SAFEs and the Section 1202 Exclusion

One of the most important tax factors that founders and start-up investors should consider upon exit from their investment is whether their capital gain may be eligible to be excluded (partially or in full) from capital gain treatment under the "qualified small business stock" (QSBS) tax exemption. The QSBS tax exemption under Internal Revenue Code Section 1202 allows non-corporate investors to exclude potentially up to 100% of the federal capital gains tax incurred when selling their stake in the start-up or small business. As many investors now receive their interests in start-ups through a "simple agreement for future equity" (SAFE), questions have arisen about if, and more importantly when, SAFE investments qualify for the QSBS tax exemption. This article examines key issues surrounding the QSBS tax exemption and SAFEs.

QSBS Requirements

The QSBS tax exemption applies to the sale of certain corporate stock received in an original issuance from a qualified small business and allows the exclusion of up to $10 million (or ten times the taxpayer's original tax basis in the stock, if greater) in capital gain from income. A discussion of the rules for eligibility can be found here. One of the key requirements is that the taxpayer must have held stock in the C Corporation for at least five years prior to the sale of stock. Only the issuance of "stock" triggers the running of the QSBS exemption's five-year holding period for an investor. Thus, when an investor provides funding to a company through a SAFE, it is critical to determine when the holding period starts for Section 1202 purposes. Is an executed SAFE "stock" for these purposes?

The Status of SAFEs

In a SAFE, an investor – in exchange for a current transfer of cash to the start-up – receives the rights to future equity in the company upon the occurrence of contractually agreed-upon liquidity events, such as the sale of preferred shares of the company. Often SAFEs include valuation caps and/or discounts, which allow holders of a SAFE to convert into equity at a preferential price per share.

A SAFE is a relatively recent instrument released in 2013 by the startup accelerator, Y Combinator, as an alternative to the issuance of convertible debt. Unlike convertible debt, the holder of a SAFE does not earn interest nor is there a maturity date associated with a SAFE. Further, SAFEs do not provide a current equity stake in the company nor do they confer other common equity rights such as voting or transferability.

This hybrid nature makes SAFEs difficult to characterize for tax purposes. If a SAFE is considered "stock" for Section 1202 purposes, the investor's five-year required holding period will start when the investment is made. If the SAFE is not considered "stock," this five-year holding period will not start until the actual conversion into equity. Given that the five-year requirement is an absolute necessity to receive the QSBS tax exemption and standard investment time horizons, the characterization is likely to be a key factor as to whether an investor receives the exemption.

Where Do We Stand?

The IRS has yet to provide any guidance on whether a SAFE will be considered "stock" for Section 1202 purposes. Further, SAFE instruments have undergone a number of changes in their terms since their introduction. Thus, the determination of whether one SAFE is treated as equity might not apply for all SAFEs.

There is certainly a push for SAFEs to be treated as equity on the date of issuance. In the latest version of the model SAFE instrument published on Y Combinator's website, section 5(g) of the template reads:

*"The parties acknowledge and agree that for United States federal and state income tax purposes this Safe is, and at all times has been, intended to be characterized as stock, and more particularly as common stock for purposes of Sections 304, 305, 306, 354, 368, 1036 and **1202** of the Internal Revenue Code of 1986, as amended."*

Although this language should provide comfort to investors looking to characterize their investment in a SAFE as equity for tax purposes, this language would not be binding upon the IRS.

A potential concern for investors is that SAFEs are similar in nature to variable prepaid forward contracts since an investor is providing cash in exchange for an amount of shares at a future date, the amount being dependent on future circumstances. The IRS has addressed the issue of variable prepaid forward contracts in Revenue Ruling 2003-7, concluding that if certain criteria were satisfied, the property (i.e., the shares of stock) will not be considered "sold" until the date the shares are delivered. If a SAFE is treated as a variable prepaid forward contract per Revenue Ruling 2003-7, the investor's purchase of the SAFE would be seen as an advance deposit without any immediate tax consequences. Thus, it would not be until the stock is received pursuant to the SAFE that the holding period of the investor would begin, delaying the start of the five-year holding period for Section 1202 purposes.

Furthermore, an additional requirement for a corporation to be considered a qualified small business for Section 1202 purposes is that the aggregate gross assets of such corporation do not exceed $50 million any time prior to or immediately after the issuance of stock. If a SAFE is considered "stock" for Section 1202 purposes, the measurement date of aggregate of gross assets would occur when the investor purchases the SAFE. This earlier measurement date is more beneficial to an investor than if the corporation's aggregate gross assets are measured later when SAFE converts into equity, especially since the hope is that the start-up will have grown when the conversion occurs.

Contact Us

As noted, the terms of SAFEs differ and could be a key factor in determining their tax treatment. PKF O'Connor Davies has worked with SAFE investors across a number of industries and can provide guidance on the tax treatment of SAFEs and other start-up investment instruments. For more information, please contact your client engagement partner or:

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