Tax Technical Corrections Bill Would Narrow the Scope of Code Section 470

Senior Congressional tax writing committee members recently introduced legislation that would narrow the scope of Section 470 of the Internal Revenue Code, a tax loss deferral rule that, as originally enacted, would impact a large number of VC funds. Due in part to the NVCA's lobbying efforts that have taken place over the better part of the past two years, the "Tax Technical Corrections Act of 2006" (H.R. 6264/S. 4026) (the "Bill"), if enacted, would modify Section 470 in a manner that we hope will exempt a large majority of VC funds from its scope. There may still be an opportunity to influence the language of the Bill before it comes to a vote, so we are eager to have members' responses.

Background – Section 470. Section 470 was added by the American Jobs Creation Act of 2004 to prevent a specific type of leasing transaction (a "sale-in lease-out" transaction or "SILO") that has been perceived to be tax abusive. Unfortunately, because of Congress' concern that partnerships could be used to replicate SILOs, Section 470 applies not just to leases but also to any partnership that (1) has both taxable and tax-exempt or foreign partners, and (2) has income or loss allocations that are not strictly proportional or "straight-up" allocations. Because of the large number of tax-exempt and foreign investors in VC funds and the disproportionate allocations necessary to implement a general partner's "carried interest," almost all VC funds would have to comply with Section 470 in its original form. At a minimum, this would require VC funds to incur the costs of determining if any tax losses, and what portions of those losses, would be deferred in any taxable year.

In recognition of Section's 470's overbroad application to partnerships, the Treasury Department has twice elected to postpone the effective date of Section 470 for most partnerships. Without further relief, however, calendar-year VC funds would have to comply with Section 470 for the 2006 tax year.

Overview of Bill Modifications. Very generally, the Bill would amend Section 470 in such a manner that a typical VC fund should only be subject to the rule if it both (1) holds property that is depreciable for tax purposes and (2) enters into certain hedging transactions, cash set-asides or other "defeasance" arrangements that last 12 months or longer. As discussed below, even if a VC fund fits within this category, it could still be exempted from the application of Section 470.

Specifically, Section 470 as modified by the Bill would exempt partnerships if either:

- the partnership's property is not depreciable or amortizable for tax purposes, or

- the partnership meets two requirements related to "synthetic" SILOs that the partnership provisions of Section 470 were intended to prevent.

First Exception – No Depreciable Property. With respect to the first exception, because stock and debt securities of corporations held for investment are not depreciable or amortizable assets for federal income tax purposes, a VC fund holding only these kinds of assets would be exempt from Section 470. If, however, a VC fund invests in equity interests of a portfolio company that is treated as a partnership for federal income tax purposes (*e.g.*, an LLC), it is likely that Section 470 will be applied on a "look-through" basis, *i.e.*, any depreciable property held by such portfolio companies would be treated as held by the VC fund. Therefore, a VC fund that invests directly in equity securities of operating companies structured as LLCs or partnerships likely would have to qualify for the second exception in order to avoid the application of Section 470.

Second Exception – Two Requirements. A partnership must meet two special requirements for the second exception from Section 470 to apply. First, no tax-exempt partner may have an option to purchase, or compel the distribution of, partnership property or any interest in the partnership for any purchase price or valuation other than fair market value (at the time the option is exercised). This kind of option to purchase or compel distribution of partnership property would be unusual in a VC fund, and typical withdrawal rights granted to regulated limited partners generally should not cause a VC fund to fail to satisfy this requirement.

The second requirement is more complicated, and provides that certain hedging transactions or funds that are set aside or subject to a defeasance arrangement by a partner or the partnership ("Set Asides") must not exceed a threshold amount. With respect to Set Asides entered into by a partnership, this threshold amount is generally 20% of the taxable partners' tax (*i.e.*, Section 704(b)) capital accounts. There is no allowance for Set Asides entered into outside a partnership. We have explained to Congressional staff that these thresholds would be too low to be of value for many VC funds. Although the allowable thresholds remain low, it is important to note that only certain Set Asides are counted for purposes of this requirement:

- First, Set Asides that are outstanding for a period of less than 12 months will **not** be taken into account. For this purpose, the Bill states that all "related" Set Asides shall be treated as one arrangement. Although the concept of "related" arrangements is not further defined, isolated Set Asides like hedges of particular publicly-traded securities for less than 12 months should not cause a VC fund to fail to meet this requirement.

- In addition, Set Asides are taken into account for purposes of this requirement only if a "reasonable person" would conclude that the arrangement is (1) for the benefit of a taxable partner or (2) for the benefit of any tax-exempt partner in order to satisfy its obligations to the partnership. This "reasonable person" standard is an undefined concept under federal income tax law, but it could help a VC fund avoid the application of Section 470 under certain circumstances.[1]

[1] For example, a VC fund that holds direct equity investments in operating LLCs and that hedges its entire position in other publicly-traded securities for longer than 12 months might take the position that a reasonable person

- Finally, Set Asides that "bear no connection to the economic relationships" among the partners, or among the partners and the partnership, are **not** taken into account. This standard is also somewhat unclear, but it could allow a VC fund to meet the second exception even if its limited partners enter into hedges or other Set Asides outside the VC fund for their own benefit. For example, if a limited partner that, for its own risk minimization purposes and outside the VC fund, hedges publicly-traded securities that will be distributed by a VC fund (*e.g.*, after a lock-up period expires), the hedge arguably should not be treated as part of the economic relationship of that limited partner to the VC fund or to the fund's other partners.

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Congressional staff has indicated that they are open to our comments on the Section 470 provisions of the Bill, so we welcome any suggestions to improve or clarify its provisions that may affect our members. If you have any comments or questions, please direct them to Jennifer Connell Dowling of the NVCA at 703-524-2549 or jennifer.dowling@nvca.org or Michael J. Sutton of Goodwin Procter LLP at 617-570-1515 or msutton@goodwinprocter.com.

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would not conclude that such an arrangement — *i.e.,* one that benefits all partners proportionately — was entered into "for the benefit" of either the taxable or the tax-exempt partners.