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Guide to the Federal Income Tax Treatment of SAFEs

The Simple Agreement for Future Equity (SAFE) was introduced in 2013 on the startup accelerator Y Combinator website as a suggested alternative to convertible notes.[1] A SAFE is a contract between a corporation and an investor. The investor pays in full up-front for the right to receive a variable number of shares of preferred stock as part of the corporation's first priced equity round, typically at a discount and sometimes with a valuation cap.[2] The investor is generally treated as selling a capital asset if the corporation is liquidated or a sale event occurs before the SAFE converts into preferred stock.[3] Upon liquidation, a SAFE is typically subordinate to debt, on an equal footing with preferred stock, and ahead of common stock.

The Y Combinator website noted in its 2013 introduction to SAFEs that while both SAFEs and convertible debt generally allow for faster and cheaper fundraising than issuing preferred stock, SAFEs were specifically engineered to avoid the complicated regulatory and tax issues associated with issuing debt. Since their introduction, many start-ups have relied on SAFEs to raise capital.

During the past 10 years, the IRS and the Tax Court have remained silent on the federal income tax treatment of SAFEs. During this same period, tax professionals have debated over whether a SAFE should be treated as stock, debt or some form of hybrid (contract) instrument.[4] The precise tax treatment of a SAFE is often not important, since SAFEs usually convert into preferred stock and holders rarely participate in dividends. But the determination of whether a SAFE is "***stock***" for federal income tax purposes can be a critical issue for those investors focused on investing in "qualified small business stock" (QSBS).

The significance of a SAFE's treatment under Sections 1202 and 1045.

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Section 1202's substantial gain exclusion applies only when an investor sells ***stock*** held for more than five years. [5] Section 1045 permits the reinvestment of original QSBS sales proceeds into replacement QSBS on a tax-free basis, but the replacement QSBS must be ***stock***.

If a SAFE is treated as ***stock*** for federal income tax purposes, then (i) the SAFE should also be treated as "stock" for purposes of Sections 1202 and 1045, (ii) the SAFE and the preferred stock that the SAFE converts into should be eligible to qualify as QSBS, (iii) the holding period for purposes of Section 1202 would commence when the SAFE is issued, whether or not the SAFE converts into preferred stock (see Section 1202(f)(2)), and (iv) the SAFE would be eligible to qualify as "replacement QSBS" under Section 1045.[6]

If a SAFE is not ***stock*** for federal income tax purposes (i) the holder would not be eligible to claim Section 1202's gain exclusion if the SAFE is sold, (ii) the SAFE would not qualify as "replacement QSBS" for purposes of Section 1045, and (iii) the holding period for purposes of Section 1202 would not commence until the SAFE converts into preferred stock.[7] If a SAFE is merely an agreement to acquire a capital asset (stock) for federal income tax purposes, the holding period for capital gains purposes should commence upon the SAFE's issuance, but would be reset to zero if the SAFE converts into preferred stock.

The significance of a SAFE's tax treatment for purposes of Section 368.

If a SAFE is treated as ***stock*** for federal income tax purposes, the SAFE can be exchanged for another SAFE or other stock in a Section 368 tax-free reorganization, so long as the SAFE is not treated as nonqualified preferred stock under Section 351(g).[8] Alternatively, if a SAFE is treated as a "right to acquire stock" (but not stock itself), then it should qualify as a "security" under Section 354 and Treasury Regulation Section 1.354-1(e) and be exchangeable in a Section 368 tax-free reorganization on a tax-free basis for another SAFE with the same terms and principal amount, but not for stock. [9]

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The significance of a SAFE being treated as property transferred for services under Section 83.

Under Section 83(a), a taxpayer who performs services in return for property has gross income equal to the excess of the property's value over the amount paid for the property. A SAFE that is treated as ***stock*** for federal income tax purposes could be subject to Section 83 if it is issued in connection with the performance of services. Presumably, Section 83 would not apply if an employee acquires a SAFE on the same terms as other investors. But there might well be an element of taxable compensation if a SAFE is issued to an employee at less than fair market value or is issued immediately before an equity round and converts at a discount into preferred stock.

If a SAFE is not ***stock*** at the time of issuance, the tax treatment under Section 83 is unclear. If the SAFE is treated as "other property," but not an option, Section 83 would tax any spread between the consideration paid by the employee and the SAFE's fair market value at the time of issuance, and assuming there are no vesting requirements, the SAFE should then be a capital asset in the hands of the employee based on the fact that it represents a right to acquire a capital asset (preferred stock).[10] If a SAFE is subject to substantial risk of forfeiture under Section 83 (i.e., vesting requirements), the recipient should consider taking the position that the SAFE is either unvested stock or other property (i.e., something other than a nonqualified option) and file a Section 83(b) election.

If a SAFE is treated as a nonqualified option under Section 83, the SAFE would not be taxable upon issuance, but the spread between the up-front payment and the amount received in a liquidity event or dissolution, or the value of the preferred stock received upon conversion, would be taxable compensation upon conversion. There are many questions left unanswered by the dearth of tax authorities addressing how SAFEs fit into the compensation rules of Sections 61, 83 and 409A.

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What are the tax consequences of SAFEs converting into preferred stock?

If a SAFE is ***stock*** at the time of its issuance, then (i) the exchange of the SAFE for preferred stock should be nontaxable,[11] and (ii) Section 1202(f) should apply and treat the conversion of the SAFE into preferred stock as a continuous holding of QSBS from and after the SAFE's original issuance date.[12] Alternatively, if the SAFE is not ***stock*** but instead a stock right (i.e., an agreement to acquire non-compensatory stock), then the SAFE should be treated as a capital asset that has a holding period commencing on the date of issuance.[13] The holder should be entitled to capital gains treatment when the SAFE is sold. But if the SAFE converts, a new holding period would commence on the date of the issuance of the preferred stock.[14]

What is the correct tax treatment for a SAFE?

This article considers the tax treatment of the Y Combinator's current post-money SAFE (Discount; no Valuation Cap).[15] Note that the Y Combinator SAFE template is often customized by the issuer or as a result of negotiations among the parties, and those changes could affect the instrument's tax treatment. Also, there is more than one Y Combinator template, each with different terms that could impact the applicable tax treatment.

The issue addressed in this article is whether the typical form of SAFE instrument should be treated as:

- a debt instrument
- a hybrid instrument (an agreement that is something other than stock – akin to an option to purchase stock that isn't itself stock)
- a share in a corporation qualifying as ***stock*** for federal income tax purposes, (including for purposes of Sections 368, 1045 and 1202)

The significance of the "form" of a SAFE (the battle between form and substance).

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The significance of an instrument's "form" and the battle over whether form trumps substance or vice versa are long-standing unresolved issues. The SAFE labels itself as a "**simple agreement for future equity**." So, the "form" of a SAFE is an agreement between the investor and the issuing corporation (a right issued by the corporation to the investor to a future share of capital stock) rather than ***stock***. In spite of a SAFE's form, the current Y combinator's SAFE include the following language: "*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).*"[16]

The IRS could assert that form should govern the tax treatment of a SAFE. The IRS might note that as to form, the existence of a class or series of ***stock*** is typically identified in a corporation's certificate of incorporation as a share of the corporation's equity. The IRS might argue that where the parties have the freedom to issue ***stock***, but instead choose to enter into an agreement that purports to establish future rights to stock, the parties should not be allowed to deviate from their chosen form. There is some support in tax authorities for this position. Judge Learned Hand stated that "*it is true that the Treasury may take a taxpayer at his word, so to say, when that serves its purpose, it may treat his corporation as a different person from himself, but that is a rule which works only in the Treasury's own favor, it cannot be used to deplete the revenue*." [17] Fortunately for taxpayers, many other cases hold that the substance-over-form doctrine is a two-way street, open to taxpayers as well as to the government. One court noted that "*One should not be garroted by the tax collector for calling one's agreement by the wrong name*."[18] The Supreme Court has permitted taxpayers to disavow a tax-oriented contract on showing that its form conflicted with economic reality, despite the government's willingness to accept the contract as written.[19]

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There are many lower court decisions that similarly allow the taxpayer to invoke the substance-over-form doctrine, and some important IRS rulings appear to follow suit.[20] Between these two extremes are cases that allow taxpayers to escape from the forms selected by them but impose a more stringent burden of proof than is ordinarily applicable in tax cases. Describing this middle ground, the Tax Court has observed that "*the so-called 'two-way street' seems to run downhill for the IRS Commissioner and uphill for the taxpayer*."[21]

If nothing else, the mix of tax authorities addressing the form over substance argument should serve as a warning to investors who are considering investing in a SAFE in circumstances where the certainty of QSBS treatment is paramount. Language in a SAFE confirming the parties' intention to treat the instrument as ***stock*** is helpful, but the fact that the parties intend to treat and report the SAFE as stock does not bind either the IRS or the judiciary, and stockholders will bear the burden of proof if challenged by the IRS.

A Review of Key Features of the SAFE

While there are no tax authorities that have addressed the proper tax treatment of a SAFE, there exists a large body of tax authorities addressing the proper classification of instruments whose form is usually debt. [22] Most of these tax authorities involve a determination of whether a debt instrument should be recharacterized as equity for federal income tax purposes. These tax authorities compare the features of the "debt" instrument (and the issuer) against a list of factors which are considered to indicate debt or equity treatment.[23] In a similar vein, we believe that the Tax Court would determine the appropriate tax treatment of a SAFE by comparing its key features, along with information regarding the issuing corporation and the investor, with factors that the court considers as indicators of the proper tax treatment.

Although we don't know with any certainty what features the Tax Court would consider relevant when analyzing the tax treatment of the SAFE, the features discussed below are likely candidates based on tax authorities addressing the proper tax treatment of debt and hybrid instruments.

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	Features	Analysis
1.	Form of the instrument	As previously noted, the SAFE calls itself a "simp equity," which certainly cracks open the door for (i.e., an agreement – not stock) should govern tr tax purposes. Issuers do not generally identify SA table, balance sheets or in their certificate of inc
2.	Intent of the parties	The SAFE includes language confirming the parti SAFE will be treated as ***stock*** for federal income IRS nor the courts are bound by the parties' inte useful in terms of confirming intent.
3.	No voting rights	Holders of the SAFE have no voting rights, and do election or appointment of directors.
4.	No fixed term	The SAFE does not have a fixed term establishing amount will be returned. In fact, the invested am connection with dissolution or a liquidity event.
5.	No periodic accrual or payments of cash or PIK interest	The payment or accrual of interest is considered The SAFE does not pay or accrue a return.
6.	Participation in common stock dividends	Holders of the SAFE are entitled to participate in of common stock, evidencing an economic right ownership from the date of the SAFE's issuance.
7.	Participation in liquidity payments and dissolution distributions	The SAFE states that in the event of a liquidity ev the SAFE functions like standard non-participati junior to debt, on par with preferred stock and s making it essentially the economic equivalent of preferred stock. In a liquidity event, in contrast to an option holde automatically participates in the sharing of the p the greater of a "Cash-Out Amount" or an amou converted (into common stock) basis. The holde non-cash consideration.[24]

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	Features	Analysis
8.	The SAFE's conversion feature	Upon the occurrence of an equity round, the SAF into preferred stock. The IRS's treatment deep in the money options c 82-150 suggests that favorable conversion right stock-like feature. Revenue Ruling 82-150 also su where there is a high likelihood of an equity roun convert.

The analysis of the SAFE that follows is based on the features of the SAFE discussed above and applicable tax authorities.

Should the SAFE be treated as a debt instrument?

The potential treatment of a SAFE as a debt instrument is discussed first because when there are three possible choices, it helps when you can easily dismiss one of the three choices as a highly unlikely candidate.

Taxpayers and the IRS have fought for decades over whether particular instruments should qualify as debt or equity. The typical battle is over whether a distribution should be treated as a non-deductible dividend or deductible interest. Section 385 and a bevy of tax authorities have established a number of key factors to consider as part of a very fact-oriented analysis.[25] The bottom line is that the SAFE has few debt-like characteristics: (i) the corporation and investors do not intend for the SAFE to be treated as debt and the SAFE is not treated as debt on a corporation's balance sheet; (ii) the SAFE does not have a set term and does not entitle holders to periodic distributions; upon liquidation, the SAFE is subordinate to debt; and (iii) in most cases, the corporation issuing the SAFE will be thinly capitalized and unable to redeem the SAFE without the occurrence of a liquidation (if at all) or a liquidity event. Given the almost complete absence of debt-like features, it seems highly unlikely that the Tax Court would conclude that the SAFE is a debt instrument.

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Should the SAFE be treated as a form of hybrid instrument (i.e., not stock)?

Some writers have suggested that SAFEs are likely to be treated as forward contracts to purchase equity (i.e., an executory contract between an investor and the issuing corporation pursuant to which the investor pays money up front to acquire stock at a future date and at a fixed or variable price).[26] The form of the SAFE as an "agreement for future equity" is a factor supporting this position (i.e., here again the form over substance argument). Also, because the "form" of a SAFE is an agreement between the issuing corporation and the investor, writers often compare a SAFE with the financial instrument considered in Revenue Ruling 2003-7.[27]

In Revenue Ruling 2003-7, the IRS focused on whether a contractual arrangement actually constituted a sale of stock and concluded that the investor neither sold stock currently nor caused a constructive sale of stock in the situation where the investor: (i) received a fixed amount of cash; (ii) simultaneously entered into an agreement to deliver on a future date a number of shares of common stock that would vary significantly depending on the value of the shares on the delivery date; (iii) pledged the maximum number of shares for which delivery could be required under the agreement, retained an unrestricted legal right to substitute cash or other shares for the pledged shares; and (iv) was not economically compelled to deliver the pledged shares. Citing Technical Advice Memorandum 200341005 (10/10/2003), the IRS noted that a significant factor in determining whether a sale occurred is whether the investor retained the right, unrestricted by agreement or economic circumstances, to reacquire the stock by delivering cash or other shares of stock. The IRS also referenced the fact that the investor also retained the right to receive dividends and exercise voting rights with respect to the pledged shares.

Applying the factors addressed in Revenue Ruling 2003-7 to the SAFE, an obvious point is that both the SAFE and the forward variable contract are agreements in "form." A further point is that both the SAFE and the forward contract involve the payment of money for the right to receive a variable amount of stock at a later

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date upon the occurrence of certain events. A yet further point is that neither the SAFEs nor the forward variable contract gives the investor the voting rights of a stockholder.[28] But apart from those factors, it is notable that the ruling in Revenue Ruling 2003-7 hinged on very specific features which the SAFE lacks. Revenue Ruling 2003-7 involved a stockholder and third-party investor while a SAFE involves an investor and the issuing corporation. More significantly, the IRS conceded in the ruling that "*a different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares*." The issuer of the SAFE does not have the option of satisfying its obligation to issue preferred stock to the holder by substituting money for stock. Further, the SAFE provides the holder has the same dividend rights as stockholders and the same right to participate in liquidity events and distributions upon dissolution as afforded holders of nonparticipating preferred stock. These differences undermine the relevance of Revenue Ruling 2003-7. In fact, aside from form, the SAFE has little in common with the hybrid instrument described in Revenue Ruling 2003-7, and little in common with typical stock rights or stock options.

If the IRS successfully argues that a SAFE is merely an equity right, one interesting argument favoring the taxpayer is that the SAFE should be treated as a deep in-the-money option (in some respects 100% in the money when issued). Since the IRS has vigorously argued that a deep in-the-money option should be treated as ***stock***, it seems reasonable that the same result should apply to a SAFE, particularly given the fact that the parties are fully committed when the SAFE is issued to the investor's future stock ownership (or at very least, the investor is sharing in economic rights equivalent to stock ownership).[29]

Should the SAFE be treated as *stock*?

The analysis of a SAFE's key features suggests that treatment of the SAFE as ***stock*** closely aligns with its economic substance. An investor issued a Y Combinator post-money SAFE immediately holds a participating share in the corporation's economic rights.

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Unlike the holder of a typical hybrid instrument (i.e., stock rights or stock options), the investor participates in dividends, liquidation distributions and sales proceeds. In fact, the investor's economic rights appear to be essentially indistinguishable from those of a similarly crafted series of preferred stock. Although the final answer will depend on how the Tax Court weighs the relevant factors, it appears that a SAFE's stock-like economic features should more than offset the potential significance assigned to the SAFE's form. In conclusion, the relevant factors suggest that the SAFE should be treated as ***stock*** for federal income tax purposes.

Introducing a new type of stock (SAFE Preferred Stock) combining the best features of the SAFE with greater certainty of tax treatment.

Until now, the best solution for investors and issuers seeking a high level of tax treatment certainty would be to forgo the SAFE and rely on traditional preferred stock. But there is a possible alternative that involves combining the best feature of a SAFE with the form of ***stock***. The creation of SAFE Preferred Stock addresses weakest feature of the SAFE in terms of its treatment as ***stock*** – the fact that in form the SAFE is not stock. SAFE Preferred Stock incorporates all of the stock-like economic features of the SAFE and is, in form, ***stock***.

On our website, we have published a ***User Guide for SAFE Preferred Stock*** with several key documents as examples. Unlike the SAFE templates on the Y Combinator website, which are often printed out by start-ups and used without modification, the Certificate of Incorporation example provided below includes provisions that incorporate key terms of the Y Combinator SAFE, but with significant modifications designed to meet a particular start-up's needs. Each of the documents, available for download below, should be viewed merely as examples.

- An example of a Certificate of Incorporation that includes a class of SAFE Preferred Stock and also incorporates Delaware "blank check preferred." **Access here.**

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- An example of a SAFE Preferred Stock Purchase Agreement. **Access here.**
- An example of a Certificate of Designations previously filed with the Delaware Secretary of State establishing a priced round of preferred stock. **Access here.**

In addition to the documents referenced above, stockholders (common and preferred) generally enter into a Stockholders Agreement addressing various matters such as participation rights (pre-emptive rights to acquire stock, restrictions on transfer, drag-along rights, governance, issuing corporation covenants and registration rights).

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Scott assists with tax planning for business formations, ownership arrangements, LLC agreements and M&A transactions, equity compensation arrangements and general corporate law matters. He has developed a national practice handling Section 1202 and 1045 issues while helping clients secure and maximize Section 1202's generous tax benefits.

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[1] Wikipedia describes Y Combinator as an American technology startup accelerator launched in March 2005 which has been used to launch more than 4,000 companies. See the article Announcing the Safe, a Replacement for Convertible Notes (12/6/2013) at https://www.ycombinator.com/blog/announcing-the-safe-a-replacement-for-convertible-notes. Features of the SAFE instrument that are touted as favorable to start-ups include the absence of interest payments and maturity dates and that SAFE instruments generally do not provide for the repayment of principal.

[2] Since 2013, the SAFE templates have evolved on the Y Combinator website. While start-ups sometimes adopt the Y Combinator forms verbatim, a significant percentage of SAFE

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instruments undergo significant customization before use. There is currently a significant amount of debate over the relative virtues of pre-money versus post-money SAFEs. With a pre-money SAFE, the corporation's capitalization excludes all securities converting in the financing (such as SAFEs and convertible notes). In contrast, with the post-money SAFE, the corporation's capitalization includes the converting securities. The larger the corporation's capitalization, the lower the SAFE price will be, resulting in the issuance of more shares issued to the SAFE holders. With post-money SAFEs, the issuance of each additional SAFE lowers the post-money SAFE price, increasing the number of shares that are issued to the SAFE holders upon conversion. Issuing a substantial amount of post-money SAFEs can have the effect of dramatically reduce the founders' percentage ownership interest in the corporation. A valuation cap establishes the maximum valuation at which a SAFE will convert into the priced round of preferred stock, a feature that protects the holder by creating a floor for the SAFE's conversion.

[3] This assumes that a SAFE would be accorded the same tax treatment as an option/contract right to acquire a capital asset (preferred stock). Section 1234 provides that *"[g]ain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him)."* Except for the specific discussion of a SAFE issued for services, this discussion of a SAFE's tax treatment generally assumes that its issuance is not governed by Section 83 which deals with property transferred in connection with the performance of services.

[4] Although Sections 1202 and 1045 have been around for decades, there are surprisingly few tax authorities addressing issues critical to interpreting the statutes, and to date there are no tax authorities addressing SAFEs in the context of Sections 1202 or 1045, or for that matter other provisions of the Internal Revenue Code.

[5] References to "Section" are to sections of the Internal Revenue Code of 1986, as amended.

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[6] An investor might desire to elect Section 1045 treatment if the holding period for the original QSBS is less than five years or the investor sells an amount of original QSBS exceeding his Section 1202 gain exclusion cap.

[7] Each of the applicable Section 1202 eligibility requirements would need to be satisfied at the time of the non-stock SAFE converted into preferred stock in order for the preferred stock to qualify as QSBS. See language from Section 1223(5) in footnote xix above.

[8] The exchange would be subject to the Section 368 rules regarding voting and nonvoting stock. All of the traps for classifying stock as "nonqualified preferred stock" should be run when dealing with a SAFE, given the fact that a SAFE would generally be considered a class of preferred stock and the negative tax consequences of falling into the nonqualified preferred stock category are significant. Generally, the unfavorable tax treatment of "nonqualified preferred stock" should not be an issue for a SAFE so long as the instrument does not include put and/or call rights that bring it within the definition of "nonqualified preferred stock" under Section 351(g).

[9] Treasury Regulation Section 1.356-3(a) provides that when securities (here a non-stock SAFE) are surrendered in a transaction to which Section 354 applies, the characterization of the securities received as "other property" (i.e., taxable) does not include securities received where the principal amount of such securities does not exceed the principal amount of securities surrendered in the transaction. If a greater principal amount of securities is received in an exchange described in Section 354 over the principal amount of securities surrendered, the term "other property" includes the fair market value of such excess principal amount as of the date of the exchange. If no securities are surrendered in exchange, the term "other property" includes the fair market value, as of the date of receipt, of the entire principal amount of the securities received (so if a SAFE is issued in exchange for stock, the fair market value of the SAFE is taxable "other property").

[10] See Section 1234.

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[11] This assumes that the SAFE would be considered a class of "preferred stock" and would qualify upon conversion as an exchange of preferred stock for preferred stock under Section 1036(a) (assuming that the neither the SAFE or the preferred stock would be treated as nonqualified preferred stock under Section 1036(b)).

[12] Section 1202(f) provides that "*if any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer – (1) the stock so acquired shall be treated as qualified small business stock in the hands of the taxpayer, and (2) the stock so acquired shall be treated as having been held during the period during which the converted stock was held.*"

[13] Section 1234 provides that gain or loss attributable to the sale or exchange of an option to buy or sell property is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has in the hands of the taxpayer. See PLR 8350041 (9/7/1983).

[14] See Section 1223(5) which provides that "*in determining the period for which the taxpayer has held stock or securities acquired from the corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date on which the right to acquire was exercised .*"

[15] Found at https://www.ycombinator.com/documents/ (most recently accessed on January 29, 2024).

[16] Y Combinator's Quick Start Guide includes a Q&A section. One of the questions on the Y Combinator Guide is *"[w]hat is the characterization of the [SAFE] for tax purposes.*" The Y Combinator answers that "*we've always intended and believed the [SAFE] (original or new) to be an equity security.*"

[17] *US v. Morris & Essex RR*, 135 F2d 711, 713 (2d Cir.), cert denied, 320 US 754 (1943). See *CIR v. National Alfalfa Dehydrating & Milling Co.*, 417 US 134, 149 (1974) ("*a taxpayer is free to organize his affairs as he chooses, [but] once having done so,…he must accept the tax consequences of his choice, whether contemplated or not*");

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Consolidated Edison Co. v. US, 10 F3d 68 (2d Cir. 1993) ("*when knowledgeable parties cast their transaction voluntarily into a certain formal structure,…they should be, and are, bound by the tax consequences of the particular type of transaction which they created*"); *Nestlé Holdings, Inc. v. CIR*, 152 F3d 83 (2d Cir. 1998) (rejecting subsidiary corporation's attempt to characterize sale to its parent for price exceeding fair market value as sale at fair market value, plus capital contribution).

[18] *Pacific Rock & Gravel Co. v. US*, 297 F2d 122, 125 (9th Cir. 1961).

[19] *Bartels v. Birmingham*, 332 US 126 (1947). The case involved an effort to shift liability for social security taxes on the wages of musicians from bandleaders to ballroom operators by vesting the latter with rights under a standard union contract that were not intended to be enforced. Despite this barefaced denial of the employment realities, the IRS was willing to accept the agreement, perhaps because the ballroom operators were more responsible taxpayers than the bandleaders. The Supreme Court, however, allowed the operators to repudiate the fictitious employer-employee relationship.

[20] E.g., *Weinert's Est. v. CIR*, 294 F2d 750, 755 (5th Cir. 1961) (taxpayer "has a right to assert the priority of substance"); *Shaw v. CIR*, 59 TC 375, 383–384 (1972) (acq.) ("preference for substance over form in tax matters extends to claims of petitioner and respondent alike").

[21] *Rogers v. CIR*, 29 TCM (CCH) 869 (1970), *aff'd*, 445 F2d 1020 (2d Cir. 1971). In *Complex Media, Inc. v. CIR*, TC Memo. 2021-14, the court stated that a taxpayer disavowing the form of a transaction "must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits . . . that are inconsistent with those the taxpayer seeks through disregarding that form." See 2023-11 IRB 529 (IRS does not acquiesce in court's statement in Complex Media that "the parties' failure to report the transactions fully or consistently should not be a major factor in a decision whether to allow a taxpayer to disavow the form of its transactions").

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[22] The Y Combinator SAFE templates are located at: https://www.ycombinator.com/documents/.

[23] E.g., *Fin Hay Realty Co. v. United States*, 398 F.2d 844 (5th Cir. 1969). See Bittker & Eustice: Federal Income Taxation of Corporation & Shareholders, ¶4.05 (WG&L)

[24] Section 1(b) of the Y Combinator SAFE provides as follows: "*Liquidity Event*. *If there is a Liquidity Event before the termination of this Safe, the Investor will automatically be entitled (subject to the liquidation priority set forth in Section 1(d) below) to receive a portion of Proceeds, due and payable to the Investor immediately prior to, or concurrent with, the consummation of such Liquidity Event, equal to the greater of (i) the Purchase Amount (the "Cash-Out Amount") or (ii) the amount payable on the number of shares of Common Stock equal to the Purchase Amount divided by the Liquidity Price (the "Conversion Amount"). If any of the Company's securityholders are given a choice as to the form and amount of Proceeds to be received in a Liquidity Event, the Investor will be given the same choice, provided that the Investor may not choose to receive a form of consideration that the Investor would be ineligible to receive as a result of the Investor's failure to satisfy any requirement or limitation generally applicable to the Company's securityholders, or under any applicable laws*."

[25] See *John Kelly Co. v. Comm'r.*, 326 U.S. 521 (1943); *Dixie Dairies Corp.*, 74 T.C. at 493; *Anchor National Life v. Comm'r.*, 93 T.C. 382, 400 (1989); *Estate of Mixon v. U.S.*, 30 A.F.T.R.2d 72-5094, 72-5097 (5th Cir. 1972); *NA Gen. P'ship & Subsidiaries v. Comm'r.*, T.C. Memo. 2012-172.

[26] Also sometimes referred to as "prepaid forward contracts," or if the amount of property to be conveyed to the buyer is variable or contingent, "variable prepaid forward contracts."

[27] Revenue Ruling 2003-7, 2003-1 CB 363. See also PLR 200450016 (12/10/2004).

[28] Of course, both nonvoting common stock and nonvoting preferred stock are a common occurrence – features that seldom are cited as support for the conclusion that the stock isn't "stock" for federal income tax purposes.

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[29] In Revenue Ruling 82-150, 1982-2 CB 110, the IRS holds that a sale of a deep-in-the-money option was, in substance, not an option but a completed sale of the applicable stock.

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