Simple Agreements for Future Equity (SAFEs)

OVERVIEW OF KEY TAX CONSIDERATIONS

The popularity of the simple agreement for future equity (SAFE) among company founders and venture capital firms has surged since the concept was first introduced over a decade ago. The existence of SAFEs in venture capital funds' investment portfolios has sparked an ongoing discussion of how to treat them from a tax perspective.

This article reviews some common characteristics of SAFEs and key tax considerations.

SAFE CHARACTERISTICS

In its simplest form, a SAFE is a funding mechanism for an early-stage company. However, they can also be used as an entry point into an investment round after initial equity financing occurs. The SAFE is considered a "seed" stage type of investment that takes place before an equity round from a venture investor or group of investors, or, in other words, a bridge to a more structured financing round.

SAFE investors are entitled to future equity in the company only if certain triggering or exit events occur, such as a future equity financing round or an M&A transaction. In the absence of such an event, a SAFE investor may receive considerably less than their initial investment, depending on the composition of the capital structure and where the SAFE investment sits in that structure. Unlike bridge loans or convertible notes, a SAFE does not accrue interest, which is highly favorable to an early-stage company.

While SAFEs do not have a stated maturity date, it is implicitly assumed that they will be converted or redeemed at the time of a future exit event. SAFEs are issued with the ability to convert into the next equity financing round's shares at a discount, which could range from 5% to over 30%. A 20% discount of the next equity round price is most common.

Frequently the conversion price incorporates both the discount and a valuation cap, allowing the SAFE holder to convert at the best of the two available prices. The valuation cap is the highest possible valuation at which the amount invested in the SAFE would be converted into shares. It is generally the most intensely negotiated term of a SAFE. If the cap is too low, it can be dilutive to the company but highly beneficial to the investor, while if it is too high, it can become unfavorable for both the company and the investor. Another feature that is sometimes present is the redemption at a time of a future M&A transaction. In this instance, the investor would receive a multiple of the SAFE's outstanding amount, where typical multiples could range from 1.0x to 2.0x.

The value of a SAFE, after its purchase, is unknown due to the ambiguity around the timing and type of exit and the actual valuation outcome of the equity round.

SAFE TAX IMPLICATIONS

Depending on the terms of the instrument, a SAFE is generally characterized as either a variable prepaid forward contract (VPFC) or equity for tax purposes. Also, given the lack of stated interest or an obligation to repay the principal amount, SAFEs are unlikely to be characterized as debt for tax purposes. A VPFC involving stock of a startup is an agreement between two parties in which one party commits to transferring stock to the other party on a specified date in return for an upfront payment. The quantity of shares exchanged can fluctuate depending on the valuation of the startup at the time of settlement.

Characterizing a SAFE for tax purposes requires evaluating certain factors of the agreement, such as voting rights, dividend rights, likelihood of converting the SAFE into shares, and fixed-versus-contingent conversion rights. A SAFE which includes voting rights, dividend rights, a fixed amount of shares at conversion, and a high likelihood of being converted to shares may potentially be characterized as equity for tax purposes. A SAFE which does not include voting rights, converts to a variable amount of shares, and has an unknown or lower likelihood of being converted to shares is more likely to be treated as a VPFC for tax purposes.

The tax characterization of a SAFE will impact holding period considerations for purposes of issues such as long-term versus short-term capital gain treatment and the qualified small business stock (QSBS) exclusion, which requires a five-year holding period. If the SAFE is treated as a VPFC, the holding period of the startup stock generally would not begin until the SAFE is converted to shares. This could have a negative impact on the tax consequences upon exit.

Where the startup entity is foreign, treatment as equity could trigger certain unfavorable consequences for U.S. investors, such as the controlled foreign corporation (CFC) and passive foreign investment company (PFIC) regimes.

Investors' ability to navigate the key characteristics and features of a SAFE is paramount given the complexity of these unique financial instruments. Before investing in SAFEs, investors should understand and be prepared to address the key tax implications so there are no surprises during the year-end tax reporting of these instruments, or when there are subsequent transactions.

CONTACT US

JOE PACELLO
Tax & Asset Management
Managing Director
jpacello@bdo.com

STEVE CUNEO
Asset Management &
Business Development Director
scuneo@bdo.com

EKA COX
Valuation & Capital Market
Analysis Director
ecox@bdo.com

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