August 14, 2017

Submitted Electronically

The Honorable David Kautter
Assistant Secretary of the Treasury (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Mr. William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: *Comments on Department of the Treasury and Internal Revenue Service Proposed Regulations Implementing Section 1101 of the Bipartisan Budget Act of 2015: REG-136118-15*

Dear Mr. Kautter and Mr. Paul,

The Bipartisan Budget Act of 2015 introduced a new centralized audit regime (New Audit Rules) for partnerships that is generally effective for taxable years beginning after December 31, 2017. The New Audit Rules replace the existing regime for auditing partnerships that was enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), as well as the audit rules for electing large partnerships. This past June, the United States Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued proposed regulations (Proposed Regulations) to implement the New Audit Rules.

The National Venture Capital Association (NVCA), whose members manage venture capital funds that invest in thousands of startup and early-stage companies each year, appreciates the efforts of Treasury and the IRS to issue comprehensive guidance regarding the New Audit Rules and is pleased to have the opportunity to comment on three points. NVCA urges that (1) the effective date of the implementation of the New Audit Rules be delayed by one year, (2) decreases in tax should be permitted to be taken into account in calculating additional tax where a Code Section 6226 election to "push out" liability for imputed underpayments (Push-Out Election) is made, and (3) adjustments resulting from a Push-Out Election should be permitted to flow through tiers of partnerships.

Delay Effective Date of Implementation of New Audit Rules

NVCA urges the effective date of implementation of the New Audit Rules be delayed by one year – to taxable years of partnerships beginning after December 31, 2018 – to allow for additional guidance on certain key aspects of the rules to be issued and to provide sufficient time for partnerships to amend their partnership agreements. Partnerships and their advisors are currently undertaking a review of their agreements to assess what modifications should be made to reflect the New Audit Rules, including procedures for appointing partnership representatives, indemnity provisions, notice provisions, and liability provisions. However, because the Proposed Regulations reserve on several issues, a number of unanswered questions remain. Delaying the

effective date will help ensure that partnerships are only required to amend their partnership agreements once to reflect the New Audit Rules.

Allow Time for Guidance on Key Aspects of New Audit Rules

The Proposed Regulations reserve on a number of key points. NVCA believes it is critical for additional guidance on these points to be issued and understood before the New Audit Rules become effective. Until additional guidance is issued, tax (and, in turn, financial accounting and economic) results may be uncertain given the possible alternative interpretations provided for by the New Audit Rules.

For example, the Proposed Regulations reserve on the issue of whether, in a tiered partnership structure where a lower tier partnership has made a Push-Out Election, adjustments may flow up through the tiers until a partner that is not a partnership (or pass-through entity) receives the adjustment. The alternative is that the direct partner in the partnership that made the Push-Out Election must pay any imputed underpayment which may be a significantly different economic result. This issue is critically important to NVCA's members since the venture capital funds they manage routinely have partnerships as direct partners. Until the operation of the Push-Out Election in the context of tiered partnerships has been resolved, the operation of a major component of the New Audit Rules is unknown and the New Audit Rules should not be implemented.

In addition, there are other core concepts – relevant to all partnerships – on which the Proposed Regulations have reserved. These include how a partnership adjustment under the New Audit Rules affects key features, such as a partnership's inside basis and book value of property, as well as the partners' outside basis and capital accounts.

Moreover, the impact of the New Audit Rules is far reaching. They will impact not only how partnerships and partners bear U.S. federal income tax, but also how they bear state taxes as many states have tax rules that generally mirror the federal tax rules. As a result, state tax authorities will need to consider implementation of the New Audit Rules at the state level.

Reporting by venture capital funds for financial accounting purposes will also be impacted. Venture capital funds generally have an obligation to provide financial statements to their partners and accounting professionals must understand and provide guidance as to how to account for potential future examinations and assessments under ASC 740, *Income Taxes* and FAS 5, *Accounting for Contingencies*. Until guidance under the New Audit Rules is more complete, financial accounting results may be uncertain or arbitrary thereby weakening the integrity of financial statements.

In short, the New Audit Rules will directly and immediately impact the financial and economic results of venture capital funds and many other partnerships. Delaying the effective date of their implementation for one year will give all parties – partnerships, partners, tax professionals, accounting professionals, Treasury, the IRS and state tax authorities – time to appropriately transition to the New Audit Rules.

Allow Partnerships to Amend their Partnership Agreements to Incorporate the New Audit Rules in an Efficient Manner

Venture capital fund partnership agreements are long term, negotiated relationships that generally have a duration of ten years or more. The existing fund partnership agreements for most venture capital funds contemplate the TEFRA partnership audit rules which are fundamentally different than the New Audit Rules. Amendments to these fund partnership agreements will need to be negotiated to incorporate the New Audit Rules.

A few examples of provisions that may be the subject of negotiation and amendment are:

- Under the TEFRA rules, the "tax matters partner" represented the partnership in an audit of the partnership. Under the New Audit Rules, a new liaison is created – the "partnership representative" – that is afforded far reaching power to bind the partnership and its partners to tax adjustments. Venture capital fund partnership agreements generally will need to be amended to incorporate the partnership representative concept and limited partners may want to negotiate notice, fiduciary responsibility and other protective provisions to reflect the New Audit Rules. Moreover, the partnership representative may want to negotiate an indemnity provision for actions taken in that capacity.

- Limited partners may want to negotiate for a partnership to make a Push-Out Election, rather than have any imputed underpayment borne by the partnership. To permit an informed negotiation regarding making a Push-Out Election, limited partners and fund sponsors need guidance regarding whether and how Push-Out Election adjustments will flow through tiers of partnerships as discussed above.

- U.S. tax-exempt and non-U.S. limited partners provide a significant amount of funding to venture capital funds. These limited partners may want to negotiate to require the partnership representative to seek reductions in any imputed underpayments based on their tax profiles as contemplated under the New Audit Rules.

The costs of drafting, negotiating and implementing amendments will be significant both in terms of dollars and time. Importantly, the costs will be even higher if the effective date of the implementation of the New Audit Rules is not delayed and venture capital funds are forced to amend their fund agreements based on incomplete rules, which will likely lead to additional amendments over time as guidance regarding the New Audit Rules is issued. NVCA urges a one year delay in the effective date of the implementation of the New Audit Rules to avoid this result.

<u>Permit Decreases in Tax to be Reflected where Push-Out Election Made</u>

The preamble to the Proposed Regulations states the view of Treasury and the IRS that Code Section 6226 does not permit decreases in tax resulting from pushed-out partnership adjustments to be taken into account in calculating additional tax where a Push-Out Election is made. According to the preamble, a number of comments were received arguing that a decrease in tax in one year as a result of the adjustments should be able to reduce the additional tax payable with respect to any other taxable year. We agree with those comments.

The stance taken in the Proposed Regulations not to allow decreases in tax to be taken into account will result in overpayment of tax and punitive results in many circumstances. By contrast, permitting decreases in tax to reduce the additional tax payable will ensure that the appropriate

amount of tax is collected. It is also consistent with Congressional intent as reflected in the technical corrections bill recently introduced by the two tax-writing committees.

Permit Adjustments Resulting From a Push-Out Election to Flow Through Tiers of Partnerships

The Proposed Regulations reserve on the issue of whether, in a tiered partnership structure where a lower tier partnership has made a Push-Out Election, adjustments may flow up through the tiers until a partner that is not a partnership (or pass-through entity) receives the adjustment. According to the preamble to the Proposed Regulations, a number of comments were received that the flow through of adjustments should be permitted. We agree with those comments. Many venture capital funds routinely have partnerships as partners and NVCA believes that permitting the flow through of adjustments is imperative to having the proper taxpayers bear the correct amount of tax.

We appreciate the opportunity to submit our comments, and we would be pleased to provide further input. Please feel free to contact me at (202) 864-5925 or bfranklin@nvca.org or Justin Field, Vice President of Government Affairs at (202) 864-5929 or jfield@nvca.org.

Sincerely,

Bobby Franklin
President and CEO