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CLIENT UPDATE

ITA Guidelines Regarding the Tax Implications of SAFE Investments

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The Israel Tax Authority (ITA) published yesterday guidelines, setting forth "green track" terms, under which SAFEs (Simple Agreement for Future Equity) will be classified as equity instruments.

In recent years, SAFEs have been commonly used for making capital investments in start-ups. A SAFE enables extending immediate funding to a company, while the issuance of shares to the investor is postponed until a future date when the company's valuation is determined, such as upon an equity financing, M&A or IPO. In consideration for its early investment, the investor is usually entitled to a discount on the price per share upon conversion, at a rate determined in advance in the SAFE (most commonly, a predetermined discount percentage or a discount derived from setting a valuation cap).

The tax issue that has been raised with respect to these agreements is whether they should be classified for tax purposes as equity, debt or a forward transaction. In addition, there is uncertainty regarding whether the discount on the share price should be treated like interest reflecting the time value of the investment to the date of issuance of the shares, or as compensation for the increased risk incurred by the investor by investing in the shares prior to their issuance. If the discount (or a portion thereof) is classified as interest, a non-Israeli resident making a SAFE investment in an Israeli resident company would be subject to Israeli tax on such interest component, and the company would be subject to a withholding tax obligation at the time of issuance of the shares.

The guidelines, published following the application of the Israel Advanced Technology Industries (IATI) and lengthy discussions conducted by IATI's tax team with the ITA, establish that if the conditions detailed in the guidelines are fulfilled, then:

1. **The issuance of shares upon conversion of a SAFE will not be a taxable event, and the Israeli resident issuing company will not be subject to a withholding tax obligation at such time, and**
2. **Any gain recognized upon the subsequent sale or disposition of the shares that were issued upon conversion of the SAFE will generally be subject to capital gains tax.**

The guidelines provide certainty with respect to the ITA's position on the tax classification of most of the SAFE instruments in the industry. Such clarification is welcome news after a considerable period of time during which the topic was under review by the ITA, which gave rise to concerns about the potential withholding obligation of an issuing company and to delays in receiving consideration from the sale of shares issued pursuant to SAFEs.

The guidelines apply to SAFEs in high-tech companies, defined as companies in which the majority of their expenses are classified as R&D expenses, or manufacturing or marketing expenses of their own products, and which SAFEs are signed on or prior to December 31, 2024 (or until other guidelines are published by the ITA).

As a result of the ITA's guidelines, further emphasis should be given to the importance of drafting SAFEs in a manner that will comply with such guidelines. While the terms and conditions set forth in the guidelines are typical to most SAFEs in the industry, it should be noted that SAFEs that do not meet the "green track" terms and conditions may still be considered equity instruments, subject to review of their specific terms and conditions.

Our firm has vast experience in advising companies and investors in all aspects of SAFE investments. Our partners took an active and significant role in negotiating the guidelines described above. We are happy to be at your service in any issue that arises in connection with SAFE investments in general, and the ITA guidelines in particular.

Contact Information

Eldar Ben-Ruby, Partner
Tax Group Leader
+972-3-6103615
eldarb@meitar.com

Dr. Michael Bricker, Partner
Tax Group
+972-3-6103810
michaelb@meitar.com

Keren Shitrit, Partner
Tax Group
+972-3-6103890
kerens@meitar.com

Noa Haimi Cohen, Associate
Tax Group
+972-3-6144843
noah@meitar.com

For additional information about our firm's Tax group, click here

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Meitar | Law offices
16 Abba Hillel Silver Road, Ramat Gan, 5250608, Israel | +972-3-6103100

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