Client Update: Israel Tax Authority Provides Guidelines Regarding Tax Aspects of SAFE Investment

Dear colleagues,

We would like to update you that on 16 May 2023, the Israeli Tax Authority (ITA) issued significant new guidelines regarding the tax implications associated with investing in a company through a Simple Agreement for Future Equity (SAFE). These guidelines were released in response to a request from the Israel Advanced Technology Industries (IATI) to address uncertainties related to the classification and taxation of SAFE transactions.

A. Background:

SAFE transactions are commonly utilized by startup companies as they offer a swift and efficient means of raising capital when the company's valuation has not yet been determined. In a SAFE transaction, the investor commits capital to the company, enabling immediate utilization of the funds. The company, in turn, grants the investor the right to shares of the company at a future undefined date when equity financing occurs, establishing a reliable valuation for the company. Additionally, the SAFE investor is typically granted a discount rate, usually 20% less than other investors participating in the equity financing (herein the "**Discount"**), or the investment is converted at a maximum company value if better for the investor.

SAFE transactions often raise questions due to their combination of elements from both loan agreements and investment agreements. On one hand, when funds are transferred to a company, the SAFE investor does not immediately receive shares. Furthermore, the value of the allocated shares the investor eventually receives may exceed the investment amount if it were invested at the time of the issuance of the shares, making the Discount akin to interest on a loan. In other words, the investment amount represents a loan, and the Discount represents interest due to the passage of time between the investment and share allotment dates. Consequently, this analysis suggests that the Discount would be subject to "tax on interest" upon conversion, necessitating tax withholding by the company.

On the other hand, the SAFE instrument incorporates various legal provisions that define the investment, including the Discount, solely as an investment for shares. From this perspective, the Discount reflects the investor's entry at an earlier stage and the subsequent increase in the company's value between the date of the investment and the date of the eventual issuance of shares. According to this viewpoint, upon investment, the investor theoretically owns shares equal in value to his investment. At the time of conversion, as the company's value appreciates, the Discount is granted to account for this appreciation. Consequently, under this analysis, the allocation of shares to the investor does not trigger a tax event since the value of the allocated shares matches the value of the investment.

The ITA's guidance focuses on the analysis of the SAFE transaction and the taxation of the difference between the cost of purchasing the shares as indicated in the SAFE and their market value determined during the capital raising.

B. Analysis of the SAFE Transaction:

The ITA has concluded that investing in a company through a SAFE transaction should be considered an advance payment towards shares. In other words, the SAFE investment is merely a downpayment for a transaction that occurs only upon the conversion to shares, ensuring that the value of the allocated shares (including the Discount) matches the value of the investment. Therefore, the SAFE transaction should be interpreted as a share investment transaction without loan and interest components.

This conclusion is based on several legal provisions typically included in SAFEs, which preclude the analysis of the SAFE transaction as a loan with interest. Instead, these provisions support the assumption that it is a share transaction:

1. The SAFE prevents the investor, without the company's approval, from transferring his rights under the SAFE to a third party until the equity event, except for specifically permitted transferees stipulated in the SAFE.
2. SAFE’s contractual agreement between the parties is not defined as a loan or debt agreement.
3. Conversion of the SAFE into shares occurs according to predetermined mechanisms, such as a capital raising, stock exchange listing, or an "exit" event involving the sale of most or all of the company's assets. The conversion can be based on either the value of the latest fundraising round (excluding the Discount) or the value resulting from the sale of all company shares.
4. The investor has no right to demand a refund of his investment from the company, except through share conversion or receiving a return equivalent to the value of the shares he would be entitled to upon conversion if all company shares were sold. No specific repayment date is predetermined, except in cases of insolvency. In such events, the SAFE instrument is subordinate to the company's debtors, and insofar as the rights of SAFE investors are determined to be equal to those of preferred stockholders, superseding ordinary stockholders but remaining inferior to any debts.
5. The SAFE states that if the investor's investment amount is refunded, he is only entitled to the investment fund and nothing beyond that.
6. The SAFE does not obligate the company to provide the investor with any monetary reward or equivalent instrument unrelated to share ownership during the period between the investment in the SAFE and the conversion event.
7. The Discount provided to the investor upon conversion does not vary linearly with time. Regardless of whether conversion occurs shortly after fund investment or years later, the discount rate remains consistent.
8. No liens, charges, or other security are imposed on the company's assets in favor of the investor.
9. The company is not required to consider the SAFE as financing expenses for tax purposes, whether as financing costs, capitalization of financing expenses, or as a result of the underwriting of the obligation.
10. The conversion of the SAFE into shares occurs as part of a capital raising event, wherein at least 25% of the capital raised is not derived from SAFE investors. This provision supports the assumption that the equity event fairly determines the value of the company.
11. The sale of shares issued through the SAFE transaction must occur at least 12 months after signing the SAFE agreement or 9 months after their allocation to the investor. This provision reinforces the notion that it is not a loan and interest transaction disguised as the immediate conversion of shares into cash, rather this is a share transaction.

These legal stipulations, typically present in standard SAFE transactions, substantiate the ITA's determination that the SAFE transaction should be treated as a downpayment for future share acquisition, rather than a loan and interest converted into shares.

C. Key Highlights:

This legal analysis of the SAFE transaction carries two major tax implications:

(a) Upon the conversion of the SAFE into shares, no tax event will apply to the investor. Consequently, the company is not required to withhold tax.

(b) When the SAFE investor sells his shares to a third party (subject to capital gains tax), the investor's profits will include not only the difference between the share value at the conversion date but also the profit from the Discount received during the conversion stage.

The ITA's guidance is subject to certain conditions and circumstances specified in the guidelines, some of which have been described above. Any deviation from the specified SAFE conditions detailed in the guidelines may result in the SAFE being analyzed as a loan, triggering a tax event upon conversion and imposing the applicable tax on the interest rate. However, even if the SAFE does not meet one or more of the guidelines set out in the guidance, that does not necessarily mean that the instrument should be treated as a loan, but rather it should be judged on its merits but without the support of this guidance.

The Tax Authority's guidelines apply to SAFE agreements that have been signed or will be signed until December 31, 2024, or until another directive is issued, subject to the conditions specified in the guidelines.

For a complete review of the guidelines, please refer to the link provided herein >>

Please note that the information stated in this document is for general information solely, it does not constitute a legal opinion or legal advice and should not be relied upon as such or used in any other way.

We are available to assist you with any questions or clarifications you may have.

Sincerely,

Daniel Chinn, Aviel Rosenberg and AYR's High-Tech Team

AYR – Amar Reiter Jeanne Shochatovitch & Co.

DanielC@ayr.co.il AvielR@ayr.co.il

The stated in this document is general information only and does not constitute a legal opinion or legal advice and should not be used in any other way.