Sections 382 and 383:
Modernize Tax Treatment of NOLs

INNOVATOR *Alliance*
EMPOWERING INNOVATION THROUGH STRATEGIC TAX POLICY

THE ISSUE:

Launching and building a new business requires investment – investment to research and develop a new technology or innovation, to prototype and perfect a new product or service, to fund the salaries for critical initial employees, and to pay other essential early expenses. Because such costs are incurred long before the first dollar of revenue, most new businesses lose money in their initial years, incurring net operating losses (NOLs). Tax law permits all businesses to deduct NOLs from taxable income. However, because most startups have little to no income during these formative years, NOLs are carried forward to offset taxable income in the future - if the startup survives.

But two aspects of the current tax code – Sections 382 and 383 – complicate the tax treatment of NOLs and other tax credits for startups. Section 382 pertains to net operating losses and Section 383 pertains to other tax credits. Enacted in the 1980s, Sections 382 and 383 aimed to prevent 'loss trafficking,' where companies acquired failing firms to exploit their tax loss and offset unrelated income. As currently written, the sections restrict startups from carrying forward NOLs and other tax credits, and can have the effect of virtually eliminating any value associated with carry-forwards for startups, following transactions perceived to be a change in ownership. And perceived changes in ownership can include investments from venture capital firms or other sources, which are essential for their survival and growth.

IMPACT ON INNOVATION:

The restrictions imposed by Sections 382 and 383 unfairly diminish the value of NOLs and tax credits, creating challenges for startups in several ways:

Reduced Investment in Innovation: Startups are discouraged from making necessary investments in developing new technologies, hiring critical employees, or scaling operations—activities essential to their growth and survival.

Lower Valuations: Entrepreneurs and investors face reduced returns on years of hard work and sacrifice. Acquiring companies often justify lower prices for startups due to the uncertain status of NOLs and tax assets, directly reducing their value.

Stifling the Innovation Cycle: When startups realize less value from IPOs or acquisitions, the proceeds that typically fund the next generation of startups are diminished. This weakens the "flywheel effect," where successful startups reinvest into the broader innovation ecosystem, fueling new jobs and economic growth.

The current restrictions penalize startups for making the very investments that federal tax policy rightly encourages for established firms, undermining U.S. innovation and competitiveness.

REQUESTED ACTION:

To further encourage the new business formation and entrepreneurship that drive innovation, economic growth, and job creation, we respectfully urge Congress to modernize the tax treatment of NOLs in Sections 382 and 383 to reflect the unique nature and importance of startups. Specifically, we urge Congress to establish a safe harbor for startups that will enable new businesses to maintain the value of NOLs and other tax credits as they continue to need and accept outside investment.

The Innovator Alliance is dedicated to empowering innovation through strategic tax reform. Our mission is to preserve and expand the innovation ecosystem while promoting the value of ownership. We believe that forward-thinking tax policy is key to driving the innovation economy forward, ensuring it remains a powerful engine for job creation, technological breakthroughs, and economic growth.

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