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In this article, Damsky explores the potential tax characterizations of a financial instrument commonly referred to as a simple agreement for future equity (SAFE) or keep it simple security (KISS).

I. Introduction

Early round fundraising that would have traditionally been structured with a convertible note is now often conducted with a simple agreement for future equity (SAFE) or keep it simple security (KISS). The SAFE and KISS are used for their business-level simplicity and reduced transaction costs. However, the proper tax treatment of these instruments is unclear. The resultant tax confusion has left interested start-ups and their investors having to decide whether to pay for costly tax advice or bear tax legal uncertainty. This article aims to help investors and their advisers determine the proper tax treatment of the SAFE and the KISS.

When tasked to characterize a SAFE,[1] tax advisers often respond that the instrument could be treated as one of a variety of tax designations, in particular (1) an option/warrant, (2) a forward contract, (3) equity, or (4) debt.[2] Because SAFEs are often issued by cash-strapped start-ups, identifying this level of analytical complexity is usually the end of the tax review because of budget constraints. To help fill that gap, this article attempts to assist taxpayers and their advisers in selecting between the foregoing characterizations, focusing on the legal strength of the designations as well as the desirability to taxpayers of each.[3]

II. Description of SAFE and KISS Arrangements

While this article is targeted to an audience with a basic familiarity with SAFEs, the following summarizes the key terms. SAFEs provide for an issuer to receive cash from an investor upon entering into the SAFE contract. The SAFE then essentially sits dormant, not accruing interest or

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[1] For simplicity, this article refers solely to the SAFE, although the discussion applies equally to the KISS except when differences between the two instruments are noted.

[2] To strive for usefulness to taxpayers, this article does not explore more complicated characterizations of SAFEs as combinations of financial instruments. Additionally, to keep the analysis to a reasonable scope, the issuer throughout is assumed to be an entity treated as a C corporation for tax purposes.

[3] This article assumes that fitting SAFEs into a particular legal bucket is the proper method of investigation; however, that idea is not free from doubt. For instance, when the IRS solicited comments on the tax treatment of credit default swaps, it stated that some commentators suggested that credit default swaps not be categorized by analogy to other instruments; rather, each of their constituent steps should just be assigned a proper tax result. *See* Notice 2004-52, 2004-2 C.B. 168. A somewhat similar analysis has been set forth for SAFEs. *See* Nancy B. Nichols and Blaise M. Sonnier, "Regulation Crowdfunding and Investor Taxation," *Tax Notes*, Mar. 6, 2017, p. 1237. However, from a practical point of view, if a taxpayer seeks to defend a tax position taken regarding SAFEs, the taxpayer may have no recourse but to do so by appeal to analogy to other instruments. *See, e.g.*, Rev. Rul. 2003-97, 2003-2 C.B. 380 ("In deciding among multiple potential characterizations, the tax law seeks to find the best match between the bundle of rights and obligations and one or more categories of widely recognized instruments.").

preferred return, until the issuer raises a preferred stock round. At the time of a preferred stock round, the SAFE mandatorily converts into preferred stock at the round's price, but generally at a discount — either an explicit discount or an effective discount through a valuation cap.[4] SAFEs also provide for payment to the investor in a sale of the issuer before conversion and participate before common stockholders in a dissolution.

Off-the-shelf iterations of the SAFE include forms with a discount, a valuation cap, and both a discount and a valuation cap. The KISS comes in an equity version and a debt version. The equity version has a discount and cap. The debt version of the KISS is distinct from the rest of the models in that it actually accrues interest before conversion and has a maturity date when cash and principal may be due.

III. Analysis of Possible Characterizations

A. Warrant

1. Strength of the characterization.

In general, a warrant is a noncompensatory option. In exchange for payment of an upfront price, a warrant gives the holder a right to purchase a fixed amount of property in the future upon the payment of an exercise price. A SAFE differs from a conventional warrant arrangement in the following ways: (1) the upfront payment and the exercise price are folded into one single prepayment that is tendered upfront; (2) the to-be-delivered property is variable (because the amount of preferred stock the SAFE will purchase will depend on the price set in the preferred round);[5] (3) the exercise period is indefinite; (4) exercisability is contingent (because conversion/exercise occurs only upon a preferred stock financing); (5) the underlying property to be issued upon exercise — that is, the preferred stock — does not yet exist (and may never exist); and (6) there is essentially no optionality to the holder regarding ultimate receipt of the property at the time of exercise. Based on these differences, the analogue of a warrant/option is strained for a SAFE.

Given these disparities, it is difficult to arrive at a legal conclusion that a SAFE can be treated as an option because the IRS and the courts have narrowly construed the option designation. Primarily, the IRS has ruled that contingencies in the ability of the holder to exercise an option (other than the contingency of the passage of time[6]) have been found to invalidate option status — especially when those contingencies are under the control of the issuer.[7] Courts have reached similar conclusions, finding, for instance, that a purported option was merely a right of first refusal when the right to exercise depended on the business decisions of the issuer and the holder had no right to compel the issuer to make those decisions.[8] Based on these precedents, and given in particular that the exercise of SAFEs is contingent on the occurrence of events outside the holder's control, it seems that legal classification as an option/warrant would be difficult.[9]

2. Desirability to taxpayers of the characterization.

However, if the taxpayer can see the way to warrant treatment, the basic tax ramifications are generally desirable. There would be no tax to the issuer on receipt of the upfront payment if it's characterized as an option premium.[10] There would also likely be no gain to the issuer on any upfront payment characterized as a prepaid exercise price.[11] The delivery of preferred stock on exercise would be tax free to the issuer and

[4] A valuation cap provides that if the pre-money valuation set by the preferred stock round is higher than the valuation cap amount, the SAFEs will convert at the lower price set by the cap.

[5] In a SAFE with a valuation cap, the price is fixed after the company's value exceeds the cap.

[6] *See* Rev. Rul. 89-64, 1989-1 C.B. 91.

[7] *See, e.g.*, Rev. Rul. 68-601, 1968-2 C.B. 124; Matthew A. Stevens, "The Tax Treatment of Contingent Options," *Tax Notes*, Jan. 27, 2004, p. 525; *see also* LTR 8936016 (the IRS declining to find option treatment when a warrant was exercisable only if the issuer issued additional common stock before expiration of the warrant).

[8] *See Saviano v. Commissioner*, 80 T.C. 955 (1983).

[9] Another problem with warrant characterization is that if the instrument is a warrant, it is a warrant that is maximally deep in the money because there is no exercise price at all. There is authority that deep-in-the-money options should be treated as equity for tax purposes. Rev. Rul. 82-150, 1982-2 C.B. 110; LTR 9747021. There is also authority that writing a deep-in-the-money call is in substance a contractual obligation to sell — which would suggest forward contract treatment. Rev. Rul. 80-238, 1980-2 C.B. 96; *Progressive Corp. and Subsidiaries v. United States*, 970 F.2d 188 (1992); FSA 956 (1992).

[10] *See Virginia Iron Coal & Coke Co. v. Commissioner*, 37 BTA 195 (1938).

[11] *See* section 1032.

investor.[12] However, complexity arises under the option characterization regarding whether the taxpayer would be able to tack the holding period of the SAFE to the holding period of the preferred stock received on conversion of the SAFE.

This complexity arises because of two competing legal frameworks for the tax treatment of a conversion of an option into stock of the issuer. On one hand, in *San Joaquin Fruit*, the Supreme Court broadly stated that the holding period for stock received upon the exercise of an option begins on the date of exercise.[13] The IRS has taken the same position.[14]

On the other hand, it's clear that stock received in exchange for a security in a section 368(a)(1)(E) recapitalization will enjoy a tacked holding period.[15] Thus, if the SAFE-as-a-warrant would be considered a security, and if the exchange of the SAFEs for preferred stock would be considered a recapitalization, the taxpayer may be able to get a tacked holding period on conversion of a SAFE, despite *San Joaquin Fruit*.[16]

Reg. section 1.354-1(e) provides that the term "security" includes "rights to acquire stock," a concept that according to the legislative history specifically meant to capture warrants.[17] Thus, it should be clear that a warrant is a security for these purposes. However, a more difficult question is whether the conversion of the SAFE to preferred stock would qualify as a recapitalization. Beyond the fact that a recapitalization is a "reshuffling of a capital structure within the framework of an existing corporation,"[18] the definition is unclear. Taxpayers can at least rely on the fact that the IRS has ruled that a conversion by the terms of an instrument does not automatically disqualify the conversion from being treated as a recapitalization.[19] Also, the fact that no additional cash payment is made at the time of conversion may suggest that a tacked holding period is appropriate.[20]

However, in total, it is unclear whether the exercise/conversion of a SAFE into preferred stock should be viewed as a mere exercise of the warrant — with no tacked holding period — or as tax-free recapitalization of the warrant into preferred stock, with a tacked holding period.

Taxpayers wishing to embrace an option characterization may want to help themselves by editing the SAFE's documents to make clear that the conversion is intended to be a recapitalization into preferred stock and the transaction is intended to be governed by section 368(a)(1)(E).[21] However, even if they do so, taxpayers will ultimately face uncertainty regarding a tacked holding period under option treatment.

There is a separate holding period problem for options under the legislative history to section 1202, which makes clear that stock received from exercise of warrants will start its qualified small business stock (QSBS) holding period at the time of conversion.[22] So even if the holding period tacks for general purposes, taxpayers are still starting the five-year QSBS clock only on conversion. This is likely a significant detriment to option treatment.

B. Forward Contract

1. Strength of the characterization.

SAFEs also resemble a financial instrument called a forward contract. A forward contract is generally a contract between two parties to exchange property at a fixed date and at a fixed

[12] *See id.*; Rev. Rul. 72-182, 1978-1 C.B. 265.

[13] *See Helvering v. San Joaquin Fruit & Investment Co.*, 297 U.S. 496 (1936).

[14] *See, e.g.*, Rev. Rul. 88-31, 1988-1 C.B. 302.

[15] *See* section 1223(1). Taxpayers may worry that section 1223(5) would prohibit a tacked holding period in any case; however, there is a strong argument that section 1223(5) should apply only to stock rights received in an issuer distribution. *See Weir v. Commissioner*, 10 T.C. 996, *aff'd*, 173 F.2d 222 (3d Cir. 1949).

[16] Commentators have discussed this tension. *See* Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions & Buyouts*, para. 604.1.2 (2014); *see, e.g.*, "Wheat, an Analysis of the New Regulations on Exchanges of Warrants in Tax-Free Reorganizations," 25 *J. Corp. Tax'n* 107 (Summer 1998).

[17] *See* T.D. 8752.

[18] *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942).

[19] *See* Rev. Rul. 77-238, 1977-2 C.B. 115; GCM 36974 (which appears to be guidance on the matter ruled on in Rev. Rul. 77-238).

[20] The concept of tacking a holding period when no fresh money is invested is used in some securities law matters. It is notable that in *San Joaquin Fruit* and Rev. Rul. 69-93, 1969-1 C.B. 139, in which there is no holding period tacking, the taxpayer made an additional payment on exercise. In Rev. Rul. 77-238, in which there was a tacked holding period, the taxpayer did not make an additional payment on exercise.

[21] The SAFE provides that on the conversion date the company will issue the preferred stock; the KISS provides that it will be automatically converted. Cautious taxpayers may also want to clarify that the SAFE instrument itself, or another document, will constitute a "plan of reorganization," although the IRS has appeared to be willing to read this into the documents. *See* Rev. Rul. 77-238, 1977-2 C.B. 115.

[22] *See* H.R. Rep. No. 103-111, 1993-3 C.B. 163 (July 1993).

price in the future.[23] SAFEs differ from conventional forward contracts in the following ways: (1) the forward price is prepaid because the investor pays the entire purchase price upfront; (2) the to-be-delivered property is variable (because the amount of preferred stock the SAFE will purchase will depend on the price set in the preferred round); (3) the forward does not have a date certain for delivery; and (4) the property to be delivered on settlement does not yet exist (and may never exist). Based on these differences, a forward contract characterization for SAFEs is plausible and likely stronger than the option characterization because the forward contract embraces a fundamental feature of the SAFE of nonoptionality of ultimate delivery of the underlying property.

Also, unlike with options, case law and IRS authorities on forward contracts have been much more liberal in finding that nuanced economic arrangements should still be characterized as forward contracts for tax purposes. For instance, variable prepaid forward contracts (VPFCs) are common and are uniformly regarded as forward contracts for tax purposes.[24] Illustratively, a recent Tax Court case took an expansive view of a forward contract by holding that an amendment of the delivery date under a VPFC was not a taxable event, suggesting that an uncertain delivery date *ab initio* (as with a SAFE) would not invalidate forward contract status.[25] Based on the broad view of applicable authorities, it is not implausible that the courts or the IRS would agree to treat SAFEs as forward contracts.

2. Desirability to taxpayers of the characterization.

The question to the taxpayer then is whether forward contract designation is desirable. The basic tax consequences of a forward contract categorization would be similar to those of a warrant: The issuer won't have any gain on the initial receipt of funds, and neither the issuer nor the investor will have any tax on the delivery of the preferred stock.[26]

But on the other hand, forward contract treatment suffers from the same uncertainty as warrants regarding whether the preferred equity received upon conversion of a SAFE will enjoy a tacked holding period. Again, the problem is that if the preferred stock is delivered simply because the forward contract is exercised, the holding period does not tack under the rationale of *San Joaquin Fruit*.[27] But if the taxpayer can successfully argue that the SAFE was exchanged for preferred stock in a section 368(a)(1)(E) recapitalization, the holding period will tack.

To be able to reach the latter result, the SAFE-as-forward-contract must again be a security. Reg. section 1.354-1(e) does not explicitly address forward contracts. However, the term of art in reg. section 1.354-1(e) is a "right to acquire stock." The term "right to acquire stock" has been broadly construed,[28] and by its literal meaning would seem to squarely cover a forward contract issued by a company to buy its own stock. Therefore, the strength of the tacked holding period argument for forward contracts would likely be as potent as it is for warrants. The same QSBS issue discussed above would apply to a forward contract.[29] In total, the forward contract designation is likely a stronger legal conclusion for taxpayers, but still

[23] Section 1259, concerning constructive sales of financial positions, defines the term "forward contract" as a contract to deliver a substantially fixed amount of property for a substantially fixed price. *See* section 1259(d)(1).

[24] *See, e.g.*, Rev. Rul. 2003-7, 2003-1 C.B. 363.

[25] *See McKelvey v. Commissioner*, 148 T.C. 13 (2017) ("The rationale for affording open transaction treatment to VPFCs is the existence of uncertainty regarding the property to be delivered at settlement. . . . By only extending the settlement and averaging dates, the extensions did not clarify the uncertainty of which property decedent would ultimately deliver to settle the contracts."). However, the IRS has treated a significant option extension as a taxable event. *See* LTR 9129002. It's odd that the *McKelvey* court based its decision on the applicability of the open transaction doctrine when options are also taxed on the open transaction doctrine yet their designation has been narrowly construed.

[26] *See* LTR 200450016 (applying section 1032 to delivery of stock under forward contract).

[27] *San Joaquin Fruit*, 297 U.S. 496.

[28] REG-133673-15 ("The term right to acquire stock means any right to acquire stock, whether pursuant to a convertible instrument (such as a debt instrument that is convertible into shares of stock), a warrant, subscription right, or stock right issued by the corporation that issued or will issue the underlying stock, or any other right to acquire stock of the corporation issuing such right (whether settled in stock or in cash).").

[29] The QSBS statute and legislative history don't mention forward contracts. That said, it seems difficult for taxpayers to make an argument that for QSBS purposes, the holding period for the SAFEs would tack to the holding period of the preferred stock received.

leaves legal uncertainty regarding tacking of the holding period.

C. Equity

1. Strength of the characterization.

Equity has been called an "unlimited claim to the residual benefits of ownership and an equally unlimited subjection to the burdens thereof."[30] Generally, equity treatment is analyzed in juxtaposition to debt treatment, as often evaluated by a checklist of factors. However, for more nuanced financial instruments, this process has often proven unhelpful, and the checklist approach isn't generally used as a mode of analysis here. Rather, this article compares the SAFE to the most similar historical financial instrument to a SAFE that the author could find: an instrument commonly referred to as "issuer-DECS" (issuer dividend enhanced convertible stock).

Issuer-DECS arrangements were popular in the 1990s. In issuer-DECS arrangements, the investor tendered cash to the issuer, and the investor received a contractual right to receive issuer common equity at a fixed point in the future. Issuer-DECS paid investors a fixed yield before conversion. The amount of common stock to be delivered upon conversion was variable, floating non-linearly with the underlying price of the common stock. The issuer-DECS arrangements were typically labeled in their governing documents as equity for tax purposes, gave holders voting rights, and paid the fixed rate yield only out of earnings of the issuer. In short, SAFEs can be viewed as issuer-DECS arrangements with the following modifications: (1) SAFEs don't pay a fixed return before their conversion into equity; (2) SAFEs don't offer voting rights to the investor;[31] (3) SAFEs don't have a fixed delivery date when they will be converted into formal equity; and (4) SAFEs aren't denominated in their governing documents as equity for tax purposes.

Commentary then was that the issuer-DECS arrangement so closely exposed the holder to the business fortunes of the issuer that the arrangement should almost certainly be treated as equity.[32] Economically, SAFEs in fact look more equitylike than issuer-DECS because SAFEs don't pay any kind of fixed return before conversion into formal equity.[33] However, SAFEs lack the equitylike features of voting rights (although the KISS has participation rights) and an explicit designation in their governing documents that the parties intend equity treatment for tax purposes. But in total, there isn't a great difference in the equitylike features of issuer-DECS arrangements versus SAFEs, and therefore, issuer-DECS arrangements provide a roadmap for equity treatment of SAFEs.[34]

2. Desirability to taxpayers of the characterization.

The question then is whether taxpayers have reason to embrace equity treatment. The answer to that question is a resounding yes. Like with options and warrants, receipt of upfront funds by the issuer and the conversion of SAFEs into preferred stock should be tax free to both the issuer and investor.[35] But much more interestingly, equity treatment solves the tacked holding period problem. Conversion of equity to equity would not be governed by *San Joaquin Fruit*. Conversion

[30] Boris Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 4.05[1][a] (7th ed. 2000 & Supp. 2018-1).

[31] The SAFE doesn't have any voting rights, while the KISS has limited participation rights.

[32] Current commentary was that the only question was whether the issuer-DECS should be considered a current class of preferred stock exchangeable into common stock, or a present sale of the to-be-delivered common stock along with option rights to replicate the kinked economics. *See* L.G. "Chip" Harter and Jeffrey M. O'Donnell, "The Tax Characterization of DECs, ACEs and Other Yield Enhanced Positions With Respect to Stock," 37 *Tax Mgmt. Memo.* 4 (Feb. 19, 1996). *See also* David H. Shapiro, "Taxation of Equity Derivatives," BNA Portfolio 188, Part III.C.2.a. ("Other financial instruments have surfaced utilizing the kinked/variable share forward pricing mechanism of a DECS . . . [in which the investor] would be fully exposed to the business fortunes of the issuer . . . consequently, such an instrument would clearly be viewed as stock of the issuer.").

[33] The other economic factors are more nuanced. Issuer-DECS arrangements retained all issuer downside risk (like all forms of SAFEs) and had imperfect (generally kinked) upside exposure (which looks similar to SAFEs with a cap). Compared with issuer-DECS, SAFEs also have significantly more practical exposure to issuer risk: Issuer-DECS arrangements were generally issued by well-established, often publicly traded companies, which would be able to support the fixed yield with reasonable certainty. A SAFE with a cap looks significantly more equitylike than the other variations because it has equity upside potential.

[34] This article doesn't consider the question whether SAFEs would be considered common equity or preferred equity for tax purposes, or other potential nuances of the equity characterization.

[35] *See* section 1036; section 368(a)(2)(E).

would instead be governed under section 1036 (to the extent applicable) or section 368(a)(1)(E), both of which give tacked holding periods.[36] Further, equity treatment should also solve the holding period problem for QSBS purposes. That is, QSBS holding periods should also tack because exchanges of stock expressly enjoy tacked holding periods under the QSBS rules.[37]

Taxpayers seeking equity status will, however, be well-advised to memorialize it in their documents. In particular, the parties will want to expressly adopt equity treatment for tax purposes and couch conversion into preferred stock as a tax-free stock-for-stock exchange (and they may also want to consider changing the name from simple agreement for future equity). However, the drafters will want to be careful that they don't inadvertently trigger any nontax concerns — for instance, too closely suggesting that the SAFE is a series of stock could implicate corporate and securities law concerns that wouldn't otherwise be applicable to SAFEs.[38] Parties may also want to consider giving the SAFE holder voting rights to further strengthen equity treatment.

D. Debt

1. Strength of the characterization.

On first blush, it is difficult to see how a taxpayer could support a characterization of SAFEs (other than the debt version of the KISS) as debt. SAFEs do not accrue interest. There is no sum certain payable at a fixed time in the future, which has been called a sine qua non of debt.[39] SAFEs can't force insolvency. Payments in issuer equity are the most likely (and intended) delivery under the instrument, not cash.[40] Indeed, the stated purpose of the creation of SAFEs was to reject as too problematic the debtlike characteristics of convertible debt.[41]

2. Desirability to taxpayers of the characterization.

As far as the favorability of the tax rules that a debt characterization would apply to SAFEs, the real — and substantial —benefit is, like with equity, a solution to the tacked holding period problem: The holding period of convertible equity will tack to the holding period of that equity once converted. This result would apply under a simple exercise of the SAFE or presumably under a section 368(a)(1)(E) recapitalization theory.[42] However, like with forward contracts and warrants, the solution to the taxpayer is only a partial one because the holding period does not tack for QSBS purposes.[43]

Debt characterization offers, however, a number of complications. First, the investor could suffer from potential phantom interest inclusions, in particular under the original issue discount rules. Conversion of the debt into preferred stock may also engender risk of a tax liability to the investor if some of the equity is considered compensation for interest in arrears. From the issuer's perspective, any interest deductions would be in jeopardy of being denied under new section 163(j).[44] Further, when converted, the debt would be treated as being retired for an amount equal to the fair market value of the stock into which it was converted; if the stock has depreciated at the time of conversion, there could be cancellation of debt income to the issuer.[45] Based on the foregoing, taxpayers likely have neither sufficient legal authority nor an impetus to try to support a debt characterization.

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[36] *See* Rev. Rul. 72-206, 1972-1 C.B. 104. Regarding section 1036, see, *e.g.*, LTR 8735056.

[37] Section 1202(f).

[38] While this article focuses on holding period issues, for equity designation in particular there are other associated tax consequences that could be relevant. For instance, equity treatment could result in effectively connected income for non-U.S. taxpayers and could be unrelated business taxable income for tax-exempt holders.

[39] *See* FSA 199940007.

[40] Notice 94-47, 1994-1 C.B. 357 (suggesting the IRS's reticence to classify debt payable in issuer equity as debt for tax purposes).

[41] Y Combinator, "Startup Documents" (Feb. 2016) ("Unlike a convertible note, a [SAFE] is not a debt instrument. Debt instruments have maturity dates, are typically subject to certain regulations, create the threat of insolvency, and can include security interests and sometimes subordination agreements, all of which can have unintended negative consequences for startups.").

[42] The SAFE should likely qualify as a security for these purposes, given, *e.g.*, that it has an indefinite term.

[43] *See* H.R. Rep. No. 103-111, 1993-3 C.B. 163 (July 1993), accompanying the Omnibus Budget Reconciliation Act of 1993.

[44] Or the interest deduction could be denied under rules regarding debt instruments payable in issuer equity. *See* section 163(l)(3).

[45] *See* reg. section 1.61-12(c)(2)(ii); TAM 200606037.

IV. Summary

Taxpayers seeking to use a SAFE or KISS have unfortunately not found the desired simplicity and efficiency when it comes to tax treatment. Warrant or forward contract treatment offers taxpayers a similar profile of tax ramifications, but forward contract treatment is likely more legally supportable. However, both those characterizations provide less favorable tax treatment to taxpayers than adopting an equity classification. Therefore, taxpayers in general will have incentives to argue for equity treatment, and it seems there is significant support for the same — especially if taxpayers are careful to slightly revise their SAFE documents to reflect their equity intent. ■