New York State Department of Taxation and Finance
Office of Counsel
Advisory Opinion Unit

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Income Tax
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STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. I080603A

A petition dated May 30, 2008 requests an interpretation of the term "qualified investment" for purposes of Section 606(r)(1)(C) of the Tax Law. Specifically, petitioner asks whether an investment in a certified Qualified Emerging Technology Company (QETC) in the form of convertible debt constitutes a qualified investment for purposes of the QETC tax credit available pursuant to section 606(r) of the Tax Law and, if so, whether the credit may be claimed in the tax year in which the note is taken or the tax year in which the note is converted.

Facts

Petitioner has advised that investments in start-up companies are frequently made in the form of convertible debt, wherein a note is taken by an investor from the company with the expectation that the note will convert into capital stock within a year or two of the initial investment. These conversions are typically structured so that the conversion will occur during a period of financing for the company where the market value of the stock is more readily ascertainable. Accrued interest, along with the principal amount invested, is often converted into capital stock.

Analysis

Section 606(r) of the Tax Law provides that a taxpayer will be allowed a credit against the tax imposed by Article 22 for certain qualified investments made in a QETC. A qualified investment is defined as "the contribution of property to a corporation in exchange for original issue capital stock or other ownership interest." (Tax Law section 606(r)(1)(C)). Since the investor does not receive the stock at the time of the investment, the issue is whether the investment represents a contribution of property in exchange for an ownership interest in the corporation within the meaning of section 606(r)(1)(C).

The role of the investor in the convertible security transaction is essentially that of an interim lender. The investor loans the money to the corporation in exchange for the promise of a stock transfer at some future date. The first issue is whether or not the loan of capital constitutes a "contribution of property" for purposes of section 606(r)(1)(C)). By its very nature, a convertible securities transaction is one in which conditions may or may not be met if and/or when the note is converted to stock. It is thus possible that the capital will be returned to the investor and the note cancelled upon the occurrence or non-occurrence of certain events. Under those circumstances, it would be difficult for us to characterize this particular transaction (i.e. the loaning of money in exchange for a note and the promise of future events) as a contribution of property for purposes of section 606.

Nor does the holder of a note evidencing a debt obligation incurred by a corporation have an ownership interest in that corporation. Although the statute does not define "ownership interest" for purposes of this credit, there are well-established *indicia* of ownership in the law. In this case, the start-up company has not given up any of its rights to control its business, there has been no substantial change in the dominion and control over its operations, and the note holder has no right to dispose of any property of the corporation. (*See*, *e.g*., Martin v. Commissioner, 56 T.C.1255 (1971), Key Homes Inc. v. Comm'r of Internal Revenue, 30 T.C. 109 (1958)).

Therefore, if the investor has neither made a contribution of property nor has acquired an ownership interest in the corporation at the time the initial investment in the QETC is made, he is not entitled to the QETC credit at that time. However, if and when the note is converted to original issue capital stock, the investor is entitled to the QETC credit at that time.

Conclusion

For purposes of the QETC credit, a qualified investment is made in a QETC in the year that a note is converted to capital stock, not in the year the note is given. The amount of the qualified investment will include accrued interest on the note at the time of the conversion.

DATED: February 5, 2009

/S/
Jonathan Pessen
Director of Advisory Opinions
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