Ibec submission on the Employment and Investment Incentive and Seed Capital Scheme

May 2014

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1. Introduction

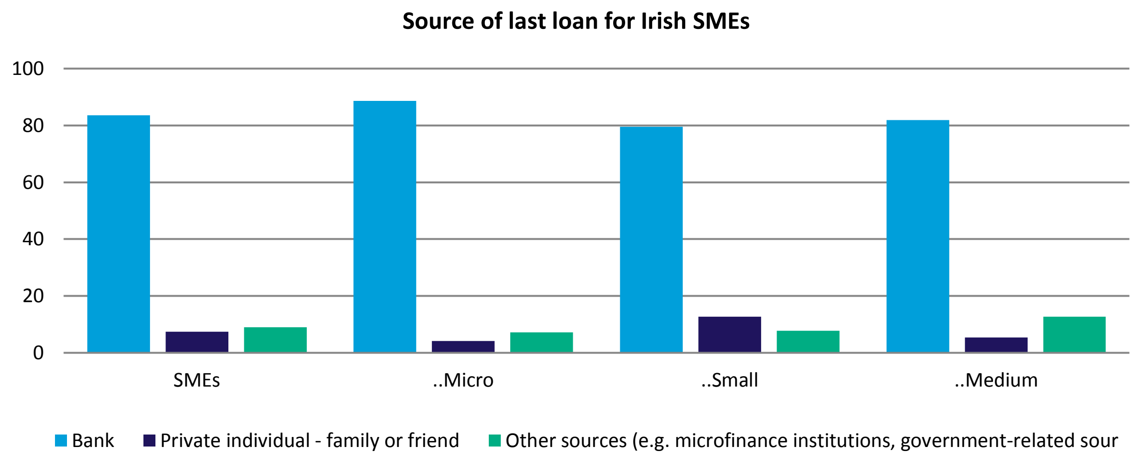
Ibec welcomes the fact that the Department is reviewing the workings of the Employment and Investment Incentive and Seed Capital Scheme (EIIS) and that the Department is seeking to consult and obtain the views of stakeholders as part of this process. It is Ibec's position that the scheme has the potential to be an integral part of Ireland's enterprise development policy particularly given the tight funding environment facing small and medium size business.

The Irish SME sector has an embedded over-reliance on bank funding and particularly funding of a short term nature. This is partly an institutional issue but it has been exacerbated by the fact that alternative sources of funding are scare for Irish firms. In this context the EIIS and Seed Capital schemes have the potential to help deliver a diversified and improved funding environment for SMEs. This submission contains three sections; in the first section we outline some of the current issues with enterprise funding sources in Ireland, secondly we look at the performance of the schemes and business views on their effectiveness, finally we look at some suggestions to improving the take-up of the schemes which has been falling in recent years.

1. Enterprise funding
2. Barriers to scheme take-up
3. Improving the SME tax incentives

2. SME funding sources

Enterprise access to credit has become a central policy issue during recent years. Available evidence suggests that lending to enterprise has dropped in part due to Irish banks engaging in repairs of their balance sheets but also due to a lack of demand from enterprises as consumer demand fell. As the economy recovers so too will consumer demand and consequently demand from business for working capital and to finance expansion of their operations will increase. With existing banks facing progressively stricter regulations in the coming year's access to alternative sources of credit as an issue will therefore become more acute.

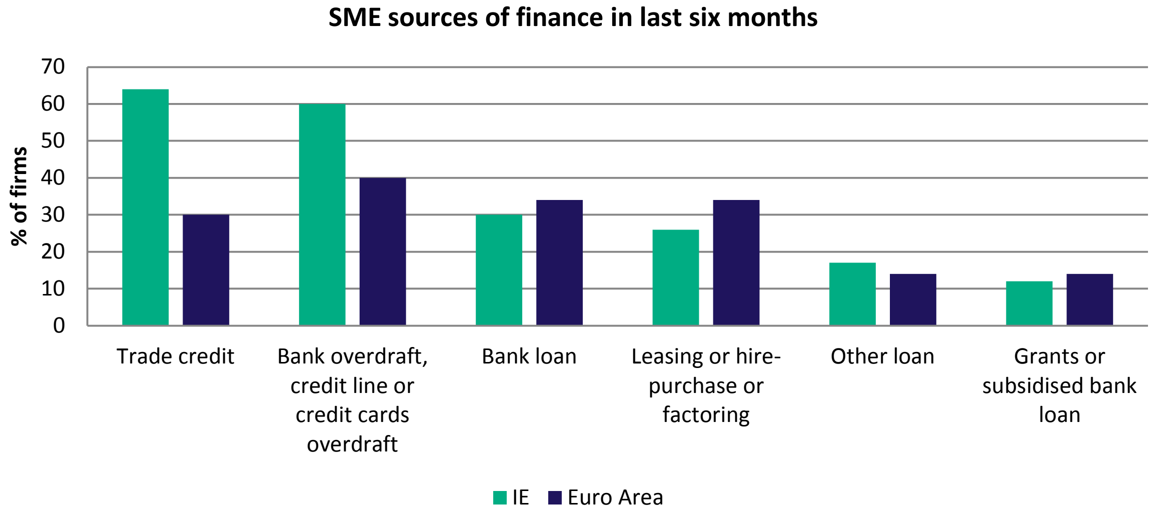


The ECB's SAFE survey showed that Irish SMEs rely heavily on banks as a source of external finance, with 71% of Irish SMEs preferring banks as a source over any other. This is not unusual in an EU context with SMEs (72%) across the majority of European countries preferring Bank financing in this manner but is less than optimal for a number of reasons.

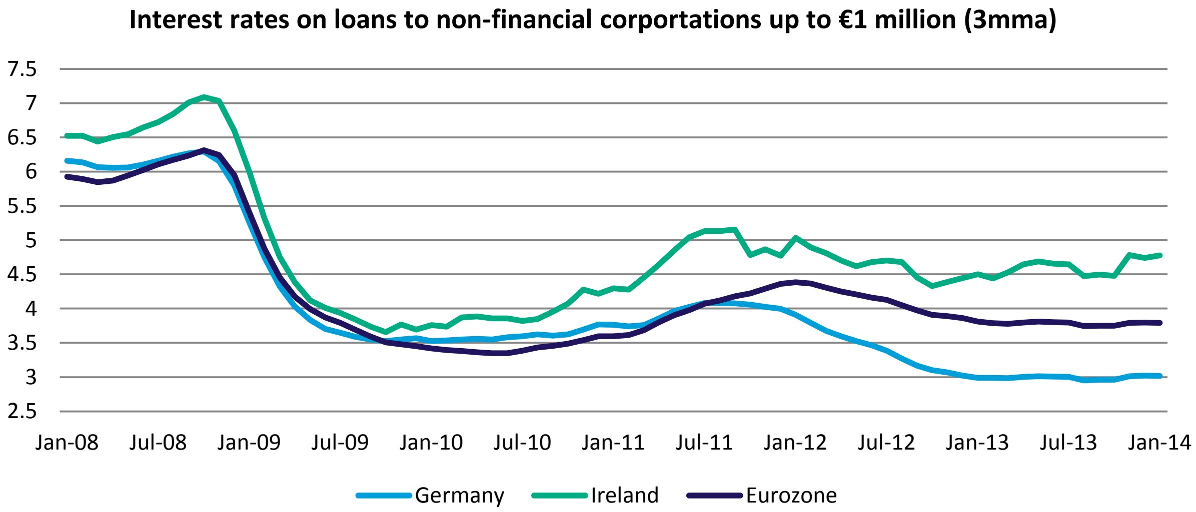
Firstly, one of the lessons learned during the previous decade is that over-reliance on bank financing for loans leaves growing companies more vulnerable to developments in the banking sector. The current Irish banking context means that over the next number of years Irish companies will need to diversify their source of external finance. A greater diversity of funding is necessary in areas which would be considered non-traditional for European companies for example venture capital and equity. Ibec believes that an improved EIIS scheme can play a key role in encouraging the development of an alternative funding/investment culture among SMEs and the public.

The SAFE survey shows that countries with well-functioning enterprise financing schemes such as the Netherlands for example have seen almost a quarter of loans to SME's and over 40% of the last loan for Micro-business coming from private individuals.

Secondly, despite the fact that Irish SMEs use external finance for much the same reasons as similar firms elsewhere in Europe Irish firms are much more likely to use short-term (overdraft facilities, trade credit) forms of financing which are relatively more expensive.



The SAFE survey shows that Irish SMEs primarily use bank overdrafts, credit lines or credit cards overdraft. Additionally, there is a much higher reliance on these short-term forms of finance compared to other Euro-area companies. This could be partly seen as both a product of enterprise culture but is also likely reflective of tight credit conditions on long term finance.



Finally, even when long term finance is available from banks the fractionalisation of the European banking market has meant that Irish firms pay an interest rate which is about 100 basis points above the Eurozone average for loans of less than €1 million and over 170 basis points higher than their German contemporaries. This puts Irish SMEs at a distinct competitive disadvantage when seeking to finance their growth. In such circumstances developing cheaper alternatives to bank financing is crucial to funding the growth of Ireland's enterprise base. A properly functioning EIIS scheme can play a crucial part in this mix.

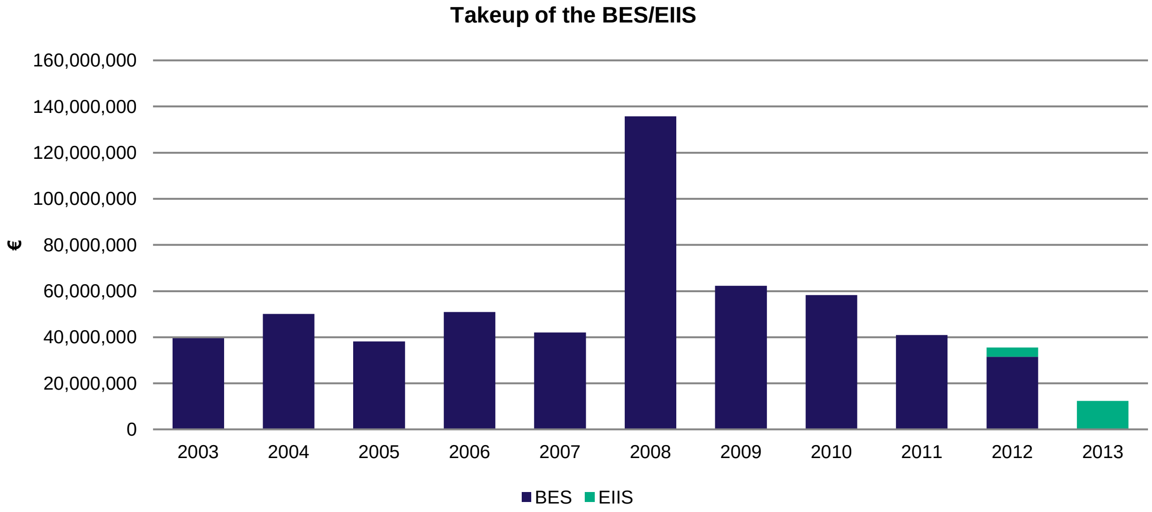
3. BES/EIIS

3.1 EIIS take-up

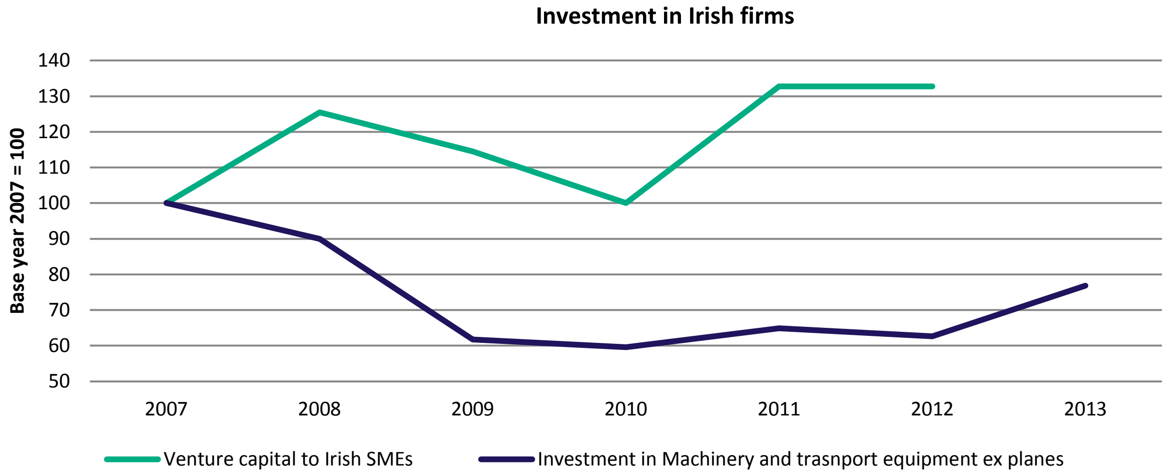
The Employment and Investment Incentive Scheme (EIIS) was introduced in 2011 as a successor to the relatively successful Business Expansion Scheme (BES). The aim of the scheme was to encourage individuals to invest in

Irish business by improving their prospective post-tax returns through tax incentives. The ultimate objective of the scheme was to finance Irish enterprise growth through alternative channels to bank financing. For a number of reasons, however, take-up on the scheme has fallen far short of what would have been hoped.

Take-up of the BES/EIIS scheme was quite solid in value terms throughout the 2000s with average take-up between 2003 and 2007 of around €44 million per annum. The scheme saw a sharp spike to €135 million in value terms in 2008 before gradually falling back to normal levels in the years to 2012. The changeover to the EIIS scheme in 2012 and 2013, however, coincided with a significant fall off in take-up with take-up falling by over 65% year-on-year. It may be tempting to allocate all of the difference in scheme take-up to a deteriorating investment environment but the figures would not support this view.



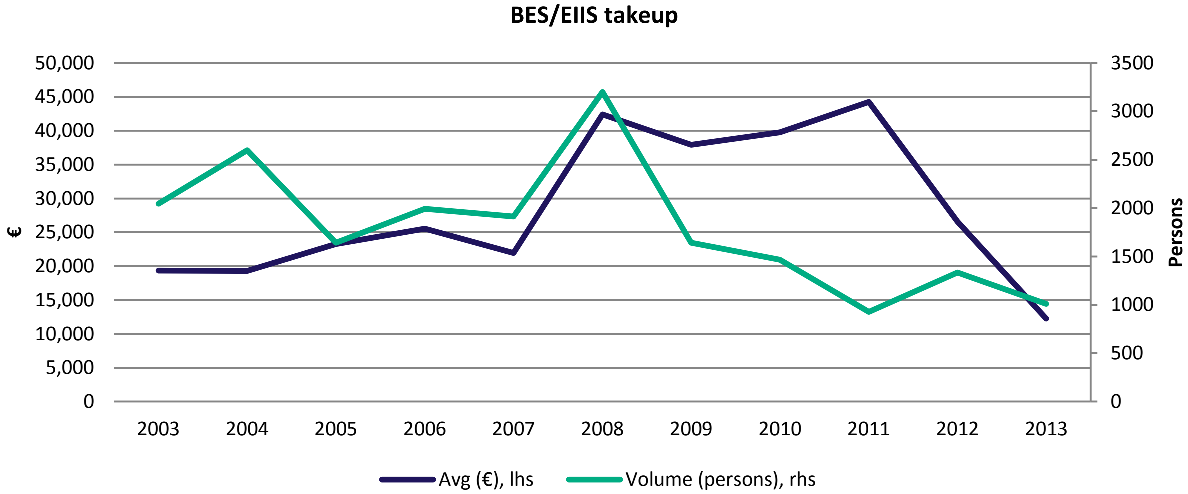
Although figures for 2013 are yet to be available EVCA data on venture capital investment to the Irish firms at which the scheme was targeted suggests a relatively stable investment environment from external finance for firms during the period 2007 to 2013. Annual venture capital funding to Irish SME's was consistently between €55 million and €70 million during these years. Additionally, despite investment in machinery and transport equipment (ex-planes) falling by almost 40% between 2007 and 2009 it has seen a strong year in 2013 rising by 22%.



The decreases in value terms in the BES/EIIS scheme do not tell the full story, however. The volume of take-up of the scheme actually rose in 2012 and 2013 despite the value falling. Over 1,000 people took up the scheme in 2013 compared to only 900 in 2009. Although these figures were down on take-up in the pre-recession period of almost 2,000 they have been broadly stable since a sharp decrease in 2009.

The take-up in the value of the scheme has been falling due to the average claim falling by over 70% between the final years of the BES scheme and the changeover to the EIIS scheme as the scheme became substantially less attractive to higher value investors. This is evident particularly in the 2012 figures where the two scheme operated in different halves of the year – without any major change to the external environment average expenditure in the scheme fells from €32,000 under the old BES to €11,363 under the new EIIS scheme showing clearly that the

makeup of the scheme rather than the external environment is the key factor in driving lower take-up. Budget 2014 began addressing this issue as the EIIS was removed from the high earners restriction for a period of three years. This should provide some renewed life to the scheme but must be marketed properly as investor impressions of the schemes attractiveness will have altered in the intervening period.



3.2 Barriers to EIIS take-up

The EIIS scheme could potentially be very important as the economy picked up and that low levels of take-up reflected both elements of the scheme and the general investment environment. The scheme is seen as complicated, risky and with low upside. Based on extensive stakeholder engagement and member feedback there are two main areas which Ibec believes are hindering the take-up of the EIIS scheme:

3.2.1 Information

Although take-up in volume terms of the EIIS scheme has not fallen significantly since 2009 it is still around half of where it was in the early 2000's. Ibec believes that there is scope to increase volume take-up in the scheme by targeting a broader cohort of non-traditional and household investors. These groups to date have tended to overinvest in the housing sector due to the perceived lack of risk in the sector and a clear understanding of housing transactions. There is a case that attitudes to risks in housing investment have changed in recent years as such promoting SME investment to traditional housing investors may be one way to broaden funding scope. There has been growing interest in the area in recent years with the advent of crowd sourcing platforms and greater public awareness of SME investment.

These investors are, however, likely to have difficulties in finding suitable information and advice on investing in SMEs. The EIIS scheme as it is currently branded is does not seem to have a clear purpose. It is certainly not clear from its current branding that the scheme is about investment in SMEs or what the benefits of investing in these companies is for the investor or for society more broadly.

3.2.2 Complexity and Risk

Non-traditional investors have a different risk profile to the typical cohort of seasoned BES/ IEES investors and are currently not sufficiently encouraged to make investments in SMEs due to relatively low value returns and relatively high investment risk. This makes investing in SME's a relatively risky proposition compared to housing, stocks or general savings. This no doubt affects the volume of scheme investment and consequently the funding SMEs receive. In addition the structure of the scheme including the R&D/Employment clause make the potential tax breaks unclear adding to the uncertainty surrounding an investment which is already high risk with low or negative average returns.

3.3 Ibec recommendations for the EIIS scheme

The EIIS is a scheme with strong potential risk but remains a risky proposition for potential investors. Ibec believes a number of measures could if adopted increase take-up of the scheme:

1. **Re-brand the EIIS scheme:** The EIIS scheme as it is currently branded does not seem to have a clear purpose. The schemes brand is far weaker than its predecessors with many investors still referring to it as the BES scheme.

   It is certainly not clear from its current branding that the scheme is about investment in SMEs or what the benefits of investing in these companies is for the investor or for society more broadly. It is Ibec's continuing position that the scheme should be rebranded to make its purpose clear; that being investing in Irish SMEs.

2. **Drop the employment or R&D restriction on the EIIS:** 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. Firstly, the addition it 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. Secondly, the restriction adds an extra layer of uncertainty for investors about their potential returns.

   Finally, 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 capital expenditure (ie new machinery and equipment) may be more beneficial than R&D or additional employees. The restriction as structured creates incentives for investors to second guess the entrepreneurs knowledge of what capital allocation will best benefit the firms growth. In these cases the overall result for employment and R&D will be negative in the medium-term as business invests 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.

3. **Target non-traditional investors:** The rebranded scheme would benefit from greater marketing and promotion to help smaller investors become aware of the opportunity's involved and allows them to easily find enterprises in which to invest.

4. **Increase company limits:** In order to make the scheme more attractive to companies particularly in high-tech sectors the maximum allowable amount which can be raised annually should be increased to €5 million while the lifetime amount which can be raised by any one company should be raised to €20 million.

5. **Reduce overall risk:** Non-traditional investors have a different risk profile to the typical cohort of seasoned BES/ IEES investors and are currently not sufficiently encouraged to make investments in SMEs due to relatively low value returns and relatively high investment risk. This makes investing in SME's a relatively risky proposition compared to housing, stocks or general savings.

   In other European countries a number of methods, including guarantees against a proportion of losses have been successfully used to promote investment schemes similar to the EIIS in other countries. The Netherlands and Austria have introduced such guarantees aimed at mitigating risk and attracting capital. Ibec believes a similar scheme should be introduced here.

6. **Extend the EIIS scheme to the film and television industry:** The audiovisual industry has in the past been precluded from claiming the EIIS credit for film, television or animation projects due to the existence of a comparable investor-based tax incentive in the form of Section 481. In Budget 2013 it was announced that Section 481 would move from being an investor-based tax relief to a corporation tax credit. This means that individual investments in production in Ireland (a market which in recent years amounted to €150 – 175 million p.a.) will now cease to benefit from tax relief.

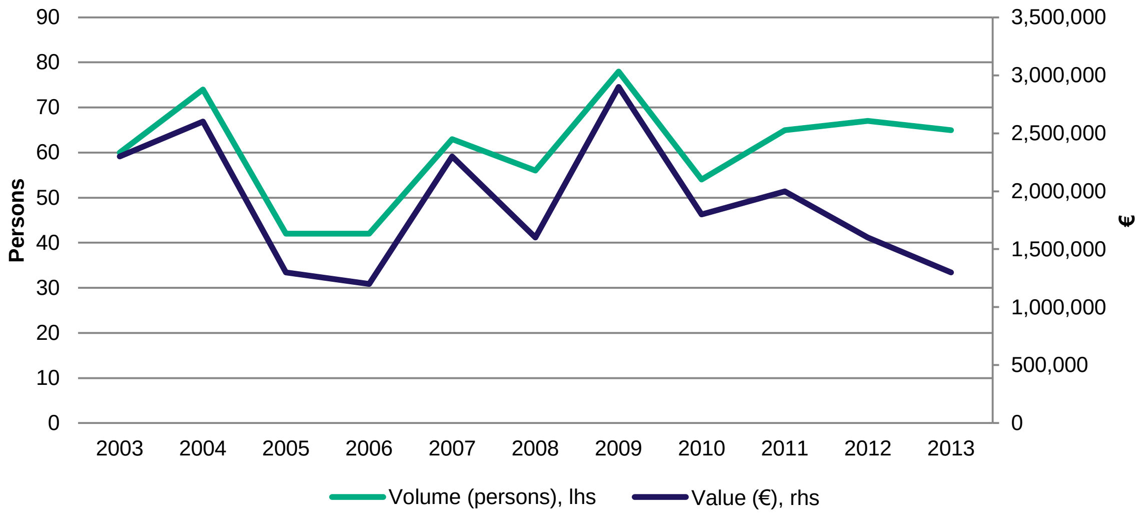
   The industry's closest competitor, the UK, operates a corporation tax credit for film and television production but also provides tax relief for individual investment in production through the Enterprise Investment Scheme. The lack of a similar incentive here will put Ireland at a distinct competitive disadvantage when competing with the UK for internationally mobile projects by increasing the relative cost of producing in Ireland. This is likely to counteract to some extent the positive impact of the enhanced benefit that the amendments to Section 481 are expected to deliver with negative consequence for employment.

   In order to protect Ireland's relative competitive position Ibec recommends that individual investments in film, television drama and animation should now qualify for the EIIS tax incentive.

4. The Seed Capital Scheme

Take-up of the seed capital scheme has fallen in value terms in recent years. Total claims on the scheme were only €1.3 million in 2013 although it has never been a large scheme with its highest value level reaching €2.9 million in 2009.

Take-up of the seed capital scheme



This scheme is likely to expand in terms of size as the economy recovers but growth will be limited unless a number of issues are address.

4.1 Ibec recommendations for the Seed Capital scheme

Information: Take-up of the scheme has been relatively steady over the past decade. Despite this existing take-up should be considerably higher in volume terms given that over 11,000 new firms are created a year. This suggests that information on their entitlements under the scheme is not reaching individuals starting a new company. This must be prioritised through the new LEO system.

Share holding period: Additionally, the period over which the shares must be held (3 years) is excessively long given the high risk of company failure in their early years. The scheme is notionally about encouraging people to establish their own business, however, given that firms formed in 2008 had only a 61% survival probability over the three years to 2011 it is unlikely that most people starting their own business will be able to fulfil the terms of the scheme this adds to uncertainty about the possible tax incentive.

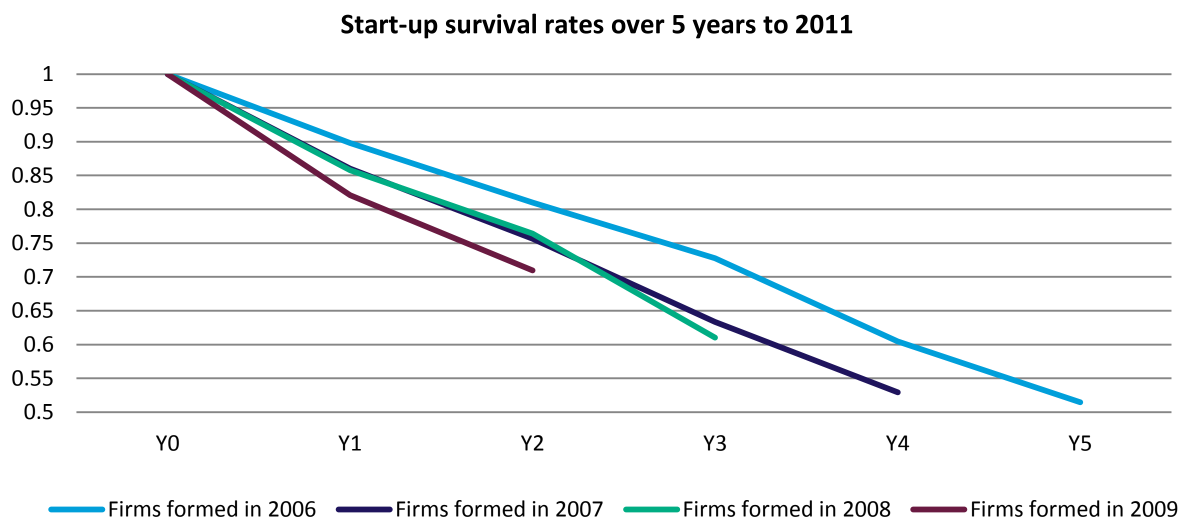
5. Diversification of venture capital schemes

In addition to restructuring existing tax reliefs on SME investment new venture capital tax reliefs in general must be structured in such a way as to take account of differing investor profiles and differing levels of investor risk. At present the mix of Irish venture capital tax incentives does not do this in any meaningful way.

5.1 SEIS schemes

The UK has recently recognised the differential risk profiles between micro and medium sized enterprises by introducing the SEIS scheme which provides more generous incentives for individuals investing in start-up firms less than two years old with gross assets of less than €200,000. This scheme acts as a compliment for the EIIS scheme in recognising the different risk profiles at different stages of company investment.

Three year survival rates for Irish start-ups range from almost 80% to just over 50% in certain industries with the average being 61%. Over five years survival falls even lower. This means that investors on average would lose all of their investment in 39% of these firms over a three year period. The numbers of start-ups profitable enough to return an investment is even lower again.



This makes these firms much more high risk in terms of investment. As a result of the lack of differentiation in risk profile in the EIIS scheme this means that these firms find it much harder to get equity funding. To help reduce the risk of investing in early stage companies Ibec believes a similar angel investment tax incentive to the SEIS should be introduced here for start-up firms and micro-enterprises in approved sectors.

5.2 Corporate Venturing

One of the major aims of Irish industrial policy over previous decades has been to see increased linkages between indigenous SME's and larger domestic and foreign firms. In this context some thought should be given to the potential of tax incentives for corporate venturing. These may be particularly successful in creating ties between these two types of firms. CV tax incentives are aimed at companies considering direct investment, in the form of a minority shareholding, in SMEs or groups of such companies in approved sectors. In the UK it provided tax incentives for corporate equity investment in the same types of companies as those qualifying under the Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) scheme.

6. Summary

In summary Ibec would like to take this opportunity to thank the Department for its invitation to submit views on the EIIS and Seed capital schemes. Both of these schemes have potential to diversify SME funding in Ireland. Both schemes also face real challenges in improving take-up. Ibec has suggested some modifications which we believe would improve take-up of these schemes, additionally we have outlined the need for a greater diversification of venture capital tax incentives in Ireland in order to move SME financing away from its over-reliance on short-term bank funding.

Ibec looks forward to continued engagement with the Department on discussions around reducing scheme complexity, promoting the scheme more effectively and ways of mitigating risk as well as providing information to the business community which may help increase take-up of these potentially important schemes.

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