IRISH VENTURE CAPITAL ASSOCIATION

Please reply to the following address:
3 Rectory Slopes, Bray, Co. Wicklow
Phone 01-276 46 47 Fax 01 274 59 15
E-Mail secretary@ivca.ie

Minister Michael Noonan TD
Department of Finance
Government Buildings
Upper Merrion Street
Dublin 2

14th July 2014

Re: Pre-Budget Submission

Dear Minister,

I attach the 2015 pre-budget submission of the IVCA for your consideration.

Our recommendations are geared to be of assistance in formulating policy in relation to supporting and developing entrepreneurship in Ireland.

The IVCA believes that changes recommended below could be introduced for companies engaged in **"innovation activities"** as outlined in the Tax Treatment of certain Venture Fund Managers detailed in **Section 541 TCA 1997 (as amended by section 46 Finance Act 2013).**

Yours sincerely

Regina Breheny
Director General

IVCA Pre-Budget Submission 2015

Contents

1. **Introduction**

The Irish Venture Capital Association (IVCA) is the representative organisation for all venture capital firms in Ireland.

The Action Plan for Jobs 2014 outlined the following policy objectives in support of entrepreneurship and innovation:

- Increase the level of entrepreneurship, become a great country for entrepreneurs, create a world-class environment in which to start and grow a business.
- Simplify tax based support schemes for entrepreneurs; adopt responsive public policies such as fiscal policy where both tax rates and targeted tax reliefs can support entrepreneurship and investment.
- Support the development of alternative sources of finance.
- Create a supportive environment conducive to indigenous start-ups and to attract overseas entrepreneurs.

We believe that these policy objectives cannot be achieved under the current tax regime. In particular:

- Ireland has undergone a significant loss of competitiveness in attracting and supporting entrepreneurship. The UK is a real credible threat to Irish inward investment. In the UK SMEs are able to operate in a more favourable environment. New Irish entrepreneurs are becoming aware that they would benefit by setting up in the UK and existing Irish entrepreneurs are considering re-locating.
- The funding crisis for SMEs is a direct result of an historic over dependence on debt which is currently in short supply. These companies should be encouraged to raise equity and the tax system should incentivise this approach instead of disproportionately rewarding investment in property.
- High marginal tax rates are making it almost impossible to attract senior executives from abroad with essential skills that are in high demand and not widely available in Ireland. The effect of this is that Ireland is becoming a "development ghetto" with high growth start-ups doing development here but building other functions e.g. sales and marketing elsewhere. Many of these companies are becoming Irish in name only and the opportunity to build essential skills in Ireland is lost.

Tax is a major determinant in whether Irish and overseas investors and entrepreneurs invest in Irish SMEs. However, the tax environment for productive investment has steadily deteriorated over the last five years. Unless we act to address this position, it threatens to seriously damage the incentive to build businesses and create jobs in Ireland.

The IVCA would like to suggest changes to the tax system that could enhance and reward equity investment in Ireland and thus radically increase the number of aspiring entrepreneurs, improve the funding environment for SMEs and encourage relocation of key personnel to Ireland.

2. Recommendations

The IVCA believes that the suggested changes recommended below could be introduced for companies engaged in "innovation activities" as outlined in the Tax Treatment of certain Venture Fund Managers detailed in Section 541 TCA 1997 (as amended by section 46 Finance Act 2013).

Entrepreneur Relief

- Reduce the CGT rate to 15%/12.5% in line with S541 TCA 1997;
- Simplify the rollover relief introduced in FA 2013 to ensure that tax is payable on earn outs only when cash is received and is a genuine rollover without any precondition of payment on a previous disposal.

Seed Capital Scheme (SCS)

- Extend this scheme to include the self employed;
- Increase the annual relief from €100k to €250k as start ups can require significant funding for R&D and product development.

Enterprise Investment Incentive (EIIS)

- Increase the annual relief from €45-61.5k to €350k so that it is aligned with the £300k relief available in the UK;
- Reduce the CGT rate to match that recommended in the Entrepreneurs Relief i.e. 15%/12.5%. This should result in no cost to the State for the next 5 years;
- Extend this relief to include investment by private individuals in VC Funds.

Special Assignee Relief Programme (SARP)

- Extend this relief to allow Irish companies to recruit from abroad.

Patent Box

- Re-introduce tax relief on patent income linked to "Innovation activities";
- Synchronise tax rates with CT of 12.5% and lower CGT rates.

Employee Share Option/Enterprise Management Incentive (ESOP/EMI)

- The EMI in the UK facilitates the creation of options valued at £250k for an individual, with no tax consequences when granted, and Entrepreneurs Relief kicks in on exercise. A similar scheme should be introduced in Ireland but restricted to companies and individuals involved in "Innovation activities".

3. Taxation Measures

3.1 Capital Gains Tax/Entrepreneur Relief

A key motivation in making investments in businesses is the potential for the capital value of the investment to increase. A high CGT rate acts as a deterrent in making investments by reducing the after tax return for investors.

CGT in Ireland is charged at a rate of 33%. In the United States, capital gains on assets held for more than 12 months are taxed at a maximum rate of 20% (compared to the income tax rate of 39.6%). In the UK the rate is between 18% and 28% but Entrepreneurs' Relief reduces this rate to 10%.

Ireland's Entrepreneur Relief provides relief to serial entrepreneurs by reducing the CGT on the second disposal and is aimed at encouraging successful entrepreneurs to reinvest the proceeds from the disposal of assets in productive trading activities in a new business. The key elements of this Relief are: a) The individual must have paid CGT on a previous disposal of business asset or shares and invest the proceeds in a new business; b) A gain made on the disposal of this new business is reduced by the lower of (i) of the CGT paid on the previous disposal or (ii) 50% of the CGT due on the new disposal. The relief is very limited as the benefit is deferred until the individual makes a subsequent entrepreneurial gain. This benefit will not increase the number of aspiring entrepreneurs, will not encourage new start up businesses and will not improve the funding environment for SMEs. Serial entrepreneurs are in a minority. Most entrepreneurs are unlikely to make multiple investments as each venture can take up to 12-15 years to grow and very often they remain with the acquirer when the company is sold.

Entrepreneurs' Relief in the UK is aimed at encouraging individuals to start a business and invest in it. The relief operates by reducing the rate of CGT payable by an individual on a disposal of qualifying business assets to 10%, as long as certain conditions have been met throughout a one-year qualifying period either up to the date of disposal or the date the business ceased. Qualifying capital gains for each individual are subject to a lifetime limit of €12m. This relief can also apply to 'relevant EMI shares'.

In Ireland there is no distinction made between entrepreneurial gains and purely speculative, non-productive gains. No account is taken in either the income tax or capital gains tax codes of the fact that an entrepreneur might have paid himself a subsistence salary (or nothing at all) for several years to build his business.

In order to improve the investment environment, the IVCA recommends that a reduced rate of CGT should be introduced for entrepreneurs engaged in "innovation activities"; to 15% if gains are received by an individual or partnership or to 12.5% if gains are received by a company. Innovation activities are defined in S541 TCA 1997 (amended by S46 FA 2013 as "new technological, telecommunications, scientific or business processes".

3.2 Seed Capital Scheme (SCS)

The Seed Capital Scheme is targeted at, and effectively limited to, PAYE workers. This significantly limits the number of investors who can avail of the relief.
The maximum investment limit of €100,000 is set too low. A high potential start up may have a higher value or require significantly more investment at start up stage. The interaction of the €100,000 investment limit and the requirement for the investor to acquire 15% of the company has the effect that an investor cannot claim the relief on his entire investment in a company if that company is valued at more than €666,667 at the time of investment. **The SCS should be extended to cover investments by self employed individuals. The annual relief should be increased from €100k to €250k as start ups can require significant funding for R&D and product development.**

3.3 Employment and Investment Incentive Scheme (BES/Seed Capital Scheme)

The Employment and Investment Incentive Scheme is an excellent example of the positive outcomes of government funding supports particularly at the seed and start up funding stage. There is significant evidence however that the BES scheme in particular has been used predominantly as a vehicle for investment in asset backed ventures reflecting investor's aversion to risk. The uptake within the technology sector is slow. The curtailment of tax reliefs for pension and other forms of investment will create a demand for tax efficient investment vehicles.A more attractive structure could ensure that use of the EIIS could create a valuable source of additional venture capital for Irish SMEs.

Structural Issues:

- Relief available to investors under the EIIS is capped at 30%-41% of €150,000 i.e. €45k- €61.5k. The UK's EIS scheme on the other hand, is capped at €1.2m annually i.e. €350k**. Increase the annual relief from €45-61.5k to €350k so that it is aligned with that available in the UK;**

- EIIS only provides for relief from income tax. CGT is payable on gains and you cannot deduct losses for CGT purposes. The UK's EIS scheme on the other hand, allows immediate relief of 30% of the cost as a credit against the entire tax liability. Gains are not liable to CGT and losses can be offset against income. Clearly the UK system is more attractive and more flexible**. Relief should also be given from USC and PRSI. Reduce the CGT rate to match that recommended in the Entrepreneurs Relief i.e. 15%/12.5%. This should result in no cost to the State for the next 5 years;**

- Tax incentivised Risk Capital is what the EIIS is designed to provide. This scheme should be expanded to encourage corporate/high net worth individuals to invest in venture capital funds. This would help to progress the political agenda of encouraging private capital to invest into the smart economy and to achieve deployment of Government funding by making it easier for venture capitalists to raise matching funds. Investors, by investing in a venture capital fund i.e. a "pool" of such companies, can mitigate the risk associated with early stage investment. **The EIIS should be expanded to include investments in VC Funds by high net worth individuals and by corporate investors.**

3.4 Special Assignee Relief Programme (SARP)

The extremely low take up of SARP is evidence of its limitations. Problems are that a) it only provides for relief from income tax, the true marginal rate includes USC and PRSI; b) the requirement that the individual must have worked for the same employer abroad prevents new hires from availing of it. Indigenous Irish companies without a foreign presence cannot use it to attract top foreign talent; c) US citizens remain tax resident in the US by virtue of their citizenship. Whilst Revenue allows qualification by concession, the legislation should be amended to achieve this; d) the level of the relief is quite low as it only applies to income above €75k. **SARP should be amended to include foreign workers who change employers to move to Ireland.** This would enable Irish businesses to more easily attract top foreign talent.

3.5 Patent Box

Up to 2010 the rate of corporation tax on patent income in Ireland was at 0% up to an annual cap for a company of €5m. This regime was removed and there is currently no preferential treatment of patent income.

In a global survey of tax regime competitiveness by KPMG the UK was chosen by 72% of respondents having increased from 28% in 2007. In the same period Ireland fell from 86% to 56%. The UK's "Patent Box" regime has contributed significantly to this turnaround in competitiveness. The objective of the regime is to encourage innovative businesses to invest in the UK and to locate high value jobs and activity associated with the development, manufacture and exploitation of patents in the UK. Ireland is significantly uncompetitive in this regard.

The Patent Box package in the UK provides: a) profits (income, licence fees, royalties etc) from qualifying patent interests (including licence holders) are taxed at a CT rate of 10%; b) the rules are phased in from 60% benefit in 2013 to 100% benefit by 2017; c) any UK company that holds interests in qualifying patents (or certain other intellectual property rights) may elect into the regime; d) even if the patented element of a product is minor, 100% of the income arising from the product falls into the regime; e) if patents relate to the internal processes by which the products are produced or underpin services provided then the Patent Box regime should still qualify; f) groups can use Patent Box and continue claiming R&D tax credits.

Reintroduce patent relief for those companies carrying out "innovation activities" as defined in S541 TCA 1997 (amended by S46 FA 2013). Tax rates should be consistent with the CT 12.5% rate and with a lower CGT rate.

3.6 Employee Share Option/Enterprise Management Incentive (ESOP/EMI)

Share Option Schemes are an important tool in aligning the interests of employees and their employer companies, and giving key employees a stake in the future profitability and success of the company. Many SMEs are highly dependent on their key personnel to implement the founder’s strategy and to realise the potential of the business. Employers need to have some flexibility in their compensation programs so that they can reward and attract key people and the tax system should play a key role in achieving this.

There are currently no employee equity incentives that are geared towards start-ups and SMEs in Ireland. Equity-based rewards for key employees have been significantly eroded in recent Budgets. The income tax regime for approved share option schemes was abolished from November 2010, and 2011 saw the introduction of 4% employee PRSI, which coincided with the introduction of the USC. In effect, the tax rate is now 52% made up of 41% income tax, the maximum USC rate of 7% plus 4% PRSI. These rates apply even if a taxpayer is not paying PAYE or USC at the top rate unless a special application is made to the Revenue for relief.

In the US where an employee holds an Incentive Stock Option for at least two years from the grant of the option and holds the shares for at least one year following the exercise of the option, no income tax applies on the grant or exercise of the option. Instead, capital gains tax (at 20%) will apply when the shares are sold. No more than $100,000 worth of shares can become eligible for exercise in a calendar year.

In the UK, in general PAYE (and sometimes National Insurance) are payable on share options. However SMEs can avail of the Enterprise Management Incentive scheme (EMI). The granting of such options is tax free, income and NHI and on exercise, can be subject to Entrepreneurs’ Relief in relation to CGT. Share options with a market value of up to £250,000 may be granted to a qualifying employee of a qualifying company, subject to a total share value of £3 million. In addition, the UK Government has introduced a new “employee shareholder” status who will have different employee rights and shares worth a minimum of £2,000 in the company they work for. Gains on up to £50,000 of shares acquired by employee shareholders will be exempt from capital gains tax.

When compared to other jurisdictions, the regime in Ireland is extremely uncompetitive. It is now very difficult to attract entrepreneurs to establish a business in Ireland. **An EMI type scheme should be introduced in Ireland but restricted to companies and individuals involved in “Innovation activities”.**