November 12, 2019

The Honorable David Kautter
Assistant Secretary of the Treasury (Tax Policy)
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CC:PA:LPD:PR (REG-125710-18)
Room 5203
Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, D.C. 20044

Re: Comments on Section 382(h) Proposed Regulations Related to Built-In Gain and Loss (REG-125710-18)

Dear Sirs:

On behalf of our members, we appreciate the opportunity to submit the following comments on the proposed regulations issued under section 382(h) regarding the determination and treatment of built-in gains and losses.

The National Venture Capital Association (NVCA) empowers the next generation of American companies that will fuel the economy of tomorrow. As the voice of the U.S. venture capital and startup community, NVCA advocates for public policy that supports the American entrepreneurial ecosystem.

New businesses are the engine of job creation in the United States, creating an average of about 3 million new jobs each year and accounting for virtually all net new job creation, according to data from the U.S. Department of Labor and the U.S. Census Bureau. Venture capital partnerships provide equity investment that helps fuel the growth of early stage startups. A recent research paper produced by Stanford University finds that of the 1,339 companies that have gone public between 1974 and 2015, a full 42 percent can trace their roots to venture capital. Venturebacked companies also account for 85 percent of all research and development spending by companies that have gone public since 1974.[1]

Investment of venture capital allows these new businesses to conduct research, develop novel products, hire new staff, expand into additional markets, and undertake other growth activities. The process of innovation and scientific commercialization is very long and capital intensive, but critical to American economic competitiveness. By necessity, venture capital partnerships are patient investors and view the natural business cycle of growth companies as far longer than the one year dictated by the annual accounting principles that control tax laws. The investments which give rise to net operating losses (NOLs) and other tax attributes that are incurred in the early years of a firm's business cycle produce, and therefore should be matched with, the income generated in the later years of the cycle. Indeed, tax policymakers have adopted this view, as reflected in the current-law carryover rules that allow, absent an "ownership change," business tax credits and losses incurred in the early years of an enterprise to be carried forward to offset fully the tax with respect to income generated in the later years of the enterprise.[2]

We appreciate that policymakers have concerns that the availability of these carryover rules may result in the trafficking of tax attributes to offset other unrelated taxable income of the acquirer. Thus, sections 382 and 383 provide limitations to the general carryover rules of sections 172 and 39. The "loss trafficking" concerns that give rise to the limitations in sections 382 and 383, however, are not present in our prototypical business model. We do not invest in a business because it has an NOL or other tax attribute to exploit; in fact, it is often the capital we provide which generates these tax attributes. We invest in businesses because we see their long-term growth potential in their people, their ideas, and their assets. Moreover, rather than buying out current shareholders, we typically make direct investments in operating businesses to advance the growth of the target firms' current trades or businesses. We do not invest to co-mingle the tax attributes of the target firm with taxable income from other entities or unrelated trades or businesses.

Yet, despite this fact, our equity infusions often will result in an ownership change in these enterprises, that will trigger the application of the section 382 limitations. Similarly, section 382 can also be triggered through an initial public offering (IPO) of these companies. Because these businesses are investing to obtain scale and taking incredible risks against long odds to become the next generation of successful American businesses, they are almost always in a loss position and the tax treatment of NOL carryovers is of critical concern and value to them. Ensuring that NOLs and other tax attributes survive and can be fully utilized after the ownership change is important to helping fulfill the economic potential of these American businesses.

We are concerned that Treasury and the Internal Revenue Service ("IRS") are reversing course on administrative guidance that has worked well to smooth the tax implications of a multi-year business cycle, and replacing those rules with less flexible rules that will stifle economic growth

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[1] https://www.gsb.stanford.edu/faculty-research/working-papers/economic-impact-venture-capital-evidence-public-companies

[2] Staff of Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 288, 294 (Comm. Print 1987) ("The [NOL] carryover provisions perform a needed averaging function by reducing the distortions caused by the annual accounting system.")

and result in uneconomic behavior. Specifically, by eliminating the "338 approach" of Notice 2003-65,[3] and requiring the use of the "1374 approach,"[4] the proposed regulations will place an unwarranted tax burden on startup businesses funded with venture capital. At a time when the Department of the Treasury is focused on bolstering U.S. innovation, we are concerned that the proposed elimination of the 338 approach will frustrate these efforts, by absorbing precious capital, inhibiting momentum and growth, and unnecessarily reducing incentives to invest in entrepreneurship by reducing the valuations of innovative startups.

The preamble to the proposed regulations discusses several aspects of section 382, the 338 and 1374 approaches, and the reasons for the change of policy represented by the proposed regulations. We would like to address aspects of these discussions below.

Neutrality principle

First, the preamble observes that the treatment of built-in gains and losses takes into account the neutrality principle underlying the changes made to section 382 by the Tax Reform Act of 1986. According to the preamble, "under this principle, the built-in gains and losses of a loss corporation, if recognized during the recognition period, generally are to be treated in the same manner as if they had been recognized before the ownership change." We believe that both the 338 approach and the 1374 approach satisfy the neutrality principle. The only issue is when the principle is satisfied. Under the 1374 approach, the principle is satisfied when built-in gain assets are sold. Under the 338 approach, the principle is satisfied as wasting assets generate revenue related to the built-in gain. For reasons discussed later in this submission, we believe the 338 approach better identifies and matches post-change income with the related pre-change loss and built-in gain of wasting assets.

Complexity and objectivity

The preamble indicates that since the release of Notice 2003-65, commentators have discussed the relative merits and weaknesses of the 338 and 1374 approaches. Proponents of the 1374 approach have emphasized its simplicity, objectivity and administrability. We acknowledge that a method that does not require calculation is simpler and more administrable than one that requires additional calculations.[5] However, requiring the 1374 approach will not eliminate, and may not reduce, complexity. As observed by commentators, the 1374 approach encourages taxpayers that want to enhance their section 382 limitations to sell assets with significant built-in gain. Determining which assets to sell (and when) from a business and tax perspective creates its own type of transactional complexity. Notice 2003-65 allows taxpayers seeking to reduce

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[3] 2003-2 C.B. 747.

[4] The 1374 approach and the 338 approach are different ways to account for recognized built-in gains after an ownership change. Under the 1374 approach, built-in gain is recognized when built-in gain assets are sold. Under the 338 approach, built-in gain is recognized as wasting assets generate revenue related to the built-in gain by comparing tax items that would have been determined had a section 338 election been made as of the ownership change to actual tax items.

[5] The 1374 approach only takes into account actual gains and losses recognized during the recognition period. In addition to tracking actual gains and losses, the section 338 approach also requires a taxpayer to calculate "hypothetical" depreciation deductions and basis adjustments as if a section 338 election had been made on the date of the ownership change. Thus, the section 338 approach arguably requires more calculations and, in some instances, may be more complex than the 1374 approach.

complexity to elect whether they prefer to avoid the computational complexity of the 338 approach or the transactional complexity of the 1374 approach.
It is unclear why commentators claim the 1374 approach is more "objective" than the 338 approach. Perhaps they mean that the 338 approach relies upon valuations, which can be somewhat subjective. But valuations generally are required under section 382 and the 1374 approach as well. Perhaps they mean that the 1374 approach relies on amounts reported on tax returns while the 338 approach uses hypothetical depreciation and amortization calculations. But these hypothetical calculations are based on the same tax rules governing amounts actually reported on tax returns as cost recovery deductions, and are no less objective.

Authority and policy considerations
Some commentators prefer the 1374 approach based on its "close adherence to a plain reading of the statutory text of section 382(h) and section 382(h)'s legislative history." The preamble goes on to say that the section 338 approach "possesses significantly less grounding in the statutory text of section 382(h) than the 1374 approach." We disagree and believe there is ample authority in the statute and legislative history for the 338 approach. More importantly, we believe that the issue is not which approach has a "closer adherence" or "less grounding" to the statute. If that was the test, administrative guidance could never provide more than one way to address complex business transactions. Rather, in this case, we believe that the issue is whether Treasury has the authority to allow the 338 approach, and whether such approach yields the appropriate tax and economic policy result. We believe the 338 approach meets both of these tests.

It is clear under the statute that the section 382 limitation is increased by gains from the disposition of property to the extent such gains existed on the date of the ownership change. But it is equally true that, pursuant to amendments made to section 382(h)(6) in 1988, recognized built-in gains and losses include income other than disposition gains and deductions other than disposition losses. Congress has long recognized that depreciation and amortization affect the application of section 382. The legislative history of the Tax Reform Act of 1986 provides that "[b]uilt-in gains are often the product of special tax provisions that accelerate deductions or defer income (e.g., accelerated depreciation or installment sales reporting)."[6] In addition, the language added to the end of section 382(h)(2)(B) in 1987 makes it clear that Congress understood that depreciation or amortization deductions could give rise to the recognition of an unrealized built-in loss the same as the disposition of an asset with an unrealized built-in loss.[7] Given Congress' clear intent to (1) treat depreciation deductions as a recognized built-in loss, and (2) treat recognized built-in gains and income the same as recognized built-in losses and deductions, we believe that the continued allowance of the 338 approach is appropriate.

The 338 approach provides the correct economic and policy result for wasting assets, without requiring a taxpayer to resort to disposing of such assets to increase its section 382 limitation. The fair market value of depreciable or amortizable property on the date of the ownership change generally represents the present value of the expected revenue from the property over its

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[6] See, Staff of Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 288, 298 (Comm. Print 1987).
[7] "Such term [recognized built-in loss] includes any amount of depreciation, amortization, or depletion for any period within the recognition period except to the extent … the amount so allowable is not attributable to [the built-in loss]." See, H.R. Rep. No. 100-391, 100th Cong., 1st Sess. (1987).

remaining useful life. If tax depreciation was determined based on economic depreciation (e.g., based on a mark-to-market system), the fair market value and the tax basis of the property would be the same on the date of the ownership change, and there would be no built-in gain or loss on such date. However, tax depreciation allowances under section 168 generally are more accelerated than economic depreciation, and many tangible assets will have a built-in gain as of the change date.[8] For loss companies, this accelerated cost recovery prior to the change date generally gives rise to (or increased) the NOL that becomes subject to 382. Not allowing the 338 approach creates a mismatch between the build-up of the NOL from cost recovery deductions before the ownership change and the income generated after the change that is not offset by the already-allowed deductions.

Consider the following simple example. Calendar-year Corp A places 5-year tangible property in service in 2018 at a cost of $1 million, expecting to generate $220,000 a year for five years beginning in 2019 (i.e., a simple 10-percent return on investment). In 2018, the taxpayer claims a $1 million deduction under section 168(k), and also has a $1 million NOL for the year. On January 1, 2018, Corp A undergoes an ownership change, and the $1 million NOL becomes subject to a limitation. Assuming for the sake of simplicity that the property retains it $1 million value, Corp A will have a $1 million unrealized built-in gain, and that amount should be available to increase Corp A's section 382 limitation. The 338 approach provides such a result over the life of the property by allowing an annual increase in the section 382 limitation equal to the applicable hypothetical depreciation deductions to offset the $220,000 of annual income.

One could argue that a taxpayer with perfect foresight would elect out of section 168(k) under these facts. Immediate expensing is used in the example to more clearly demonstrate how an ownership change can separate and mismatch pre-change deductions from related post-change income. Under the example, *any* depreciation allowable in 2018 would create an NOL subject to limitation (and a related unrecognized built-in gain), and the related taxable income would still be taken into account after the ownership change. In addition, it would seem that the appropriate tax policy answer should be that Corp A be accorded the same tax treatment whether or not it elected the applicability of section 168(k). That is, if Corp A had not expensed its property before the change date, it would have had sufficient adjusted basis and depreciation deductions after the change date to partially offset the $220,000 annual income. The 338 approach achieves that result by allowing NOL utilization in lieu of deprecation.

The 1374 approach achieves this result only if Corp A sells the property during the recognition period. In fact, under the 1374 approach, Corp A would be well-advised to sell its property as soon as possible after the change because the amount of built-in gain is greatest at that point. If Corp A holds the assets to produce additional income, the value of the asset (and the amount of the potential recognized built-in gain) will decline (presumably by approximately $200,000 a year). It is poor tax and economic policy to promote the fire sale of assets. The 338 approach lessens the incentive to sell assets.

[8] A similar analysis holds for intangible property. Taxpayers generally are allowed to deduct, rather than required to capitalize, the costs incurred with respect to self-created intangible assets. These deductions create or increase NOLs, and upon an ownership change, the intangible property generally will have a fair market value but a zero adjusted tax basis.

The preamble to the proposed regulations also criticizes the 338 approach because it gives rise to recognized built-in gains, "even though no actual recognition of gain or income has occurred." We believe the discussion and example above refute this assertion. To the extent a taxpayer has accelerated depreciation or other cost recovery in excess of economic depreciation before an ownership change, a portion of the taxable income that the taxpayer recognizes and reports after the ownership change essentially is "depreciation recapture" that represents recognized built-in gain. Further, the 338 approach is consistent with section 382(h)(6)(A), which requires that any income taken into account during the recognition period must be "attributable to" periods before the change date. A portion of the post-change income from a wasting asset is directly attributable to depreciation deductions claimed in pre-change periods, and the 338 approach is an appropriate way to identify and characterize such income as recognized built-in gain.

Finally, as discussed in the preamble, section 382 is based on a neutrality principle that provides that "under this principle, the built-in gains and losses of a loss corporation, if recognized during the recognition period, generally are to be treated in the same manner as if they had been recognized before the ownership change." The "as if" language implies a transaction no less hypothetical than the deemed transaction under the 338 approach. In addition, the neutrality principle requires recognized built-in gain "to be treated in the same manner" as before the ownership change. As demonstrated by the discussion and example above, the recognized built-in gain attributable to wasting assets is recognized over time under the 338 approach. This is the "same manner" as the built-in gain was created, i.e., over time as accelerated depreciation deductions were claimed.

<u>Issues under the Tax Cuts and Jobs Act</u>

The preamble to the proposed regulations also cites various provisions the Tax Cuts and Jobs Act ("TCJA") that create issues under the 338 approach. We understand these concerns. However, we believe that these issues do not implicate the overall validity of the 338 approach (as discussed above) and can be addressed specifically and directly.

First, Treasury and IRS explain that the expansion of the depreciation allowance provided under section 168(k) to used property distorts the application of the 338 approach by allowing taxpayers to increase their section 382 limitation by the full amount of the built-in gain for qualified property immediately following the ownership change. One could argue that implementing the 338 approach by allowing the section 168(k) deduction is appropriate in cases similar to the example above (i.e., where a taxpayer's NOL was increased by, and the basis of property was reduced by, a pre-change section 168(k) allowance). Further, the actual disposition of an asset will trigger the entire unrecognized built-in gain, similar to allowing a hypothetical section 168(k) deduction. Nevertheless, to address the government's concern, we suggest that the final regulations could adopt the simple solution offered in Notice 2018-30,[9] and provide that section 168(k) does not apply to the hypothetical depreciation calculations required under the 338 approach.

Treasury and IRS are also concerned that other provisions of the TCJA requiring determinations based on some variant of taxable income may pose issues under the 338 approach. The preamble does not discuss the nature of these issues. We appreciate that requiring taxpayers to recalculate a

[9] 2018-21 I.R.B. 610 (2018).

hypothetical taxable income based on hypothetical depreciation allowances creates some complexity. These issues arose prior to the TCJA. For example, a taxpayer may have had a different amount of deduction under section 199 under the hypothetical 338 approach than it claimed on its tax return. We cannot identify areas where this hypothetical taxable income determination creates significant distortions for section 382 purposes.

To address the concerns raised in the preamble, we suggest that final regulations implement the 338 approach by eliminating the requirement of Notice 2003-65 that a taxpayer recalculate all of its items that are used to determine taxable income (or variant thereof) by using the hypothetical results that would have occurred had a section 338 election been made at the change date. Rather than comparing hypothetical taxable income to actual taxable income, final regulations should simply compare the hypothetical depreciation, amortization and depletion deductions (as if a section 338 election had been made) to actual depreciation, amortization and depletion deductions, and treat the difference as an adjustment to the section 382 limitation. Appropriate adjustments to the hypothetical basis of property would be made, as under the current 338 approach. We believe that this method is significantly easier, and will provide results roughly comparable to those required under Notice 2003-65.[10]

Conclusion

In conclusion, to summarize, we believe that the section 338 approach is consistent with the statutory provisions of section 382 and the Congressional intent underlying the amendments made by the Tax Reform Act of 1986. More importantly, we believe that the section 338 approach more accurately reflects the appropriate treatment for recognizing built-in gains with respect to depreciable and amortizable assets. Eliminating the 338 approach will significantly increase transactional complexity, depress startup valuations, and discourage the deployment of needed capital to promising start-up businesses and critical U.S. technologies in the middle of a global innovation race. We recognize the potential complexity of implementing the 338 approach following enactment of TCJA, and hope we have adequately offered suggestions to address these concerns.

We appreciate the opportunity to submit these comments on behalf of our members. We appreciate the time and effort that you have devoted to this important issue. If you have any questions or comments, please do not hesitate to contact [name] at [contact info].

Sincerely,

Bobby Franklin

Bobby Franklin
President and CEO

[10] In fact, this proposed method is demonstrated in Examples 11 and 12 of Notice 2003-65.