SAFEs, Section 1202, and the OBBBA: When Does the QSBS Clock Actually Start?

by Jason J. Galek

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In this article, Galek examines different characterizations and timing for simple agreements for future equity in light of the lack of direct IRS guidance and the related federal tax consequences under section 1202, as amended by the One Big Beautiful Bill Act.

The views expressed are those of the author and do not necessarily reflect the views of any client, firm, or institution.

I. Introduction

The simple agreement for future equity (SAFE) has become the default instrument of early-stage venture finance. In 2025 U.S. startups on the Carta platform raised $10.4 billion across more than 50,000 SAFEs and convertible notes, and the majority of early-stage rounds under $4 million were completed on those instruments.[1] In a typical early-stage financing closing in 2026, a venture investor would expect to pay cash to a development-stage C corporation and receive a SAFE. The parties may well assume, without further inquiry, that the investor has begun holding qualified small business stock (QSBS) for purposes of section 1202.[2] That assumption is contestable. Despite more than a decade of widespread SAFE use, no published statute, Treasury regulation, IRS ruling, or judicial decision directly classifies a standard SAFE for federal income tax purposes.[3] The IRS likely would analyze a SAFE under general debt-versus-equity principles applied to the instrument's specific terms, with the analysis drawing principally on section 385; reg. section 1.385-1(b); Notice 94-47, 1994-1 C.B. 357; and the multifactor framework developed under the case law.[4]

The section 1202 stakes are as pervasive as the instrument, although they are harder to measure. Public empirical evidence does not measure QSBS adoption by startups at the time of formation or at the time of financing. Treasury economists have explained that there are no information returns for QSBS issuance and no requirement that eligible corporations register with the IRS. As a result, the government generally observes QSBS only when stock is sold, and the exclusion is claimed on Form 8949, "Sales and other Dispositions of Capital Assets." Treasury's best available claims-based

[1] *See* Carta, "State of Pre-Seed: 2025 in Review" (Feb. 19, 2026) (reporting $10.4 billion raised across 50,316 SAFEs and convertible notes by U.S. startups on Carta in 2025, with the majority of early-stage rounds under $4 million completed on convertible instruments); Carta, "State of Pre-Seed: Q1 2026" (May 14, 2026) (reporting that convertible notes fell to a record low of 7 percent of pre-seed rounds and 8 percent of pre-seed dollars in Q1 2026, and describing SAFEs as "the default financing instrument for early-stage startups").

[2] Section 1202.

[3] The IRS has not addressed the federal income tax characterization of SAFEs. *See* Lucille S. Murray, "SAFEs and the Section 1202 Exclusion," PKF O'Connor Davies (Aug. 2, 2021) ("The IRS has yet to provide any guidance on whether a SAFE will be considered 'stock' for Section 1202 purposes."); Lesley P. Adamo, "Tax Treatment of SAFEs," Lowenstein Sandler LLP (July 12, 2018); Eric Brauer, "Tax Treatment of SAFE Instruments Is Not a Lock," RSM US LLP (Aug. 30, 2022).

[4] Section 385; reg. section 1.385-1(b); Notice 94-47; *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968).

data thus measure exit-stage use rather than company-level adoption. Those data report more than $140 billion of claimed section 1202 exclusions from 2012 through 2022.[5] On the adoption side, however, the indirect evidence is unmistakable: QSBS has become a routine venture-financing planning item, reflected in model legal documents from the National Venture Capital Association (NVCA) (whose stock purchase agreement carries a QSBS representation updated in October 2025 for the OBBBA's expanded exclusion) and in tax professional commentary describing QSBS representation and certification mechanics in NVCA-style financings.[6] The combination of the default financing instrument of early-stage venture capital and one of the code's most generous exclusions raises a single question: When does the SAFE holder's QSBS holding period begin? No authority answers that question, no information reporting surfaces it at issuance, and it first becomes visible to the government only at exit, on a Form 8949. By this point, the clock can no longer be restarted.

The classification question has consequences for several code provisions, including section 382 (ownership change),[7] section 1061 (carried interest holding period),[8] sections 267 and 958 (related-party and controlled foreign corporation attribution),[9] and the passive foreign investment company tests under sections 1297-1298.[10] But its most consequential application is to section 1202, in which the answer determines whether the QSBS holding period begins on the date the SAFE is signed or only on the date stock is actually issued upon conversion.

Before the One Big Beautiful Bill Act, signed July 4, 2025, section 1202's holding period rule was, for QSBS acquired after September 27, 2010, binary in practical effect. A noncorporate taxpayer holding QSBS for more than five years could exclude 100 percent of the qualifying gain; a shorter holding period results in no section 1202 exclusion. For QSBS acquired after July 4, 2025, amended section 1202(a) adopts a graduated regime: a 50 percent exclusion for stock held at least three years, 75 percent at four years, and 100 percent at five years, with the non-excluded portion of a three- or four-year hold taxed at the higher rates discussed in Section IV.B. Amended section 1202 determines the applicable exclusion tier by reference to the taxpayer's acquisition date, as determined under section 1202(a)(6)(B) after applying section 1223; the statute's issuance-date language governs the gross asset test.[11] The OBBBA also raised the per-issuer exclusion cap from $10 million to $15 million (indexed for inflation) for QSBS acquired after July 4, 2025, and raised the gross asset eligibility threshold from $50 million to $75 million for stock issued after that date.[12]

That change is the principal reason to reconsider SAFE characterization now. Under the prior law, the SAFE holding period question affected only one threshold. Under the OBBBA, the question affects three. An investor whose holding period begins at signing reaches each of the 50 percent, 75 percent, and 100 percent thresholds earlier than an investor whose holding period begins at conversion, and the head start at every tier equals the period the SAFE remained outstanding before conversion. For a SAFE outstanding for one year, each threshold arrives one year sooner; for a SAFE outstanding for three years, three years sooner. The dollar consequences at the lower exclusion thresholds are smaller than at full exclusion but no longer zero, and the additional 28 percent rate on the non-excluded

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[5] Zahrah Abdulrauf et al., "Quantifying the 100% Exclusion of Capital Gains on Small Business Stock," Treasury Office of Tax Analysis Working Paper 127, at 2 (Jan. 2025) (explaining that "there are no information returns for QSBS issuance and no requirements for eligible corporations to register with the IRS," so that "the IRS does not observe anything about QSBS until taxpayers sell the stock and claim the exclusion on Form 8949," and reporting "over $140 billion in all exclusion claims since 2012" on e-filed returns through 2022).

[6] *See* NVCA, "Model Legal Documents" (2026); Louis Lehot et al., "Breaking Down the October 2, 2025 NVCA Updates to the Model Legal Documents: What Founders and VCs Need to Know," Foley & Lardner LLP (Oct. 21, 2025) (describing the revised QSBS representation in the NVCA model stock purchase agreement, updated for the One Big Beautiful Bill Act's expanded exclusion); James B. Jumper et al., "Modeling the Market: The National Venture Capital Association Revises Its Model Documents," Troutman Pepper (Sept. 15, 2020).

[7] Section 382.

[8] Section 1061.

[9] Sections 267(b), 958.

[10] Sections 1297-1298.

[11] Section 1202(a)(1)(B), (a)(5), (a)(6), as amended by OBBBA section 70431; *see* Matthew Widmyer and James E. Wreggelsworth, "QSBS Just Got a Major Upgrade," Davis Wright Tremaine (July 15, 2025).

[12] Sections 1202(b)(1), (d)(1), as amended by OBBBA section 70431.

portion further amplifies the spread between the two regimes.

II. The SAFE and the Characterization Problem

A. Background

Startup accelerator and venture capital firm Y Combinator introduced the SAFE in late 2013 as an alternative to the convertible note.[13] In its original form, the SAFE provided that an investor would pay cash to a corporation in exchange for the right to receive equity upon a triggering event such as a priced equity round, a sale of the corporation, or a dissolution event. The eventual number of shares depended on a valuation cap, a discount, or both, applied at the time of the triggering event. The original SAFE lacked an interest rate, a maturity date, voting rights, dividend rights, and any current ownership rights. The investor's position was essentially a contractual right to receive a variable amount of equity in the future, contingent on a future financing or liquidity event.

In September 2018 Y Combinator released a revised SAFE form, generally referred to as the "post-money" SAFE.[14] The post-money form differs from the original "pre-money" form in three ways relevant to the characterization analysis. First, the post-money SAFE measures the investor's ownership percentage after all SAFE proceeds have been raised but before the next priced round, providing greater certainty about the investor's eventual stake. Second, the post-money form gives the investor the right to participate in dividends if dividends are declared on common stock and provides preferred-stock-style liquidation rights if there is a liquidity event or dissolution event. Third, the post-money form contains an express tax-characterization clause stating that the parties intend the SAFE to be characterized as common stock for purposes of sections 304, 305, 306, 354, 368, 1036, and 1202.[15] The boilerplate language is not binding on the IRS, but it constitutes evidence of party intent under the common-law debt-versus-equity factors.[16]

B. The Absence of Direct Authority

No code provision, Treasury regulation, or published IRS ruling addresses SAFEs.[17] No reported case addresses the characterization of a SAFE for federal income tax purposes. The characterization question must therefore be resolved under general principles applied to the instrument's specific terms. That silence is notable given the centrality of SAFEs in venture financing and the number of code provisions for which instrument classification matters. The authorities discussed below also operate at different levels: section 385 and the common-law cases supply the governing framework; revenue rulings on other instruments supply analogies; and private letter rulings, field service advice, and chief counsel advice are nonprecedential indications of the IRS's analytical approach. None is a holding on SAFEs.

The principal statutory entry point is section 385, which authorizes Treasury to prescribe regulations distinguishing stock from indebtedness and identifies five nonexclusive factors that may be considered. In the absence of a

[13] *See* Paul Graham, "Announcing the Safe: A Replacement for Convertible Notes," Y Combinator (Dec. 2013); Adamo, *supra* note 3.

[14] *See* Carolynn Levy, "Safe Financing Documents," Y Combinator (Sept. 2018) (post-money SAFE forms); Adamo, "Potentially Improved Tax Treatment of the New Post-Money SAFE," Lowenstein Sandler LLP (Apr. 9, 2019).

[15] Y Combinator, "Safe (Simple Agreement for Future Equity) — Postmoney," section 5(g) (Sept. 2018). The provision states: "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."

[16] *See* Notice 94-47 (identifying "the label placed on the instruments by the parties" as a relevant factor); *Estate of Mixon*, 464 F.2d at 402 (intent of the parties as relevant factor); *see also* Brauer, *supra* note 3 (boilerplate "may be intended to keep things simple, [but] can present complications since treatment as stock may or may not be appropriate").

[17] Publicly available guidance, including the Internal Revenue Bulletin and released private letter rulings and chief counsel advice memoranda, does not appear to include a ruling addressing a SAFE. The closest analog is LTR 201636003, discussed *infra* note 40, addressing the meaning of "stock" for federal tax purposes in the context of a limited liability company conversion.

SAFE-specific rule, however, the analysis largely reverts to common-law debt-equity principles.[18] Reg. section 1.385-1(b) provides that, except when the code or regulations supply a specific rule, the determination of whether an interest in a corporation is stock or indebtedness is made under common law, including common-law factors.[19] Courts applying the common-law inquiry have developed multifactor tests that vary by circuit; a frequently cited formulation is the 13-factor analysis articulated in *Estate of Mixon*.[20] The IRS's articulation of the relevant factors appears in Notice 94-47, which identifies the following eight factors: (1) 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; (2) whether holders possess the right to enforce payment of principal and interest; (3) whether the rights of holders are subordinate to general creditors; (4) whether the instruments give the holders the right to participate in management of the issuer; (5) whether the issuer is thinly capitalized; (6) whether there is identity between holders of the instruments and stockholders of the issuer; (7) the label placed on the instruments by the parties; and (8) whether the instruments are intended to be treated as debt or equity for nontax purposes.[21]

When an instrument fails the multifactor test for debt treatment but does not unambiguously confer current ownership of stock, forward-contract and open-transaction authorities provide the principal analogies. Rev. Rul. 2003-7, 2003-1 C.B. 363, addresses a variable prepaid forward contract in which the shareholder pledged the maximum deliverable shares to a third-party trustee, and holds that such a contract is neither a current sale under section 1001 nor a constructive sale under section 1259, provided the number of shares deliverable varies significantly, the shareholder retains an unrestricted legal right to substitute cash or other shares, and the shareholder is not economically compelled to deliver the pledged shares.[22] Rev. Rul. 78-182, 1978-1 C.B. 265, supplies the open-transaction analogy under which a payment received under an open equity-linked contract is not treated as gross income on receipt.[23] Section 1032(a) itself provides that a corporation recognizes no gain or loss on the receipt of money or other property in exchange for its own stock, language that on its face covers the physical issuance of stock in settlement of a forward contract. Chief counsel advice ILM 201025047 supplies the interpretive bridge between settlement postures: Because physical and cash settlement of a forward on the issuer's own stock are economically the same, a cash-settling corporation is in effect deemed to issue its stock at the forward price and immediately repurchase it at fair market value, and section 1032(a) applies either way. LTR 200450016, whose analysis the advice explains, applied section 1032(a) in the cash-settlement posture.[24] Tax professionals draw on these authorities by analogy rather than as direct precedent on issuer-side equity formation when concluding that a SAFE is best treated as something other than current stock.

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[18] Section 385(b) (identifying as factors: (1) whether there is 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; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question).

[19] Reg. section 1.385-1(b).

[20] *Estate of Mixon*, 464 F.2d at 402. The 13 factors are: (1) the names given to the certificates; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management; (6) subordination; (7) the intent of the parties; (8) thin or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) payment of interest only out of dividend money; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

[21] Notice 94-47.

[22] Rev. Rul. 2003-7. The ruling addressed a shareholder's prepaid variable forward contract for existing, pledged shares; it did not address an investor's payment to an issuing corporation under a SAFE or the section 1202 holding period for stock later issued by that corporation.

[23] Rev. Rul. 78-182 (addressing exchange-traded puts, calls, and straddles; the premium received by an option writer is not included in income on receipt but is carried open until the option lapses, is exercised, or is closed, and the holder's premium is a nondeductible capital expenditure that enters basis on exercise).

[24] ILM 201025047, articulating the physical/cash-settlement equivalence analysis underlying LTR 200450016. The advice's immediate holding denied an abandonment loss deduction for issuance costs; its section 1032(a) equivalence discussion appears in the reasoning. Chief counsel's advice may not be used or cited as precedent. Section 6110(k)(3).

III. The Three Candidate Characterizations

A. Debt

A standard SAFE is a poor candidate for debt treatment under both the section 385(b) statutory factors and the common-law multifactor analysis. The instrument typically lacks (1) a fixed maturity date, (2) stated interest, (3) an unconditional obligation to repay a sum certain, and (4) creditor remedies such as default rights, acceleration, or foreclosure. The holder's claim is generally junior to all creditors and limited to a contingent right to receive equity upon a triggering event.[25] The absence of a fixed maturity date strongly weighs against debt characterization,[26] and the absence of stated interest likewise weighs against debt treatment under section 385(b)(1), as one element of the multifactor weighing rather than an independently dispositive feature.[27] The economic position of a SAFE investor is more akin to that of a preferred stock investor than that of a creditor; the investor's return depends on the corporation's growth rather than on the time value of money.

The IRS analysis in FSA 199940007 reinforces this conclusion by analogy.[28] There, the IRS treated an instrument with some bond-like features as not debt because the amount payable depended on stock value rather than on a fixed principal amount. A standard SAFE, which generally lacks even those bond-like features, is an even weaker candidate for debt characterization. Commentary generally concludes that a typical SAFE is a weak candidate for debt treatment, while recognizing possible nondebt characterizations, including equity, warrants, or options, and variable prepaid forward contracts.[29]

B. Variable Prepaid Forward Contract

The conclusion that a SAFE is not debt does not, by itself, establish that the SAFE is stock. If a SAFE is not debt, the next question is whether it is current stock or a nondebt equity-linked contract, most plausibly a variable prepaid forward contract. The forward-contract analogy is strongest for the pre-money SAFE form. Under that form, the investor pays a fixed cash amount at inception, and the corporation agrees to deliver, on a future date corresponding to a triggering event, a number of shares that varies significantly with the corporation's valuation at conversion. The investor has no current dividend right, no current voting right, no current right to repayment, and no current ownership stake of any kind. These features track closely with the conditions identified in Rev. Rul. 2003-7 for respect of a variable prepaid forward contract.[30]

If a SAFE is treated as a variable prepaid forward contract or similar nonstock prepaid equity-linked contract, several issuer-side and timing consequences follow from existing authority, while the holder-side settlement consequences are less directly addressed in the SAFE context. The issuance of the SAFE is not a taxable event to either party, although the issuer-side label requires care. The controlling realization framework is the "complete dominion" test of *Indianapolis Power & Light Co.*: A refundable security deposit is not income on

[25] *See* Adamo, *supra* note 3 ("The investor lacks the primary advantages of being a creditor. There is no fixed maturity date, the investor lacks the unconditional right to repayment of the purchase price or interest, there are generally contingencies on the right to any repayment on or conversion of the instrument, and the investor would be subordinated to any debt of the company.").

[26] *See Farley Realty Corp. v. Commissioner*, 279 F.2d 701, 704 (2d Cir. 1960) ("numerous cases have held that the absence of a fixed maturity date is a critical factor weighing against a corporate taxpayer's claim that a debtor-creditor relationship existed between it and its payee").

[27] Section 385(b)(1) (identifying a fixed rate of interest as a factor); *Estate of Mixon*, 464 F.2d at 409-410 (advance carried no provision for interest; the court agreed that the lack of such provisions indicated a capital contribution, weighing the point as one of 13 factors rather than treating it as dispositive); *cf. Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) (debt requires "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").

[28] *See* FSA 199940007; *see also* FSA 200131015 (reaching a consistent conclusion on analogous facts).

[29] *See* Murray, *supra* note 3; Adamo, *supra* note 3; Adamo, *supra* note 14; Brauer, *supra* note 3; Scott W. Dolson, "Can Convertible Debt or SAFEs Qualify as QSBS for Section 1202's Gain Exclusion?" Frost Brown Todd/FBT Gibbons (Feb. 22, 2021); Joe Pacello, Steve Cuneo, and Eka Cox, "Simple Agreements for Future Equity (SAFEs): Overview of Key Tax Considerations," BDO USA (July 30, 2024); Bruce Feinstein, "Wading Through the Uncertainty of Simple Agreements for Future Equity," Baker Tilly (Oct. 30, 2023).

[30] Rev. Rul. 2003-7. The ruling enumerates five conditions: (1) the seller receives a fixed amount of cash; (2) the seller simultaneously enters into an agreement to deliver, on a future date, a number of shares that varies significantly based on the value of the shares on the exchange date; (3) the seller pledges the maximum number of shares deliverable under the agreement; (4) the seller retains an unrestricted legal right to substitute cash or other shares for the pledged shares; and (5) the seller is not economically compelled to deliver the pledged shares on the contract's maturity date. By contrast, when a prepaid variable forward is coupled with a share-lending arrangement, the benefits and burdens of ownership may shift at execution and produce a current sale. *See Anschutz Co. v. Commissioner*, 664 F.3d 313 (10th Cir. 2011).

receipt because the recipient has no guarantee that it will be allowed to keep the money, while an advance payment is income on receipt because the seller is assured that, so long as it fulfills its contractual obligation, the money is its to keep.[31] Because a SAFE payment is not refundable, the issuer's deferral cannot rest on deposit treatment; it rests on the open-transaction principle that the contract remains executory until settlement.[32] On settlement of the contract (the event the SAFE documents label conversion), the issuer-side treatment is clear — the corporation recognizes no gain or loss on the issuance of its own stock under section 1032(a).[33] The holder-side consequences are less directly addressed by existing authority; section 1032(a) protects the issuer, not the investor.

A defensible holder-side analysis treats stock delivery as completion of an open, prepaid equity-linked contract rather than as a taxable exchange, but no authority directly addresses a SAFE issued by the corporation whose stock is delivered, and the holder-side result should not be described as settled law. On that holder-side analysis, the investor's initial tax basis in the stock received generally should equal the amount paid for the SAFE, consistent with section 1012(a) and subject to transaction cost and other basis adjustments;[34] and, because no clearly applicable section 1223 tacking rule attaches a SAFE or prepaid-forward-contract holding period to later-issued stock, the investor's holding period in the stock begins on the date of the conversion.[35] Most of these consequences are neutral mechanics. The exception is the timing of the holding period's commencement. A clock that begins only at settlement is the heart of the section 1202 analysis discussed in Section IV of this article.

The variable prepaid forward contract analysis is the most commonly cited, and generally the most conservative, treatment of a pre-money SAFE in current commentary.[36] It is not, however, free from doubt. Rev. Rul. 2003-7 itself involved a contract between a shareholder and a counterparty, not between an investor and the issuing corporation. The fit is imperfect in several further respects: A SAFE involves no pledged shares; the issuer is not selling shares it already owns; settlement occurs by original issuance of new stock; the shares to be delivered may not exist (or may not be authorized in the relevant class) when the cash is paid; and there may be no fixed date for delivery. Section 1032(a) resolves issuer-side recognition, but it does not itself classify the investor's instrument as a forward contract, and chief counsel advice ILM 201025047 is nonprecedential. The use of those authorities as the bridge to applying the forward-contract analysis to a corporation-issued SAFE is a reasonable extension, but not a clearly compelled one. A tax practitioner taking a variable prepaid forward contract position is taking a defensible, though not unimpeachable, position.

C. Current Equity

The strongest argument for treating a SAFE as current equity from inception applies to the post-money form. For purposes of this discussion,

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[31] *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 209-210 (1990) (customer deposits securing future utility bills were not income on receipt because the utility lacked "complete dominion" over the funds; "the key is whether the taxpayer has some guarantee that he will be allowed to keep the money," and an advance payment, by contrast, is income because the seller "is assured that, so long as it fulfills its contractual obligation, the money is its to keep").

[32] Rev. Rul. 78-182 (option premiums held open until lapse, exercise, or closing; no income to either party on receipt or payment), applied by analogy; the ruling does not address forward prepayments or SAFEs. The prepaid-forward deferral itself rests on the open-transaction, obligation-to-deliver rationale reflected in Rev. Rul. 2003-7, not on security deposit treatment.

[33] Section 1032(a); ILM 201025047 (cited for its section 1032(a) reasoning rather than its holding); *see* reg. section 1.1032-1(a) (the disposition by a corporation of its own stock for money or other property "does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction," including on original issuance); reg. section 1.1032-1(b) (section 1032(a) "also does not relate to the tax treatment of the recipient of a corporation's stock," a statement of scope rather than an affirmative rule for the holder, whose treatment is governed by other provisions).

[34] Section 1012(a).

[35] *See* section 1223. No provision of section 1223 tacks the holding period of a SAFE or prepaid forward contract to stock later issued in settlement; section 1223(1) and reg. section 1.1223-1(a) permit tacking only when the property received has, in whole or in part, the same basis as the property exchanged and the property exchanged was a capital asset or section 1231 property. The presence of instrument-specific tacking rules elsewhere in section 1223 (*e.g.*, for securities futures contracts) underscores that contract-period tacking is statutory and instrument-specific, and section 1223(5) affirmatively provides that stock or securities acquired from a corporation by the exercise of rights to acquire them are treated as held only from the date of exercise. Even if the SAFE itself is a capital asset in the investor's hands, the settlement is better viewed as performance of an executory contract to issue stock rather than an exchange to which section 1223(1) clearly applies.

[36] *See* Murray, *supra* note 3; Adamo, *supra* note 3; Brauer, *supra* note 3; Dolson, *supra* note 29.

"current equity" means treatment of the SAFE as present stock for federal income tax purposes, not merely as an equity-like contractual interest. The post-money SAFE includes (1) dividend rights, (2) liquidation rights resembling nonparticipating preferred stock, (3) a fixed or substantially fixed ownership percentage, and (4) the express tax-characterization clause stating the parties' intended stock characterization.[37] Under the benefits and burdens analysis applied in *Grodt & McKay Realty*[38] and *Anschutz Co.*,[39] a holder that has dividend rights, liquidation rights, and a fixed economic stake, and whose interest is consistently treated as stock on the issuing corporation's books and the parties' tax returns, has a colorable argument for present ownership of stock.

The IRS's position on the meaning of "stock" for federal tax purposes is consistent with that approach. In LTR 201636003, the IRS observed that:

> the term 'stock' for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, i.e., the right to which the owner has in management, profits, and ultimate assets of a corporation.[40]

Although the ruling is nonprecedential, it reflects the IRS's broader economic-substance view of what can constitute stock for federal tax purposes. The principle the ruling applies, drawn from Rev. Rul. 69-591, 1969-2 C.B. 171, cuts both ways. Substance can establish stock ownership without certificates, but only when the present rights of ownership actually exist. In Rev. Rul. 69-591 every right attributable to stock ownership was vested in, and exercised by, the holder from incorporation, and in the letter ruling the taxpayers held complete ownership of the converted entity. A conventional SAFE holder has neither before conversion, so the substance-over-form principle sharpens rather than softens the distinction between an equity-flavored contract and present stock. A post-money SAFE with dividend and liquidation rights confers at least some of those incidents of ownership.

The case for equity treatment is not, however, automatic. Three considerations weigh against it. First, the post-money SAFE holder generally lacks voting rights, a factor that historically has weighed against equity characterization in cases applying the *Grodt & McKay* benefits-and-burdens framework. Second, the conversion economics still depend on a later financing event, and the eventual share count is not finally determined at the SAFE execution date; the lack of a final fixed share count is not necessarily fatal if the holder has a presently existing equity interest in a defined class or series, but it adds uncertainty. Third, the express tax characterization clause is not binding on the IRS.[41] The IRS is free to look beyond the boilerplate to the parties' substantive rights. Section 385(c)(1) makes the issuer's characterization binding on the issuer and its holders (subject to holder disclosure of inconsistent treatment), but expressly not on the secretary.

Moreover, section 1202 requires stock in a C corporation acquired at original issue, not merely an equity-flavored contractual claim, and the holder of a conventional SAFE may own no share of corporate stock under the issuer's charter at all. The instrument may remain, as a matter of state corporate law, a contractual right to receive stock at a later date. Whether a contractual SAFE can be treated as present stock also depends, in part, on the validity of the issuance mechanics and the corporation's governing documents.[42]

A pre-money SAFE that lacks dividend rights, liquidation rights resembling preferred stock, voting rights, and a fixed conversion percentage

[37] *See* Adamo, *supra* note 14; Y Combinator, *supra* note 15.

[38] *Grodt & McKay Realty Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981).

[39] *Anschutz Co.*, 664 F.3d at 326.

[40] LTR 201636003. Private letter rulings may not be used or cited as precedent. Section 6110(k)(3). The ruling addressed the conversion of LLC member interests under sections 1202(c), (f), and (h), relying on Rev. Rul. 69-591, 1969-2 C.B. 171, a section 1504 affiliation ruling treating uncertificated ownership as stock when all rights attributable to stock ownership were vested in and exercised by the holder.

[41] *See* Murray, *supra* note 3 ("Although this language should provide comfort to investors looking to characterize their investment in a SAFE as equity for tax purposes, this language would not be binding upon the IRS").

[42] *See, e.g.*, Rev. Rul. 83-98, 1983-2 C.B. 40 (notes labeled as debt treated as equity for tax purposes when likelihood of conversion was very high).

will be substantially harder to defend as current equity. Most of the commentary concludes that the equity position is reasonable for properly drafted post-money SAFEs and difficult to sustain for original-form pre-money SAFEs. With the candidate characterizations in place, the analysis turns to what each one produces under section 1202 as amended.[43]

IV. Section 1202 Consequences After the OBBBA

A. The Statutory Requirements

Section 1202(a)(1) excludes from gross income a noncorporate taxpayer's gain on the sale or exchange of QSBS that satisfies the applicable holding period rule, requiring more than five years for QSBS acquired on or before July 4, 2025, and at least three years (with graduated exclusion percentages) for QSBS acquired after that date.[44] Section 1202(c)(1) defines QSBS as any stock in a C corporation acquired by the taxpayer at original issue (other than in exchange for stock, and other than for underwriting services) in which the issuing corporation satisfies the gross asset test under section 1202(d) and the active business test under section 1202(e).[45] The statute requires that the issuing corporation be a qualified small business as of the date of issuance, with aggregate gross assets tested at all times before and immediately after issuance, taking into account amounts received in the issuance.[46] The required holding period is determined under section 1223, with the general tacking rules supplemented by special rules for stock acquired in conversion of other QSBS under section 1202(f).[47]

B. Collateral Requirements and Scope

Three further statutory points frame the analysis.[48] First, the per-issuer limitation is not solely a dollar cap. Section 1202(b)(1) limits eligible gain from stock of a corporation to the greater of the applicable dollar limit or 10 times the aggregate adjusted bases of QSBS issued by that corporation and disposed of by the taxpayer during the tax year. Second, any taxpayer advancing a current-equity theory for a SAFE must satisfy both the holding period requirement and the original-issue requirement of section 1202(c)(1). The argument over when stock first exists is analytically before any tacking question, and secondary purchases of SAFEs or SAFE-derived stock raise separate original-issue problems beyond the scope of this article. Third, because SAFEs are frequently held through venture funds, special purpose vehicles, and family office vehicles, section 1202(g) adds its own timing requirements for passthrough investors. The passthrough entity must hold the QSBS for the required period, and the taxpayer must have held the passthrough interest on the date the entity acquired the QSBS and at all times after until disposition.

The OBBBA amended section 1202(a) for QSBS acquired after July 4, 2025, replacing the prior all-or-nothing five-year holding period with a graduated exclusion that allows 50 percent for stock held at least three years, 75 percent for stock held at least four years, and 100 percent for stock held at least five years, with the acquisition date determined under section 1202(a)(6)(B) after applying section 1223.[49] Gains not excluded under the three- or four-year tiers generally are subject to the 28 percent rate of section 1(h)(4), plus any applicable net investment income tax, rather than the generally applicable 20 percent maximum long-term capital gain rate.[50] The OBBBA also raised the per-issuer exclusion cap from $10 million to $15 million (with inflation indexing)

[43] *See* Adamo, *supra* note 14; Dolson, *supra* note 29; Brauer, *supra* note 3.

[44] Section 1202(a).

[45] Section 1202(c)(1); *see* section 1202(c)(1)(B) (except as provided in subsections (f) and (h), the stock must be "acquired by the taxpayer at its original issue (directly or through an underwriter)" in exchange for money, property other than stock, or services).

[46] Section 1202(d)(1) (defining qualified small business as a domestic C corporation with aggregate gross assets that did not exceed the threshold at all times before, and immediately after, the issuance of the stock).

[47] Sections 1223, 1202(f).

[48] This article focuses on the stock characterization, holding period, and gross asset timing consequences of SAFEs; except when stated otherwise, it assumes the issuer satisfies the active-business, redemption, and other section 1202 requirements.

[49] Section 1202(a)(1)(B), (a)(5), as amended by OBBBA section 70431. Section 1202(a)(6)(B), as amended, determines the acquisition date for this purpose after the application of section 1223.

[50] Section 1(h)(4); *see* Widmyer and Wreggelsworth, *supra* note 11.

and raised the gross asset eligibility threshold from $50 million to $75 million (with inflation indexing for tax years beginning after 2026); the higher gross asset threshold applies to stock issued after July 4, 2025.[51]

C. When Does the Holding Period Begin?

The threshold question is whether a SAFE is stock under section 1202(c)(1). The IRS has not issued an opinion on the question, and no judicial authority addresses it directly. The analysis defaults to the general federal income tax characterization framework discussed previously in sections II and III.

If the SAFE is respected as a nonstock forward-type contract rather than as present stock, the investor should not be treated as holding section 1202 stock before shares are issued; absent a specific section 1223 tacking rule, the holding period in any stock the investor eventually receives begins on the date of conversion. When the SAFE is best described as a right or contract to acquire stock, section 1223(5) points the same way affirmatively: Stock acquired from a corporation by exercising rights to acquire it is treated as held only from the date of exercise.[52] That conclusion is the stronger view under Rev. Rul. 2003-7's open-transaction analysis. Until shares are delivered, the investor does not hold stock and cannot have a holding period in stock. For pre-money SAFEs, that result is the more defensible one under current authorities, absent unusually equity-like rights.

Two qualifications keep the contract branch in perspective. First, a contract characterization does not necessarily forfeit section 1202 for the stock ultimately received. Shares issued at conversion are issued directly by the corporation and may be acquired at original issue for money or other property if the issuer then satisfies the statute's requirements. Second, when the SAFE itself is property exchanged for the stock, section 1202(i)(1) treats the stock as acquired on the date of the exchange with a basis no less than the FMV of the property exchanged.[53] The second qualification cuts both ways. Because section 1202(i) applies only for purposes of section 1202, the FMV basis floor fixes the starting point for measuring eligible gain at the conversion-date value of the SAFE. Appreciation between SAFE execution and conversion is permanently outside the exclusion, and for a SAFE signed at a low valuation cap that converts after substantial growth, the walled-off appreciation may be most of the investment's gain. The same floor, however, enlarges the per-issuer limitation, because the 10-times-basis prong of section 1202(b)(1)(B) is computed on the higher section 1202 basis. The qualification also sits uneasily beside the open-transaction analysis described in Section III.B. If conversion is mere completion of an executory contract rather than an exchange of property for stock, section 1202(i) arguably does not apply at all, and the investor's basis and eligible-gain computation begin from the cash paid under section 1012. The two framings produce materially different exclusion ceilings, and no authority chooses between them.

If the SAFE is properly treated as stock from inception, the section 1202 holding period should begin on the SAFE execution date. If the SAFE is itself treated as stock that is QSBS in the investor's hands, the subsequent conversion of the SAFE solely into other stock of the same issuer should fall within section 1202(f)(1), which preserves QSBS status and the holding period in the conversion.[54] Section 1202(f)(2) provides that the holding period in the stock received in the conversion is determined by reference to the period during which the original QSBS was held. For a post-money SAFE with the equity-

[51] Sections 1202(b)(1), (d)(1), as amended by OBBBA section 70431. The $15 million applicable dollar limit and its inflation adjustment appear in section 1202(b)(4), as amended.

[52] Rev. Rul. 2003-7; *see* section 1223. Section 1223 contains no rule tacking a SAFE or forward-contract holding period to later-issued stock; section 1223(1) and reg. section 1.1223-1(a) require that the property received take its basis, in whole or in part, from the property exchanged and that the property exchanged have been a capital asset or section 1231 property. The securities futures tacking rule in section 1223 underscores that contract-to-security tacking requires a specific statutory rule. Section 1202(a)(6)(B), as amended, provides that for section 1202 purposes the acquisition date is the first day on which the stock was held by the taxpayer after applying section 1223. If the SAFE is itself stock that is QSBS, section 1202(f)(1)-(2) may preserve QSBS status and holding period on conversion solely into other stock of the same issuer.

[53] Section 1202(i)(1); *see* section 1202(i) (introductory language limiting the basis rules to purposes "of this section"); section 1202(b)(1)(B). The taxpayer's basis for other purposes remains determined under section 1012 or applicable carryover rules. The interaction of the section 1202(i)(1)(B) basis floor with the 10-times-basis limitation is illustrated in Section IV.F.

[54] Section 1202(f)(1).

supportive features described in Section III.C, that result is defensible. Section 1202(f) does not, however, solve the threshold characterization issue; it preserves QSBS treatment and holding period only if the taxpayer already held stock whose QSBS status can carry over in a qualifying conversion. If the SAFE is not stock at inception, the taxpayer generally cannot invoke section 1202(f) to bootstrap an earlier holding period. Nor is the equity characterization costless within section 1202 itself. An acquisition date at execution lengthens the period during which the issuer must satisfy the active-business requirement, which applies during substantially all of the taxpayer's holding period, and a development-stage corporation whose assets consist largely of SAFE proceeds will be relying on the working capital rules of section 1202(e)(6) for that longer window. The earlier issuance date also shifts the redemption testing periods of section 1202(c)(3) correspondingly earlier.[55]

D. The Gross Asset Measurement Date

A collateral consequence of the characterization is the timing of the section 1202(d) gross asset measurement. The statute requires that the issuer's aggregate gross assets not exceed the threshold at all times before the issuance and immediately afterward.[56] For this purpose, aggregate gross assets means cash plus the aggregate adjusted bases of other property held by the corporation, with contributed property measured as if its basis equaled FMV at the time of contribution, so amounts received in the financing itself count toward the ceiling under section 1202(d)(1)(B). If the SAFE is treated as stock, the relevant issuance date is the SAFE execution date, generally a favorable measurement point because the issuing corporation is typically smaller at that time. If the SAFE is not itself stock, the relevant issuance for section 1202(d)(1) should occur only when the corporation actually issues stock on conversion or settlement, a point at which the corporation may have grown materially and may have crossed the threshold. The OBBBA's increase of the gross asset threshold from $50 million to $75 million mitigates this concern but does not eliminate it. For a high-growth issuer that crosses the $75 million threshold between SAFE execution and conversion, the consequence is severe: Under the variable prepaid forward contract characterization, the stock acquired on conversion is not QSBS at all.

E. Implications of the Graduated Exclusion

Under the prior law, the SAFE characterization question had only one practical consequence for section 1202: whether the five-year clock had run. Under the OBBBA's graduated regime, the question has three consequences. Assume an investor pays $1 million for a SAFE on March 1, 2026; the SAFE converts into preferred stock on March 1, 2027; and the investor sells the stock on March 2, 2030, for $11 million. The example assumes the stock otherwise qualifies as QSBS in the investor's hands. Under the equity characterization, the investor has held the QSBS for at least four but less than five years, entitling the investor to a 75 percent exclusion of the $10 million gain: $7.5 million excluded, $2.5 million taxed at 28 percent, for a federal tax of $700,000. Under the variable prepaid forward contract characterization, the investor has held the stock for at least three years but less than four, entitling the investor to a 50 percent exclusion: $5 million excluded, $5 million taxed at 28 percent for a federal tax of $1.4 million. The difference is $700,000 of federal income tax on a single transaction, before any net investment income tax, state income tax, or other limitations.

The marginal benefit at the lower tiers should also be kept in perspective. Because the non-excluded portion bears the 28 percent rate, a 50 percent exclusion produces an effective federal rate of 14 percent, only six points better than the generally applicable 20 percent maximum rate. The comparison sharpens once the net investment income tax is included on both sides. The excluded portion escapes section 1411 entirely, so the all-in effective federal rates are approximately

[55] Section 1202(c)(2)(A) (active business requirement during substantially all of the taxpayer's holding period); section 1202(e)(6) (working capital); section 1202(c)(3) (redemption rules); reg. section 1.1202-2.

[56] Section 1202(d)(1)(B), (d)(2)(B).

15.9 percent at the three-year tier and 7.95 percent at the four-year tier, against a 23.8 percent all-in baseline for non-QSBS long-term capital gain.[57] The savings at the three-year entry point are thus modest insurance, roughly eight percentage points, while the four-year and five-year boundaries carry the real economics. Tax professionals should weigh whether the risk of an aggressive current equity position is justified by the relatively modest savings at the three-year mark.

Extending the example, an investor that sells in April 2031 has a five-year holding period under the equity characterization (full exclusion) but only a four-year holding period under the variable prepaid forward contract characterization (75 percent exclusion). The spread at the five-year mark is $700,000 of federal income tax. An investor that sells in April 2032 reaches the 100 percent threshold under both characterizations, and the spread disappears. The graduated regime thus creates three distinct decision points at which the characterization matters, rather than the single decision point that existed under the prior law.

F. Straddle SAFEs and Regime Selection

The OBBBA's effective-date structure adds a further wrinkle for SAFEs signed on or before July 4, 2025, that convert after that date. Because the graduated tiers and the $15 million cap apply only to QSBS acquired after the enactment date, and the $75 million gross asset threshold applies only to stock issued after that date, the characterization question for these straddle instruments does not merely move the start of the holding period; it selects the governing regime. If the SAFE is stock from inception, the investor acquired QSBS before enactment and remains under the prior law — the all-or-nothing five-year holding period, the $10 million cap, and the $50 million gross asset test measured at execution. If the SAFE is a contract, the stock is first acquired at a post-enactment conversion, and the amended statute applies — graduated exclusions at three, four, and five years, the $15 million cap, and the $75 million threshold, each measured from conversion.[58]

The consequence is that stock-at-inception treatment is not uniformly investor-favorable for straddle SAFEs, and for large exits the polarity can reverse. Assume an investor pays $1 million for a SAFE in March 2024; the SAFE converts in March 2026, when the SAFE is worth $6 million; and the investor sells in April 2031, realizing $50 million of gain over the cash invested. Both characterizations reach a 100 percent exclusion tier. The equity characterization yields a holding period of more than seven years under the prior law, and the contract characterization yields a holding period of more than five years under the amended statute. The caps, however, diverge sharply. Under the prior law, the per-issuer limitation is the greater of $10 million or 10 times the investor's $1 million basis; $10 million is excluded, and the remaining $40 million is taxed, on the better view at the generally applicable long-term capital gain rate plus the net investment income tax rather than at the 28 percent rate, because section 1(h)(7) defines section 1202 gain by reference to gain that would be excluded but for the percentage limitation of section 1202(a), and above-cap gain is blocked by the dollar limitation instead. Under the amended statute, if section 1202(i)(1)(B) fixes the section 1202 basis at the SAFE's $6 million conversion-date value, the limitation is the greater of $15 million or $60 million, and the entire $45 million of post-conversion appreciation is excluded; only the $5 million of pre-conversion appreciation is taxed, at the generally applicable rate on the same reasoning. The earlier start of the holding period, the principal investor-side benefit of equity characterization throughout this section, is worth nothing to this investor, while the later acquisition date is worth millions. The magnitude of the reversal, though not its direction, depends on the open question discussed in Section IV.C —

[57] Sections 1(h)(4), 1411. Excluded section 1202 gain is not net investment income. The taxed portion bears 31.8 percent (28 percent plus 3.8 percent), so the effective all-in federal rate on the total gain is 15.9 percent with a 50 percent exclusion and 7.95 percent with a 75 percent exclusion, against 23.8 percent (20 percent plus 3.8 percent) for ordinary long-term capital gain. For taxpayers below the top brackets, section 1(h)(4) operates as a ceiling, and the comparison may differ.

[58] Section 1202(a)(6), as amended by OBBBA section 70431 (acquisition date determined after the application of section 1223); *see supra* notes 49, 51 (effective date provisions). Because section 1223 supplies no tacking rule for a SAFE or prepaid forward contract, see *supra* note 35, the contract characterization places the acquisition date at conversion and thereby within the post-enactment regime.

whether section 1202(i) or the open-transaction analysis fixes the section 1202 basis.

The straddle analysis also softens, for this vintage of instruments, the section 382 opposition described in Section VI. When the contract characterization is the investor's preferred result, the loss-corporation issuer's interest in deferred ownership-change measurement and the investor's interest in a post-enactment acquisition date point the same way, and the parties' reporting positions can be aligned rather than adverse. For a straddle SAFE with a large projected exit, contract characterization may thus be affirmatively advantageous rather than merely conservative: A conversion-date acquisition carries the $15 million cap, the section 1202(i) basis floor with its 10-times multiple, and the $75 million gross asset ceiling. Characterization is not elective, however. The instrument's terms must support the position, reporting must be consistent from issuance, and the equity-supportive drafting recommendations of Section VII invert for this vintage, because terms that strengthen stock-at-inception treatment entrench the prior law's smaller caps and five-year cliff. The regime selection question should be analyzed instrument-by-instrument, against projected exit values, before any reporting position is taken.

G. Stacking and Pre-Conversion Transfers

The characterization question also controls a second planning lever — so-called stacking, under which an investor multiplies the per-issuer limitation by spreading QSBS among multiple taxpayers, most commonly non-grantor trusts. The per-issuer limitation applies taxpayer by taxpayer, and section 1202(h) permits a donee of QSBS to step into the donor's position. Stock transferred by gift is treated as having been acquired in the same manner as the transferor acquired it, and the transferor's holding period tacks.[59] Each properly structured donee thus takes its own per-issuer limitation, now $15 million for post-enactment acquisitions.

Section 1202(h) applies, however, only to transfers of stock. If a SAFE is respected as stock from inception, an investor can gift SAFEs to multiple trusts before conversion, early and at low value, and each trust takes QSBS with a tacked holding period and its own per-issuer limitation. If the SAFE is a contract, a pre-conversion gift transfers no QSBS at all. Each donee's holding period, original issue analysis, and gross asset measurement begin only at conversion. The viability of pre-conversion stacking therefore rises or falls with the same characterization question that governs the investor's own holding period, and a stacking structure built on gifted SAFEs inherits the full audit risk of the stock-at-inception position.

Stacking also carries a risk independent of characterization. It is one of the most visible candidates for future administrative or legislative limitation. Treasury's claims data show that exclusions claimed by complex trusts grew from negligible amounts to $6.65 billion in 2021, and the Treasury study attributes part of the growth in claims to "creative tax planning." Section 1202(k) grants the secretary express authority to prescribe regulations to prevent avoidance of the section's purposes through split-ups, shell corporations, partnerships, or otherwise; the House-passed version of the 2021 reconciliation legislation would have curtailed the exclusion percentages for high-income taxpayers and for trusts; and guidance under section 1202 already appears on Treasury's 2025-2026 Priority Guidance Plan as an OBBBA-implementation project.[60] A planner relying on SAFE-based stacking is therefore exposed twice — once on whether the gifted instrument was stock when transferred, and once on whether stacking itself survives in its current form. The conservative course is to stack with converted or chartered stock rather than contractual SAFEs, and to treat multiplied caps as a benefit that may not be available indefinitely.

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[59] Section 1202(h)(1)-(2) (a transferee of QSBS by gift or at death is treated as having acquired the stock in the same manner as the transferor and as having held it during any continuous period immediately preceding the transfer during which it was held by the transferor).

[60] Abdulrauf et al., *supra* note 5 (reporting complex trust claims of $6.65 billion in 2021 and total trust claims of about one-sixth of individual claims); section 1202(k); H.R. 5376, 117th Cong. section 138150 (as passed by the House, Nov. 19, 2021) (limiting the 75 percent and 100 percent exclusion percentages for taxpayers with adjusted gross income of $400,000 or more and for trusts and estates); Treasury, "2025-2026 Priority Guidance Plan" (Sept. 30, 2025) (OBBBA implementation item 26: "Guidance under section 1202 regarding the exclusion of gain from the sale or exchange of qualified small business stock").

H. State Nonconformity

Several states do not conform fully to the section 1202 exclusion; state conformity changes frequently, and the summary here is current only as of this article's date. As of mid-2026 commentary, California, Pennsylvania, Alabama, and Mississippi are commonly identified as taxing QSBS gain in full at the state level, and the OBBBA changes do not alter that result.[61] New Jersey enacted conformity effective for QSBS dispositions in tax years beginning on or after January 1, 2026.[62] Other states conform only in part or require separate analysis. Practitioners must verify whether conformity is rolling or static in each relevant jurisdiction, because a state that ties its tax code to a specific version of the Internal Revenue Code may not have adopted the federal change to the graduated exclusion. State-level planning strategies, including incomplete-gift non-grantor trusts sitused in no-income-tax jurisdictions in appropriate cases, may remain relevant for SAFE-derived gain but are highly state-specific and subject to antiabuse, residency, and source-income rules.[63] The characterization question, therefore, has both federal and state-level consequences, and the state-level dollars can be material. This article does not attempt a full 50-state survey; conformity should be verified separately as of the transaction date.

V. The Section 1045 Rollover Trap

Section 1045 permits a taxpayer other than a corporation that has held QSBS for more than six months to elect to defer gain to the extent the amount realized does not exceed the cost of replacement QSBS purchased during the 60-day period beginning on the date of sale.[64] The critical statutory requirement is that the replacement stock must itself be QSBS under section 1202(c) at the time of acquisition.[65] An investor that uses QSBS sale proceeds to purchase a SAFE within the 60-day window has placed the entire rollover at risk if the SAFE is later recharacterized. If the SAFE converts into actual QSBS within the 60-day replacement window, the analysis may differ. The trap addressed here is the common case in which the contractual SAFE remains outstanding beyond that period. The OBBBA's new three- and four-year section 1202 tiers do not alter section 1045's separate requirement that the original QSBS be held for more than six months.

The mechanics of the trap are unforgiving. Assume an investor sells QSBS in March 2026 for \$10 million, deferring a \$9 million gain. Within 60 days, the investor uses the proceeds to acquire a SAFE. In 2031, the SAFE converts to stock, and in 2034, the investor sells. If the IRS successfully argues on examination that the SAFE was a variable prepaid forward contract rather than stock, no replacement QSBS was acquired within 60 days of the original sale. The rollover fails not because the later-issued stock is necessarily non-QSBS, but because the taxpayer did not purchase replacement QSBS within the 60-day statutory window. The original 2026 sale becomes taxable for 2026, with interest running from the original due date and penalties applying only if otherwise imposed under the generally applicable penalty rules. The holding period in the stock received on the 2031 conversion begins in 2031, not 2026. The investor loses both the section 1045 deferral and the early commencement of the section 1202 holding period, an outcome that compounds the cost of the characterization risk.

The section 1045 trap is the strongest case for issuing actual stock rather than a SAFE when the section 1202 outcome is central to the investment.[66] An investor relying on section 1045 should not use a contractual SAFE as the replacement instrument unless the investor is prepared to sustain — and, when appropriate, disclose — the position that the SAFE is stock

[61] *See* Widmyer and Wreggelsworth, *supra* note 11 (identifying nonconforming states).

[62] New Jersey S.B. 3489 (effective Jan. 1, 2026).

[63] *See* Widmyer and Wreggelsworth, *supra* note 11 (discussing non-grantor trust planning in Alaska, Delaware, Nevada, South Dakota, and Wyoming).

[64] Section 1045(a).

[65] Section 1045(a) (limiting nonrecognition by reference to the cost of QSBS purchased by the taxpayer during the 60-day period beginning on the date of sale); section 1045(b)(1) (defining QSBS by reference to section 1202(c)).

[66] *See* Dolson, *supra* note 29 (characterizing the use of a SAFE to satisfy section 1045 as a "bet the farm" issue).

when acquired. When a section 1045 rollover is in play, the cleaner approach is actual stock — a priced equity round or, at minimum, a chartered "SAFE preferred stock" structure as discussed in Section VII.C. If the parties nonetheless proceed with a SAFE, the agreement should at least state expressly that the parties will treat the instrument as stock for all federal income tax purposes and should include a covenant that the issuer will provide section 1202-consistent reporting from issuance, protective terms that strengthen the intent and consistency factors, although they cannot substitute for substantive equity rights.

VI. The Section 382 Mirror Image

Section 382 limits a corporation's use of pre-change net operating losses and certain other tax attributes after an ownership change, defined as an increase of more than 50 percentage points in the stock ownership of 5-percent shareholders during a three-year testing period.[67] The annual limitation equals the value of the loss corporation immediately before the ownership change multiplied by the long-term tax-exempt rate.[68] Whether a SAFE counts as stock for purposes of measuring the ownership change is informed by general federal income tax characterization principles, but section 382 is not a pure debt-versus-equity inquiry.

Section 382 brings its own special rules. Section 382(k)(6)(B) authorizes Treasury to treat warrants, options, contracts to acquire stock, convertible debt interests, and similar interests as stock, and section 382(l)(3)(A)(iv) treats an option as exercised if exercise would result in an ownership change, with a similar rule for contingent purchases, warrants, convertible debt, puts, and contracts to acquire stock. Under reg. section 1.382-4(d), an option or similar interest (a category that can be broad enough to cover many SAFEs, depending on their terms) generally is not treated as exercised before its actual exercise date, but it is deemed exercised at issuance if it satisfies an ownership, control, or income test, each keyed to whether a principal purpose of the instrument's issuance or structuring is to avoid or ameliorate an ownership change. A safe harbor exists for commercially reasonable stock acquisition contracts that close within one year, although it does not protect against the income test.[69] Separately, a SAFE with effectively nominal conversion economics bears the risk that the holder will be treated as having acquired beneficial ownership of the underlying stock at the outset under general tax principles, bypassing the option rules entirely. A SAFE, therefore, may matter under section 382 even if it is not treated as current stock for section 1202 purposes; the analysis must address both whether the SAFE is stock and whether it is a contract or similar interest treated as exercised under the option rules. This article does not attempt a comprehensive section 382 regulatory analysis; the point is that an investor-favorable current equity position can create issuer-unfavorable ownership-change timing consequences.

The section 382 analysis runs counter to the investor-favorable section 1202 analysis. Treating a SAFE as stock at issuance shifts ownership earlier, typically at a lower corporate valuation. The earlier and lower valuation results in a smaller annual section 382 limitation, reducing the corporation's ability to use NOLs going forward. Treating the SAFE as a variable prepaid forward contract defers the measurement to the conversion date, when the corporation typically has a higher valuation and the annual limitation is correspondingly larger.

[67] Section 382(g)(1).

[68] Section 382(b)(1); *see* section 382(e)(1) (value measured immediately before the ownership change); section 382(f) (long-term tax-exempt rate).

[69] Reg. section 1.382-4(d)(1) (an option is not treated as exercised except as provided in paragraph (d)(2)); reg. section 1.382-4(d)(2)(i) (deemed exercise on the date of issuance or transfer if the option satisfies the ownership, control, or income test); reg. section 1.382-4(d)(3)-(5) (the three tests, each keyed to whether "a principal purpose of the issuance, transfer, or structuring of the option" is to avoid or ameliorate the impact of an ownership change); reg. section 1.382-4(d)(7)(i) (safe harbor for a stock purchase agreement or similar arrangement with commercially reasonable terms, obligations subject only to reasonable closing conditions, and closing within one year, which does not exempt the option from the income test); reg. section 1.382-4(d)(9)(i) (treating "any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest" as an option "regardless of whether it is contingent or otherwise not currently exercisable"). The temporary regulations also treat certain nonstock interests offering a potential significant participation in corporate growth as stock when pre-change losses are sufficiently large, reg. section 1.382-2T(f)(18)(iii) (but reg. section 1.382-4(d)(12) provides that the rule does not apply to treat an option as stock, so for a SAFE within the reg. section 1.382-4(d)(9)(i) option definition the option rules remain the operative framework).

The following example isolates the valuation-timing effect and assumes, without resolving, that the applicable section 382 option and deemed-exercise rules produce the stated measurement date.

Consider a development-stage corporation with $5 million of NOLs. Assume that a SAFE issuance, together with other testing-period shifts if necessary, produces a more-than-50-percent increase by 5-percent shareholders, and assume that the value of the old loss corporation immediately before the ownership change is $9 million. If the SAFE is treated as stock and the ownership change is measured at that time, the annual section 382 limitation equals $9 million multiplied by the long-term tax-exempt rate. Assuming a hypothetical long-term tax-exempt rate of 4.4 percent, the annual cap is $396,000. If the SAFE is treated as a variable prepaid forward contract or an unexercised option and the same ownership shift is not measured until conversion occurs in a subsequent year, when the old loss corporation is worth $36 million, the annual limitation is $1.584 million. The same percentage shift measured at four times the value produces four times the annual limitation. The point is not the rate for any particular month but the timing effect: Stock-at-signing treatment can measure the ownership change earlier, when the value is lower.[70] The corporation can use four times as much NOLs per year under the variable prepaid forward contract characterization as under the stock characterization.

The consequence is that, for a loss corporation, the section 1202 win for the investor may be the section 382 loss for the issuer. The corporation and the investor have opposing economic interests in the characterization. The opposition is rarely discussed at the deal table, when the SAFE is typically presented as a simple cap-table addition rather than a tax-characterization question, but it should be considered before signing. When the loss corporation's NOLs are material, the issuer may have a meaningful interest in a SAFE structure that supports deferred measurement (whether as a forward contract or as an unexercised option) even at the cost of the investor's section 1202 position. Conversely, when the investor's section 1202 position is central, and the issuer has no material NOLs, the equity-supportive drafting recommendations in Section VII apply without internal conflict. The table summarizes the consequences of each characterization across the provisions discussed in sections IV through VI.

VII. Drafting Recommendations

The analytical uncertainty involving SAFE characterization can be reduced, though not eliminated, by careful drafting. The recommendations that follow proceed from the governing common-law framework, identify the substantive terms that support stock characterization, and conclude with a five-tier hierarchy of structural responses, including discussion of chartered SAFE preferred stock as an emerging alternative, followed by a note on return positions and disclosure.

A. The Governing Framework

The IRS's analysis of any hybrid instrument turns on the instrument's legal rights and economic substance, not its label.[71] The regulation under section 385 specifies that, except when the code or regulations supply a specific rule, the determination of whether an interest in a corporation is stock or indebtedness is made under common law.[72] The central tax distinction is economic risk; equity holders bear the business's upside and downside, while debt holders generally have a fixed repayment claim. Drafting should therefore make the SAFE investor look economically and legally like a shareholder, not a creditor or a holder of a prepaid forward contract. The express tax-intent clause is evidence of intent but is not binding on the IRS.[73] Substantive equity rights carry the real weight.

[70] The example assumes a long-term tax-exempt rate of approximately 4.4 percent. The actual rate is published monthly by the IRS in revenue rulings.

[71] *See* LTR 201636003.

[72] Reg. section 1.385-1(b).

[73] *See supra* notes 16 and 41.

Characterization Consequences for SAFE-Derived QSBS

	Current Equity	Variable Prepaid Forward Contract	Debt (Atypical)
Tax status on issuance	If respected as stock, stock acquired at original issue	Prepaid contract, not stock; payment held open until settlement	Debt instrument, not stock
Section 1202 holding period begins	SAFE execution date (if the SAFE is stock/QSBS)	Conversion date	Conversion date
Section 1202(d) issuance date (gross asset test)	SAFE execution date	Conversion date	Conversion date
Section 1045 replacement?	Defensible if the SAFE is stock/QSBS when acquired and the other section 1045 requirements are met	Generally fails if the SAFE itself is the claimed replacement asset and stock is not issued within the 60-day window	Generally fails if the debt itself is the claimed replacement asset and stock is not issued within the 60-day window
Section 382 effect	Earlier ownership-shift measurement, typically at lower valuation	Measurement generally deferred, subject to the section 382 option and deemed-exercise rules	Generally no stock ownership shift until conversion, subject to the section 382 option and deemed-exercise rules

B. SAFE Terms That Support Stock Characterization

The following terms support stock characterization, in declining order of importance: (1) subordination to all creditor claims, an express factor under section 385(b)(2); (2) liquidation rights resembling nonparticipating preferred stock, including a "greater of" formula entitling the holder to a defined cash-out amount or the as-converted equity value; (3) participation in dividends if any are declared, either currently or on an as-converted basis; (4) voting rights or, at minimum, protective consent rights over amendments to the SAFE terms, creation of senior securities, sale or liquidation of the corporation, and any tax treatment inconsistent with stock characterization; (5) fixed or substantially fixed conversion economics, reducing the prepaid-forward-contract risk identified in Rev. Rul. 2003-7 (although substantially fixed economics may instead make the instrument resemble a right to acquire stock, whose holding period would begin on exercise under section 1223(5)); (6) automatic conversion solely into stock of the same corporation, supporting section 1202(f) tacking on conversion; (7) cap-table treatment as an equity-like security from issuance; (8) absence of all debt features: no maturity date, no interest, no original issue discount, no fixed yield, no unconditional repayment obligation, no default or acceleration rights, no creditor remedies, no security interest; (9) consistent tax reporting by both parties, in accordance with section 385(c)(1); and (10) the express Y Combinator section 5(g) tax-intent clause stating the parties' intended stock characterization for section 1202 purposes, evidence of intent that is subordinate to the substantive terms listed above.[74]

C. The SAFE Preferred Stock Alternative

A structural alternative has begun to appear in practitioner materials — chartering an actual series of preferred stock (sometimes called SAFE preferred stock) that incorporates SAFE-style economics, sits on the cap table as equity, and is reflected in the issuing corporation's certificate of incorporation.[75] Under this structure, the instrument's legal form is a stock rather than a contract. The threshold section 1202 requirement that the taxpayer hold stock in a C corporation is

[74] Y Combinator, *supra* note 15.

[75] *See* Dolson, "User Guide for SAFE Preferred Stock with Examples," Mondaq (June 6, 2024) (describing the SAFE preferred stock structure); Idin Sabahipour and Drew Macklin, "Can a SAFE Qualify as Qualified Small Business Stock?" SeedLegals (Dec. 30, 2024).

addressed directly, without the need to resolve whether a contractual SAFE is stock. The structure does not, however, make section 1202 automatic. Original issuance, C corporation status, aggregate gross asset testing, active-business qualification, the redemption limitations of section 1202(c)(3), and holding period compliance still must be satisfied, and the certificate of designation should be reviewed to confirm that redemption rights, mandatory repurchase features, and conversion mechanics do not create separate section 1202 or corporate law issues. The advantage is not that section 1202 becomes automatic; rather, the investor begins with legal stock, not a contract whose tax character must be argued. The structure preserves much of SAFE's commercial flexibility (including valuation caps, discounts, and automatic conversion features) while replacing the SAFE contract with actual preferred stock issuance.

The principal cost is incremental legal work. Charter amendments to authorize a new series of preferred stock require board and shareholder approval; the certificate of designation must be drafted to incorporate the desired economic features; and the issuance is documented as a stock-purchase transaction rather than as a SAFE. The transaction cost is real but materially less than the cost of a full-priced round, and the section 1202 certainty obtained may be worth far more than the incremental legal fees. When the section 1202 outcome is central to the investment thesis, SAFE preferred stock represents the most defensible middle ground between issuing conventional preferred stock and issuing a contractual SAFE. Nomenclature alone cures nothing; calling an instrument SAFE preferred stock is not enough, and the charter, governing rights, issuance mechanics, cap-table treatment, and tax reporting must all consistently reflect actual stock.

In practice, the issuer should (1) file the charter amendment or certificate of designation authorizing the class or series; (2) include at least a nominal liquidation preference establishing a legal preference over common stock; (3) issue shares through valid certificate or book-entry procedures; (4) adopt board and any required shareholder resolutions authorizing the issuance of stock rather than the execution of a contract; (5) document the investment as a stock-purchase transaction; (6) reflect the issued shares on the cap table; (7) provide stockholder notices, consents, and information rights consistent with the charter; and (8) report the instrument consistently with stock treatment for tax purposes and classify it as equity for financial statement purposes if supportable under the applicable accounting rules.

D. Drafting Hierarchy

Drawing the threads together, the practical drafting hierarchy from strongest to weakest is as follows:

1. *Issue actual common or preferred stock at the outset.* The investor plainly receives stock, eliminating the threshold question of whether a contractual SAFE is stock; the remaining section 1202 requirements must still be satisfied.
2. *Charter SAFE preferred stock.* The instrument's legal form is stock, provided the shares are validly authorized and issued under applicable corporate law; the SAFE-style economics are preserved through the certificate of designation.
3. *Use a post-money SAFE with the full set of equity-supportive features described in Section VII.B.* The position is defensible but term-dependent and carries audit risk.
4. *Use a standard contractual SAFE with no current equity rights.* The conservative position is that the section 1202 holding period begins only on conversion.
5. *Use convertible debt or SAFE terms with interest, maturity, repayment rights, default rights, acceleration, security, or other creditor remedies.* This is the weakest structure for claiming stock treatment at inception. It may still qualify as a QSBS if and when stock is issued upon conversion and the section 1202 requirements are satisfied at that later issuance date, but the holding period and the aggregate gross asset test should be measured from conversion rather than from the original issuance of the debt or contract.

The hierarchy is not absolute. A loss corporation may have countervailing interests under section 382 (Section VI), and a fund relying on section 1045 should avoid steps (3) through (5) unless it is prepared to defend stock status at acquisition (Section V). Within those constraints, the hierarchy supplies a useful ordering of drafting alternatives.

E. Return Positions and Disclosure

A final practical note concerns return-position strength. Because no direct authority classifies SAFEs for section 1202 purposes, a taxpayer claiming stock-at-inception treatment should separately analyze the strength of the reporting position and the need for disclosure. A low-comfort position may warrant consideration of disclosure on Form 8275, "Disclosure Statement," while a position supported by substantial authority or rising to more-likely-than-not may not. The disclosure question is distinct from the substantive characterization question and should be evaluated on an instrument-by-instrument basis. Whether substantial authority exists for either position cannot be stated categorically. The standard is objective and weighs only enumerated authorities. The code, regulations, rulings, and cases count, and so do private letter rulings and technical advice memoranda despite their nonprecedential status (whether chief counsel advice, a category postdating the regulation's enumerated list, also qualifies is less clear), but commentary does not. On that inventory, the conversion-date position should ordinarily satisfy the standard, supported by the text of sections 1202(a)(6)(B) and 1223(5), the open-transaction line of authority, and the absence of contrary direct guidance. The execution-date position is term-dependent. For a post-money SAFE with substantive equity rights, the section 385(b) factors, the benefits-and-burdens cases, and LTR 201636003 may aggregate to substantial authority, while for an original-form pre-money SAFE they likely do not rise above reasonable basis. A blanket conclusion that substantial authority exists for both treatments of every SAFE would overstate the law and understate the role of the instrument's terms.[76]

VIII. Conclusion

The federal income tax treatment of the SAFE has been unsettled for more than a decade. The OBBBA does not resolve the characterization question, but it materially increases the practical importance of resolving it. The graduated exclusion tiers create three decision points at which the SAFE characterization affects the investor's after-tax outcome; the higher per-issuer cap and gross asset threshold expand the dollars at stake; and the preservation of the prior all-or-nothing rule for QSBS acquired on or before July 4, 2025, leaves legacy SAFEs and newly issued SAFEs under different regimes. Indeed, as Section IV.F discusses, a pre-July 4, 2025, SAFE may fall into either regime depending on characterization. If the SAFE is treated as stock from inception, the prior section 1202 regime may apply, while if it is treated as a contract and stock is first acquired on a post-enactment conversion, the post-OBBBA acquisition-date rules may apply.

Several practical conclusions follow. First, the variable prepaid forward contract characterization remains the more defensible position for most pre-money SAFEs, and the more conservative position is that the holding period for those SAFEs begins at conversion rather than at SAFE execution. Second, a properly drafted post-money SAFE supports a colorable equity position, but the position remains uncertain and depends on the substantive rights conferred rather than the boilerplate tax-intent clause. Third, the section 1045 rollover trap is severe and avoidable: The safest replacement instrument is actual QSBS, not a contractual SAFE whose stock status must be defended later. Fourth, the section 382 mirror image puts loss-corporation issuers and SAFE investors on opposite sides of the

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[76] Reg. section 1.6662-4(d)(2) (substantial authority is an objective standard, satisfied only if the weight of the authorities supporting the position is substantial in relation to the weight of contrary authorities); reg. section 1.6662-4(d)(3)(iii) (enumerating the types of authority, including private letter rulings and technical advice memoranda issued after October 31, 1976, and providing that conclusions reached in treatises, legal periodicals, and opinions rendered by tax professionals are not authority).

characterization question; the trade-off should be analyzed before signing, and the section 382 analysis must account not only for whether the SAFE is stock but also for the statute's special treatment of options, contracts to acquire stock, and similar interests. Fifth, the chartered SAFE preferred stock structure represents a useful middle ground that avoids the threshold question of whether a contractual SAFE is stock while preserving most of the SAFE's commercial flexibility.

The IRS has been silent on SAFEs for more than a decade. With the OBBBA increasing the federal dollars at stake, the case for guidance is stronger than ever, and Treasury and the IRS have in fact placed guidance under section 1202 on the 2025-2026 Priority Guidance Plan as part of OBBBA implementation.[77] The plan does not state the scope of the project, and the natural focus is the mechanics of the amended statute, but the SAFE holding period question belongs on that list. A revenue ruling — or even an informal advice memorandum addressing the section 1202 holding period question — would benefit both taxpayers and the IRS by reducing the costs of audit and litigation over a class of instruments that now sits at the center of early-stage venture financing. Until that guidance arrives, careful drafting, consistent reporting, return-position analysis, and structural alternatives such as SAFE preferred stock remain the principal tools available for managing characterization risk. ■

[77] Treasury, "2025-2026 Priority Guidance Plan" (OBBBA implementation item 26); *see supra* note 60.