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**PROGRAM MATERIALS**

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## **Identifying Tax Traps in Convertible Debt and SAFEs**

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# IDENTIFYING TAX TRAPS IN CONVERTIBLE DEBT AND SAFES

Celesq  
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# TOPICS COVERED

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- Business Overview
- Discharge of Indebtedness Income
- Debt Assumption as Consideration
- Exceptions to Income Recognition
- Section 752
- Contributions to Controlled Corporations

# TOPICS COVERED

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- S Corporations
- Simple Agreements for Future Equity (“SAFEs”)

# OVERVIEW

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Convertible Debt

Simple Agreements for Future Equity

# DISCHARGE OF INDEBTEDNESS INCOME

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## Basics

Discharge of Indebtedness or cancellation of debt (“COD”) income as accession to wealth.

IRC §61(a)(11), Kirby Lumber, 284 U.S. 1 1931).

No income on borrowing of funds.

Income is equal to face amount reduced by amount paid for discharge.

# DISCHARGE OF INDEBTEDNESS INCOME

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Realization of COD income is either when debt is satisfied for less than principal amount or when clear will not be repaid.

Related party acquisition of debt.

# DISCHARGE OF INDEBTEDNESS AS CONSIDERATION

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Amount realized from a sale or disposition of property includes discharge of liabilities resulting from the sale. Treas. Reg. §1.1001-2(a)(1)

Amount realized on sale or disposition of property does not include amounts that are COD income. §1.1001-2(a)(1)

Sale or disposition of property securing nonrecourse liability discharges the transferor. Treas. Reg. §1.1001-2(a)(4(i)).



# DISCHARGE OF INDEBTEDNESS AS CONSIDERATION

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Sale or disposition of property securing recourse liability bifurcates the transaction.

Amount received when transfer property in satisfaction of debt is fair market value of transferred property. The remainder of debt discharge is COD income

Treas. Reg. §1.1001-2(a)(4)(ii), §1.1001-2(c) Ex 8,

# DISCHARGE OF INDEBTEDNESS EXCLUSIONS

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COD income does not include:

- From discharge in bankruptcy case.

- When taxpayer is insolvent

- Qualified farm indebtedness

- Qualified real property indebtedness

- Qualified principal residence indebtedness

IRC §108(a)(1)

# DISCHARGE OF INDEBTEDNESS EXCLUSIONS

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Insolvency exception

Exclusion does not exceed amount by which taxpayer is insolvent.

Insolvency is the excess of liabilities over the fair market value of assets.

IRC §108(a)(3)

Reduction of tax attributes. IRC §108(b).

# DISCHARGE OF INDEBTEDNESS

## EXCLUSIONS:

### DEBT FOR EQUITY

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Satisfaction of corporate or partnership debt with equity is considered payment with money equal to the fair market value of the equity. IRC §108(e)(8).

Satisfaction of corporate debt by contribution to capital is treated as payment of amount of money equal to the shareholder's adjusted basis in the indebtedness. IRC §108(e)(8).

# SECTION 752

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Increases in a partner's share of liabilities of a partnership are contributions of money to the partnership. IRC §752(a).

Decreases in a partner's share of liabilities of a partnership are contributions of money to the partnership. IRC §752(b).

Distributions of money to a partner in excess of adjusted basis are considered from gain on sale or exchange of partnership interest. IRC §731(a).

# OTHER PARTNERSHIP TAX RULES

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Partnership requires carrying on trade, business, operation or venture and agreement to divide the profits therefrom. Treas. Reg. §301.7701-1(a)(1).

Basis in partnership interest increased by contributions and share of taxable income. IRC §705(a), (a)(1).

Basis in partnership interest decreased by distributions share of losses. IRC §705(a)(2).

# CONTRIBUTIONS TO CONTROLLED CORPORATIONS

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No gain or loss if property contributed to a corporation by one or more persons solely for stock, if immediately after, such persons have control under IRC §368(c). IRC §351(a).

An assumption of a liability on a IRC §351 contribution is not usually treated as a payment of money or other property. IRC §357(a).

# CONTRIBUTIONS TO CONTROLLED CORPORATIONS

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If in a IRC §351(a) transaction, the liabilities assumed exceed the total adjusted basis of transferred assets, the difference is considered gain from the sale of the respective assets. IRC §357(c)(1).

Does not include liabilities that give rise to current deductions.

Does not apply if it would effect a tax avoidance purpose or is part of a “G” reorganization where no shareholder receives consideration for stock.



# S CORPORATIONS

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Corporations that have made the S election are not taxed, and instead are treated as pass-through entities. Key requirements.

No more than 100 shareholders.

No shareholders who are not individuals or specified estates, trusts, or exempt organizations.

No nonresident alien shareholders.

Only one class of stock.

IRC §1361(b)(1)

# S CORPORATIONS

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A corporation has one class of stock as long as “all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds”  
Treas. Reg. §1.1361-1(l)(1)

Test is based on formality, not inadvertence: “the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds”  
Treas. Reg. §1.1361-1(l)(2)

# CONVERTIBLE DEBT OF PARTNERSHIP

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No taxation on receipt of proceeds.

Conversion triggers Code Section 752 deemed distribution.

Query when partners may have depleted basis.

# SAFEs

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## Typical terms:

Amount paid by investor upfront.

Variable equity payable in the future.

Frequently has provision that will be treated as conferring equity interest in corporation.

Query effect when SAFE entered into by partnership with equity deliverable on conversion.

Query whether investors satisfy definition as partners.

Query effect when SAFE entered into by S corporation.

# CONTACT INFORMATION

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