ANGEL CAPITAL ASSOCIATION | NATIONAL VENTURE CAPITAL ASSOCIATION | Biotechnology Innovation Organization | AdvaMed Advanced Medical Technology Association

Section 382 NOL Safe Harbor

Tax rules relating to the treatment of losses can unintentionally punish start-ups for investing in the growth of their companies. The rules, in Section 382 of the tax code, were written in the mid-1980s with the intent of preventing loss trafficking, or the strategy of companies acquiring failing firms with enormous losses on their books for the sole purpose of using the tax losses to offset other unrelated income. While we recognize the importance of preventing abusive loss trafficking, the excessive application of these rules has created an impediment for start-ups which depend on investment capital and often accumulate net operating losses (NOLs) as a result of substantial R&D expenditures and rapid hiring. Under Section 382, accepting these critical equity investments can limit a start-up's ability to utilize its NOLs in the future. Thus, Section 382 discourages investment in innovation and works at cross purposes with tax policy that generally seeks to encourage R&D, such as the R&D credit.

Congress can foster economic growth and job creation without creating a new tax expenditure, simply by modernizing the rules in the code to stop penalizing start-ups for investing in job creation and innovation. Congress should create a safe harbor from Section 382 NOL limitations (and related Section 383 credit limitations) for start-ups going through viable fundraising rounds and ownership changes.

We support the following safe harbor proposal that would apply to companies less than 12 years old:

- Exempt capital contributions to the company from ownership change calculations. Under Section 382, an ownership change triggers limitations on future use of NOLs. The safe harbor would allow capital contributed to the company from a fundraising round to be disregarded for purposes of determining an ownership change under Section 382.

- Exempt R&D expenses (defined as Section 174 expenses) from limitation, preserving the start-up's ability to use its full NOLs generated from R&D expenditures.

- Exempt R&D credits from limitations under Section 383.

- Provide a more robust limitation calculation for all other accumulated NOLs by allowing an additional 5 percentage points to be added to the long-term tax-exempt rate (currently around 2%).
    - The current limitation is determined by multiplying the fair market value of the company by the long-term tax-exempt rate. This equation creates the ceiling for the amount of NOLs that can offset income per year going forward. The lower the long-term rate, the more severe the limitation will be.
    - For instance, a company that sells at a $50M valuation could see their allowance triple from an annual limitation of $1.25M to $0.375M.

- Retain anti-abuse protections. The special rules for qualified new loss corporations would not apply to loss corporations that do not comply with the existing continuity of business enterprise test in Section 382.

With this effective and tailored safe harbor, the loss limitation rules should still be able to accomplish the objective of preventing tax abuse but avoid the unintended consequences of discouraging investment in innovation and job creation.