Avoiding Phantom Income on Conversion of Bridge Notes

The Issue Spotter | *September 8, 2015*

BLAIS, HALPERT & LIEBERMAN LLC
TAX LAW FOR BUSINESS

This edition of *The Issue Spotter* concerns how to avoid phantom income on the conversion of bridge notes with accrued interest. The common scenario is that, in anticipation of a round of VC financing, a company raises cash in exchange for "bridge notes." The notes typically convert into the same series of company stock sold in the next round at some modest discount (maybe 10%). The structure is often driven by uncertain valuation, that is, the company can't or doesn't want to set its pre-money value before negotiating the terms of the next equity round. The bridge notes are a convenient way to give the new investors a liquidation preference but adopt a "wait and see" approach to valuation.

The tax impact of converting accrued but unpaid interest on the notes is seldom foreseen amid the other pressures of a bridge note financing.

The tax impact of converting accrued but unpaid interest on the notes is seldom foreseen amid the other pressures of a bridge note financing. To illustrate, let's imagine a company issues a bridge note for $1 million that bears 8% interest and is converted into preferred stock 1 year later. The preferred stock received in respect of the $1 million principal is tax-free. But the preferred stock received in respect of $80,000 in interest is taxable income (subject to special rules for tax-exempt and foreign investors). The tax bill may or may not be affordable, but it will almost certainly be a surprise. And neither the company nor the investor may have sufficient cash to pay the tax - the IRS doesn't accept series B

About BH&L

Blais, Halpert & Lieberman is a transactional tax boutique focused on tax-sensitive structuring and implementation of high-value business transactions, including mergers & acquisitions, private equity and venture capital investments, fund formations, and executive compensation arrangements.

certificates as a medium of payment.

Consider Waiving Interest or Treating as Equity

One crude but effective solution is to waive the interest, that is, provide in the original notes that the interest is payable in cash upon maturity but is waived upon conversion. A surprising number of investors are amenable to this solution because, psychologically, the interest was never a part of their expected economic return. Their investment goal was to own preferred stock and their risk was compensated through the conversion discount.

But our own favorite solution is to declare in the original notes that, for tax purposes, the investment will be treated as *equity* rather than debt. Instead of taxable interest, the 8% return is treated for tax purposes as a stock distribution, which in this context is normally tax-free. The "cost" of this solution is that the company loses its interest-paid deduction, which is a startup accumulating tax losses doesn't need anyway. True, the terms of the note will need to be more equity-like than debt-like, thus jeopardizing the "debt" status of the notes in bankruptcy. But unfortunately, the note holders of an insolvent startup company inevitably take on the role of "owners," voluntarily or not.

Equity treatment has additional, collateral tax benefits. In addition to creating a potential tax liability, interest can be a terrible hassle to compute, especially under the complex rules for "original issue discount" and "contingent payment debt instruments." Further, in a distress situation, the company avoids the possibility of "cancellation of debt income" if the notes are converted into equity with a value lower than the outstanding debt.

Drafting Tips

Whether a financial instrument is debt or equity for tax purposes depends on all the facts and circumstances, so there are no magic words. That said, you'll want a simple statement to the effect of "the parties intend this instrument to be equity for U.S. tax purposes." Ways to grant equity characteristics to a note include: (i) eliminating interest accrual; (ii) deferring maturity indefinitely until a liquidity event or dissolution; (iii) eliminating "creditor remedies" on default; (iv) granting note holders voting and dividend rights comparable to shareholders; or (v) limiting interest payments to the company's retained earnings, in a manner similar to dividends.

Bridge financing instruments with equity characteristics are rapidly entering the mainstream. For instance, prominent startup accelerator programs are promoting documents that utilize the first three factors described above - eliminating interest, deferring maturity indefinitely, and eliminating creditor remedies. They're publicly available - Y Combinator's Simple Agreement for Future Equity ("SAFE") at ycombinator.com/documents and 500 Startups' Keep It Simple Security ("KISS") at 500.co/kiss. There are several variations on each agreement, some investors may find them too company-friendly, and they make no mention of tax treatment, so they're a good starting point if not completely plug-and-play.

Takeaway

When bridge notes convert into stock, any stock received in respect of accrued interest may be unexpected phantom income. Plan ahead by drafting the bridge notes to manage or avoid this issue, perhaps by providing for the interest to be waived on conversion or by treating the entire note as equity for tax purposes. Model bridge financing documents with equity characteristics are publicly available, so they're worth a look.

BLAIS, HALPERT & LIEBERMAN LLC
One Financial Center, 15th Floor • Boston, MA 02111
(617) 918-7080
www.blaistaxlaw.com