Ibec submission to the consultation on the taxation of entrepreneurship

A submission to the Department of Finance

July 2015

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Summary of recommendations:

1. Establish a long term aim of introducing an EITC for the self employed

The lack of an EITC for the self-employed is not supported on any reasonable basis. The government should commit to rectifying this situation over the medium-term.

2. Remove the USC surcharge for the self-employed over the medium term

The USC surcharge is an anachronism given the direction of enterprise policy elsewhere and should be removed over time.

3. Reform the entrepreneurs' relief to compete with the UK

CGT changes in recent years have made Ireland relatively unattractive place to grow of scale a high potential business. This has led to many smaller Irish ran companies rebasing to the UK. A CGT rate of 10% should be central to this with specific caps to limit erosion of the tax take.

4. Reform the EIIS scheme

Following Ibec's submission on the consultation on the EIIS in 2014 there was significant changes to the EIIS in Budget 2015. There are a number of further reforms of the scheme which we believe remain outstanding:

- Re-brand the EIIS scheme
- Drop the employment or R&D restriction

5. Introduce an equivalent to the SEIS scheme

An introductory version of the SEIS scheme similar to its UK equivalent would remove a barrier to small start-up business whilst also getting first time investors into the market. For example a 50% income tax credit on investments in new or microforms on similar terms to the UK scheme.

6. Reform employee share options schemes

Budget 2016 should encourage more people to join or work in start-ups by introducing a scheme similar to the EMI scheme in the UK where share options are given relief from income tax and USC.

7. Introduce an SME tax credit for small firms

The administrative costs associated with the R&D tax credit are too burdensome for smaller firms to participate with the credit. A pro-forma R&D tax credit should be introduced to help smaller firms overcome these costs and engage with the credit.

1. Introduction

Ibec welcomes the opportunity to submit on the taxation of entrepreneurship. We welcome the fact that the Department is taking a keen interest in this space and that it is seeking to consult and obtain the views of stakeholders in this process. It is Ibec's position that tax reform in general should be a key priority in growing Ireland's productive capacity post-crisis. A key part of this, which we have focused on in recent submissions on the EIIS, seed capital scheme and recent budget submissions, is reform of the tax environment to encourage small business and entrepreneurship. It is Ibec's position that reform of taxation for entrepreneurs has the potential to be an integral part of Ireland's enterprise development policy particularly in light of other regulatory and structural reforms aimed at small business and start-ups in recent years.

2. Entrepreneurship and Irish tax policy

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 in particular, account for the majority 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 well-being. Less than 500 large firms (0.3% of the enterprise base) account for over 55% of Irelands total Gross Value Added (GVA) and a similar share of its business R&D spend (or over €1 bn per annum). 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 that are survive and scale. New enterprises in recent years have had an average 5 year survival rates of just 50%; that is only one in two new companies are still trading half a decade after they form.

Entrepreneurs have often been defined as 'bearers of uncertainty' within the economy system (Cantillion, 1755; Knight 1921). 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 toward one which reduces uncertainty about potential returns and therefore encourages entrepreneurs to take on the burden of risk.

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. This applies not only to the capital taxes placed on entrepreneurial activity. As a series of important papers by Carroll, Holtz-Eakin, Rider and Rosen (2000) in the US have shown marginal tax rates faced by entrepreneurs have important implications for their decisions to take on staff, grow their firms and invest in physical capital. Reform of taxation of entrepreneurship can play an important part in encouraging more people to enter work for themselves, to hire others and to grow the Irish business base.

Figure1: Self employed and propritary directors, % of tax take

Entrepreneurs face a number of challenges in Ireland. Existing entrepreneurs face legacy debts, a relatively high cost base, rates, rents and other obstacles to staying in business, maintaining cash-flow and expanding their operations. In addition, despite various changes in recent years making it much easier to start-up a business and access state supports it remains a fact that our tax system makes Ireland a relatively unattractive place to grow a business or be self-employed. Many of the tax schemes aimed at entrepreneurs introduced in recent years, such as the entrepreneurs relief, add no real incentive or even have perverse incentives while the major tax heads – the tax rate for self-employed and proprietary directors, CGT, dividends and stock options have either been increased or deteriorated in attractiveness; particularly compared to the UK.

This submission outlines some of the major issues facing entrepreneurs in the current Irish taxation system and suggests changes which could improve the incentive to start a business. Many of these changes may be costly so will necessarily need to be introduced or changed over a period of time. The fact remains, however, that many of them have been longstanding issues (a number of which were identified in previous reports of the Commission on Taxation) which have in many cases dis-improved with time. Now is the time to set a plan in place to make the Irish taxation system the most attractive to entrepreneurs in Europe by the end of the decade.

3. Taxation of entrepreneurship

3.1 Taxation of the self-employed and proprietary directors

Taxation of the self-employed is an issue which has received much warranted attention in recent times. Policy makers over the past decade have often lauded entrepreneurs as being central to developing indigenous firms which can compete globally. The signal we send through our tax system, however, differs greatly from the rhetoric. The Taoiseach in a speech at Ibec's CEO conference, earlier this year, acknowledged as much by referring to the higher rate of tax for the self-employed as "discriminatory". With the higher rate of USC for the self-employed and the higher rates of CGT introduced in recent years our tax system has gone in the opposite direction to much of enterprise policy. If we are truly serious about creating a high skilled entrepreneurial economy these two issues should be central to our thoughts in the upcoming budget.

The 3% USC surcharge on self-employed incomes above €100,000 is an anachronism at a time when government is trying to encourage entrepreneurship elsewhere in the tax system. The notional reason for the charge is that self-employed persons have available to them the means to reduce tax liability by claiming for expenses. This reasoning has never made sense given that the expenses can only be claimed back in tax if they are wholly and solely incurred in the operation of the business. In addition around half of the self-employed (proprietary directors) have no recourse to these expense claims at all. In either case PAYE workers receive that very same benefit under expense regimes within firms.

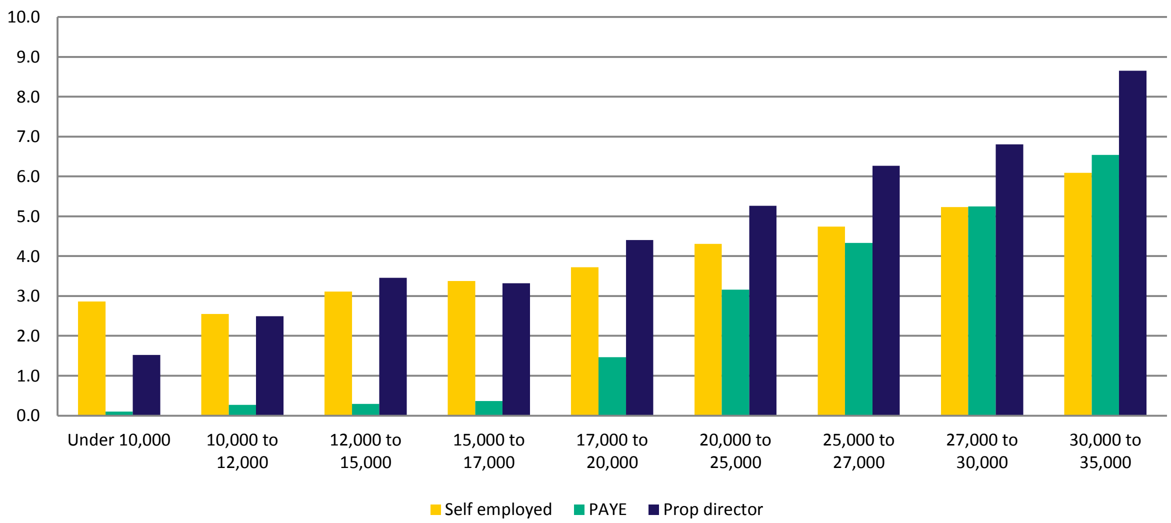
The surcharge incentivises people to avoid self-employment or the expansion of relatively small operations by increasing the marginal rate of tax for entrepreneurs in direct opposition to stated government policy elsewhere. With multiple schemes operating to try to encourage self-employment, this USC surcharge is likely to have significant deadweight loss and Budget 2016 should see the beginning of its end.

Recommendation 1: Remove the USC surcharge for the self-employed over the medium term

The USC surcharge is an anachronism given the direction of enterprise policy elsewhere and should be removed over time.

The PAYE tax credit in effect allows an individual to earn €8,250 free from income tax. The lack of a PAYE tax credit equivalent for self-employed persons or proprietary directors means their effective income tax rates are much higher than PAYE workers at the same level.

Figure 8: Actual effective tax rates of lower than average incomes



Source: Revenue Commissioners

This leads to a situation where, even with tax reliefs available to self-employed persons accounted for, self-employed and proprietary directors at less than average incomes have much higher effective tax rates than PAYE workers. It is arguable that this is particularly disconcerting for proprietary directors as they are taxed under the

PAYE system and as a result do not have many of the tax benefits which other self-employed have access to. Given that it is proprietary directors who are typically those who employ others; this is a particular issue when building a business in Ireland. Ibec believes the government should commit to introducing a modest earning income tax credit (EITC) for all self-employed persons. Due to the large cost of this (€450 million in 2015), it would necessarily be a staged process over multiple years. Ibec believes that given they are already taxed under the PAYE system this should begin with proprietary directors expanding to broader self-employed with time.

Recommendation 2: Establish a long term aim of introducing an EITC for the self employed

The lack of an EITC for the self-employed is not supported on any reasonable basis. The government should commit to rectifying this situation over the medium-term.

3.2 Reform CGT entrepreneurs' relief which is unworkable

Following increases in capital gains tax (CGT) in recent years it was necessary that the rate was left unchanged in Budget 2014 and that a new CGT incentive was introduced for entrepreneurs. However, the new entrepreneurial relief as currently structured is excessively restrictive.

In particular, the holding period on the new investment is too long and would require in some cases entrepreneurs to remain in a new business longer than is optimal in order to claim the full benefit of the credit. Additionally, receiving the CGT relief on disposal of the second investment means that it is likely to be almost a decade before the entrepreneur could hope to see any return from the tax credit. Even at that it is extremely rare that an individual who realises a significant capital gain on disposal of one business realises a second gain and reinvests those proceeds.

These issues have meant that the initiative has no cost to the Exchequer until 2017 at the earliest and is likely to have minimal cost even then; reflecting its lack of usability. The current CGT regime means that Ireland as a base for Irish entrepreneurs continues to be much less attractive than the UK in which to grow or invest in a business. Indeed, feedback from Ibec members has suggested that the relief is likely unusable to all but a very small handful of entrepreneurs and is not significantly attractive enough to even render it preferable for that group than to move to the UK or another jurisdiction. The relief should be withdrawn and the UK experience in providing targeted CGT relief for trading enterprises should guide a less onerous reform.

Recommendation 3: Reform the entrepreneurs' relief to compete with the UK

CGT changes in recent years have made Ireland relatively unattractive place to grow of scale a high potential business. This has led to many smaller Irish ran companies rebasing to the UK. A Entrepreneurs CGT rate of 10% should be central to this with specific caps to limit erosion of the tax base.

3.3 Enterprise Investment Incentive Scheme (EIIS) reform

Following its removal from the high earners restriction in Budget 2014 we saw some turnaround in take-up of the EIIS scheme. Furthermore a number of recommendations from Ibec's 2014 submission to the DOF consultation on the scheme were taken on board. The EIIS scheme was expanded and the amount of finance that can be raised by a company increased to €5m annually. The qualifying sectors for the scheme were expanded to nursing homes, medium-sized enterprises in non-assisted areas, and internationally traded financial services. In addition, the required holding period for shares was increased from 3 to 4 years.

Ibec welcomed the improvements to the EIIS scheme which have the potential to help SME's find willing investors, take on extra employees and expand their operations. The changes are a positive step while use of the scheme is likely to pick-up as the economy improves and the high-earners restriction is removed. Challenges still remain, however, with the schemes branding and risk characteristics, with the changes announced unlikely to make the scheme attractive to non-traditional investors.

It is not clear from its current branding that the scheme is about investment in SMEs or what the benefits of investing in these companies are for investors or for society more broadly. It is Ibec's continuing position that the scheme should be rebranded to make its purpose clear; namely investing in Irish SMEs. Indeed reverting to the 'BES' branding would be preferable to the current convention with most users referring to it as 'the old BES'.

In addition to unclear branding the purpose of the scheme has been confused by the inclusion of the employment growth/R&D spend restriction. While both aims are laudable, they create unnecessary levels of complexity for both firms and investors.

The requirements are unlikely to have any substantial marginal benefit for either jobs or R&D as growing firms are likely to grow employment and R&D in either case. The restriction also adds an extra layer of uncertainty for investors about their potential returns.

Although employment and R&D are positive on a macro level, restricting small firms in this way may hamper rather than help their growth. For example a large number of firms in receipt of EIIS funding are in manufacturing where raising money to invest in plant and machinery is the largest cost obstacle they have to overcome. These firms are labour and capital intensive but severely disadvantaged by the terms of the scheme.

Additional employment will not come in the absence of the basic capital goods needed for production regardless of the scheme design. The restriction as structured creates incentives for investors to second guess the entrepreneurs knowledge of what capital allocation will best benefit the firm's growth. In these cases the overall result for employment and R&D will be negative in the medium-term as businesses invest available funds sub-optimally.

Ibec recommends that the restriction be lifted with a 30% up-front payment and 11% over a three year period regardless of how the funding is allocated.

Recommendation 4: Reform the EIIS scheme

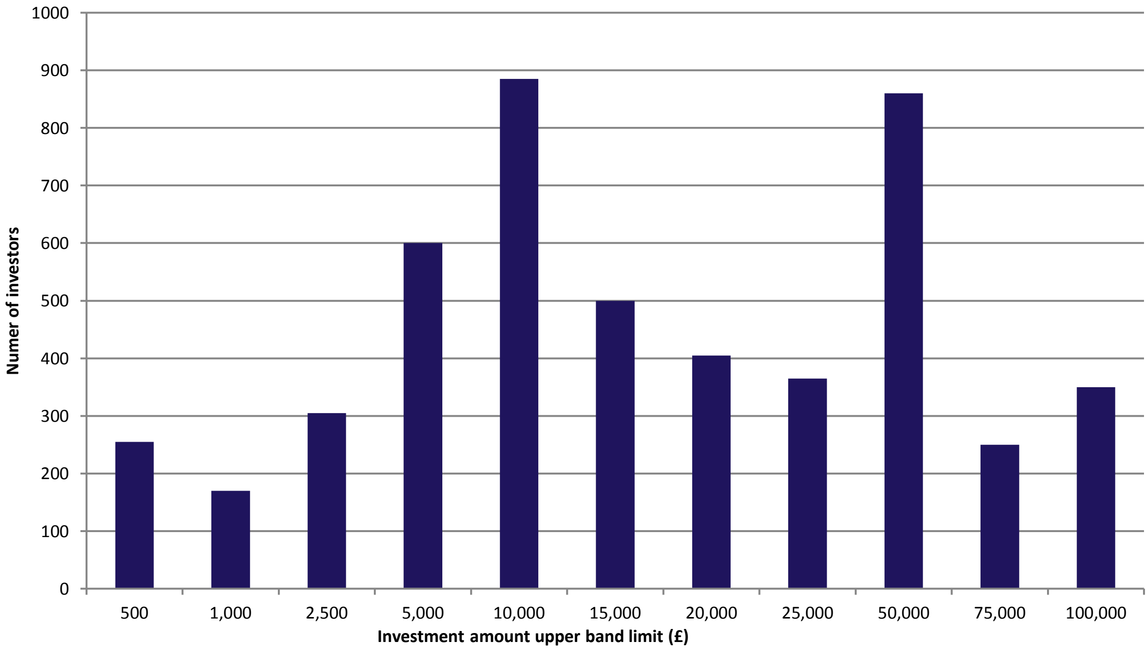
Following Ibec's submission on the consultation on the EIIS in 2014 there was significant changes to the EIIS in Budget 2015. There are a number of further reforms of the scheme which we believe remain outstanding:

- Re-brand the EIIS scheme
- Drop the employment or R&D restriction

3.4 Seed Enterprise Investment Scheme (SEIS) scheme

The UK has recognised the differential risk profiles between micro and medium sized enterprises by introducing the SEIS which provides more generous incentives for individuals investing in start-up firms less than two years old with less than 25 employees and gross assets of less than €200,000. Costing £58.5 million (€81 million) this scheme is targeted at a totally different category of firms than the EIS namely those very small and micro-firms which are newly formed. In this sense it complements rather than competes with the EIS scheme where most if not all of the funding tends to go to mid-cap companies.

Figure 9: SEIS (UK) investor profile



Source: HM Treasury

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 almost half of the investments were of less than £10,000 showing the schemes 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 micro-enterprises in approved sectors.

Recommendation 5: Introduce an equivalent to the SEIS scheme

An introductory version of the SEIS scheme similar to its UK equivalent would remove a barrier to small start-up businesses whilst also getting first time investors into the market. For example a 50% income tax credit on investments in new or microforms on similar terms to the UK scheme.

3.5 Stock options in start-ups

Share-option and profit sharing schemes can be a very important way for start-up companies to reward and retain key employees. They also have proven benefits for established companies in rewarding key staff and generating higher productivity through employee buy-in. The current system of taxation for these schemes worked well in the past but changes in recent years have reduced the attractiveness of such schemes to firms.

Firstly, the operation of the revenue approved APSS and SAYE schemes could be reformed to be more flexible to companies' reward structures. Currently these schemes must be operated by rigidly applying the same terms to all employees. This is growing ever more difficult for companies to implement given the work undergone in recent years to link reward to individual and team productivity and performance.

Secondly, the tax treatment of stock-options in start-ups is a particularly pressing issue for new firms which should be addressed by the Government. Typically staff in start-up companies 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 majority part of the remuneration package for many employees in start-ups. In this sense the onerous taxation on stock options in these firms is a particular disincentive to leave more stable employment in larger companies to start or join a start-up firm.

Currently gains on stock options are taxed as income when they are exercised and additionally as capital gains when they are sold. Typical examples could see fairly small gains attract an effective tax rate of 52% which would necessarily be paid out of the low salaries of these employees (as no cash gain arises until disposal). As a result in many cases employees struggle to raise cash to meet that liability and therefore only exercise their options when the company is being sold, at that time paying 52% of what they receive. This is a once-off gain which few of them will ever make again.

The UK has recognised this with the introduction of the EMI (Enterprise Management Incentive) credit which in effect waives the income tax due on the gain between the granting and exercising of the option for employees within start-up and small firms; instead taxing them only on the capital gain from the sale of stock. A similar scheme is needed in Ireland and would make working in a start-up company much more attractive to many. At the very least the income tax owed should be taxed as a capital gain and averaged over a number (up to 5) years rather than paid in the lump sum which is now the case. In line with the UK this would have no cost in the immediate term and no substantial cost overall but would be a welcome targeted relief for entrepreneurs.

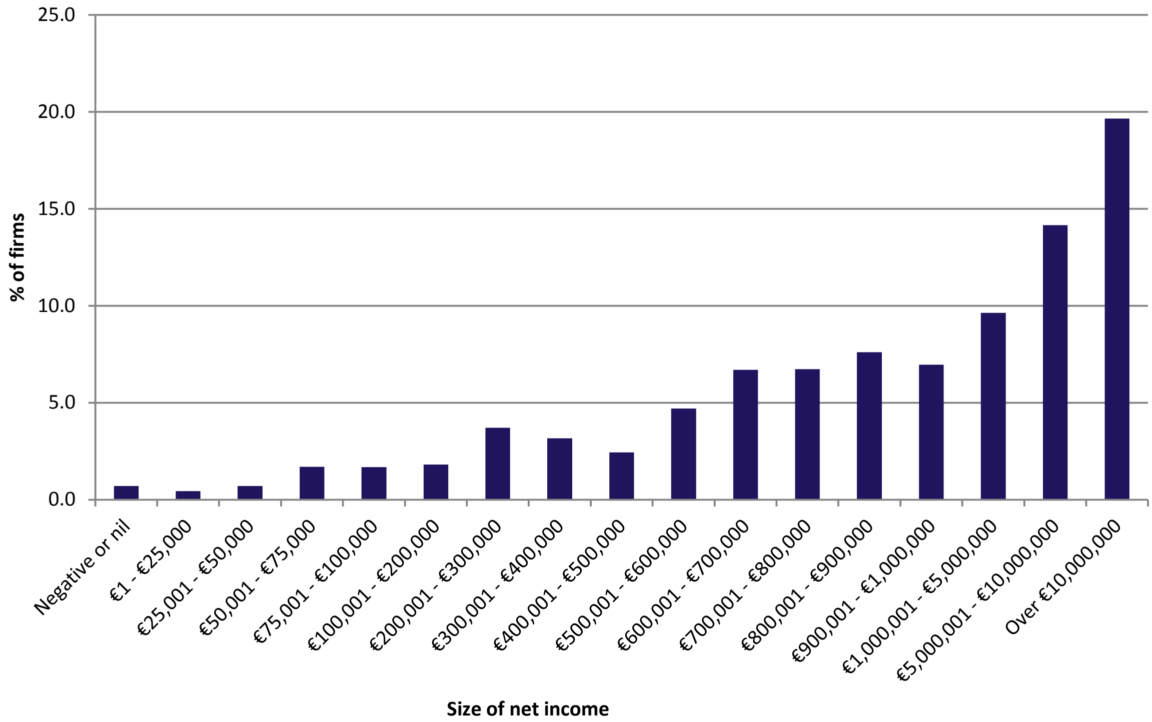
Recommendation 7: Reform employee share options schemes

Government should encourage more people to join or work in start-ups by introducing a scheme similar to the EMI scheme in the UK where share options are given relief from income tax and USC.

3.6 SME R&D tax credit

Ibec believes the government should consider launching a 'credit lite' R&D tax credit model for SMEs. Many SMEs, despite undertaking research and development activities, are not engaging with the credit due to its complexity and administrative requirements. This in turn limits the amount of R&D small indigenous firms are engaged in. Ireland is also out of line with many of its competitors by not having a significantly more attractive tax credit regime for SMEs.

Figure 10: R&D tax credit take-up by firms size



We recommend that a streamlined or 'credit lite' model should be developed for SMEs which 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.

Recommendation 8: Introduce an SME tax credit for small firms

The administrative costs associated with the R&D tax credit are too burdensome for smaller firms to participate with the credit. A pro-forma R&D tax credit should be introduced to help smaller firms overcome these costs and engage with the credit.

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