tax Treatment of Derivatives* (JCX-21-08), Mar. 4, 2008, at 6-7.

36 148 T.C. 13 (2017).

37 T.A.M. 9129002.

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A different conclusion was reached in *Anschutz Co. v. Commr.*[38] There, the Court found that a prepaid forward contract that was accompanied by share-lending agreements and a master stock purchase agreement, resulted in a current taxable sale of the underlying shares because the overall effect of the transactions amounted to a sale of the pledged shares. On the facts presented, the benefits and burdens of ownership were transferred when the P.V.F.C. was agreed to. The decision was based on the answers to the following questions:

- **Did legal title pass?** Yes. No restrictions were placed on the counterparty's rights to immediately sell, assign, or otherwise transfer the shares.
- **How did the parties treat the transaction?** While the agreement treated the agreement as an executory contract to be performed at a later date, it was understood that the counterparty would sell the pledged shares to pay off amounts that were previously borrowed in order to fund amounts payable to the taxpayer.
- **Did the purchaser acquire equity in the property?** Yes. The forward seller in the agreement effectively exchanged its ownership rights in the pledged stock for an upfront cash payment equal to 75% of the pledged stock's then-existing market value. It retained the potential of benefitting to a limited degree if the pledged stock increased in value over the life of the transactions. It eliminated all risk of loss of value in the pledged property. The counterparty obtained the right to use the pledged stock as it saw fit, and used most of the pledged stock to repay its borrowings from pre-transaction short sales. In this manner, the counterparty acquired an equity interest in the pledged shares.
- **Did the contract create a present obligation on the seller to execute and deliver shares and a present obligation on the purchaser to make payments?** Yes. Under the terms of the agreement, the forward seller had an obligation to give the pledged shares to the counterparty, which had an obligation to pay the forward seller the requisite prepaid lending fee. Considered together, these obligations bore substantial similarity to a sale of the pledged stock.
- **Was the right of possession vested in the purchaser?** Yes. Although the forward seller had the right to recall the property lent to the counterparty, the counterparty retained possession of the pledged shares or the proceeds of sales of those shares.
- **Which party bore the risk of loss?** The forward seller was protected against a fall in the price of the property.
- **Which party had the opportunity for gain?** The forward seller capped its opportunity for gain at 50%, which ultimately translated into relinquishment of the next 20% to 40% of the appreciation over the following 10 years.
- **Which party held the voting rights?** The counterparty retained the right to vote the shares.
- **Which party had the right to receive dividends?** Although the forward seller retained a modified right to dividends from the pledged shares, restrictions

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[38] 664 F.3d 313, (10th Cir. 2011), affg., 135 T.C. 78 (2010).

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were placed on that right to protect the counterparty if the value of the pledged shares dropped below a specified level at maturity. No dividends would accrue to the forward seller until the share value was known at maturity.

Application to a S.A.F.E.

Rev. Rul. 2003-7 and *Anschutz Co*. establish the parameters by which a transaction results in (i) a prepaid variable forward contract or (ii) an immediate sale. In the former, no immediate sale of the shares was deemed to occur because of the limited rights enjoyed on a current basis by the forward seller. In the latter, the majority of the benefits and burdens of ownership were transferred to the counterparty immediately.

A typical S.A.F.E. would resemble the P.V.F.C. discussed in Revenue Ruling 2003-7 more than the agreement in *Anschutz Co*. Under a typical S.A.F.E., the investor receives no legal title in the underlying stock, no voting rights, and no rights for dividends. On the other hand, the investor would have an interest in appreciation of company shares, but those shares remain unissued until the safe is converted into shares. In the circumstances, it appears more likely than not correct to conclude that that the S.A.F.E. will be treated as a P.V.F.C. for tax purposes.

TAX IMPLICATIONS OF A PREPAID VARIABLE FORWARD CONTRACT

The V.P.F.C. characterization is generally desirable for the parties because the transaction is not considered closed until the property is delivered.[39] Accordingly, similar to the tax treatment of an option,[40] the company has no taxable income on the receipt of the investor's funds. Such payment is treated as an advance deposit, without immediate tax consequences. In addition, when the SAFE is converted into stock of the company, there is no taxable event for the company[41] and for the investor.[42]

If the S.A.F.E. is viewed as a P.V.F.C., the holding period in the underlying stock will only start upon the conversion of the S.A.F.E. into stock.[43] As a result, the holding period in the S.A.F.E. prior to its conversion into stock will not be taken into account,

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39 *Lucas v. North Tex. Lumber*, 281U.S. 11 (1930); *Virginia Iron Coal & Coke Co. v. Commr.*, 37 B.T.A. 195 (1938).

40 Rev. Rul. 78-182; Rev. Rul. 58-234.

41 Code §1032.

42 Settlement of a forward contract generally should be treated for tax purposes in the same manner as a sale of the underlying assets. C.C.A. 201025047, P.L.R. 200450016, P.L.R. 200518062. A sale of shares by the issuing company to a shareholder involves not realization for the buyer and thus it is generally not a taxable event for the buyer. In addition, it is not a taxable event for the issuing company. See, section 1032.

43 L.P. Adamo, *Tax Treatment of S.A.F.E.s*, *supra*, note 6; E. Zimmerman and B.A. Silikovitz "Gimme Shelter: VC-Backed M&A Tax Strategies for QSBS/1202" *Forbes* (July 19, 2016). The Supreme Court has held that when a prepaid forward contract remains executory (that is, not yet fully performed or carried out), the receipt of the prepayment is not taxable income to the recipient until the contract is no longer executory. (*Lucas v. North Texas Lumber Co.,* 281 U.S. 11 (1930).

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and a sale of such stock within one year from the date of issuance, will trigger short-term capital gain treatment and higher tax rates.[44] Similarly, the holding period in the S.A.F.E. will also not be taken into account for purposes of the five-year holding requirement that must be met to trigger the Q.S.B.S. exemption.

NONE OF THE ABOVE – SIMPLY A NEW TYPE OF SECURITY?

A S.A.F.E. is close in nature to stock, warrants, and prepaid variable forward contracts, but it does not really fall within the four walls of any of those categories. Instead of trying to fit the S.A.F.E. into one of the existing categories, perhaps it is more accurate to treat a S.A.F.E. as a security that differs from a stock, a note, a warrant, and a forward contract.

Under Tres, Reg. §1.354-1(e), the term "security" includes rights to acquire stock and such general definition seem to include a S.A.F.E.

"... the term 'security' includes rights to acquire stock and such general definition seem to include a S.A.F.E."

If a S.A.F.E. is considered a new type of security, its issuance should not give rise to any taxable event, for the same reasons that issuance of stock, a warrant or a P.V.F.C. does not create taxable income for any of the parties.[45] Further, the conversion of the S.A.F.E. into stock should not be a taxable event if it is treated as a recapitalization under Code §368(A)(1)(E).[46]

As to the holding period, it makes sense that a S.A.F.E. security will have its own holding period and the underlying stock, being a separate asset, will have its own holding period as well. However, as explained above, some commentators[47] suggest that stock received in exchange for S.A.F.E. may benefit form a tacked holding period that includes the holding period in the S.A.F.E. itself. This argument is based on the premise that the conversion S.A.F.E. to stock should be treated as a section 368(A)(1)(E) recapitalization.[48] The fact that no additional investment is made, further supports the proposition that a tacked holding period should apply.[49]

The matter has not been resolved as of the date of publication of this article. It likely will not be resolved finally until all of the following events occur:

- A stout-hearted investor tacks the holding period of the S.A.F.E. onto the holding period of shares.
- The investor sells those shares within the following 12 months.

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[44] The ordinary income tax rates of up to 37%, instead of lower tax rates of 20%. Whichever rate applies, the gain will be subject to an addition 3.8% N.I.I.T.

[45] Issuance of such securities involves no realization for any of the parties.

[46] For further discussion on this point, see Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS'*, *supra*, note 6, at page 833. Under this approach, the S.A.F.E. document should be viewed as the plan of reorganization.

[47] Damsky, *Pigeonholing the 'S.A.F.E.' and 'KISS'*, *supra*, note 6, at page 833.

[48] In general, stock received in exchange for a security in a section 368(A)(1)(E) recapitalization entitle the holder to benefit from a tacked holding period. The S.A.F.E. is a security.

[49] Rev. Rul. 77-238.

- The investor claims long-term capital gain treatment based on the tacking of the holding period for the S.A.F.E. to the holding period of the shares.
- The extended holding period is challenged by the I.R.S.
- A final decision is rendered by a court.
- Congress does not amend the law to legislatively reverse the court decision on a prospective basis.

CONCLUSION

In the absence of specific guidance from the I.R.S. or the courts as to the proper characterization of S.A.F.E. for U.S. tax purposes, S.A.F.E. is expected to be treated as the instrument it resembles most, for which existing taking rules apply.

Characterizing the S.A.F.E. as an equity grant would generally be most desirable for the S.A.F.E. investor. Not only there will be no taxable income upon issuance of the S.A.F.E. or its conversion to stock, but also the holding period in the stock will relate back to the date the investor purchased the S.A.F.E. The longer the holding period is, the higher the investor's chances to benefit from reduced tax rates[50] or even an exemption[51] in case of a suture sale of the stock.

The second-best category, at least from the investor's point of view, is the P.V.F.C. Most commentators mentioned the V.P.F.C. characterization as the most probable one to be adopted by the I.R.S. in the future. If the S.A.F.E. will be viewed as a P.V.F.C., no income will be recognized on the issuance of the S.A.F.E. or its conversion. However, the holding period in the underlying stock will only start upon the conversion of the S.A.F.E. into stock.

In light of the above, practitioners can and should design the terms of a S.A.F.E. to fit better a plan to raise equity than a plan to borrow money. One commentator suggests that start-up entities seeking funding for operations through the issuance of a S.A.F.E., should take steps emphasizing the link between the funding through the S.A.F.E. and the next round of equity funding.[52]

Earlier this year, the I.R.S. invited the public to submit recommendations for items to be included on the 2023-2024 Priority Guidance Plan.[53] The American Institute of Certified Public Accounts responded to the invitation with 35 pages of suggested items that should be addressed. Item no. 11 that appears on page 2 of the

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[50] Long term capital gain rates are subject to a reduced rate of 20% and an additional Net Investments Income Tax of 3.8%.

[51] Under Code §1202, which allows for an exemption on the sales of a "qualified small business stock," under certain circumstances outlined in the Code and regulations.

[52] See, Adamo, *Tax Treatment of S.A.F.E.s*, *supra*, note 6. The commentator suggests that the more likely it is that the S.A.F.E. will convert into shares of stock based on the circumstances surrounding the S.A.F.E. issuance (for example if, at the time the S.A.F.E. is issued, an equity financing is substantially certain to occur), the stronger the support for treating the S.A.F.E. as an equity grant.

[53] The I.R.S. uses the Priority Guidance Plan to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices, and other published administrative guidanc

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submission is a request for guidance clarifying the tax characterization of Simple Agreement for Future Equity as a prepaid forward contract, a warrant, or equity.

While the I.R.S. may not address the characterization of S.A.F.E. in the 2023-2024 Priority Guidance Plan, sooner or later light will be shed on the characterization of S.A.F.E. for U.S. tax purposes, and it will then be safer to use a S.A.F.E.

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