

Venture capital in the headlights: How President Biden's proposed changes to capital gains could impact the innovation economy

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President Biden recently shared his American Families Plan, which includes a proposal to double the tax paid on capital gains and other taxes on investment earnings. This plan includes increasing long-term capital gains taxes from 20 percent to 39.6 percent for high earners.

The President also wants to reimpose significant taxes on inherited wealth, closing the loophole in the tax code that allowed recipients to receive a step-up in basis on appreciated assets and pay capital gains upon subsequent sale upon the quantum of appreciation from death.

The changes to taxation on capital gains and inherited wealth, combined with a higher tax rate on ordinary income, could raise hundreds of billions of dollars in revenue for the federal government at a time when it is seeking funding for historic stimulus and infrastructure programs. But the changes to the way capital gains are taxed will change the incentives for those that deploy capital and work.

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In this post, we examine the potential impacts to venture capital and anticipated responses and strategies to mitigate the risks, both of which could fundamentally impact the innovation economy over the next decade.

The venture capital industry has registered its angst about the President's tax plans. In a statement issued promptly upon its announcement, the National Venture Capital Association, or NVCA, said it was "disappointed to see that the American Families Plan...includes unprecedented tax increases on long-term capital gains.

Such a significant increase to capital gains rates will reduce long-term investment and entrepreneurship by making short-term economic activity relatively more attractive." One can surmise that the NVCA and its members are working the halls of Congress

to make the case that tax increases will disproportionately hurt innovation.

When the income tax was first created in 1913, capital gains were taxed at the same rates as regular income — and has risen to rates as high as 77 percent in 1918 when the first world war ended. Then, after the war, conservatives started to make a case for tax cuts, so in 1922, Congress lowered the top tax rate to 58 percent and split off capital gains from regular income, lowering it down to 12.5 percent.

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Since then, capital gains rates have jumped around, going as high as 40 percent but usually lower than the top rate on an ordinary income. Currently, the federal capital gains tax rate is 20 percent on incomes over \$441,450 and 15 percent on incomes between \$40,001 to \$441,450, and there is no capital gains tax on revenue of \$40,000 or less.

Today, supporters of lower capital gains rates say it incentivizes entrepreneurship in America, insofar as it takes away some of the stings of our corporate tax system, which captures tax twice: once at the corporate level, when the corporation profits, and again when the corporation shares the profits with its stockholders.

Inflation disincentivizes investors who would otherwise hold assets for the long term, undermining the value of ownership. Lower rates on capital gains from appreciation of assets counteract this. Meanwhile, some say that cutting capital gains rates will not significantly affect economic growth as much as the current projections would indicate and irreparably hurt the economy in the meantime.

But capital gains are primarily earned by high-wealth, high-earning taxpayers, and tax breaks for capital gains disproportionately benefit the wealthiest taxpayers, making them a target for politicians. This is because those earning under \$75,000 receive 1.2 percent of the benefit of lower capital gains rates, while those earning over \$1 million receive over three-quarters of the benefits of lower rates.

Moving forward, how will a material increase in taxes on capital gains, inherited wealth, or taxation of “carried interest” as ordinary income change the way that venture capitalists will invest? Only time will tell. Meanwhile, the following is a quick survey of potential strategies that we may see investors attempt to mitigate the pain of increases in capital gains.

- *Early-stage startups are winners.* Section 1202 of the IRS Code - a tax break for investors in “qualified small business stock,” or “QSBS,” issued by corporations taxed under subchapter C. “C corps” constitute the vast majority of tech and life sciences startups. Investors in QSBS may exclude 100 percent of the capital gains made on those investments if the stock is held for at least five years and is acquired at issue, but this has a limit of \$10 million or 10x the basis of the stock sold.
- *VCs hold onto stock for longer.* VCs may also succeed in minimizing the impact of higher rates on capital gains from the President’s proposal by holding onto stock longer and deferring the tax to be paid. While today VC’s typically sell stock as soon as possible after a portfolio company goes public or they receive stock of a public company in exchange for the stock of portfolio companies (or distribute it in kind to limited partners, who in turn sell), an increase to capital gains rates may push some VC’s to defer the sale. This would allow an investor to avoid paying taxes but also prevent a return of capital to limited partners and the potential for further investment.
- *VCs look for higher rewards, and higher risk, investments.* Late-stage investors may want to change some strategies to increase the potential for higher returns, which inevitably will narrow their scope of action and tilt investment bias towards higher risk.
- *Tax-loss harvesting.* Meanwhile, we expect many investors will attempt to harvest tax losses contemporaneous with tax gains. The play here would be to sell investments which would trigger a loss in the same taxable period as you sell assets with gains, thereby offsetting gains with losses and avoiding tax.

- *Accelerate the sale of appreciated assets now.* While the government could always make an increased tax rate apply retroactively, Congress would rarely penalize taxpayers. As a result, we expect that the already hot M&A market will continue to heat up in 2021 as investors look to accelerate the recognition of capital gains rates by selling assets with built-in gains before the increases tax effect.
- *Installment sales.* We believe that buyers and sellers will explore the deferral of taxes by structuring sales as installments over taxable years. If tax rates do not come down, this is merely a deferral, but time is money.
- *Qualified opportunity funds.* Finally, we expect there to be renewed interest in government-subsidized investment vehicles, like qualified opportunity funds (QOF), which enable long-term deferral of gains.

Others can argue what the relative priorities for spending and the appropriate sources of funds to pay for them are, there is no escaping that fundamental changes to our tax system may bring equally fundamental changes to the incentives that drive people to start companies, invest in them, and make them great.

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