A WORD FROM DELOITTE

Venture capital's uncertain tax policy future

Heather Gates
Audit & Assurance Private Growth Leader, Deloitte & Touche LLP

With more than 30 years of financial services experience, Heather serves as the national Private Growth Leader, with oversight of the Deloitte Private, Emerging Growth Company, and Private Equity businesses within Audit & Assurance.

Gordon Perl
Business Tax Partner, Deloitte Tax LLP

Gordon is a partner for Deloitte's Silicon Valley Tax Practice where he serves as the National Tax Leader for the Deloitte Emerging Growth Practice. Gordon has more than 20 years of public accounting experience.

It's generally known that in an election year, taxes can be a major topic. With the 2024 election approaching, the venture capital (VC) world is buzzing like a trading floor right before the opening bell. The potential tax policies each candidate is outlining could lead to vastly different outcomes, placing the VC ecosystem in a high-stakes game of "what if?" VCs and their portfolio companies may need to plan for multiple possible outcomes at both the presidential and congressional levels and be ready to pivot quickly.

For guidance, Deloitte's Heather Gates and Gordon Perl provide their insights on how venture capitalists can navigate the present ambiguity. Together, they paint a picture of a landscape marked by the need for agility and strategic planning.

The roller coaster terrain of VC

Beyond the direct impact of pending tax policies, the broader economic road ahead for startups and VCs may likely remain bumpy. The past few years have seen a market correction, with funding and valuations taking a hit. The frenzied gold rush of 2021 has given way to a more cautious approach, with many VCs now focusing on "inside rounds" (when a round is primarily funded by investors from a previous round) to sustain their most promising portfolio companies.

The correction may have also impacted market exits, which have largely paused, as a result of volatility and doubt. While a few companies are moving forward with their initial public offering (IPO) plans, according to the latest Road to Next report, most are staying on the sidelines in hopes of more clarity after the election.[1] Now, with these possible tax policy changes taking center stage, the ride may just be getting started.

The approaching impact of new tax laws

Historically, we've seen that elections can serve as a catalyst for tax policy changes—driven by an administration's budgetary needs and broader legislative goals.[2] With the sunset of provisions from the 2017 Tax Cuts and Jobs Act (TCJA) due to occur at the end of 2025, there is significant debate about whether they will be extended, altered, or left to expire. Private financial markets should prepare for possible changes that impact both individual and corporate taxation.

While tax policy might be the headliner, interest rates and geopolitical factors play key roles in this financial landscape. High interest rates have made it more expensive for many private equity firms to leverage deals, leading to a slowdown in transaction activity. However, as interest rates stabilize or potentially decrease, we could see a resurgence in dealmaking, giving the VC ecosystem the boost it's been waiting for.

Key tax issues on the horizon

Several key tax issues are top of mind for the VC community according to Gordon: corporate tax policy changes, potential changes to the capital gains tax rates, and the capitalization of research and development (R&D) costs.

Under current law, R&D expenses must be capitalized over five or 15 years—a significant shift from their previous ability to expense the costs immediately. Gordon says, "This change has led to real cash outflows for many startups, straining financial resources at a critical stage in development."

Some politicians have advocated for higher capital gains rates to raise revenue and make the tax code "fairer" between wage and unearned income. Others think doing so would

1: "Road to Next: Exit avenues: The era of inside and down rounds," Deloitte, Q3 2024.
2: "Taxes, Tariffs and Debt: Investors Start to Fear the Presidential Election," The Wall Street Journal, Gunjan Banerji, April 29, 2024.

discourage investment, risk-taking, and entrepreneurship. Those who want to keep the rates lower argue it's necessary for the United States to maintain a competitive edge in the global economy, creating an advantageous environment for more investment. In short, any increase in capital gains taxes could cool the VC enthusiasm just when startups need it most.

Changes to capital gains tax rates also have the potential to ripple through the VC ecosystem. If rates increase, the attractiveness of venture investments could diminish, as returns would be taxed more heavily. This could lead to a reduction in investment activity, particularly in early-stage startups, which are already navigating a tough funding environment.

Charting a course through uncertainty

In this uncertain climate, scenario planning becomes paramount. Startups and VCs may want to conduct "if-then" analyses to prepare for various outcomes. This typically involves modeling the potential impacts of different tax scenarios on cash flow, valuations, and investment strategies. Heather compares it to assembling a complex matrix of decisions, preparing the right actions to effectively address the situation.

One area with a range of options at play is IPO strategy. The potential increase or decrease in corporate tax is likely to affect a company's decision time frame to go public. If the expectation is that corporate taxes will decrease, it might make sense to delay an exit to benefit from that more favorable tax environment in the future. If, on the other hand, expectations are that corporate taxes will rise, there may be a premium on going public before those changes occur. The stakes are high all around, but Heather notes: "With detailed planning and a bit of flexibility, the VC world could possibly come out stronger in the end."

Potential industry winners and losers

Heather believes that the industry will be impacted regardless of how the tax laws change or don't change, which will drive the investing behavior of funds and may affect what their future investments look like. Gordon adds that the life science industry could be among those most affected by the capitalization of R&D, due to the extended length of time required for drug approvals. If R&D costs are being capitalized with little to no income, taxes are paid immediately, perhaps leaving less money for research spending or other investments.

Preparing for the future

As the elections near, startups may need to do more than just cross their fingers. They may need to get their financial houses in order and create a robust system to handle the potential complexities of future tax policies. This may include running diagnostics on their financial health, ensuring compliance, and being ready to adapt to changes in the regulatory environment. Gordon says, "We're working with a lot of startups right now, holding brainstorming sessions to analyze their tax footprint over the next several years. What will they need to do to prepare for an IPO? How will different tax policies impact business changes? These are all important steps in doing the sort of analysis needed to be ready to adapt to a dynamic environment."

With a Deloitte advisor at your side, you can have a plan for potential scenarios. While the future remains uncertain, startups and VCs should stay sharp, informed, and ready to pivot at a moment's notice.

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