Ibec submission to the Department of Finance:

Review of SME taxation

24 May 2019

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Ref: Consultation process on SME tax incentives

I am pleased to communicate the views of Ibec and its members on the issues surrounding the taxation of Small and Medium Sized Business (SMEs) in Ireland. Ibec represents the interests of Irish business including indigenous and multinational enterprises and SMEs, spanning all sectors of the Irish economy.

Ibec and its sector associations work with government and policymakers at a national and international level to shape business conditions and drive economic growth. A key part of this, which we have focused on in much of our work in recent years is reform of the environment to encourage small business and entrepreneurship. Although there have been some tax, regulatory and structural reforms aimed at small business and start-ups in recent years these have not gone far enough, in our view, to bridge the gap to having an indigenous sector on par with elsewhere in Europe.

In this submission, we will set out the views of our members on the operation of, and improvements which should be made to, several tax schemes aimed at supporting SMEs including the CGT regime, KEEP, and the EIIS. While we note the short period given for consultation with stakeholders, we are more than happy to expand on the points made in this submission in advance of Budget 2020.

1. Overview

Some notable successes aside, there is a strong argument that we have not done enough over the past 60 years to fulfil the promise of the First Programme for Economic Expansion to 'foster in every way' the development of Irish indigenous business. If we are to follow through on the economic promise of the last six decades, then it is evident we must go further than industrialisation by invitation and develop our indigenous enterprise base.

Recent years have seen dramatic changes in the business tax environment in Ireland. In one sense the impact of BEPS has been dramatic, in another, we have yet to see its true impact. It has massively boosted both capital investment in Irish based MNEs and led to a sharp increase in our corporate tax returns. However, the measures underpinning the BEPS process are only now being translated into concrete action, companies are still changing their structures to manage this new framework. BEPS2 is also underway and will, in our view, have significant implications for Irish industrial policy going forward. We are entering a world where the impact of our headline rate of corporate tax alone will be more muted than in the past, and companies are increasingly looking at the broader context. To guard against the risk of relying on too few firms for our exports and tax receipts Ireland will need to strengthen its indigenous enterprise base.

Our indigenous business sector has made some progress over recent years. To survive the downturn, firms invested in new products, engaged in capital deepening, and became leaner. The impact of this and better cost competitiveness in the Irish economy can be seen in the fact that Irish exports over the eight years to 2017 were between five and six times more responsive to growth in global demand than they had been between 2001 and 2008. As a result, for the first time in 2015 enterprise agency figures showed Irish owned exporters accounting for a greater share of agency supported employment than foreign MNEs. In a post-BEPs environment, it is inevitable that continued strong investment by large firms will increase costs across the economy, particularly if our public infrastructure cannot bear the strain. We must focus on increasing productivity in indigenous firms to deal with this.

While Ireland does not produce enough start-ups, equally worryingly is the fact that not enough small companies make it big. Finance, access to export markets and the ease and cost of doing business all remain significant hurdles. We need a business environment that supports entrepreneurship and rewards innovation and risk taking. Enterprise policy must focus on helping companies scale up by improving investment supports such as the EIIS and CGT. We must also encourage firms to invest in innovative activities by making the R&D tax credit more accessible for firms seeking to scale.

We must go further, however. All available evidence shows that Irish indigenous firms are well below 'best in class' when it comes to management, innovation and exporting — three of the main drivers of business growth and productivity. Improving management practices, helping firms innovate or export earlier will increase the productivity and growth of Irish indigenous firms. We also have low start-up rates compared to the majority of our European neighbours – the second lowest in the EU15 and one-quarter that of the UK. We must do more to help start-ups build high-skilled teams. Given the constraints on cash in start-ups, this can only be done within a sensible tax environment for share-options.

To change this, we need to address what is within our control. Irish firms face several ongoing challenges to their growth. These include high legacy debts and costs, a small domestic market, a lack of diversified funding options, barriers to innovation, and challenges accessing and competing for the right skills to help them grow. These challenges are not unique to the Irish market but the challenges to growth from the funding environment, market size, and peripherality are far more acute in Ireland than most developed countries. Tax policy must be part of a coherent overall policy for growing our indigenous base and must be cognisant of the broader context. There are several levers within the tax system which can be used to help overcome some of the broader systemic disadvantages facing our indigenous business community. Below we set out some of the key tax policy levers which we believe can help Irish business to grow.

2. The role of taxation in supporting young and small business

Entrepreneurs including business owners, managers and the self-employed are a crucial part of Ireland's economic fabric. Firms with fewer than twenty employees make up over 98% of the enterprise base and employ 44% of the workforce underlining the importance of small business to Ireland. Young firms account for much of employment growth. Despite this, it is clear that the Irish economy is over-reliant on a small number of large firms for its economic wellbeing. Less than 500 large firms (0.3% of the enterprise base) account for over 55% of Ireland's total Gross Value Added (GVA), 75% of its exports and well over half of its business R&D spend. This is partly due to our unique economic structure but just as culpable is the fact that not enough companies are created in Ireland and importantly not enough of those survive and scale.

Entrepreneurs have often been defined as 'bearers of uncertainty' within the economic system. A key role, therefore, for the tax system is to mitigate part of the risk borne by entrepreneurs thereby making it more attractive for owners of capital to invest in productive assets which create jobs and have high value added. Ibec's view is that that the Irish tax system, which today has very mixed signals for entrepreneurs, must transition towards one which reduces uncertainty about potential returns and therefore encourages entrepreneurs to take on the burden of risk.

Ireland is a relatively easy country in which to start a business, but Irish small firms face several challenges to their growth. Targeted tax expenditures on entrepreneurship and tax reform can raise the private return to undertaking entrepreneurial activity and thus reduce uncertainty and risk for entrepreneurs. Many studies suggest that the monetary returns to going into business for yourself are little different on average than becoming an employee. This, despite the fact that entrepreneurs bear large financial risk, work longer hours (on average 10 hours more per week) and have less access to social welfare supports. Hamilton (2000) for example shows that in the US the value to the median entrepreneur of a business lasting 25 years was 25% less than the value of a paid job over the same period.

It is Ibec's view that the Irish tax system, which today has very mixed signals for entrepreneurs, must transition toward one which acknowledges that fact. To achieve this, we need to see changes which make it more attractive for people to take on the burden of risk, grow their companies and invest their time and money in the things which create jobs and wealth.

The clear view of our members is that while efforts to improve the tax system over recent years have been welcome, they have also led to increased levels of frustration. New or changed schemes have often required ongoing reforms long after their introduction in order to make them workable. This is reflected in the low take-up figures for many of the schemes. It is important that schemes, when introduced, are straightforward to administer, reflect the advice of business on 'what works', and are cognisant of the time-constraints on SME owners. Too often SME taxation in Ireland has failed on these counts. Changing this will require much stronger stakeholder engagement, and an opportunity for greater legislative scrutiny before changes are introduced through the Finance Bill. Ibec strongly believes that the long-term direction of SME taxation, along with other areas of taxation, should be looked at within the model of a new Commission on Taxation.

3. Business priorities to support SMEs through the tax system

Recommendation 1: Make it clear we are serious about broadening our indigenous base by lowering the CGT rate for productive business activities

High potential start-up companies in areas like Tech, Med-Tech, Food, Biopharma, or other high-tech/creative industries typically do not achieve high distributions of profits throughout their early years. Instead, they re-invest for growth in the company. As such, many start-up owners do not gain significant benefit from Ireland's 12.5% corporate tax regime. The main pay-back for owners for their substantial risk is achieved on the sale of their company.

The first thing any businessperson asks when deciding whether to invest in a business is what their rate of return will be. Tax plays a key role in this decision. During the crisis years, CGT increased from a rate of 20% to its current rate of 33%. This means for every euro an entrepreneur makes in profit from starting, building and selling their business the government took one-third. This rate is the third highest in the OECD. The failure rate in start-ups in Ireland is about 50% within five years. As such the probability of even getting a business to this point is low. The chances of an entrepreneur making a substantial profit even less. In venture capital intensive high growth firms an entrepreneur's share can be diluted quite quickly. The CGT entrepreneur's relief exists, but with a maximum limit of only €1 million is of no significant assistance. This leaves our regime significantly less attractive than in other developed countries.

International evidence in public finance[1,2] shows that high CGT rates lower entrepreneurial risk-taking, disincentivise the growth of venture capital both on the demand and supply side, and damages high-potential companies by locking entrepreneurs into their business for far longer than is optimal. High CGT rates on entrepreneurs also fundamentally alter the incentives for investment of private capital in the economy. As it stands, even with the entrepreneur's relief, there is more favourable tax treatment for investing in a larger primary dwelling house or risk-free Government debt than there is for a high-risk activity such as investing in companies. Indeed, the effective rates for capital gains from entrepreneurial activity are not significantly different than those for gains from inheritances or gifts from family. This sends a clear signal to entrepreneurs when it comes to how they are valued by the State.

Fundamentally Ibec's view is that owners of high-potential companies should be encouraged to grow their companies and pay the same tax on the benefits of that as larger companies do on their profits. In addition, people should be incentivised to invest in high-risk enterprises and build an equity market in Ireland which would diversify potential funding streams for companies.

[1] https://www.sciencedirect.com/science/article/abs/pii/S004727270300046X
[2] https://www.sciencedirect.com/science/article/abs/pii/S0047272705001702

Recommendations for reform:

- Send a signal of intent to serial entrepreneurs by radically improving the CGT entrepreneurs' relief by introducing a 12.5% rate with no lifetime limit on capital gains.

- Expand CGT entrepreneurs to passive investors in high-potential areas (Tech, Med-Tech, Food, Biopharma, or other high-tech/creative industries) to increase the supply of equity for Irish companies.

- In the case of earn-outs, where some of the gains from selling a company is reliant on future events or paid in instalments, CGT should only be charged on receipt for entrepreneurs. As it stands, the current system ties up cash to re-invest for several years and can lead to high levels of debt for entrepreneurs without access to cash.

Recommendation 2: Improve investment supports through the EIIS

Ireland's broader investment tax environment for indigenous business is an outlier in its lack of attractiveness by international norms. We have the third highest capital gains tax rate in the OECD and a stamp duty regime on shares which is the highest in the world (twice that of the second highest). This perverse treatment of investment by indigenous business cannot be allowed to continue if we are serious about growing internationally competitive companies. Whilst the administrative improvements in the EIIS scheme in Budget 2019 were welcome they only began to fix the damage done by previous enforced changes. There remain significant shortcomings in the scheme relative to the gap for equity finance in Ireland versus our international competitors.

Ireland has a narrow market for private equity, particularly for early-stage companies. This has resulted in recent years in several high-potential Irish start-ups incorporating in other jurisdictions in order to access seed funding from investors abroad. There is continued feedback from our members that investors in Irish start-ups are also increasingly wary of the EIIS due to the inconsistencies they see in their treatment under the scheme by Revenue.

In addition, the UK has recognised the differential risk profiles between micro and medium-sized enterprises by introducing the Seed Enterprise Investment Scheme (SEIS) which provides more generous incentives for individuals investing in start-up firms. This scheme is targeted at a different category of firms than the UK's EIIS namely those very small and micro-firms which are newly formed. In this sense, it complements rather than competes with the EIIS scheme.

The SEIS scheme also has the added advantage of being more attractive to small investors who can invest up to €100,000 in a single tax year over a number of companies. They receive a 50% tax credit on their investment which is sufficiently attractive to bring new investors to small firms with limited alternatives for funding. Additionally, they receive a CGT exemption on the sale of SEIS shares. Almost half of the investments were of less than £10,000 showing the scheme's ability to attract non-traditional investors into the market in small sums. This is partly due to the fantastic branding of the scheme and ease of use. Ibec believes a similar angel investment tax incentive should be introduced here for start-up firms and microenterprises in approved sectors.

Recommendations for reform:

- At a time when Irish firms are struggling to acquire adequate funding to diversify and invest for Brexit the annual limit of €150,000 on investment is perverse and is restricting the flow of capital to firms. In Budget 2017, for example, the UK increased its limit for investment in specific firms from £1 million to £2 million. We believe a similar limit should be introduced here.

- The current system of split relief based on employment levels or R&D expenditure introduces a level of uncertainty for the investor over which they have very little control. This has long been a limiting factor on the attractiveness of the scheme and should be removed with full relief given in the investment year.

- Introduce a more generous scheme, similar to the UKs SEIS for start-up firms. In the absence of a new SEIS scheme, it will be necessary to ease restrictions on connected parties (friends, family) for smaller firms in the scheme. Associates should be permitted to invest up to an aggregate amount of €250,000 in the first 24 months of establishment of a company employing fewer than 10 people.

- In line, with the recommendations of the Indecon review losses on EII investment should be allowed for CGT purposes and any capital gains on the sale of shares are taxed as capital gains rather than as income, as is currently the case.

- Companies which would benefit or may ‘pivot' during the operation of the scheme face undue barriers on going in a direction which may be best for their own growth. This is particularly when firms may pivot into a restricted services sector (i.e. from manufacturing equipment to advising on installation of equipment). This needs to be addressed in guidance, particularly for some of the non-traditional professional services categories.

- There are particular concerns in companies within the Med-tech and Biotech communities where R&D may have long lead times before it becomes revenue generating. Some firms have been denied the EIIS status as they were ‘not trading' as they were pre-revenue. These firms are, however, solely in the industry of developing IP and then commercialising that IP in later years through sale or development. In this way to qualify for EIIS firms in this space would need to dispose of IP within the relevant period, despite the fact that lead times to optimal revenue from that IP may be longer.

Recommendation 3: Allow SMEs to find and retain talent through a reformed KEEP scheme

Small firms and particularly start-ups also face problems attracting the necessary human capital and skills they need to grow. This is a particular problem due to the fact that staff in start-up companies typically will have low incomes, relative to the market, as the business builds. As a result, share options may well be a central if not the major part of the remuneration package for many employees in start-ups.

Share-option and profit-sharing schemes can be a very important way for companies to reward and retain key employees. They also have proven benefits in rewarding key staff and generating higher productivity through employee buy-in. These benefits accrue to both firms and employees alike. Various policy reviews from the UK’s 2012 ‘Nuttall Review’ to the 2014 review by the European Commission’s DG Internal Market have extolled the virtues of employee ownership from both a business and broader economic point of view. The latter concluded comprehensively that “thirty years of research have confirmed that companies partly or entirely owned by their employees are more profitable, create more jobs and pay more taxes than their competitors".

In effect both business and employees benefit from greater levels of employee ownership. The business benefits of employee share ownership come under a number of headings, including – higher productivity, profitability, greater access to skills, higher levels of employee participation, lower levels of absenteeism and improved competitiveness.

Two UK studies in recent years by Bryson and Freeman (2008) and HM Revenue and Customs (2007) find positive effects of share ownership which may be informative in an Irish context. The HMRC study looks at the productivity impact of the UK's APS (approved profit sharing), SAYE (save as you earn) schemes which are quite similar in scope to their Irish counterparts. They find that "the effect of tax-advantaged share schemes is significant and increases productivity by 2.5 percent in the long run" with larger impacts where companies have more than one scheme in operation. While Bryson and Freeman (2008) find similar results based on survey data - linking employee participation in share options schemes with higher levels of productivity within firms.

There are clear benefits too from an employee point of view – the 2015 report of the Commission on Inclusive Prosperity, chaired by Larry Summers and Ed Balls, argued that profit sharing and employee share ownership were win-win policies given that they benefit employees at the same time as producing better outcomes for the business. Workers not only benefit from higher wages as a result of increased productivity, but they also have an opportunity to gain more fully from those productivity gains through shareholding in the company. The expansion of share-options ownership in effect encourages employee incomes to be linked much more closely with profits and the performance of firms.

In addition, there is no evidence that employees' ownership gains are offset by lower wages or benefits elsewhere (Kruse et al, 2008). Overall household wealth increases as a result of ownership and indeed there is strong evidence that broader employee ownership helps build the stock of wealth in lower- and middle-income families, reducing inequality in pay levels. Kruse et al (2008) for example find evidence that expansion of employee ownership reduces the share of gains in wealth accruing exclusively to households in the top 10% of the income distribution.

Although we welcome moves toward a scheme of this nature through the introduction of KEEP – the clear feedback from our members is that the scheme as it stands is cumbersome and creates great uncertainty, as currently designed. Although these points have been reflected on a number of occasions in recent years, changes made in the Finance Bill have been marginal. These issues are clearly evidenced in the continued negligible take-up of the scheme. It is time to radically reform KEEP, or it will be necessary to introduce a new scheme entirely.

Recommendations for reform:

- At present, the limit of €3 million on the market value of issued but unexercised KEEP shares is overly restrictive for truly high-potential firms where early rounds of investment may place the companies valuations at many multiples of this level.

- Given the low liquidity in the market for equity in Ireland, the restrictions on employer share buy-backs are unreasonably onerous and can render the scheme unusable for many workers. This should be removed.

- Ensure better guidance is given for firms around the definition of holding companies and excluded activities (i.e. Fintech) under KEEP. These issues create significant challenges for several sectors.

- As it stands, it is difficult for many early-stage companies to value their companies. The cost of doing this for the operation of KEEP alone is disproportionate and a major impediment for many early-stage companies. An agreed 'safe harbour' approach to share valuation must be developed.

- Fix the significant technical issues in the legislation regarding employees who transfer to a group company.

Recommendation 4: Simplify support for R&D in SMEs

We must look at boosting Ireland's capacity for innovation and exploitation of spill-overs. SMEs may experience greater challenges than larger companies to dedicate and develop internal resources needed to engage successfully with universities and to capitalise on their research outputs. These enterprises will require additional state support to build the absorptive capacity and to participate in any research collaboration.

The OECD has highlighted that the productivity gap between indigenous SMEs and larger multinational organisations is widening. Too many SMEs miss opportunities to fully realise the potential of research activity in higher education institutions and too few have the knowledge and skills to develop, value and exploit the situation.

The R&D tax credit has been a successful model in encouraging Irish companies to invest in R&D and create value in the economy. In line with international research, a 2013 Ibec study showed that for every €1 given in tax credit to participating firms they spend in the region of an additional €2.50 on R&D over and above what they would otherwise have spent. A Department of Finance Study showed similar results in 2016. Both estimates are at the higher end of effectiveness in the international literature. Studies in the UK suggest this additional spend could rise as far as €3.60 in the long-run and that it is higher for smaller firms (Nguyen & Van Reenan, 2016).

Smaller firms and start-ups face, often insurmountable, funding constraints for R&D investments. Despite this, the R&D tax credit's take-up among smaller companies has been weak. Only 1% of companies with turnover less than €1 million use the tax credit each year, compared with 12.5% above that mark. Some part of this is again down to sectors in which they are operating but evidence (ESRI, 2010) suggests that other factors taken into consideration foreign owned and internationalised domestic firms are far more likely to invest in innovation and were more likely to translate this investment into tangible gains than domestic-facing indigenous Irish firms.

In particular, Ibec surveys of companies for previous submissions on the credit have shown that the administrative costs associated with the R&D tax credit are too burdensome for smaller firms to participate with the credit. An Ibec survey in 2013 found that among SMEs in R&D intensive sectors 31% of the firms saw the administrative burden involved as being the number one reason they had for not claiming the R&D tax credit despite engaging in R&D.

Recommendations for reform:

- A pro-forma R&D tax credit should be introduced to help smaller firms overcome these costs and engage with the credit.

- This would include the use of pro-forma templates for R&D project management, recording R&D activity and calculation of eligible costs and revenue benefit associated with the credit. Simple on-line calculators demonstrating the benefit and eligibility rules of the credit would be a useful resource for SMEs and would also greatly improve awareness and promotion of the scheme.

- The UK's Research and development tax relief for SMEs gives a good example on which to base an Irish version. It is an excellent example with clear and simple guidance for SMEs. The tax treatment is more generous (particularly if you have outsourced your R&D), but the key advantage for small operators is that you only need to file the claim with your tax return and a short form outlining how you qualify. There are no additional recordkeeping requirements and you receive ‘advanced assurance' for the first three times you claim it. These two help smaller firms deal with uncertainty, professional services costs, and the administrative burden of the existing credit.