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SELECTED TAX ISSUES IN PRIVATE COMPANY FINANCINGS

By

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I. Overview

Private companies, especially in the technology and startup sectors, have long used instruments that provide the investor with a priority right to receive its money back, but then a participation in upside of the venture. The classic form of financing would be convertible preferred stock or convertible debt. More recently, however, startups and other private companies have been using special types of convertible promissory notes and Simple Agreements For Future Equity (SAFEs) as financing mechanisms in advance of preferred stock. These instruments raise a classic tax characterization issue: i.e., should their legal form govern the tax characterization and should they be treated as equity for tax purposes? Selected authorities and arguments pro and con are summarized below for convertible notes, and SAFEs in turn. Importantly, the characterization also has various downstream issues for taxpayers and advisors of companies with these instruments.

A. Venture Capital Convertible Preferred Stock

Convertible preferred stock carries a liquidation preference over common stock into which it may be converted at the option of the holder. This entitles the holder to receive a priority return of its invested capital on an exit before any payments are made to the common stock. It also carries various governance and contractual rights.

Beyond the liquidation preference, VC Preferred has features mostly similar to common stock. The preferred converts into common stock at a conversion price, and then enjoys “greater of” participation on a liquidation between its preference and the as-if converted value of the stock. A multiple liquidation preference or “participating” preferred is not common in the VC setting. Redemption rights and annual accruing yields also are rare.

Convertible preferred stock may have priority dividend rights, such as an 8% cumulative or non-cumulative dividend that must be paid before paying dividends on common. In the context of VC Preferred, this priority dividend has little significance, because it does not accrue as additional value (absent an actual declaration of a dividend, which is very rare).

VC Preferred typically is structured as “evergreen.” That is, it remains outstanding until a liquidity event, and does not have any redemption rights or maturity dates at which it will be retired by the company.

B. Convertible Notes

As an alternative to a convertible preferred stock financing, a startup company might raise capital through convertible promissory notes. A company might use this instead of preferred stock for several reasons, often because it wants to raise capital on interim basis without establishing an equity valuation through a preferred stock issuance. Usually, these notes are seen as a bridge to a later preferred stock round, with the anticipation that the noteholders will convert into shares in that future equity round, and receive additional shares for the interest accrued on the notes and other inducements to investing at an earlier stage. Convertible notes are used in part because they are easier to document and execute and because they afford parties more flexibility in creating inducements for early investment.

The convertible notes are cast in the legal form of a debt instrument. Like other debts, the notes have a fixed maturity date (usually in the shorter range of, e.g., 2 years). At maturity, the issuer usually is required to pay the note in cash, although not always.[1] Interest accrues on the debt at a stated right and typically is added to principal and repaid at maturity.

Thus, convertible notes thus have several hallmarks of debt. From the author's experience, convertible notes are usually reflected on the financial statements as indebtedness. On the other hand, the notes have significant equity features to their economic profile, and are much less like true debt than the public company convertibles.

Unlike a standard public company convertible, startup convertible promissory notes are mandatorily convertible into the next round of preferred if the company does a "qualified financing" (i.e., raises the amount of capital that is expected). In this scenario, the noteholder is required to convert its notes into the next round of preferred stock. The holder cannot decide to retain its notes with creditors' rights or demand repayment in cash.

Moreover, startup convertible promissory notes do not have a fixed conversion price. Rather, the conversion price is a variable price that references the price at which the company may issue preferred stock in the future. For example, the note might convert into the next round of preferred stock at the price of the next round, with a 20% discount to the preferred price.

The conversion price might also be subject to a so-called valuation cap. For example, such a note might provide for conversion into the next round of preferred at the preferred stock price, so long as that price does not exceed an $80 million overall equity valuation. Convertible notes with a valuation cap have the same call option economics of a public company convertible. However, at a qualified financing below the valuation cap, conversion into equity will still be mandatory, albeit into a larger number of shares. Convertible notes also frequently combine valuation caps and discounts.

In circumstances where a sale or liquidation of the company is an expected outcome, the noteholder will receive a premium (e.g., 50% or 100% of principal) payable on a change of control ("***CoC***"). In this scenario, the notes have a senior claim to the principal, plus interest and the CoC premium, and through their conversion rights, also enjoy equity upside beyond that (if applicable).

C. Simple Agreements for Future Equity (SAFEs)

The SAFE was popularized by Y Combinator as a more company friendly alternative to a convertible note. The SAFE, like a convertible note, allows companies to raise capital on an interim basis, without setting a stock valuation, but unlike a convertible note, it has no maturity date, no interest rate or the "teeth" that come with the creditors' rights inherent in a debt instrument.[2]

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[1] Some convertible notes will provide that at maturity, the notes automatically convert into the last round of preferred stock the Company has issued at that price, subject to any applicable discount. Most convertible notes, however, provide for payment of cash at maturity.

[2] Such default provisions have rarely if ever been exercised by startup noteholders in the author's experience. In most cases, a company with convertible notes that fails to raise equity or be sold will have few assets for the creditors to recover if they forced the issuer into default.

SAFEs are cast in the form of a pre-funded agreement to purchase shares. Like a note, the number of shares to be delivered is determined by reference to the next equity round price, incorporating the same valuation cap and/or discount mechanisms discussed above. In a "qualified financing," the SAFE is automatically converted into the specified number of shares, and otherwise, the holder can retain its SAFE and attendant conversion rights.

Unlike a convertible note, a SAFE has no maturity date. SAFEs do not bear interest. Thus, SAFEs may exist indefinitely until the issuer is sold, wound up or events occur that convert the SAFE to stock. In a liquidation event, SAFEs may rank *pari passu* with preferred stock, rather than having a senior position over any outstanding preferred. SAFEs in more recent years also have provided for dividend rights on as-converted basis, although the companies that issue SAFEs virtually never pay dividends.[3]

II. Tax Characterization Issues for SAFEs and Convertible Promissory Notes

A. Introduction

A threshold question in considering the tax issues from a company using one of the foregoing financing structures is its tax characterization. In the case of a convertible preferred stock, the tax characterization is clearly as an equity instrument. For SAFEs and convertible notes, there is a substance-over-form question in that the instruments have substantial equity-like features, but are in form cast as a debt instrument or forward contract, respectively. How the instrument is characterized can then affect the tax consequences to the parties.

The doctrines limiting a taxpayer's ability to disavow its form and prior tax reporting positions can also come into play in considering the various tax issues from these instruments.

B. Characterization of a SAFE for Tax Purposes

The tax treatment of a SAFE is not directly addressed in any case law or rulings.[4] While there is nothing directly on point, several different analogies can be considered by way of comparison to a SAFE to shed some light on its treatment.

1. Variable Prepaid Forward Contracts

Forward contracts have been governed by the open transaction doctrine. Executing a contract to buy or sell something in the future generally does not have any tax consequences to either party. When the contract is closed and the purchase and sale completed, the seller recognizes gain or loss and the buyer takes a basis and holding period in the property.

In Revenue Ruling 2003-7, the IRS issued guidance on a variable prepaid forward contract (VPFC) over public equities. There, the IRS ruled that the VPFC would be treated in accordance with its

[3] The author suspects that the dividend rights were added to SAFEs primarily to buttress the position that SAFEs are equity for U.S. federal income tax purposes.

[4] There also is very little secondary literature on the classification of SAFEs. See Damsky, "Pigeonholing the 'SAFE' and 'KISS'," 159 Tax Notes 831 (May 7, 2018).

form, so that the Seller would be governed by the open transaction doctrine.[5] The fact that the Purchaser had prefunded a large part of the purchase price of the contract didn't change the treatment of the VPFC.

Superficially, the VPFC has some resemblance to a SAFE in that it is (1) a contract to buy stock; (2) for a variable price; and (3) involves the buyer paying the seller most or all of the purchase price upfront, at the execution of the contract. If this ruling were to govern the tax treatment of a SAFE, the investor's holding period would only begin when the shares are delivered. More on the impact of holding period on treatment of a SAFE below.

On the other hand, other features of a SAFE distinguish it from the VPFC at issue in Rev. Rul. 2003-7. A VPFC has a limited contract term – in the ruling, three years. The VPFC typically involves stock with an established market price, and the variable settlement terms are a way of the buyer and seller sharing price appreciation over the contract term with reference to that trading price. Thus, the VPFC is properly characterized as a derivative contract over an asset.

The SAFE by contrast, is harder to distinguish from the asset itself (issuer's shares). The unstated price term of a SAFE is not a risk-shifting mechanism, but more an open price term because the stock's price is not yet known. The contract term is also indefinite; there is no end date at which both sides of a trade are measured. As noted above, current versions of SAFEs will also provide the holder with dividend rights, and the SAFE's rights on liquidation may rank *pari passu* with any preferred stock that is outstanding at that time.

2. Stock Subscription Agreements

There are some older cases involving corporations that received partial payments under stock subscription agreements prior to the shares being issued and addressed various issues, such as whether there is actual or imputed interest on such a contract or whether a corporation would recognize income on termination of such an agreement without delivering the shares. *See, e.g.*, *Inland Finance v. Commissioner*, 23 B.T.A. 199 (1931) (corporation did not recognize gross income when it defaulted on agreement and kept the prepayments despite never delivering the shares); *Balt. & Ohio R.R. v. Commissioner*, 35-2 USTC ¶ 9479, 78 F.2d 460 (4th Cir. 1935) (time value of money discount provided to purchasers who prepaid stock subscription agreements did not cause actual issuance of shares to give rise to tax deductible interest); *Duval Sulphur & Potash Co. v. Phinney*, 56-2 USTC ¶ 9969, 56-1 USTC ¶ 9969, 56-1 USTC ¶ 56,532 (W.D. Tex. 1956) (reaching contrary conclusion where subscription agreement expressly labeled the additional shares as "interest").

Although these cases have some similarity to SAFEs, they fail to shed much light, being older cases focused on targeted issues and with limited reasoning to draw from.

3. ACRNs and Other Similar Notes

In Rev. Rul. 83-98, the IRS addressed a financial product called ACRNs. The terms of an ACRN were as follows:

- Public company issued convertible notes for $1,000 at a time when 50 shares of the Company's common stock were worth $1,000.

[5] The IRS also ruled that the seller under the VPFC would not recognize gain under Section 1259. This allowed for the use of properly structured VPFC as a product for monetizing appreciated stock positions without current recognition of gain.

- The ACRN entitled the holder to periodic "interest" payments, equal to the dividends on 50 shares of outstanding stock, but not in excess of 17.5% per year. A minimum of 2% cash interest was due per year. At the time, comparable non-convertible debt of the issuer was paying interest at a 12% rate.

- At the maturity date in year 20, the holder was entitled to receive, at its election, either $600 of cash or 50 shares of common stock.

- In addition, at any time after year 2, the Company could call the instrument by offering to redeem it at $600. The holder could then elect to convert the note into stock.

The Service concluded that ACRNs would be treated as equity for tax purposes. The Service stressed the very high probability that the notes would be converted to stock – effectively the issuer's right to call the notes by delivering its stock was priced at a 40% discount to the face value of the note. This was expected to economically compel a conversion. The purported "interest" in large part provided the holder with an equivalent yield to the dividends on the Company's underlying common stock. Thus, despite the legal form of debt, the ACRNs in substance were equity for U.S. federal income tax purposes. *See also* GLAM 2012-007 (finding that a mandatorily exchangeable note, used to circumvent the restrictions on consolidation, was equivalent to equity where features economically compelled the holder to convert the note to shares).

These instruments have a lot of similarity to SAFEs. The SAFE like the ACRN is constructed to turn into shares in the future, given the discount and automatic conversion on a qualified financing. SAFEs also enjoy dividend rights and no interest or similar economics (as in a VPFC) on the contract price. In addition, and as an additional factor favoring equity characterization of a SAFE, the issuer of a SAFE is much less capitalized than the public companies that sold ACRNs.

C. Consequences of Characterization of a SAFE as Equity or a Contract Right

If a SAFE is treated according to its form as a forward purchase agreement, the open transaction doctrine would govern its treatment. Under the open transaction doctrine, no gain or loss should result to a holder of a SAFE when it receives shares under the SAFE, even if there is economic appreciation. However, the holding period of the stock would only commence on delivery of the shares. Although there are no authorities specifically addressing a SAFE, that is the treatment accorded to shares delivered under an option or forward contract,[6] and there is no authority to doubt that treatment for shares in settlement of a SAFE, if a SAFE is characterized as a prepaid forward contract.

1. QSBS Considerations

The possibility of a delayed holding period is often most important for a SAFE holder given the different ramifications for "qualified small business stock" (QSBS) investments. For stock to be QSBS, the corporation must not have more than $50 million of gross assets immediately after the issuance or, for stock issued after July 4, 2025, $75 million of gross assets.[7]

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[6] *See* Rev. Rul. 78-182; *Helvering v. San Joaquin Fruit & Inv. Co.*, 297 U.S. 496 (1936).

[7] *See* OBBBA § 70431(c). The new threshold of $75 million of gross assets also is increased for inflation beginning in 2027.

Section 1202 generally provides a 100% capital gain exclusion for eligible gain from the sale of QSBS held for at least five years. Under the OBBBA, for stock acquired[8] by the taxpayer after July 4, 2025, a 50% gain exclusion is available beginning after a three-holding period is met. For stock held for 4 years, but not 5 years, 75% of the gain is excluded.[9]

Both of these requirements can be affected by the characterization of a SAFE as an equity instrument or as a contract to acquire stock. The legislative history of Section 1202 indicates that, in the case of a loan or an option to acquire stock, the QSBS investment is only deemed made when the loan or option is converted into actual shares.[10] The relevance of this rule and the treatment of a SAFE as a forward contract or equity can be illustrated by the following Example.

Example. Systems.AI is formed and then in March 2025 raises $20 million through a series of SAFEs. In June 2026, after further technical development, Systems.AI issues a Series A preferred stock round, raising $90 million of additional capital and the SAFEs convert into series A preferred stock.

The series A stock issued to new investors is not QSBS because Systems.AI has more than $75 million of gross assets immediately after the shares are issued. § 1202(d)(1). Similarly, if the SAFE is viewed as a forward contract, the issuance of shares to the SAFE holder would also fail to be QSBS for the same reason.

Even if the Company did not have more than $75 million of gross assets immediately after the financing, the treatment of a SAFE as contract will further delay the investor's satisfaction of the necessary five-year holding period to meet Section 1202.

The reference in the legislative history noted above to a convertible instrument noted above should be understood to refer to a SAFE (or loan) that is property treated as a bona fide debt or contract right. By contrast, if the context of a SAFE that is viewed properly viewed as equity from the outset, the SAFE investment itself should be QSBS eligible stock under the plain language of Section 1202.

When the SAFE is converted into actual shares of the issuer, this then should be treated as a tax-free stock-for-stock exchange in the same issuer. Under § 1202(f), QSBS status tacks in this situation as if it were a single investment. *See also* PLR 201603010 (QSBS status of membership interests in an LLC electing to be taxed as a corporation were unaffected when the LLC converted under state law into an actual corporation in a § 368(a)(1)(F) reorganization); Committee Reports on Omnibus Budget Reconciliation Act of 1993, P.L. 103-66 ("In the case of convertible preferred stock, the gross assets determination is made at the time the convertible stock is issued, and the holding period of the convertible stock is added to that of the common stock acquired upon conversion.").[11]

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[8] The determination of whether stock is acquired prior to July 5, 2025, is made by taking into account the period for which the taxpayer held the stock under Section 1223. OBBBA § 70431(a)(6)(B).

[9] Since QSBS eligible gain is taxed at a 28% rate, see Sections 1(h)(4)(A)(ii) and 1(h)(7), the effective rates of Federal tax (including NIIT) is 15.9% on 50% excluded gain and 7.95% on 75% excluded gain.

[10] See Committee Reports on Omnibus Budget Reconciliation Act of 1993, P.L. 103-66.

[11] Section 1202(h)(4) allows for QSBS status to survive most corporate reorganizations, but provides for the benefit to be frozen at the exchange date valuation if the successor corporation is not itself a small business. This rule should not apply to single-entity reorganizations in Sections 368(a)(1)(E) and 368(a)(1)(F) given the more specific provision in Section 1202(f).

Given the importance of this issue for SAFE investors, it has evolved to be market standard for SAFEs to include the following tax treatment language as to the status of a SAFE:

"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. Accordingly, the parties agree to treat this SAFE consistent with the foregoing intent for all United States federal and state income tax purposes (including, without limitation, on their respective tax returns or other informational statements)."[12]

2. Additional Wrinkles Involving the Effective Date of OBBBA § 14301

Section 14301 of the OBBBA significantly augmented the tax benefits of Section 1202 for QSBS acquired after the date on which the OBBBA was signed into law (i.e., July 4, 2025). These benefits include the following:

- A 50% gain exclusion for stock sold after a three-year holding period and a 75% gain exclusion for stock sold after a four-year holding period.
- A maximum gain exclusion that increases from $10 million per taxpayer to $15 million (subject to indexing for inflation through the year of sale).
- An increase in the permitted gross assets for a corporation to be a Qualified Small Business from $50 million to $75 million. The $75 million also will be indexed to inflation.

A taxpayer that invested in a SAFE or convertible note before the OBBBA and then converts it into actual shares after the OBBBA may want to argue that it is acquiring "new stock" after July 4, 2025. If a SAFE or note is treated as equity, then this position would seem untenable, as the acquisition date for purposes of the $15 million limit and partial gain inclusion rule takes into account tacked holding periods under Section 1223. OBBBA § 14301(a)(6). Thus, taxpayers in this situation may want to treat SAFEs or notes in accordance with their form. For a convertible note, Section 368(a)(1)(E) still may potentially apply and result in a tacked holding period, whereas for a SAFE that is respected as a forward contract, the general open transaction standard would seem to start the holding period when the SAFE is converted into stock.

3. Collateral Consequences of Treating a SAFE as Equity for Tax Purposes

As discussed above, the investor in a SAFE issued by a QSBS eligible corporation will strongly prefer to have the SAFE treated as equity for tax purposes. The corporation may be relatively indifferent between whether the SAFE is treated as equity or a contract to buy equity, given the direction of Section 1032 that a corporation does not recognize gain or loss on transactions in its stock. Thus, the parties frequently will agree to the language above as to the tax classification of the SAFE.

The corporation and its advisors should be aware that once a SAFE is treated as equity, the taxpayer's general duty of consistency can have downstream consequences on other tax issues that may arise in the course of the company's life. Some of the ramifications of treating a SAFE as stock for tax purposes can include:

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[12] See YC Safe Financing Documents | Y Combinator.

1. S Corporation "one class of stock" requirement. To qualify as a subchapter S corporation, a corporation can have only a single class of outstanding stock. A SAFE, if treated as equity, would constitute a second class of stock and thus prevent the corporation from being eligible for an S Corporation election.[13]

Most SAFE issuers do not intend to make subchapter S elections. However, on a sale of the company, Section 280G contains a carve-out for C corporations that are small business corporations eligible for an S election.[14] If a SAFE is a second class of stock, it would preclude the corporation from relying on this exception.

2. Retirement of a SAFE. On occasion, issuers and SAFE holders may agree for the company to return some or all of the SAFE holder's money and cancel a portion of the SAFE. If the SAFE is equity, cancelling the contract and returning the investment amount would be characterized as a redemption under Section 302. Section 1202(c)(3)(B) disqualifies stock from QSBS if it is issued within one year of a "significant" redemption from any shareholder.

3. Corporate Reorganizations under Section 368. Section 368(a)(2)(E) permits tax-free reorganization treatment for a single step reverse merger in which the Parent acquires, solely for its voting stock, stock of the Target constituting "control." "Control" is defined by Section 368(c) as stock constituting 80% of the total voting power of all classes of stock entitled to vote, as well as 80% of the number of shares of any class of nonvoting stock. SAFEs generally do not have any voting rights,[15] so that if they are treated as equity, they would be considered non-voting stock, 80% of which must be converted into Buyer voting stock for the single step reverse merger to be tax-free.[16] This would provide for a potential reorganization issue if the SAFE is settled for cash, as may be required to settle a "change of control" premium.

Conversely, if the deal terms provide for a SAFE to receive buyer stock, can this stock be relied on to satisfy the "continuity of interest" requirement? The typical SAFE will contain tax reporting language that requires the parties to treat it as stock for tax purposes. However, this language, of course, is not binding on the Internal Revenue Service (IRS). Instead of being equity, if a SAFE were viewed as a contract to acquire stock, Buyer stock exchanged for the SAFE would be outside the continuity of interest calculation.[17]

4. SAFEs issued by an LLC Taxed as a Partnership

Originally, the SAFE was an instrument designed for fundraising by startups taxed as C corporations. It has become increasingly popular for startups to form as LLCs and convert into C corporations in connection with the first "priced" round; and during this interim period, the LLC might

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[13] Even if not treated as equity for tax purposes generally, a SAFE may give rise to a second class of stock under the rules in Treas. Reg. § 1.1361-1(l) regarding debt with conversion features that are substantially certain to be exercised.

[14] I.R.C. § 280G(b)(5)(A)(i).

[15] *See* YC Safe Financing Documents | Y Combinator.

[16] *See also* Rev. Rul. 59-259 (ruling that the 80% of the number of shares test must be met separately with respect to each class of non-voting stock).

[17] *See generally Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

turn to a SAFE as a form of bridge financing. In addition, businesses that are formed as LLCs sometimes use SAFEs as a funding mechanism for the same business advantages provided by C Corporations while intending to remain an LLC indefinitely.

Where an LLC issues a SAFE, this raises technical and practical issues for the Company and the investor's tax advisor.

As a technical matter, the legal standard for characterizing a SAFE (or a convertible note) appears to be the same, whether the issuer is a C Corporation or an LLC taxed as a partnership. *See Hambuechen v. Commissioner,* 43 T.C. 90 (1964). This appears to be true, even though most partnership debt-equity case involve lenders that sought to sustain equity treatment to enjoy tax benefits that wouldn't arise from a loan. *See, e.g., Historic Boardwalk Park v.* Commissioner, 2012-2 USTC ¶ 50,538 (3d Cir. 2012); *TIFD III-E, Inc. (Castle Harbor) v. United States,* 2006-2 USTC ¶ 50,442 (2d Cir. 2006).[18] Thus, the same considerations discussed above regarding the potential treatment of a SAFE as a current equity instrument would apply in the context of a SAFE issued by an LLC.

The treatment of a SAFE as equity in an LLC, however, raises some significant practical considerations. As an LLC member, the SAFE holder should be allocated profits and losses and receive a Schedule K-1. Unless drafted with care, the typical LLC agreement will leave gaps for how to treat a SAFE in the distribution and allocation waterfall. The SAFE holder may not be anticipating an allocation of losses, which in any event will often be suspended under Section 469. Some SAFE investors may not want to be partners in a partnership engaged in a trade or business.

By contrast, the parties might take the position that a SAFE of the LLC is taxed according to its form. During the course of an LLC's operations, this treatment may better align with the parties' expectations in terms of allocations of the LLC's profits and losses. Since an LLC investment is not QSBS, the investor does not have the same desire for treating an LLC's SAFE as equity for tax purposes.

However, treating an LLC's SAFE as a contract to buy equity has some important downstream consequences that need to be considered for conversion of the LLC into a C Corporation or the SAFE into actual units in the LLC. As the LLC generates losses using the funds from the SAFE, these will be allocated to LLC members and can cause deficits in the tax basis capital accounts. This can result in gain to the members under § 357(c) or § 752(d) on the conversion. In addition, consider the treatment of the C Corporation shares issued to holders of a SAFE in qualification of the conversion as a Section 351 transaction.

Example. LLC is owned by three founders and raises $5 million of SAFE investments. After the SAFE funds have been spent, LLC converts to a C corporation to raise $10 million of new preferred stock financing. At this time, the LLC's tax basis in its assets is zero. The LLC converts through a statutory conversion under Delaware law. This is characterized as an "assets over" transaction, whereby the LLC transfers all of its assets subject to its liabilities to a new C Corporation in exchange for its stock and then liquidates, distributing the stock to its members.[19]

[18] In addition to the common law, Treas. Reg. § 1.761-3 provides for a regulatory anti-abuse rule that treats certain non-compensatory partnership options as partnership interest, where the options are structured to obtain significant tax savings. Although SAFEs and convertible notes appear to satisfy the first part of the test in the regulation (option confers rights substantially similar to those of an equity holder), the lack of any tax avoidance motive should preclude this regulation from applying to a typical SAFE.

[19] Rev. Rul. 2004-59; Rev. Rul. 84-111, Situation No. 3.

Some of the issues for analysis are the qualification of the conversion as a Section 351 transaction and the recognition of any gain to recapture the benefit of the $5 million of the losses allocated to the members from the SAFEs. On the Section 351 qualification, Rev. Rul. 84-111 implicitly holds that the LLC's distribution of the new C Corporation shares to its members does not break the "control" requirement of § 351. However, does the same treatment apply to C corporation shares that the LLC is deemed to transfer to its creditors under the SAFEs?[20]

For loss recapture, it would seem that the members recognize $5 million gain either under Section 357(c) (because the SAFEs are a liability that the C corporation assumes from the LLC in the conversion) or because the reduction in the LLC Members' share of liabilities causes them to recognize gain under Section 731. See I.R.C. § 752(d). In either case, if the members' share of the $5 million losses were suspended (e.g., under Section 465), those suspended losses should be available to offset gain recognized on the conversion into a C Corporation. Prop. Treas. Reg. § 1.465-66.

D. Convertible Promissory Notes

1. Debt-Equity Analysis

In contrast to SAFEs, the classification of convertible notes is analyzed under a well-developed body of case law setting out the "debt-equity factors." The non-excusive list of debt-equity factors includes the form of the instrument, whether there is a provision for interest, the ability of the creditor to be repaid at a definite maturity date or on demand, the debtor's debt-to-equity ratio, and whether the debt is subordinated to other creditors. *See, e.g., Fin Hay Realty Co. v. Commissioner*, 398 F.2d 694 (3d Cir. 1968). The ultimate inquiry is whether "the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business." *Gilbert v. Commissioner*, 248 F.2d 349, 406 (2d Cir. 1957).

It is well-established that convertible debt instruments issued by public companies constitute bona fide debt for tax purposes. *See, e.g.*, PLR 8735008.[21] However, the convertible promissory notes issued by startups differ in many important ways from convertible debt of public companies. Like the SAFE, the notes are mandatorily convertible into equity on certain events, such as a qualified financing and often at a discount to the offering price. The conversion price is left open until a later financing round occurs, potentially subject to a valuation cap. In form these instruments are more akin to a prepayment on issuance of shares in the future than bona fide debt.

Another relevant factor is the nature of the convertible note issuer as a company that has little wherewithal to repay the note in a downside scenario. The most likely expected outcomes of a convertible note investment is either (a) a qualified financing, which converts the note into shares; or (b) failure to raise capital in which case the note will likely be worthless or heavily impaired. Although the noteholder typically has creditors' rights to be repaid at maturity, often it would be futile to exercise these rights if the company raised funds. Thus, if neither (a) nor (b) has occurred by the maturity date, the note holder might well choose to leave the note outstanding and wait for one of these events to occur. These facts as a whole would suggest that the note is, in substance, risk capital.

[20] In cases where the SAFEs will receive less than 20% of the C Corporation's stock, the "control" requirement would be satisfied in any event.

[21] The Section 163(l) legislative history also indicates that public company convertible debt should be treated as bona fide debt for tax purposes. *See* H.R. Rep. No. 105-220, at 524 (1997). *See also* I.R.C. § 279 (presupposing that subordinated convertible debt of companies with a large debt to equity ratio is bona fide debt for tax purposes).

2. Section 385(c) Overlay

In addition to the substantive analysis of debt vs. equity, one also to consider the impact of taxpayer's prior reporting positions under Section 385(c). Section 385(c)(1) provides that the "characterization by the issuer" as of the time of issuance as to whether an instrument is stock or indebtedness is binding on the issuer and on all holders, absent, in the case of a holder, a timely disclosure of an inconsistent position by the holder. *See* I.R.C. § 385(c)(2). Thus, if the issuer has previously "characterized" a convertible note as debt, that may bind taxpayers (but not the Service) to maintain debt treatment.

Example. Tremendous SaaS, Inc (TSSI) issues convertible notes to U.S. and foreign investors in 2024. The notes bear 8% interest and are convertible in a qualified financing at a 10% discount, subject to a valuation cap of $40 million. During 2026, TSSI raises a Series A financing and the notes convert into Series B shares. In January 2027, TSSI needs to decide whether to issue Form 1099-INT to the convertible noteholders on satisfaction of their accrued but unpaid interest in the form of Series A shares.[22]

Assume that the parties conclude that the notes are more properly treated as equity for U.S. federal income tax purposes. The question then would be whether Section 385(c) and whether TSSI has previously "characterized" the notes as debt for tax purposes. Some of the relevant ways in which TSSI might have "characterized" the notes include the following:

- Reporting the notes as debt on its financial statements, including on Schedule L (Balance Sheet) of its tax return.
- Previously reporting interest expense on its tax return – which may have been a product of failing to reverse out book interest expense on a Schedule M.
- Deducting interest expense and including it in an increased net operating loss carryforward.
- Deducting interest expense and using the interest expense to reduce its corporate tax liability in a prior year.[23]

The legislative history of Section 385(c) indicates that Section 385(c) was primarily concerned with preventing taxpayers from whipsawing the IRS.[24] Thus, a prior claim of interest expense deductions, in situations where they did more than add to a balance of NOLs, would seem to run afoul of Section 385(c). In the other situations above, the prior tax reporting does not seem to raise the whipsaw concern.

[22] This Example assumes that, as chance would have it, TSSI has not issued any Form 1099-OID for the interest accruing on the loans during 2025 and 2026.

[23] As discussed below, it is questionable that interest expense on a convertible note would be deductible in any event due to Section 163(l).

[24] *See* H.R. Rept. No. 102-716, 102nd Cong. 2d Sess., 4 (1992). *See also Taiyo Hawaii Co., Ltd. v. Commissioner*, 108 T.C. 590 (1997) (prior to Section 385(c), Tax court ruled that a foreign corporation engaged in a U.S. trade or business that generated losses and treated intercompany advances as debt, could not later disavow that treatment to avoid interest withholding tax).

There are only a few private rulings involving Section 385(c). For example, in TAM 200419001, the treatment of an instrument as debt on a taxpayer's financial statements was held not to preclude a contrary position under Section 385(c), where the taxpayer reversed out interest expense on its tax return, and consistently reflected the notes as equity on informational disclosures on the Form 1120 and the foreign subsidiary's Form 5471. There, the Service also advised that the foreign tax treatment of the notes was immaterial. *See also* TAM 200650017, revoking TAM 200512020 (same).

One practical consideration is that the typical convertible note issuer is relatively unsophisticated and may not be considering the tax treatment of a convertible note. A company issuing convertible notes that wants to sustain equity treatment (often the most advantageous treatment) would be well advised to file all tax returns on that basis starting with the issuance of the notes.

E. Pros and Cons of Debt vs. Equity Classification of Convertible Notes

Many of the same considerations discussed in the section above pertaining to SAFEs also apply to convertible notes. From a U.S, holder's perspective, the desire to make a qualified small business stock investment from the funding of the note is a major benefit to equity treatment. Convertible notes treated as equity also will have the same downstream implications for treatment of SAFEs as stock.

However, since convertible notes are cast in the form of debt and carry an interest coupon, they raise additional tax planning issues which are discussed below.

1. Deduction of Interest by the Company

At least in principle, a corporate issuer might treat convertible promissory notes as debt in order to claim an interest expense deduction. However, even if the corporation has sufficient taxable income to deduct interest expense, Section 163(l) creates significant barriers to deducting interest on a convertible note.

Section 163(l) disallows interest expense on certain "disqualified debt instruments." This provision was enacted to govern the taxation of certain hybrid instruments, which sustained debt treatment under classic debt-equity principles, but were likely to be converted into stock. This would include later better constructed versions of the ACRNs discussed above. *See*, *e.g.*, Rev. Rul. 85-119 (instrument similar to ACRN, but where issuer was required to issue stock with a FMV equal to the principal of the debt, constituted bona fide debt allowing the issuer to deduct interest expense); Notice 94-47.

Section 163(l) defines a disqualified debt instrument as any of the following:

- A debt instrument where a "substantial amount" of principal or interest is required to be paid or converted, or at the option of the issuer may be required to be paid in equity.
- A debt instrument where a "substantial amount" of principal or interest is determined by reference to the value of the issuer's equity.
- A debt instrument that is part of an arrangement that is reasonably expected to result in a conversion into equity.

This would include a debt instrument that is convertible into stock at the holder's option, but only if the holder is substantially certain to exercise the option at the time of issuance of the debt. As noted above, the legislative history to Section 163(l) makes clear that this last rule was not intended to disrupt the settled tax treatment of public company converts, which typically have a conversion price significantly higher than the fair market value of the stock on the date of that the note is issued.

As can readily be seen, typical startup convertible notes will likely be disqualified debt instruments. The note is required to be converted into stock in certain events, such as a qualified financing. While this conversion is contingent on certain events, it would seem clear that, together with the discounted conversion price, is part of an arrangement that is reasonably expected to result in conversion of the note to equity.

If one assumes that Section 163(l) will disallow the deduction for interest expense, treatment of a convertible note as debt is an unappetizing outcome: the holder has ordinary income for the interest coupon, including on receipt of illiquid shares on conversion, while the company cannot deduct the interest expense.

2. Holder Issues for a Convertible Note Treated as Debt for Tax Purposes

(a) U.S. Investors

If a convertible note is considered to be bona fide debt, the holder of the note would be taxed on the interest coupon on the note. Many notes are structured so that interest is not payable by the issuer prior to the maturity date. Alternatively, on a conversion event, the accrued interest will increase the number of shares that the holder receives.

A debt instrument is considered to have original issue discount ("OID") to the extent that the stated redemption price at maturity exceeds the issue price of the note. The stated redemption price at maturity is defined as the sum of all payments to be made under the note, except for qualified stated interest ("QSI"). QSI is defined as interest that is unconditionally payable in cash or property no less frequently than annually.[25] Thus, the interest on a note generally will be considered OID if, as is commonly the case, it is due only at maturity or on a conversion event. OID is taxable to the holder as it accrues under the "constant yield method," regardless of the holder's method of accounting.

In addition, even if the note does not have OID, the conversion of the accrued interest into additional shares would be taxable as interest income. Since the shares into which the note converts will be illiquid private company stock, this represents phantom income. Avoiding this phantom income is a significant incentive on the parties to treat a convertible note as equity for tax purposes.

(b) Foreign Investors

A non-U.S. Holder would be subject to U.S. withholding tax at 30% on a payment of interest, except where a treaty applies or where the interest qualifies for the "portfolio interest exemption." The portfolio interest exemption has several requirements:

1. The note is in "registered form."

2. The interest is not contingent on the debtor's net income, cash flow or other similar metrics.

[25] QSI must also be imposed at single fixed rate (or qualified floating rate). The typical convertible note's interest is typically a fixed rate, so that this requirement is met.

3. The creditor is not 10% shareholder of the debtor, by voting power, and taking into account a modified form of Section 318's constructive ownership rules.

4. The creditor is not a bank acting in the ordinary course of business or CFC that is a related party as to the debtor.

5. The creditor provides a timely statement to substantiate its non-U.S. status.

Often these requirements would be met. The most common issue that arises is the 10% shareholder requirement. The note investor might be a pre-existing shareholder of the company. Section 318 attribution also includes shares that would be received on a conversion of the note into equity. See Rev. Rul. 68-601. This attribution rule can sometimes cause the noteholder to exceed 10% stock ownership by voting power, either on its own or together with other equity holdings.

On the other hand, if a note is treated as equity for tax purposes, the foreign holder would be subject to dividend withholding tax on payment of the "interest" coupon, to the extent that the issuer has "earnings and profits." Dividend withholding tax is, at best, reduced by a tax treaty, but will not apply where the issuer has significant tax losses and thus doesn't have "earnings and profits" over the life of the note.

3. If a Convertible Note is Equity, What Type of Equity Is It?

If the note is treated as equity, the conversion of the note into actual shares, as in the case of a SAFE, should generally be a tax-free stock for stock exchange. *See* I.R.C. § 368(a)(1)(E); § 1036. In this scenario, "interest" on the note would be considered an accruing dividend. Under general principles, the accrual dividend is generally not taxable until the dividend is declared and paid. *See* Rev. Rul. 69-131.

However, Section 305(b) should also be considered. How Section 305 applies will depend on whether the convertible is considered "preferred stock" for Section 305 purposes. Accrued dividends or redemption premium on a preferred stock are taxable as deemed dividends where the preferred stock has a redemption maturity date or right to be repaid at maturity. *See* Treas. Reg. § 1.305-5. If a convertible note is treated as preferred stock, it would have a maturity date since the note itself provides for this.

In addition, a recapitalization of "preferred stock" with dividends in arrears will also be taxable in part as a dividend to the extent that the fair market value or liquidation preference of the stock received exceeds the issue price of stock exchanged. *See* Treas. Reg. § 1.305-7(c)(1)(ii). Thus, if the issuer has "earnings and profits," the treatment of the convertible note as preferred stock may create taxable dividend income with respect to the interest component either as it accrues or when it is satisfied with shares on the conversion date.[26]

Treas. Reg. § 1.305-5(a) looks to whether preferred stock participates in corporate growth through participation in current and anticipated earnings and on liquidation beyond its preferred position. The participation rights must not lack substance, as shown by a "real and meaningful probability of

[26] If it is clear that the issuer will not have any "earnings and profits," a taxable Section 305 stock dividend may not be as much of a concern. A taxable stock dividend not paid out of "earnings and profits" would be tax-free under Section 301(c)(2). However, this could still have an adverse effect on the noteholder's holding period, unless the stock dividend is tax-free under Section 305(a). Cf. I.R.C. § 1223(4); § 307(a).

actually participating…" The determination of whether stock is preferred stock is made without regard to any right to convert such stock into another class of stock.[27]

As noted above, convertible preferred stock usually will automatically participate on an as-if converted basis in dividends and liquidating distributions, so that it is not necessary to rely on a right to convert the stock to establish upside participation.

A convertible note, by contrast, only enjoys stockholder rights after it is converted into stock. The terms of the note, treated as a hypothetical equity instrument, need to be analyzed to determine whether a convertible note is "preferred stock" for Section 305(b)(4) purposes. Scenarios involving automatic conversion into preferred stock might be distinguished from optional conversions in applying the regulations. The effect of a valuation cap also should be considered.

4. Additional Issues for Change of Control Premiums

Convertible notes issued by later stage companies that anticipate an acquisition will often include a change of control ("COC") premium entitling the noteholder to receive a multiple of its investment, such as a 1.5x or 2x return on its investment, in addition to stated interest. COC premiums raise important issues on both the company and the holder side, especially if a convertible note is treated as debt for tax purposes.

(a) Section 249

Generally, redemption of a debt instrument at a premium to its issue price is deductible as interest. *See* Treas. Reg. § 1.163-7(c). At first blush, this would seem to confer a significant corporate tax benefit to the retirement of a convertible note at a premium, or a buyer of such a company which may have sufficient taxable income to absorb the deduction.

However, in addition to Section 163(l)'s disallowance of interest on "disqualified debt instruments" discussed above, Section 249 would generally disallow the deduction of a COC premium. Section 249 disallows deductions for redemption premiums of convertible debt instruments to the extent the premium exceeds a "normal call premium," except to the extent that the premium is attributable changes in the prevailing cost of borrowing. A normal call premium generally is limited to one year of stated interest on the note. *See* Treas. Reg. § 1.249-1(d).

(b) Contingent Payment Debt Instrument (CPDI) Issues

From the holder's perspective, the main concern is whether a COC premium will cause a convertible note to be classified as a Contingent Payment Debt Instrument ("CPDI"). CPDIs are subject to a very complex "non-contingent bond method" set out in Treas. Reg. § 1.1275-4(b). This method requires the estimated fair market value of the contingent payment to be accrued ratably as OID, by reference to the interest rate that would apply to a similar debt instrument without the contingent payment feature. In addition to being inordinately complex to apply in practice, the CPDI rules result in all payments on the debt, including the value of stock received on conversion, being currently taxable as ordinary income. Treas. Reg. § 1.1275-4(b)(8)(i).

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[27] Compare similar definitions of "preferred stock" for purposes of Section 351(g)(4) and Section 1504(a)(4).

The CPDI rules do not apply to contingent payments that are "remote" (i.e., very unlikely to occur), or where the debt provides for a single payment schedule that is *significantly* more likely than not occur. Treas. Reg. § 1.1275-4(a)(5), § 1.1272-1(c)(2). Given that the COC premium is being added to a convertible note with some expectation of a new term change of control, it may be difficult to rely on these exceptions.

Alternatively, Treas. Reg. § 1.1275-4(a)(4) provides that the CPDI rules do not apply to a debt instrument merely because it provides an option to convert the debt into stock of the issuer or money or property with an amount approximately equal to the fair market value of such stock. Some have analogized the COC premium in a typical convertible promissory note to an amount approximately equal to the value of the conversion price of stock, by providing the holder with an additional payment where the COC event causes the conversion price no longer to apply.

If a convertible note is treated as equity, of course, the CPDI rules do not apply.