Can Convertible Debt or SAFEs Qualify as QSBS for Section 1202's Gain Exclusion?

Feb 22, 2021

Categories:

Blogs
Qualified Small Business Stock (QSBS)
Tax Law Defined™ Blog

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Only the issuance of "stock" triggers the running of Section 1202's five-year holding period and only a seller of "stock" can claim Section 1202's gain exclusion. We are often asked whether *Simple Agreements for Future Equity* (SAFEs) or *convertible debt* qualify as "stock" for purposes of Section 1202's generous gain exclusion. The answer to this question is critical because only the issuance of "stock" triggers the running of Section 1202's five-year holding period.

This is one in a series of articles addressing planning issues relating to qualified small business stock (QSBS) and the workings of Sections 1202 and 1045 of the Internal Revenue Code.

An "interest" in a C corporation must be "stock" to potentially qualify for Section 1202's gain exclusion. Although not the specific focus of this article, a good starting point for an overall understanding of what works and doesn't work for purposes of Section 1202 is the following summary of how various equity and equity rights are treated.

"Stock" for Section 1202 purposes includes voting and nonvoting stock and common and preferred stock. Stock issued by an S corporation will never ever qualify for Section 1202's gain exclusion, no matter how much the founders may regret that fact (note that this problem can be remedied with professional help). Incentive stock options (ISOs), nonqualified stock options, warrants, stock appreciation rights, restricted stock units, phantom equity or other miscellaneous bonus arrangements do not qualify as "stock" for Section 1202 purposes. Equity or equity rights issued by an LLC or limited partnership taxed as a partnership do not qualify as "stock" for Section 1202 purposes. But note that if an LLC is taxed as a C corporation, its membership interests can qualify as "stock" for Section 1202 purposes.

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As discussed below, SAFEs and convertible debt can qualify as "stock" for Section 1202 purposes, but that characterization will never be without doubt when the parties elect to issue an interest whose form is "debt" in the case of a convertible debt instrument or a "hybrid" instrument in the case of a SAFE.

In many circumstances, issue of whether a SAFE was "stock" for QSBS purposes will impact the beginning date for the running of an investor's five-year holding period requirement for claiming the Section 1202 gain exclusion. If the SAFE is "stock," then the subsequent conversion of the SAFE into issuer stock is permissible under Section 1202 and will continue the QSBS status of the equity and the running of the holding period. Obviously, if the investor holds the SAFE for a long period of time and it is ultimately determined that the SAFE was a hybrid instrument rather than "stock," this delay in achieving "stock" status could result in a failure to satisfy Section 1202's five-year holding period requirement.

The characterization of a SAFE as "stock" becomes more of a "bet the farm" issue when an investor is rolling over QSBS proceeds into a SAFE. Under Section 1045, if a holder of QSBS sells before satisfying the five-year holding period requirement, the holder can reinvest the proceeds in replacement QSBS within 60 days an defer tax on the initial sale and potentially qualify for the Section 1202 gain exclusion if the replacement QSBS is sold after satisfying the five-year holding period requirement. The critical point is that the replacement stock must be QSBS on the date of issuance. If the SAFE isn't "stock" for Section 1202 purposes, then the investor won't acquire replacement QSBS until the SAFE converts, which will often cause the investor to fail to satisfy Section 1045's requirement that replacement QSBS be purchased within 60 days after the sale of the original QSBS. Here the recharacterization by the IRS of a SAFE as a hybrid instrument rather than stock would result in the initial sale being taxable, with the holding period for the replacement QSBS commencing on the conversion date.

A potentially critical factor for taxpayers looking to characterize a SAFE or a convertible debt instrument as "stock" is whether their tax advisor believes that there is "substantial authority" for taking the return position that the instrument is stock for Section 1202

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purposes. Under the Internal Revenue Code, a taxpayer has "substantial authority" for a position when the weight of tax authorities supporting a tax position is substantial in relation to the weight of opposing authorities. See "A Taxpayer's Consumer Guide to Substantial Authority Tax Opinions" for a discussion of tax opinions and their uses.

SAFEs

Background

In late 2013, the Y combinator introduced the original SAFE. The User Guide on the Y combinator website notes that when SAFEs were first introduced, startups and investors were primarily using convertible notes for early-stage fundraising and the original SAFE was intended to be a replacement for those convertible notes. SAFEs were intended to provide a simple means for investors to fund early-stage companies, using documents (contracts) originating on the Y combinator's website that were sometimes modified and customized within the start-up community to fit the needs of the parties. The Y combinator website now refers to the "original" SAFE and the "new" SAFE, and notes that the difference between the two contract forms is that the new SAFE is intended to be as a post-money security.

All varieties of SAFEs are basically contract arrangements setting forth the terms upon which the investor's contract right will convert into shares of preferred stock in a priced round. The typical SAFE also has economic rights in connection with certain liquidity events, such as the issuer's change of control, sale, merger or dissolution. The Y combinator's User Guide indicates that in a "Liquidity Event" or "Dissolution Event", the SAFE functions like standard non-participating preferred stock that ranks junior to payment of outstanding indebtedness (including outstanding convertible notes), on par with payments to other SAFE holders and preferred stockholders, and senior to payments to common stockholders.

What the Y combinator says about the characterization of SAFEs for tax purposes. The Y combinator's Quick Start Guide includes a Q & A section. One of the questions is "[w]hat is the

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characterization of the [SAFE] for tax purposes." The Y combinator answers that question as follows: "We cannot give tax advice, so the only definitive thing we can say is that you should consult with your tax advisor if this question is material to your usage of the SAFE. But we've always intended and believed the [SAFE] (original [SAFE] or new [SAFE]) to be an equity security."

Y Combinator also includes several versions of SAFE instruments on its website that are commonly used as a template starting point for drafting a SAFE instrument. Section 5(g) of the SAFE template reads as follows:

"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)."

While it should comfort investors if the issuing corporation agrees to treat a SAFE as equity, that treatment and characterization is not binding on the IRS. Note that the starting point for the usual "debt" versus "equity" tax court case between a taxpayer and the IRS is usually an instrument called and treated as a debt instrument by debtor and creditor and as equity by the IRS. Of course, any investor rolling QSBS proceeds over into a SAFE should demand that the issuing corporation include the Y Combinator provision quoted above.

Should You Invest in a SAFE if You Want an Interest That Will Qualify as "Stock" for Section 1202 Purposes?

SAFEs are hybrid interests that don't fall neatly within the equity classification. If the potential benefits of Section 1202 are a high priority, then issue conventional common or participating preferred stock.[1] There are two problems with SAFEs in terms of their

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qualification as "stock" for Section 1202 purposes. First, SAFEs have an image problem. SAFEs don't look like stock, are not called "stock" and lack certain economic features that are commonly associated with stock. Can the IRS or the courts then be blamed if they decide to look skeptically at whether SAFEs are, in fact, stock for Section 1202 purposes? Second, although it is unlikely that the IRS would successfully argue that SAFEs are debt (and therefore not stock), it is altogether possible that the IRS would argue that SAFEs should be treated for tax purposes as a prepaid forward contract. The technical merits of this argument are discussed below. A significant problem for holders of SAFEs is that in spite of their advertised simplicity, not all SAFEs are identical, and the determination of whether a SAFE is properly characterized as a prepaid forward contract or stock will depend on the terms of the SAFE and the facts and circumstances surrounding the issuing corporation. This presents holders with the opportunity to assert that SAFEs are stock for Section 1202 purposes, but it also presents the IRS with the opportunity to assert otherwise. Finally, it is often difficult enough to conclude that there is "substantial authority" to claim the Section 1202 gain exclusion when considering each of Section 1202's eligibility requirements without adding the issue of whether a SAFE is stock to the analysis.

A Technical Analysis of What SAFEs Are (and Are Not) for Tax Purposes.

The IRS could argue that SAFEs should be treated as a prepaid forward contract for tax purposes rather than equity. The fact that a typical SAFE does not identify itself as an equity interest opens the door for the IRS to argue that a SAFE should be treated as a prepaid forward contract for tax purposes rather than equity eligible to qualify as QSBS.

The typical prepaid forward contract involves a party paying cash in exchange for an agreement to deliver a variable number of shares at the settlement date. For tax purposes, an open transaction has occurred, with the shares not being considered as being sold until the settlement date. Basically, the up-front payment is an advance deposit, with the tax consequences occurring on the settlement date. In the SAFE context, there would be no tax consequences if

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preferred stock was issued and if the SAFE is cashed out, the party holding the SAFE would be taxed on any cash payment received in excess of the deposit.[2]

The IRS addressed the tax treatment of prepaid forward contracts in Revenue Ruling 2003-7 and concluded that the derivative should be accorded open transaction treatment based on certain specific features. Revenue Ruling 2003-7 identifies the following features of an instrument that should be accorded open transaction treatment: (1) the issuing corporation receives a fixed amount of cash, (2) at the time of the issuing corporation's receipt of cash, it simultaneously enters into an agreement to deliver a variable number of shares on a future date, (3) the holder of the instrument is not entitled to dividends or voting rights, and (4) the issuing corporation retains the right to substitute cash upon the occurrence of a liquidity event. Most SAFEs will have at least several of these features, which opens the door for an IRS position that SAFEs should be accorded open transaction treatment rather than equity status.

If the issuance of a SAFE is treated as an open transaction from a tax standpoint, the issuance of the preferred stock upon conversion of the SAFE would be treated as the payment of cash for the stock at the time of issuance, satisfying a Section 1202 requirement and triggering the commencement of the required five-year holding period for claiming the Section 1202 gain exclusion. Unfortunately, the five-year holding period would not commence when the SAFE is itself issued.

Holders of SAFE's do often have a reasonable basis for taking the position that their interests should be treated as "stock" for Section 1202 purposes. Most SAFEs do have several equity-like features. Typically, the SAFE agreement provides that the SAFE's liquidation preferences is on par with preferred stock. Holders of SAFEs generally participate alongside the holders of common stock in a liquidity event. In many cases, neither the holders of SAFEs nor stock anticipate receiving distributions until a liquidity event. The argument that a SAFE should be treated as equity is strengthened where there is a high likelihood at the time of issuance that an equity financing in the foreseeable future will trigger the conversion

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of the SAFE into preferred stock. Subject to the reservations outlined above that it is safer and less costly in terms of audit and tax litigation expenses (if you are unlucky enough to be challenged by the IRS to prove that your SAFE was "stock" for Section 1202 purposes) to acquire preferred stock, there are often strong arguments why a particular SAFE investment should be treated as the purchase of stock.

If a particular SAFE interest is QSBS, the exchange of that SAFE for preferred stock would be permissible under Section 1202, and the stock issued upon conversion would retain QSBS status and continue the running of the five-year holding period requirement.

Most SAFEs should not be treated as "debt" for tax purposes. The courts have said that an instrument is clearly debt if it is "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."[3] SAFEs basically fail the most critical features associated with debt. SAFEs do not have a fixed maturity date with any degree of certainty of repayment, and SAFE's do not accrue interest. The typical SAFE expressly states that in terms of liquidity priority, the SAFE is junior to debt and creditor claims, is on par with preferred stock and other SAFEs and is senior to common stock.

If a SAFE qualifies as equity under the traditional "debt versus equity" analysis, then the SAFE should be treated as "stock" for Section 1202 purposes. Section 385, which addresses the treatment of interests in corporations as stock or indebtedness, refers to the determination of whether an interest in a corporation is to be treated "for purposes of this title" as stock or debt. Title 26 of the Internal Revenue Code includes Section 1202, so the conclusion that a SAFE is stock under Section 385 and cases analyzing whether interests in corporations are equity, should definitively answer the question of whether the SAFE is "stock" for Section 1202 purposes.

Convertible Debt

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The question of whether convertible debt qualifies as "stock" for Section 1202 purposes usually arises where the five-year holding period requirement would be satisfied only if the taxpayer's convertible debt holding period is tacked onto the holding period for the stock issued when the debt was converted.

Start-ups that issue convertible debt rather than preferred stock typically do so in order to allow the issuing corporation a deduction for the yield (interest) accruing on the debt, and afford the investor a return of capital treatment (thereby avoiding Section 302's dividend treatment) on the redemption of the debt. Obviously, if qualifying for Section 1202's gain exclusion is a high priority, a taxpayer is starting from a weak position in making the "equity" argument when holding a "debt" instrument. But as discussed below, convertible debt instruments issued by many start-ups satisfy many of the requirements to be treated as equity when the traditional debt versus equity analysis is applied. Section 385(c)(1), however, may prove to be an insurmountable stumbling block for many holders of convertible debt instruments.

Section 385(c)(1) May Block the Argument That Convertible Debt Is "Stock" for Section 1202 Purposes

In many instances, we believe that a holder of convertible debt will not be in a position to claim under the Internal Revenue Code that the debt instrument, prior to conversion, should be treated as "stock" for Section 1202 purposes. Section 385(c)(1) provides that "the characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest. . ." Section 385(c)(2) provides that "except as provided in regulations, paragraph (1) shall not apply to any holder of an interest if such holder on his return discloses that he is treating such interest in a manner inconsistent with the characterization referred to in paragraph (1)." If interest is paid on convertible debt, the issuer must issue a Form 1099-INT to the noteholders. If interest is accrued on convertible debt, the issuer must issue a Form 1099-OID to the noteholders. Either way, in the situation where the note issuer is calling the corporate interest a "convertible note" and treating that note as debt (i.e., deducting interest and issuing Form 1099s to

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noteholders), Section 385(c) would normally preclude the noteholder from claiming that the convertible note was QSBS "stock." This would be true unless the noteholder consistently treated the note as stock from the date of issuance (i.e., with respect to amounts paid, treating those payments as taxable dividends and with respect to the Form 1099-OID amounts, and taking the position that there was no original issue discount with respect to equity), and identified this position contrary to the issuer's treatment on applicable tax returns.

An obvious question is why the holder of a convertible note who intends to treat the note as equity for tax purposes doesn't simply acquire convertible preferred stock rather than convertible debt. Perhaps the holder wants to be in a position to argue that the note is debt for non-tax purposes. For example, in a liquidation, noteholders would have priority over holders of preferred stock.

If a holder of convertible debt consistently treats the convertible debt as equity and reports that inconsistency on any applicable tax returns, Section 385(c) won't prevent the holder from arguing that the convertible debt is stock for Section 1202 purposes. But the fact that Section 385(c) doesn't preclude a taxpayer's argument that convertible debt should be treated as equity only means that both taxpayer and the IRS are both free to apply a subjective debt versus equity analysis to the facts and circumstances surrounding the convertible debt. As previously mentioned, if convertible debt is properly characterized as stock, it would be treated so for all purposes of the Internal Revenue Code, including for purposes of Section 1202.[4]

Debt versus equity analysis. If Section 385(b)(1)'s requirements are successfully navigated, the analysis of whether the interest should be treated as equity rather than debt is inherently subjective, requiring both a careful review of all relevant facts and circumstances and applicable tax authorities.

The determination of whether an instrument that is referred to by the parties as "debt" is actually "equity" for purposes of the Internal Revenue Code will be governed by Section 385(b)(1), which refers to "a written unconditional promise to pay on-demand or on a specified date a sum certain in money in return for an adequate

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consideration in money or money's worth, and to pay a fixed rate of interest", along with the numerous court decisions and other tax authorities addressing the debt versus equity issue.

In the situation where the holder of a corporate interest wants to claim equity rather than debt treatment when the interest is styled as a debt instrument, the following factors will be critical in supporting or opposing that position: (1) whether the holder of the interest disclosed the inconsistent treatment of convertible debt as equity on his return as required by Section 385(c); (2) whether the instrument has debt characteristics, such as a fixed and reasonable maturity date, accrues market-rate interest and has other reasonable debt-like provisions – either the failure of an interest to have customary debt features or a track record of failing to adhere to the terms of the interest supports equity characterization; (3) whether the issuer has a high debt to equity ratio (e.g., higher than 5-to-1 would be a factor supporting equity characterization); and (4) whether the issuer has the projected ability to service debt (i.e., the necessary cash flow). Convertible debt issued by start-up corporations often fails one or more of the criteria outlined above. [5]

Other Related Section 1202 Issues.

Given the right circumstances, the door remains open for a taxpayer to successfully take the position and perhaps win an argument based on the subjective debt/equity test that convertible debt is "stock" for Section 1202 purposes. Taxpayers taking that position would also argue that Section 1202(f) applies to the conversion of the debt to common stock in connection with a liquidity event. Under Section 1202(f), the stock acquired upon conversion of QSBS (i.e., in this case, the convertible debt) is treated as QSBS and the holding period of the convertible debt (i.e., here treated as QSBS) tacks onto the holding period of the common stock.

Some advice regarding the use of convertible debt when chasing the Section 1202 gain exclusion prize. Taxpayers shouldn't lose sight of the fact that there isn't any guarantee that the IRS, applying its vision of the subjective debt versus equity

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tests, will agree that convertible debt should be treated as stock, in particular where the issue under consideration is whether the convertible notes were "stock" for Section 1202 purposes. A taxpayer making that argument will certainly be starting from a poor gate position since both the issuer and the taxpayer agreed to name the interest debt rather than stock, which might invite IRS scrutiny and a close look at whether the parties satisfied all of Section 1202's eligibility requirements. On the other hand, it isn't difficult to reach the conclusion that many convertible debt interests issued by start-ups with little or no current means to repay the debt clearly exhibit more equity-like than debt-like features.

The best advice is that if qualifying for the Section 1202 gain exclusion is a planning priority, the parties should avoid the debt label and call the interest stock. The reality is that a preferred stock interest can be crafted with many of a SAFE's features. The one missing feature would most likely be the priority of the debt instrument over equity in connection with a corporate liquidation or bankruptcy.

Closing Remarks

In spite of the potential for extraordinary tax savings, many experienced tax advisors are not familiar with Section 1202 and Section 1045 planning. Venture capitalists, founders and investors who want to learn more about Section 1202 and Section 1045 planning opportunities are directed to several articles on the Frost Brown Todd website:

- Section 1202 Qualification Checklist and Planning Pointers
- A Roadmap for Obtaining (and not Losing) the Benefits of Section 1202 Stock
- Maximizing the Section 1202 Gain Exclusion Amount
- Advanced Section 1045 Planning
- Recapitalizations Involving Qualified Small Business Stock
- Section 1202 and S Corporations
- The 21% Corporate Rate Breathes New Life into IRC § 1202

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For another article addressing SAFEs, see Frost Brown Todd attorney Bill Strench's article: When SAFEs Fail.

Contact Scott Dolson if you want to discuss any Section 1202 or Section 1045 issues by telephone or video conference. You can also visit our **QSBS & Tax Planning Services page** to get our latest insights and analysis.

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[1] See *United States v. Title Guarantee & Trust Co.*, 133 F.2d 993 (6th Cir. 1943).

[2] The issuing corporation would be shielded from tax by Section 1032, which provides that a corporation is not taxed on the receipt of money or other property in exchange for stock of such corporation.

[3] *Gilbert v. Commissioner*, 248 F.2d 402 (2nd Cir. 1957). See also Section 385(b)(1) which refers to "a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest."

[4] Section 385, which addresses the treatment of interests in corporations as stock or indebtedness, refers in Section 385(a) to the determination of whether an interest in a corporation is to be treated "for purposes of this title" as stock or debt. Title 26 of the Internal Revenue Code includes Section 1202.

[5] In Notice 94-47, the IRS noted that intended to scrutinize certain instruments to determine whether their purported status as debt for federal income tax purposes is appropriate. The IRS prefaced its eight factors by noting that: "The characterization of an instrument for federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances." The IRS further noted that, "[n]o particular factor is conclusive in making the determination of whether an instrument constitutes debt or equity. The weight given to any factor depends upon all the facts and circumstances and the overall effect of an instrument's debt and equity features must be taken into account." The eight factors the IRS considered important in a review of whether a corporate interest was debt or equity for federal income tax purposes are as

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follows:

- Whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future
- Whether holders of the instruments possess the right to enforce the payment of principal and interest;
- Whether the rights of the holders of the instruments are subordinate to the rights of general creditors;
- Whether the instruments give the holders the right to participate in the management of the issuer;
- Whether the issuer is thinly capitalized;
- Whether there is identity between the holders of the instruments and stockholders of the issuer;
- The label placed on the instruments by the parties;
- Whether the instruments are intended to be treated as debt or equity for non-tax purposes.

Also note that in Revenue Ruling 83-98, the IRS found that the parties structured a corporate interest as "convertible notes" in order to receive the tax benefits of having the note categorized as debt in spite of the fact that it was, in reality, an equity investment. Critical to the IRS' determination was the fact that there was a high probability was the notes would be converted into stock, and that the notes did not represent a promise to pay a sum certain.

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