



QAPITA

Convertible Notes

The Complete Guide for US Founders

A founder's guide to convertible debt in the US market: how it converts, what it really costs, and why it's quietly become the exception rather than the default. Covers interest, discounts, valuation caps, maturity, the tax mechanics most guides skip, and a full comparison against SAFEs and KISS notes - with worked examples throughout.

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01 • THE LANDSCAPE

Why Convertible Notes Still Exist

Long before SAFEs (2013) or KISS notes (2014) gave founders a simpler alternative, the convertible note was the only tool available for pricing a company that had no price. It borrowed a structure everyone already understood a loan and bolted on one new feature: the lender's option to take stock instead of cash when the company's value finally became clear.

That debt DNA is still the note's defining trait today. Every convertible instrument that followed was, in effect, a reaction to it. The SAFE stripped the debt out entirely no interest, no maturity, no repayment risk. The KISS kept a version of it back in its Debt variant, while going further than a SAFE on investor protections like information rights and pro-rata. The convertible note is what's left when you keep all of the original loan structure intact, negotiated line by line rather than accepted as a free template.

Pre-2013

Convertible notes are the only bridge instrument in common use

2013

Y Combinator launches the SAFE, removing the debt component

2014

500 Startups launches the KISS as a middle path

Today

Notes persist as the deliberate choice, not the default

A loan first, equity second

A convertible note is a real promissory note: a defined principal amount, an interest rate, and a maturity date the company is legally obligated to honor unless a qualifying conversion event happens first. That legal reality is what every other term on the note exists to manage: the discount and the cap compensate the investor for taking early risk, and the maturity date is the backstop that makes the arrangement enforceable as debt rather than a handshake.

Every later instrument reacted to it

Reading the note first is what makes the SAFE and the KISS make sense: both are best understood as edits to the note's original template, each one removing or reshaping a specific piece of debt risk that the note still carries in full.

Why founders still ask about it in 2026

Even at 7% of the pre-seed market, notes haven't disappeared - they've become a deliberate choice rather than a default. Understanding the mechanics below is what lets a founder recognize when that choice is being made for a real reason versus out of habit or an unfamiliar lawyer's template.

FAST FACT

Before the SAFE existed, "convertible note" and "seed round" were nearly synonymous - the instrument now used in roughly 1 in 14 pre-seed deals was, a decade ago, the default in almost all of them.

None of this makes the note obsolete - it makes it specialized. The sections that follow walk through exactly how it works today, where it quietly costs more than founders expect, and the specific situations where reaching for one is still the right call rather than a habit worth breaking.

02 · THE INSTRUMENT

Anatomy of a Convertible Note

Six terms do almost all of the work on a modern note. Get the interaction between the discount and the cap right, and the rest of the instrument falls into place.

Interest rate

Typically 5–8% simple interest, often benchmarked to the IRS Applicable Federal Rate to avoid an imputed-interest problem later.

Maturity date

18–24 months out. If no priced round happens first, the note becomes due or the investor can force a conversion.

Discount rate

Usually 15–25%, most often exactly 20% — the note holder's reward for pricing risk before anyone else would.

Valuation cap

A ceiling on the price used at conversion, regardless of what the next priced round actually values the company at.

MFN clause

If the company later issues a note with better terms to someone else, the existing holder can claim those terms too.

Qualified Financing threshold

A minimum round size (commonly \$1M+) that must be cleared before automatic conversion is triggered.

2026 STANDARD

The prevailing US seed-stage template pairs a 20% discount with a valuation cap, an 18–24 month maturity, an MFN clause, and change-of-control language the same structure now standard across most institutional note templates.

Worked example: which price wins?

A note carries a \$50,000 principal, a \$9M cap, and a 20% discount. The company later raises a priced round at a \$1.00 share price implied by a \$13M valuation. The discount alone gives the investor a conversion price of \$0.80/share. But the \$9M cap, applied against the same round, implies roughly \$0.69/share cheaper still. The lower price always wins, so the note converts at the cap-implied price: about 72,500 shares instead of 62,500. This "whichever is lower" mechanic is the single most common source of founder surprise at a first priced round.

WHY IT MATTERS

Both the cap and discount are always live at conversion negotiating only one of them and assuming the other won't bind is the mistake that turns into a hard conversation at the term sheet stage.

**What to check before signing**

Confirm all four terms explicitly a note silent on the cap or discount doesn't mean the term is waived, it means it defaults to whatever your jurisdiction's standard template assumes. Ask your counsel to spell out each one in writing rather than relying on "market standard" as a substitute.

Every term above interacts with the others: the interest rate changes what "converts" at maturity, the cap changes what "converts" at a priced round, and the discount is the floor beneath both. Treat them as one system, not four separate negotiations.

03 · THE COMPARISON

Notes vs. SAFE vs. KISS

Three convertible instruments, three different philosophies. Here's where the note actually differs — not just from the SAFE, but from the KISS it's often confused with.

Term	Convertible Note	SAFE	KISS
Legal form	Debt	Not debt	Debt (Debt) / Not debt (Equity)
Interest	Yes, ~5–8%	None, ever	Debt version only, ~5%
Maturity date	Yes, 18–24 months	None, ever	Debt version: ~18 months
Cap / discount	Both, standard	Optional	Both, standard
MFN clause	Common	Not standard	Standard
On non-conversion	Principal + interest due	Nothing due, ever	Principal + interest due (Debt)
Tax mechanics	AFR + OID rules apply	None (no debt component)	AFR + OID rules apply (Debt)

The note is the only one of the three that is unambiguously debt on the balance sheet which is exactly why it carries interest, a maturity date, and real repayment risk that neither the SAFE nor the KISS Equity version has. That single structural fact explains almost every other row in this table, and it is the question worth asking before comparing any other term.

**READING
THE TABLE**

Cap and discount look identical across all three instruments on paper. What differs is what happens when the round never comes and that is the row that should actually drive your choice.



Note = enforceable debt obligation



SAFE = no repayment risk, ever



KISS = a negotiated middle ground

A note on the KISS, specifically

The KISS is often pitched as "a note with extra investor protections," but its Equity version actually removes the debt component entirely making it closer to a SAFE with MFN and information rights bolted on than to a true convertible note. Don't assume KISS and note behave the same way just because both have "convertible" in the name.

BOTTOM LINE

If your lawyer hands you a note without explaining why, it's worth asking whether a SAFE would close just as fast the market has increasingly answered that question with "yes."

The next section walks through what actually happens at each of a note's three possible endings conversion, maturity, and sale in more detail than the summary table above can capture.

04 · THE SCENARIOS

Conversion, Maturity or Sale

A note has four possible endings. Which one you get depends on timing, not intentions — and the terms behave differently in each.

Qualified financing round

Once the next priced round clears the note's minimum size (a "Qualified Financing Event," commonly \$1M or more), the note converts automatically at whichever is lower: the discounted price or the cap-implied price. Accrued interest is typically added to the principal converting, not paid out in cash.

Sale of the company

The note holder chooses: convert to common stock at the cap, or take principal plus accrued interest back in cash often with a 1.5x–2x multiple written into the change-of-control clause, sweetening the payout beyond a flat return of capital.

Maturity without a round

The note becomes due and payable. In practice, most founders and investors renegotiate the maturity date rather than trigger repayment but the legal right to demand cash back is real, and it is the one outcome a SAFE can never produce.

Early, voluntary conversion

Most notes also allow conversion before any triggering event, at the option of the holder or the company, on the same cap-and-discount terms as if a qualifying round had happened. This gives both sides flexibility to resolve the note without waiting on outside events.



Whichever ending applies, the underlying math never changes: principal plus accrued interest, priced against whichever of the cap or discount produces the lower conversion price for the holder.

PLAN FOR ALL FOUR

Founders who only plan for the qualified-financing scenario are routinely caught off guard by a maturity date or an acquisition offer build your cap table model to handle all four endings, not just the one you're hoping for.

05 · THE HIDDEN COSTS

The Interest Rate Isn't Optional

Founders often treat a note's interest rate as a negotiation formality something to set low and forget. The IRS disagrees, and the mechanism is worth understanding before it surprises anyone at conversion.

The AFR floor

Under IRC Sections 1274 and 483, a note priced below the IRS's monthly Applicable Federal Rate risks having part of its principal recharacterized as imputed interest. Short-term AFRs have run roughly 3.5–4.5% through 2026 quietly setting a real floor under what looks like a freely negotiable number.

Phantom income for the investor

Notes issued with original issue discount can require the holder to report accrued interest as taxable income every year it accrues even though no cash changes hands until conversion or maturity. Sophisticated investors price this in; first-time angels often don't see it coming.

Illustrative 2026 Applicable Federal Rates (annual compounding)

~3.5–3.6%

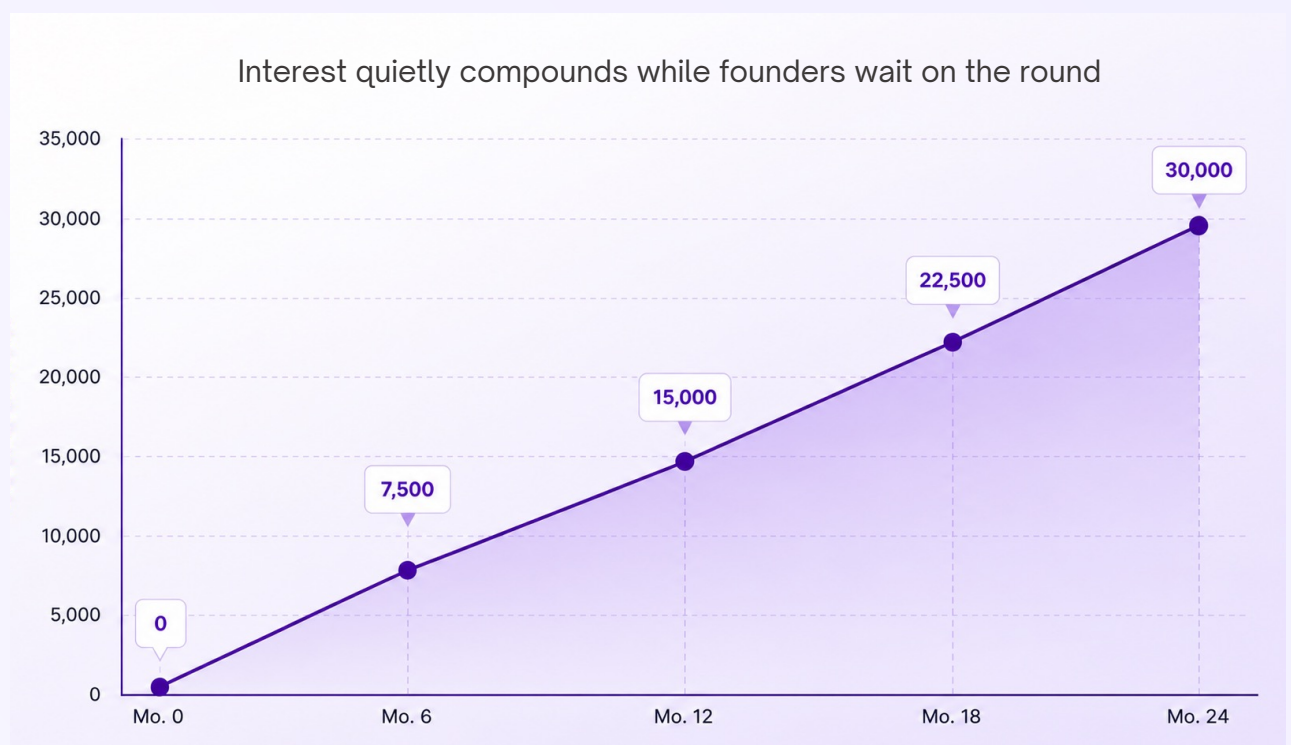
Short-term (≤ 3 yrs)

~3.7–4.0%

Mid-term (3–9 yrs)

~4.2–4.5%

Long-term (> 9 yrs)



WORTH KNOWING

Neither issue exists on a SAFE, because a SAFE isn't debt there's no principal to accrue interest on and no OID calculation to run. It's a quiet reason lawyers reach for the simpler instrument by default, not just habit.

The below-market loan angle

Section 7872 imputed-interest rules were originally written for below-market loans generally, including between related parties. A convertible note priced with no explicit interest rate at all can, in rare cases, invite the same scrutiny as a founder loan.

Where to see it in the document

Look for a stated "Interest Rate" section referencing a specific percentage, and check whether it names the AFR explicitly or leaves the rate to be set at signing the latter is the version worth double-checking with counsel.

None of this is exotic it's the same logic that applies to any family loan or seller-financed transaction. Convertible notes just apply it to a less familiar context, which is exactly why it gets missed.

05 · THE HIDDEN COSTS

The QSBS Clock, and Stacked Notes

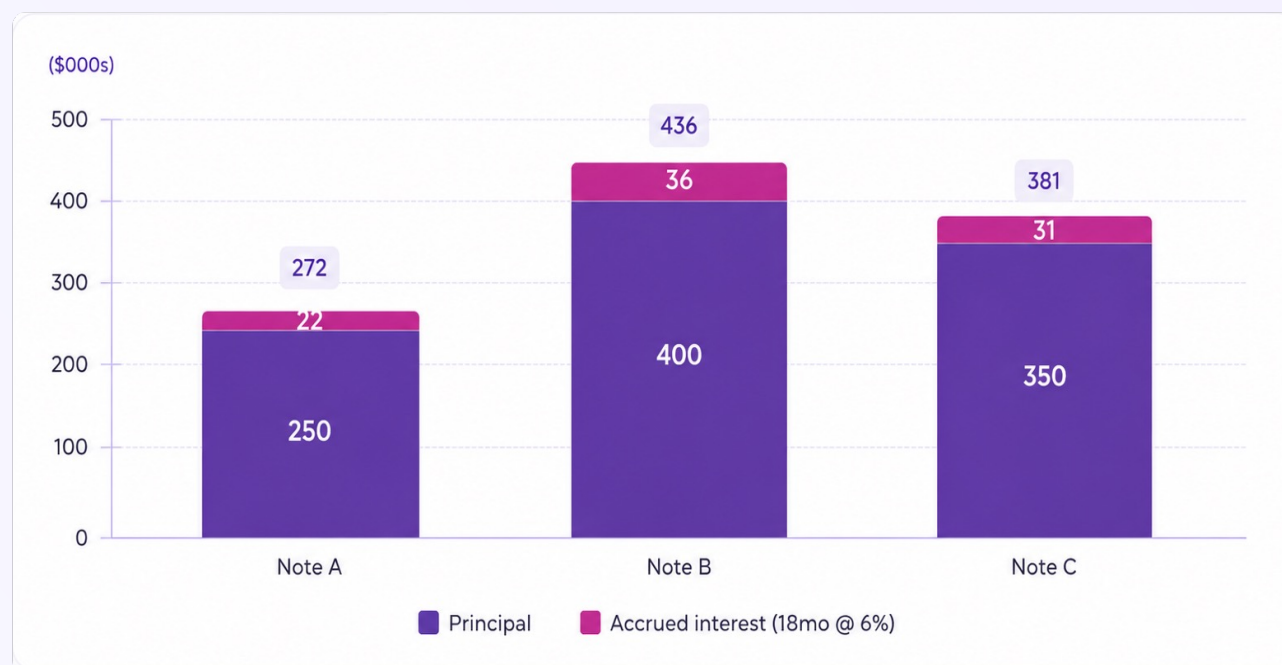
One place the note is actually cleaner: QSBS

For Section 1202 qualified small business stock, the five-year holding period starts on the date the stock is acquired. A convertible note is debt until the moment it converts, so that acquisition date is unambiguous. A SAFE's pre-conversion status is a forward contract with no settled IRS position on when or whether the clock could start earlier, which is exactly the kind of ambiguity that makes some tax advisors cautious. This is general information, not tax advice confirm QSBS treatment with a qualified advisor before relying on it.

Stacked notes compound like stacked SAFEs plus interest

Three notes at \$250K/\$8M cap, \$400K/\$10M cap, and \$350K/\$12M cap look manageable alone. At an \$18M priced round, all three convert simultaneously at their own cap-implied price, plus whatever interest has accrued on each by that date.

What actually converts: principal + accrued interest, per note (\$000s)



Founders who model one note at a time routinely underestimate total dilution, because the interest component keeps growing for as long as the priced round is delayed and every additional month of delay makes the eventual conversion more expensive for the founder, not less.

How to actually track it

Model every open note and SAFE in a single spreadsheet or cap table tool, updated whenever a new one is issued not reconciled once a year. Include the principal, the cap, the discount, and a running accrued-interest balance for each, and re-run the stack against your target round size before every fundraising conversation.

RULE OF THUMB

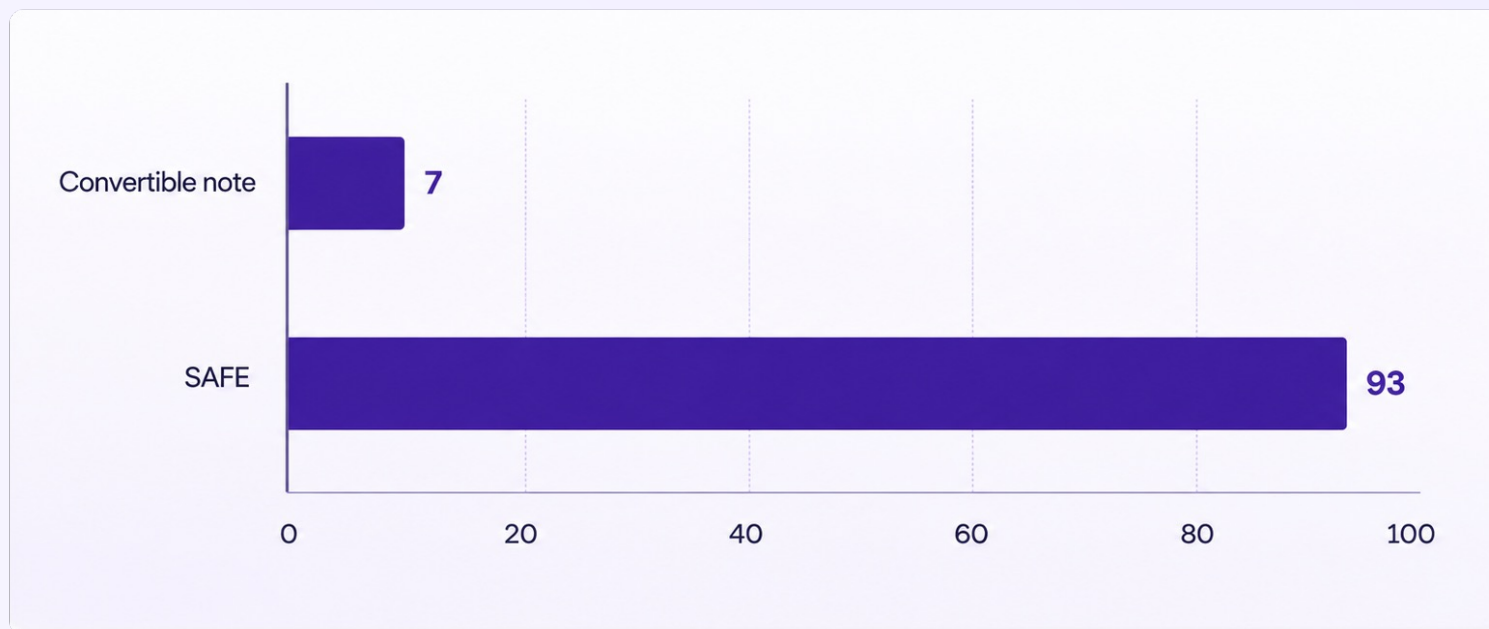
If you can't say, right now, what your fully diluted cap table looks like after every open note converts, you're not ready to negotiate the next one.

The two issues on this page QSBS timing and stacked-note dilution rarely show up in a term sheet negotiation. They show up months later, at the first priced round or the first exit conversation, which is exactly why they're worth resolving early rather than discovering under time pressure.

06 · THE NEW PERSPECTIVE

Down to 7%: Has the Note Already Lost?

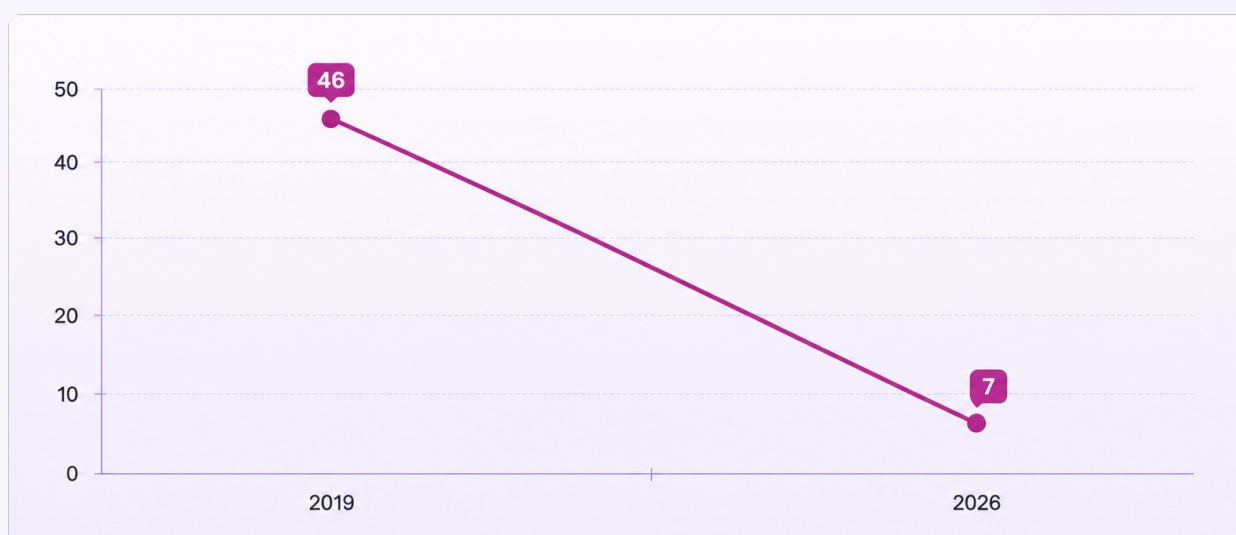
Carta's Q1 2026 data across US pre-seed startups puts the answer in one chart: convertible notes now make up a record-low share of the market.



**7% / 8% of
instruments / dollars**

Convertible notes hit a record low at pre-seed in Q1 2026, per Carta, comprising just 7% of instruments and 8% of dollars raised.

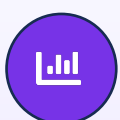
The seven-year decline



The dollar picture tells a similar story at the broader seed stage: Carta counted more than 50,000 SAFEs and convertible notes issued in 2025 across the US, totaling roughly \$10.4 billion with the note's share of both the count and the dollars still shrinking quarter over quarter.

READ THE TREND

A declining share doesn't mean the disappears it means the bar for using one deliberately keeps rising each year.



**93% of instruments
are SAFEs**



**~50% of pre-seed dollars
go to AI startups**



**Post-money SAFEs
are ~90% of all SAFEs**

The next two pages unpack why this shift happened, and the specific, nameable situations where the note still earns its place on the cap table despite the broader trend.

06 · THE NEW PERSPECTIVE

Why the Note Lost Ground

The note wasn't a worse document it was a differently optimized one. Four forces explain the seven-year decline.

**Standardization beat the debt structure**

Y Combinator's free, widely-reviewed SAFE template became the thing every lawyer already knew, making it faster to close than a note's more customized debt terms even when the underlying economics were similar.

**Debt brings real downside for founders**

A maturity date is a deadline the company can actually default on. Founders juggling a slow raise increasingly preferred an instrument that could never force repayment, regardless of how the fundraising timeline played out.

**The tax mechanics added friction investors didn't need**

AFR compliance and OID reporting are one more thing for counsel to get right on every note friction a SAFE simply doesn't generate, since it was never structured as debt in the first place.

**Smaller checks stopped justifying the overhead**

As pre-seed rounds bifurcated into scrappy sub-\$1M checks and a handful of well-funded outliers, a note's legal overhead increasingly outweighed its benefit for the smaller, more common deal size.

WORTH REMEMBERING

Standardization, not superiority, usually wins early-stage markets. The instrument with the lowest friction to "just use the default" tends to compound its lead every quarter.

THE TAKEAWAY

None of these forces make the note wrong for a given deal, they explain why it now needs a specific reason to be chosen, rather than being chosen by default.

This is the same pattern that has played out with SAFE-vs-KISS as well: the market consistently rewards the instrument with the least friction to close, and punishes anything that requires an extra explanation, even when that extra explanation would ultimately protect the founder or the investor.

07 · THE EXCEPTIONS

When a Convertible Note Still Wins

"Rare" is not "never." A handful of situations still favor the note's debt structure over a SAFE's simplicity.

**Long, capital-intensive development**

Biotech and hardware startups with multi-year runways to a priced round sometimes prefer a note's interest accrual as a way to compensate early capital for real time-value of money.

**Non-Delaware entities**

The SAFE's tax and legal treatment assumes a Delaware C-corp. Outside that structure, a conventional debt instrument can be the more legally coherent choice in the relevant jurisdiction.

**You need a forcing function**

A real maturity date creates leverage to force a conversion or repayment conversation, useful if the path to a priced round is genuinely uncertain and open-ended.

**Your lead already holds notes**

An existing note holder's MFN or pro-rata terms can make matching the instrument simpler than introducing a fourth kind of security onto the cap table.

**An investor requires it as a matter of internal policy**

Some funds and angel syndicates standardize internally on notes for compliance or portfolio-accounting reasons unrelated to your specific deal. Fighting that policy on a small check rarely produces a better outcome than simply accepting the note.

READ IT RIGHT

None of these are arguments for notes over SAFEs in the abstract, they're arguments for matching the instrument to a constraint you can actually name, not a preference you can't.

If none of the five situations above apply to your round, the honest default answer in 2026 is the post-money, cap-only SAFE and that's a fine place to start the next conversation.

**Biotech / hardware****Non-Delaware structure****Need a forcing function**

Whichever of these applies, name it explicitly in the term sheet discussion "the market default was fine, but here's our specific reason to deviate" is a stronger position than either defaulting or deviating silently.

08 · THE FRAMEWORK

Choosing Your Instrument

A practical order of operations for founders deciding what to send investors.

- 1 Default to the post-money SAFE, cap only**
Fastest to close, most familiar to investors and lawyers. Start here unless something specific argues otherwise.
- 2 Check what your lead investor is used to**
A biotech-focused fund or a non-US entity structure may make the note the more natural fit don't fight this on a small check.
- 3 Price the interest rate against the AFR, not just habit**
Setting a rate below the IRS's Applicable Federal Rate creates imputed-interest exposure neither side wants to discover later.
- 4 Model the maturity date as a real deadline**
Build your runway assuming the note could actually come due not assuming it will always be extended by mutual agreement.
- 5 Stack every open note and SAFE before you sign a new one**
Total dilution is the sum of every instrument converting together, each at its own cap, discount, and accrued interest balance.
- 6 Document everything for audit-readiness**
Keep signed copies, conversion terms, and accrued-interest schedules in one place investors and auditors will ask for a clean history at your first priced round.

BEFORE YOU START

Have your last cap table, all open instruments, and your target round size in one place before starting this checklist — step 5 is only useful if step 4 has real numbers behind it.

This order of operations isn't a legal opinion it's the sequence experienced founders and their counsel typically work through before a term sheet is drafted.

ONE LAST CHECK

Run the same six steps against every SAFE and KISS you're considering too the framework doesn't change just because the instrument does.

08 · THE FRAMEWORK

Common Mistakes to Avoid

The instrument rarely causes problems. Poor bookkeeping and unchecked assumptions around it do.

✗ Treating the interest rate as free

Below-AFR pricing creates imputed-interest exposure for both sides, not just extra paperwork to file away.

✗ Forgetting interest compounds the cap math

Accrued interest adds real dollars to the amount converting at the cap — model it explicitly, don't estimate it after the fact.

✗ Ignoring the maturity date until it arrives

A note past maturity is legally due and payable; renegotiating from that position is weaker than extending ahead of time.

✗ Assuming QSBS treatment without checking

Confirm conversion-date acquisition and holding-period mechanics with a tax advisor before counting on Section 1202 benefits.

✗ Mixing notes and SAFEs without one model

Every open instrument converts against the same priced round — track them together on one cap table, not deal by deal.

✗ Letting the MFN clause become boilerplate

An MFN clause can retroactively upgrade an earlier holder's terms the moment a better one is issued plan future rounds with that in mind, not as an afterthought.

THE FIX

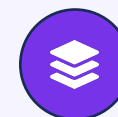
None of these mistakes are complicated to avoid they're just easy to skip when a note is signed months apart from the others under real fundraising time pressure.



Model interest, don't estimate it



Track maturity dates on a calendar



Keep every instrument in one place

A five-minute review against this list before signing anything new catches most of the problems founders otherwise discover at their first priced round.

WHO SHOULD DO THIS

Whoever owns your cap table founder, finance lead, or outside counsel should be the one running this checklist, not whoever happened to negotiate the note.

08 · THE FRAMEWORK

One Cap Table for Every Instrument

Whichever instrument you choose — note, SAFE, KISS, or all three across different rounds — the real risk isn't the paperwork. It's losing track of how interest, caps, and discounts all convert together.

Every instrument, one ledger

Issue & track notes, SAFEs, & KISS agreements side by side including accrued interest with no separate spreadsheet reconciliation required.

Live dilution modeling

Stack every open cap, discount, and interest balance against a hypothetical priced round before you sign anything new.

Compliant, ready-to-issue templates

Attorney-informed convertible note, SAFE, and KISS templates built for the US market, AFR-aware by default.

Built for Seed to IPO

Clean conversion records and audit-ready history for the day every instrument converts into your first priced round.

Interest and AFR tracking built in

Accrued interest updates automatically against each note's stated rate, so nobody has to reconstruct the balance by hand at conversion.

Investor-ready reporting

Give note and SAFE holders direct access to track their own instruments, without extra email threads back and forth.

See it on *your own cap table*

Qapita models how your open SAFEs and KISS notes actually convert side by side with your priced-round scenarios so you know your real dilution before you're in the room with a term sheet.

[Book a Demo](#)