STARTUPS NEED A SAFE HARBOR FROM OVERLY-BROAD TAX RULES
Stop Penalizing Startups for Investing in Innovation

The Problem
Tax rules relating to the treatment of losses can unintentionally punish startups 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. As enacted, these rules have become an impediment for startups that often accumulate net operating losses (NOLs) when using investment capital to try to build a successful company. Section 382 can create an unintentional tax penalty for investment in innovation and entrepreneurship that works at cross-purposes with tax policy that generally seeks to encourage R&D (such as the R&D credit and the deduction for R&D expenditures under Section 174).

Startups are seeking solutions to some of the most challenging issues we face, including cures for cancer and other diseases, technological innovation, cybersecurity and energy. They work on these challenges by raising and investing significant capital that may exceed revenues for years while trying to build an idea into a successful company. This basic model of entrepreneurship necessarily generates NOLs that should be available to offset income if the company becomes profitable. Section 382 undermines this entrepreneurial model by restricting future use of NOLs.

Importantly, because startups generally spend most of their capital on R&D and salaries, the types of expenses these rules limit for startups are some of the most societally beneficial expenditures with the greatest economic and human impact. Section 382 rules actually penalize startups for incurring the same expenses that, for incumbent companies, federal policy successfully encourages.

Solution
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 startups for investing in job creation and innovation. Congress should create a safe harbor from Section 382 NOL limitations (and related Section 383 R&D credit limitations) for startups going through viable fundraising rounds and ownership changes.

NVCA supports 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 Sections 382/383.
- Exempt R&D expenses (defined as Section 174 expenses) from limitation, protecting these expenses, which generally receive favorable tax treatment, from loss limitation penalties.
- Exempt R&D credits from limitations under Section 383.
- Retains 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 under subsection (c)(1), disregarding (c)(2).
- Provide a more robust limitation calculation for all other accumulated Net Operating Losses (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 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 $1M to $3.5M.
- 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 under subsection (c)(1), disregarding (c)(2).

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