November 12, 2019

Internal Revenue Service
CC:PA:LPD:PR (REG-125710-18)
Room 5203
Post Office Box 7604
Ben Franklin Station, Washington, DC 20044

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

Dear Sir or Madam:

The undersigned organizations are writing to the Department of Treasury to comment on the application of Section 382 of the Internal Revenue Code of 1986, as amended ("Code") to a significant portion of our respective memberships.[1] This is a matter of critical importance to our members because tax policy impacts the capital formation that enables our members to start businesses, create jobs, and develop successful companies.

Each of our organizations represents members that are early stage businesses and/or their investors and many of these companies are formed as C corporations due to the requirements of their investors. These businesses operate in industries in which there is typically a significant mismatch in the timing of start-up losses and income (where the businesses prove successful). This mismatch occurs because the underlying businesses concentrate on research and development ("R&D"), hiring and other growth activities. In the case of our life science member companies (or our members' portfolio companies), this lengthy R&D period is attributable to (1) the identification of promising medicines, therapies and devices; (2) the R&D necessary to obtain regulatory approval from the Food and Drug Administration; (3) the clinical evidence required to achieve adequate coverage and payment from both the Centers for Medicare and Medicaid Services and private insurers; and (4) commercialization of the technology. Under the Code, these businesses can deduct many of their expenditures under Section 174, which allows deductibility of research and experimental expenditures. Because the companies are generally in

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[1] AdvaMed member companies produce the medical devices, diagnostic products and digital health care technologies that are transforming health care through earlier disease detection, less invasive procedures and more effective treatments. AdvaMed members range from the largest to the smallest medical technology innovators and companies. For more information, visit www.advamed.org.

The Angel Capital Association (ACA), which represents over 14,000 accredited investors who provide an estimated $25 billion annually to over 70,000 start-up companies fueling innovation and job creation in the US economy.

The Biotechnology Innovation Organization (BIO), a not-for-profit trade association that represents approximately 1,000 biotechnology companies, academic institutions, state biotechnology centers, and related organizations in all 50 states. BIO members are working toward groundbreaking cures and treatments for devastating diseases, developing technologies for advanced biofuels and renewable chemicals, and researching novel gene traits for identifying food sources that could help combat global hunger.

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.

a loss position or entirely “pre-revenue” – that is, they don’t generate income because they do not have a saleable good or service – these deductions result in net operating loss (“NOL”) carryovers. It is these NOL carryovers that become subject to the harsh limitations of Section 382, which can significantly reduce or eliminate a valuable tax attribute.

Another significant feature of these businesses is the way in which investors fund them and the nature of the mergers and acquisition transactions in which they are involved. The typical startup financing model provides companies with multiple rounds of investment over a number of years, sometimes exceeding a decade, as various research and growth milestones are met. For example, in the case of a technology company, the business may raise funds that are expended on the initial R&D. As the product is commercialized, the business must raise larger sums to continue that R&D as well as to hire additional employees and build out operating capacity. In the case of pre-revenue companies, capital is used to continue R&D and pay for the significant costs of obtaining regulatory approval before commercialization. The investors in later rounds may, but often will not, overlap in whole or in part with the earlier investors. As a result, these growth financing transactions often change the percentage ownership of the companies over time in a manner that can trigger the application of Section 382. It is not unusual for there to be sufficient changes in ownership over the relevant testing period to cause a Section 382 ownership change that limits the use of the NOLs of the company. An initial public offering (IPO) can also trigger Section 382 limitations for the same reasons.

In addition to Section 382 ownership changes occurring on account of serial rounds of investment, mergers and acquisition (“M&A”) transactions may also cause an ownership change. The early stage companies may be acquired in M&A transactions when more established companies see an opportunity to acquire a promising technology. The M&A transaction serves to assist the early stage company in the development and commercialization of its technology by providing access to the capital resources of a larger organization. In most instances, the acquisition results in a Section 382 ownership change that limits the use of the NOLs of the company.

Two primary factors have mitigated the harsh impact of Section 382 on the NOLs of these early-stage businesses: (1) the companies have positive fair market value (reflected in the “pre-money” valuation of the company, on which basis the new investors purchase equity); and (2) the companies have significant “net unrealized built-in gains” (“NUBIG”) on account of their Section 174 deductions. The first factor results in a relatively higher Section 382 limitation. The second factor permits the company to increase that Section 382 limitation by any “recognized built-in gains” (“RBIG”).

Since 2003, companies have been able to apply the “Section 338 approach” set forth in Notice 2003-65, 2003-2 C.B. 747, to determine the amount of their RBIG. The Section 338 approach is particularly beneficial to these companies because the increase to the Section 382 limitation for RBIG does not require an actual sale or exchange of an asset. Rather, RBIG is calculated using an “as-if” method comparing the hypothetical tax deductions for depreciation and amortization that would have been available if the company’s assets had been stepped up to fair market value (as in the case of a Section 338 election) to the actual depreciation and amortization deductions that are allowable. The Section 338 approach is valuable to our members because it permits their R&D-intensive businesses to salvage at least a portion of the NOLs that otherwise would be lost due to the application of Section 382. However, recently-proposed regulations would eliminate the Section 338 approach in favor of a second approach set forth in Notice 2003-65, the “Section 1374 approach.” Preamble to Prop. Reg. § 1.382-7, Fed. Reg. Vol. 84, No. 175B p. 47455 (September 10, 2019). We do not support the proposed regulations because, as a general matter, this would eliminate the possibility of preserving additional portions of the NOLs of

these loss companies. Already, Section 382 fails to permit R&D-intensive loss corporations to appropriately match their start-up losses to the income generated from the related R&D activities. Eliminating one of the few available methods to preserve the value of some of these losses – and that can incentivize both increased investment and earlier investment in the R&D-intensive loss corporation – is short-sighted tax policy that will unnecessarily depress technology startup valuations. Tax policy should encourage investment in innovation and Section 382 should not be applied in a manner that works at cross-purposes with the pro-R&D policy carried out by the Section 174 deduction and the Section 41 R&D credit.

In closing, we emphasize that the investment rounds and M&A transactions that are so typical for our members are not the type of "loss trafficking" transactions that Section 382 should police. These transactions involve patient equity investment in the continued development of technology that has not yet been – and may never be – proven. The investments and/or acquisitions have an acceptable business purpose and do not revolve around the acquisition of losses to shelter unrelated income. For this reason, Treasury should maintain the Section 338 approach to preserve the use of NOL carryovers for the types of transactions that Treasury described as not having the "indicia of loss trafficking." *See* Treasury Decision 9638 (October 22, 2013) (exempting certain transactions involving the stock of loss corporations from the Section 382 segregation rules because they did not implicate the policies underlying Section 382).

At a time when policymakers are more focused than ever on the global innovation competition, this proposal would place an unnecessary hurdle in the way of American entrepreneurial innovation. We respectfully request your reconsideration of the elimination of the Section 338 approach to RBIG set forth in Proposed Regulations §1.382-7.

Sincerely,

Advanced Medical Technology Association
Angel Capital Association
Biotechnology Innovation Organization
National Venture Capital Association