Irish Tax Institute

Budget 2014 Submission

Developing a Culture of Entrepreneurship

July 2013

Irish Tax Institute

Leaders in Tax

Budget 2014 Submission

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About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

1. Executive Summary

Increasing threat to movement of capital, investment and jobs

Tax is a major determinant in whether Irish and overseas entrepreneurs invest in Irish start-ups and expanding companies. However, the tax environment for entrepreneurs has steadily deteriorated over the last five years and, unless we act to address this position, it threatens to damage the incentive to build businesses and create jobs in Ireland. Repeated change has led to uncertainty, fuelled by further speculation in advance of this year's Budget.

If a decision is made by an entrepreneur not to invest, then the capital is lost for that project and may be lost from the Irish tax system entirely.

So how has the outlook changed for investors in Ireland in this five year period?

- The capital gains tax (CGT) and capital acquisitions tax (CAT) rates have both increased by 65% from 20% to 33%.

- The CAT thresholds have effectively been halved.

- Marginal income tax rates have risen by close to 20%, from 46.5% to 55%.

- Reliefs and incentives previously available to investors have been scaled back or abolished completely e.g. the patent royalty incentive, interest relief for monies borrowed for investment in trading companies and CGT retirement relief.

- The Business Expansion Scheme (BES) has been abolished and replaced with a new Employment and Investment Incentive (EII). However, the High Earners' Restriction (HER) significantly limits the attractiveness of the EII for those who have money to invest in Irish business, and take-up has been low.

The Challenge of International Mobility

Capital and income taxes are key influencers for individuals with wealth to invest. This is a population which is increasingly mobile and entrepreneurs can travel easily - particularly those involved in high-tech, IT and high-performing start-ups.

Irish investors who have a natural nexus with this country should be given every possible encouragement to put their wealth to work in Ireland. We also need to create a competitive environment for attracting wealth from overseas and, in the year of *The Gathering,* attracting some of our more successful entrepreneurs back to Ireland.

In its *Entrepreneurship 2020 Action Plan*, the European Commission has stressed the need for investment:

> *"An important component of a successful entrepreneurial ecosystem consists of an array of* ***early stage investors*** *(venture capitals and business angels) that provide seed and first round equity investments…The Member States are invited to…****assess the need of amending current national financial legislation*** *with the aim of facilitating new, alternative forms of financing for start-ups and SMEs in general...".*

While we have been increasing our rates of CGT, CAT and income tax, other countries have been enhancing and promoting their offerings for the investor community. A number of countries have focused on capital tax initiatives to attract business investment. This creates risks at a time when Irish investors are becoming increasingly mobile and they can make clear comparisons with tax rates applicable to their fellow investors based in other countries, as illustrated in Figure 1 below.

Tax reform in the UK and our geographical proximity to Northern Ireland present particular challenges. The UK Government's actions in pursuit of its stated ambition *"for the UK to be the best place in Europe to start, finance and grow a business"* are now posing a real threat to investment, entrepreneurial drive, wealth creation and jobs in Ireland.

As well as the threat from international mobility, there is competition for capital from property investments which have been particularly popular in Ireland.

> *"Irish high net worth individuals are likely to hold the majority (55%) of their wealth in property, more than in any other country globally. Only 2% of wealth is held in business/entrepreneurial interests…"*[1]

While the tax system has been used to incentivise investment and activity in the property and construction sector in recent times, with initiatives such as the CGT incentive introduced in Budget 2012 and the introduction of REITs, we believe that the job-creation potential of the trading sector merits a similar focus.

The consequences of continuing with this policy

Once Irish businesses start to export and get to a certain scale, many begin to grow through the acquisition of businesses which are often overseas. The question then arises as to where to consolidate the business activities post-acquisition. In this early stage it may be attractive to consolidate in Ireland, with the potential benefit of overseas jobs being relocated here.

However, if the tax environment is unfavourable and increasingly uncertain, then the investor may choose to keep their next acquisition located in its home jurisdiction and, before long, the nexus with Ireland is weakened. The ultimate concern is that the investors will reach a tipping point where they are no longer prepared to pay more tax than their overseas counterparts and they exit the country completely.

[1] Press Release on launch of the Barclays Wealth Insights Report 17 June 2013

The issue here is one of *"enterprise drain"*[2], where Ireland becomes uncompetitive as a location for the consolidation of an investor's business activities and employment base, with the consequent loss not only of tax revenues and jobs but also the skills and knowledge of the business founders, its key employees and its investors.

Institute Recommendations

We believe that the capital held by wealthy individuals must be harnessed for productive investment in small, high-potential businesses. 99% of all Irish businesses are SMEs, and SMEs employ almost 70% of the workforce[3]. The biggest issue facing these businesses at the moment is access to funding.

There have been welcome initiatives introduced to date to deal with funding challenges from other sources e.g. the Microenterprise Loan Fund Scheme and the amendments to the carried interest rules. In addition, the 10 Point Tax Reform Plan for SMEs provided some welcome developments for the underlying businesses concerned. However, the wealthy individual investor is a critical part of any strategic approach to expanding domestic direct investment (DDI) in Ireland and their position has received little focus to date. For these individuals, the key consideration is the tax environment in which they operate and invest, and how it compares with the environment in other countries.

We recommend that the following 3 steps are taken in Budget 2014 to address these issues:

1. Improve the tax environment for investors and entrepreneurs and address the CGT and income tax issues currently facing this sector:

   (a) As an immediate measure to improve the investment environment, we recommend that a reduced CGT rate of at least half the current rate of 33% be introduced for gains realised on the disposal of business assets and shares in active trading companies. The relief should be contingent on and linked to employment growth in the company. We would also urge that the relief be clearly designated as a targeted measure for entrepreneurs, and marketed and promoted as such. Other conditions could be attached to the relief, and the relief could be reviewed to ensure it achieves the intended aims.

   (b) Introduce a package of income tax measures to make the system more conducive to self-employment and investment, including the following elements:

      1. Commit to ending the 3% additional Universal Social Charge (USC) on non-PAYE income in excess of €100,000 at the end of 2014, as planned.

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[2] Minister Brian Hayes comments in *SME Credit and Funding Newsletter* – Department of Finance, Summer 2013

[3] *Economic Assessment of the SME Sector in Ireland* - Department of Finance, November 2012

2. Remove the EII relief from the scope of the High Earners' Restriction, and review the incentive's restrictive 3-year investment timeframe. It might also be worth revisiting the marketing and promotion of this incentive, making it clear that it forms part of an overall entrepreneurship package, together with the CGT relief proposed above.
3. Consider amending the operation of the Seed Capital Relief so that the tax relief helps to finance the qualifying investment, reducing the need for the investor to raise all of the investment capital before they can make the investment.
4. Introduce a tax relief for individuals making loan capital investments into high potential SMEs.

2. Take measures to assist entrepreneurs' underlying businesses and to incentivise them to hire additional employees:

(a) Incentivise businesses which take on staff and continue to build their workforce by introducing a progressive Employer PRSI relief which reduces the Employer PRSI liability incrementally for each additional hire. For ease of administration, the relief could be granted as a refund at year-end.

(b) Consider introducing a system of reduced commercial rates targeted at small businesses with low turnover – the ones most adversely affected in the current economic climate.

3. Provide an efficient means for small employers to reward their most valuable employees. Equity incentives can be an important tool in aligning the interests of employees and their employer companies, and giving employees a stake in the future profitability and success of the company. There are currently no employee equity incentives which are geared towards start-ups and SMEs in Ireland and we believe it would be worth considering introducing an equity incentive geared towards employees in this sector.

4. Complement our successful strategy for attracting foreign direct investment (FDI) with an ambitious DDI policy. We recommend that a comprehensive "Roadmap for Entrepreneurial Activity and Investment" be developed, which would address the broad fiscal climate for DDI, and identify clear targets for the medium and longer term.

2. The environment for entrepreneurs in Ireland

2.1 Developments on non-tax supports

There have been initiatives undertaken by Government to assist in providing finance to business, such as the introduction of the Microenterprise Loan Fund Scheme and the amendments in Finance Act 2013 to the "carried interest" provisions which facilitate collective investment approaches. Grant aid administered through Enterprise Ireland continues to be a valuable source of funding, while non-bank private sector financing may also be provided to SMEs through institutional investors and venture capital funds. Similarly, a number of incentives have been introduced for SME businesses themselves at the various stages of their life-cycle (albeit the incentives are generally limited to corporates rather than unincorporated businesses). An overview of these is provided at Appendix I.

While these are important elements of the overall strategy, we believe that a diversity of investment sources is desirable in practice, and another source of funding could also be released and harnessed more fully, in the right conditions. We refer to the private capital held by individuals who have the means to invest in Irish businesses, whether it is their own business or that of a third party.

2.2 The tax environment for entrepreneurs

Our DDI strategy to date does not appear to have focussed attention on private investors with capital to spend. In fact, the environment for this kind of investment has actually become less favourable (in terms of the applicable CGT and income tax rates) in recent times.

	2008	**2013**
CGT rate	20%	33%
CAT rate	20%	33%
Value of transfer which can be made from parent to child free of CAT	€521,208	€225,000
Marginal income tax rate for entrepreneurs	46.5%	55%
CGT Retirement Relief	Relief available for any investor over age 55	New age cap reduces the incentive to pass on business after age 66

	2008	2013
Business Expansion Scheme / EII	HER applied effective tax rate of 20% 5-year payback timeframe	HER applies effective tax rate of 30% 3-year payback timeframe
Share options were used to reward employees	No PRSI applied	PRSI at 4% applies since 2011
Interest relief for individuals on loans used to invest in trading companies	Income tax relief at the investor's marginal rate	N/A – abolished for loans made after 2010
Patent Royalty Incentive	Tax exemption for income from qualifying patents used to incentivise employees/directors	N/A – abolished in 2010

Successive amendments to the capital tax rates and thresholds have resulted in a significant level of uncertainty as to the direction and the strategic objective of policy in this area, and there is speculation about further increases in capital taxes in Budget 2014. The certainty associated with the 12.5% corporation tax rate is widely valued and it is felt that the same level of certainty should be brought to the DDI space. The Department of Finance has recognised the importance of creating *"the conditions of certainty that institutional investors require"*[4]. Certainty is an equally critical requirement for the private individual investor.

Our feedback is that, similar to income tax, there is a point beyond which investors will not tolerate additional increases in capital tax rates. As a small open economy whose wealth creators operate on a global basis, we are particularly susceptible to this issue and we should have a strategy for retaining wealth for productive investment within Ireland.

While we have been increasing our rates of CGT and income tax, other countries have been enhancing and promoting their offerings for the investor community. This creates risks at a time when Irish investors are becoming increasingly mobile and they can make clear comparisons with tax rates applicable to their fellow investors based in other countries, as illustrated in Figure 1 below. Our geographical proximity to Northern Ireland presents a particular challenge in light of the UK's advances in this area – discussed further at section 3.

Once Irish businesses start to export and get to a certain scale, many begin to grow through acquisitions. The question then arises as to where to consolidate the business activities post-acquisition. Our feedback is that Ireland is becoming increasingly uncompetitive as a location for the consolidation of business activities, as business

[4] SME Credit and Funding Newsletter – Department of Finance, Summer 2013

owners begin to form exit strategies and assess their likely tax liabilities on exit. The nexus of the business then moves abroad, with the loss not only of the associated tax revenues but also the skills and knowledge of the business founders, its key employees and its investors. We note that this phenomenon has been recognised by Minister Hayes, who has discussed the issue of *"enterprise drain"*[5].

[5] SME Credit and Funding Newsletter – Department of Finance, Summer 2013

3. The environment for entrepreneurs in other countries

The importance of entrepreneurship and the SME sector as the driving forces for job creation has come to be widely acknowledged, across the EU and internationally. The European Commission published its *Entrepreneurship 2020 Action Plan* in January 2013 and the Irish Presidency of the EU expressed support for the proposed framework, *"particularly the focus on the fostering and promotion of entrepreneurs, entrepreneurship and an entrepreneurial culture at a European and National level"*[6]. Over the past 5 years, SMEs have accounted for 80% of new jobs created across the EU[7].

It is recognised internationally that encouraging DDI and driving a prosperous indigenous SME sector is a key strategic focus. Strategies for fostering DDI and entrepreneurial activity vary internationally, and we have summarised below some of the approaches adopted in other countries.

Austria

To facilitate the provision of risk capital to SMEs in their early and expansion stages, Austria has introduced special purpose investment vehicles (MFGs) which offer tax advantages to the MFGs themselves and the investors in the MFGs. This incentive was granted State Aid clearance by the European Commission[8].

Canada

Canada set up a OneStop Business Registry in 2004, which allows business owners to find information on starting a new business, to register their business name and their business, incorporate a company, change their business address, and access a range of business resources.

In 2011, the Canadian government also created the Red Tape Reduction Commission which is charged with identifying irritants to business that stem from federal regulatory requirements and recommending options that address these issues. The focus is on issues that have a clear detrimental effect on growth, competitiveness and innovation.

China

In 2011, China introduced measures to attract potential Chinese entrepreneurs from overseas. Enterprises started by Chinese entrepreneurs who have returned from overseas can receive support, such as a proportion of their start-up capital during their start-up phases.

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[6] Minister Richard Bruton, presentation to the Industry Research and Energy Committee of the European Parliament – 23 January 2013
[7] European Commission, 2012 SME Assembly
[8] State Aid reference: N621/2007

France

France introduced an “auto-entrepreneur” status in 2009. This initiative is aimed at those who wish to operate as a one-person business of a commercial, skilled trade or professional nature. Certain turnover limits apply and advantages include exemptions from certain registration requirements, simplified and reduced social security charges based on turnover for the previous month or quarter and the option of paying tax on a pay-as-you-earn basis.

It has been reported in recent times[9] that the French President proposes to introduce measures including a reduction of up to 85% in capital gains taxes for investors in start-ups in an effort to encourage venture-capital and stock-market financing for SMEs.

In 2012, France set up a one-stop online business registration system (Le Guichet Unique de la Création d’Entreprises). This website, which targets current and new entrepreneurs, is intended to assist entrepreneurs in setting up a business.

Malta

Malta has introduced a venture capital fund, Malta Venture Capital plc, to provide risk capital to Malta-based SMEs in their early and expansion stages of development, and to raise financing for innovative processes, ideas and techniques. Investors in the fund are entitled to a tax credit equal to 30% of the amount invested. This incentive was also granted State Aid clearance by the European Commission[10].

United Kingdom

The UK Government’s stated ambition is *“for the UK to be the best place in Europe to start, finance and grow a business”* and Entrepreneurs’ Relief is a critical tool in pursuing this strategy.

Entrepreneurs’ Relief was introduced in the UK from 2008 and it was aimed at encouraging individuals to start a business and invest in it. The relief operates by reducing the amount of CGT payable by an individual on a disposal of qualifying business assets, 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 £10 million (for disposals on or after 6 April 2011). It is notable that this lifetime limit has been increased three times since the relief was introduced, increasing from an initial level of £1m to the £10m limit which applies now. Qualifying gains are subject to CGT at a rate of 10%, instead of the normal 18% and 28% rates. Relief can be claimed on a disposal of qualifying business assets or shares in your “personal company” (i.e. you hold at least 5% of the ordinary share capital and 5% of the voting rights).

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[9] *France – Tax proposals for capital gains from share sales* – KPMG Regulatory Update, 3 May 2013
[10] State Aid reference: N69/2007

The UK Government also recently announced that it will expand the list of qualifying investments for stocks and shares Individual Savings Accounts (ISAs) to include shares traded on SME equity markets. This change is intended to benefit SMEs with shares quoted on markets that do not currently qualify for ISAs. HM Treasury said that, *"[a]t a time when many SMEs are looking for alternative types of finance, this change could provide a major capital injection for SME equity markets and encourage investment in growing businesses"*[11].

United States

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%). "Qualified" dividends (dividends received from a domestic corporation or certain foreign corporations) are also taxed at 20%.

The Startup America Partnership was launched in 2011 with a view to bringing the private sector together to maximize the success of America's entrepreneurs. It is a network of founders, entrepreneurial leaders, investors, mentors and executives who work together to strengthen local start-up communities and help young companies to grow.

The effect of these differing regimes for the individuals concerned can be illustrated by way of an example.

Figure 1:

Three Investors Compared: Irish, UK and US

- An Irish SME technology company seeks a €1.5m investment to fund its expansion.
- It sources funding from three equity investors, one Irish, one UK-based and one based in the United States.

The following table illustrates the tax analysis for each investor over a 5-year holding period:

	Irish resident investor	UK resident investor	US resident investor
Investment	€500,000	€500,000	€500,000
Marginal tax rate on interest/dividend income	55%	47%	20%
Tax rate on exit after 5 years	33%	10%*	20%

*Assuming the investor qualifies for Entrepreneurs' Relief.

[11] *Tax free ISA investment into small business is being expanded* – HM Treasury, 1 July 2013

4. Institute Recommendations

Arising from the analysis outlined above, we make the following recommendations for Budget 2014 and beyond:

4.1 Capital taxes on entrepreneurs - recommendations

We recommend taking action on the CGT and the income tax issues which are currently hindering private investment and are therefore likely to result in "enterprise drain" from this country.

(a) Introduce a targeted reduced CGT rate for business investment

While a straight-forward cut in the CGT rate may be the simplest option, it would not be a particularly focused measure as it would not make any distinction among assets and activities.

Therefore, we propose introducing a targeted CGT relief, which would apply a special reduced rate of at least half the current rate of 33% to gains on the disposal of business assets and shares in trading businesses. In order to better achieve the objective of job creation it could be linked to an increase in employment levels, similar to the EII and the corporation tax start-up relief. The relief could also have some of the following features: limited to certain types of business assets and shares, a minimum investment period, and a lifetime limit.

It would be important to conduct a cost-benefit analysis prior to implementation and the relief would need to be closely monitored to ensure it had the intended effect. While it is difficult to estimate the potential cost of the relief, it is worth noting that previous reductions in the general CGT rate did not lead to reductions in the CGT yield, but rather stimulated activity, which in turn led to increased yields.

(b) CGT roll-over relief

While we believe the optimal approach would be to introduce a special reduced CGT rate for entrepreneurs, a roll-over relief would be appropriate if that approach were not adopted and if the headline CGT rate remained at its current high level.

It would involve a re-introduction of a form of the relief on the disposal of certain business assets and shares which applied before 2003. It is worth revisiting the comments made by the Minister for Finance in the context of the abolition of both this relief and indexation relief at Budget 2003: *"All of these reliefs and allowances made sense when the CGT rates were 40 per cent…"*[12]. The CGT rate is now closer to 40% than it is to 20% (the rate which applied when the reliefs were abolished).

[12] Financial Statement of the Minister for Finance Mr. Charlie McCreevy, T.D. - 4 December 2002

A re-introduced roll-over relief would allow gains to be deferred where the proceeds of disposal are reinvested in productive business assets or shares in active trading companies.

4.2 Income tax on entrepreneurs - recommendations

(a) Address the USC disparity between the employed and self-employed

The current legislation states that the additional 3% USC on non-PAYE income in excess of €100,000 will cease to have effect for the tax year 2015 and subsequent years[13]. This will restore parity between the marginal tax rates applicable to employees and the self-employed. We are seeking a commitment at Budget 2014 that this position will be achieved as planned.

The ESRI has commented on the disparity in marginal income tax rates applicable to employees and the self-employed, which, it says, *"could be questioned on both equity and efficiency grounds"*[14]. It further notes that *"[h]orizontal equity requires the equal treatment of equals – it is not clear what difference justifies the 3 per cent surcharge on the self-employed"*.

(b) Improve the attractiveness of the EII

Relief under the EII is included in the list of "specified reliefs" for the High Earners' Restriction. Relief available to investors under the EII is already capped at €150,000 but the impact of the High Earners' Restriction is that the cap is actually €80,000 unless the investor has a significantly high level of "adjusted income". The relief is curtailed further where the investor is availing of other "specified reliefs". It is notable that the UK has decided to leave business reliefs broadly unaffected by their new cap on income tax reliefs, on the basis that business reliefs are already capped and further limitations simply prevent investors from taking business risks.

Feedback from our members indicates that uptake of the EII is limited, and the inclusion of the relief in the list of "specified reliefs" is a major factor in this. The removal of EII relief from the scope of the High Earners' Restriction could be considered, as a positive signal that encouraging investment in trading businesses with employment potential is a policy priority.

Another factor which we understand accounts for the limited take-up of the EII to date is the 3-year investment timeframe. We understand that this is proving quite restrictive and it is difficult for companies to invest funds received through the EII and generate a return sufficient to pay back the investment within a 3-year period. Numerous companies have cited this to our members as a drawback of the scheme and a reason for not using the EII as a source of finance, and we believe it should be reviewed.

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[13] Section 531AN(4) Taxes Consolidation Act 1997
[14] *Taxes on Income: Ireland in Comparative Perspective* – Callan et al, June 2013

(c) Amend the conditions attaching to Seed Capital Relief

We understand that the conditions attaching to the Seed Capital Relief are also limiting its attractiveness for potential entrepreneurs. The income conditions which apply to the investor in the years prior to the investment effectively limit the relief to PAYE employees and exclude those who have a track record as self-employed entrepreneurs. Another issue is that individuals are required to have capital up front in order to make the investment (with a time-lag between the purchase of the shares and the cash inflow from the tax relief) instead of potentially leveraging the tax relief to make the investment. Difficulty in accessing capital for investment means that the relief cannot be availed of.

We believe it would be worth considering the approach previously adopted for CGT roll-over relief, whereby the cash benefit of the tax saving on the disposal of the “old assets” was applied for further productive investment. Applying this approach to Seed Capital Relief could mean that the income tax refund would arise upfront and then be applied to make the qualifying investment. Appropriate safeguards could be applied, as under CGT roll-over relief, to ensure withdrawal of the relief where the investment does not take place.

4.3 Recommendations to reduce costs and increase employment in the underlying businesses

(a) Introduce a progressive relief from Employer PRSI

One of the most significant disincentives to hiring additional staff is the Employer PRSI liability. The 10.75% monthly cost of taking on an additional staff member has a considerable impact on the cash flow of a small business. The impact of hiring an additional highly-skilled and therefore higher-paid employee is greater due to the fact that the liability applies without a ceiling.

We recognise that the aim of the new Jobs Plus scheme, which replaces the Employer Job (PRSI) Incentive Scheme, is to encourage employers to recruit staff who have been long-term unemployed. However, we would recommend that a broader approach be taken to incentivise employers to hire additional employees. This is the approach being taken in the UK, where, from April 2014, all businesses will be entitled to a £2,000 Employment Allowance per year towards their employer National Insurance Contributions (NICs) bill.

What we recommend is an Employer PRSI relief for all employers who increase their net headcount beyond their current net levels. To encourage employers to continue to build their workforce, the relief would be progressive in that it would increase incrementally for each additional hire. Rather than seeking to apply different PRSI rates during the year, it might be administratively simpler to grant the relief by way of refund at the end of the year, based on the increased headcount. The relief could apply for a limited period of time and the level of relief given could be capped. The relief would need to be reviewed to ensure it operates effectively.

(b) Review the current system for calculating commercial rates

Commercial rates are a fixed cost for business and they currently have little correlation with the size or scale of turnover of the business. Consideration should be given to introducing a reduced rate system targeted at small businesses with low turnover – the ones most adversely affected in the current economic climate, e.g. small retail businesses etc.

4.4 Tax supports for loan funding

Many entrepreneurs with small businesses may be reluctant to dilute share ownership but still have a pressing need to access capital for growth. Loan investment can meet this need for capital and can also provide more flexible options on exit, thereby offering a more attractive option for potential investors with cash.

The Institute, in its submission in advance of the Jobs Initiative in 2011 and in its Budget 2013 submission, made a suggestion which would help to stimulate the provision of loan finance by private individuals to viable SMEs.

A tax relief for individuals making loan capital investments would encourage lending from the private sector into SME businesses. The necessary cost/benefit exercise would be required before making any final decisions, but the proposed relief could have the following characteristics:

- The relief could be limited to investment in SMEs which are active trading companies and where the potential for job creation is demonstrated.
- There could be a minimum investment period of 3 to 5 years.
- To provide additional security for investors, the loan investment could be based on convertible loan stock, with conversion into share capital occurring only in the event of default.
- In order to diversify risk for individual investors, a facility for investing in pooled funds could be made available.
- The relief could be based on a tax deduction for individuals, which could be limited to the standard rate of income tax.
- To compete with other forms of investment, any interest return on these loan investments could be subject to income tax at DIRT rates.
- The administrative burden must be kept to a minimum to avoid some of the difficulties that arose under the Business Expansion Scheme (BES).
- If we are to introduce a meaningful incentive for investment, then it must be excluded from the High Earners' Restriction.

An alternative option may be to permit small pension funds to provide loan finance to active trading businesses. Pension scheme rules in the UK permit small personal pension funds to provide loan finance in certain circumstances. With a Small Self-Administered Scheme (SSAS), up to 50% of the value of the fund can be lent to the company. Security has to be given and the loan has to be made on commercial terms. Land and property can also be purchased from and/or leased back to the company by the SSAS. This can assist in raising working capital funds for the company with the property remaining under the control of the trustees of the fund. The fund can also borrow funds to assist in the purchase of property; borrowing is restricted to 50% of the pension fund value before the purchase takes place.

4.5 Consider targeted measures for key employees

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 can play a key role in achieving this.

We believe that equity incentives can give employees a stake in the medium to long term profitability and success of their employer company, and can be an important tool in aligning the interests of employees and their employer companies.

The mechanisms for rewarding key employees in Irish companies have been restricted considerably in recent years, as equity-based rewards for key employees have been significantly eroded in recent Budgets. While, historically, share-based remuneration had been a favourable method of rewarding employees and giving them a stake in the profitability and success of the business, the income tax regime for approved share option schemes was abolished from November 2010, and 2011 saw the introduction of 4% employee PRSI, which unfortunately coincided with the introduction of the USC.

The introduction of the R&D tax credit surrender option for key employees was welcome, but our feedback is that there is limited take-up due to the conditions which need to be satisfied.

It is particularly striking that there are no employee equity incentives which are geared towards start-ups and SMEs in Ireland. We understand that the set-up and administrative costs associated with Save as You Earn and Approved Profit Sharing Schemes make these types of incentives feasible only for larger companies. We believe it would be worth considering introducing an incentive which would give a small company's key employees a stake in the profitability and success of the company. For any such relief to be effective, the compliance burden on the employer company would need to be as light as possible.

We set out below some approaches adopted in other jurisdictions:

United States – Incentive Stock Options

Where a US 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 will apply when the shares are sold. No more than $100,000 worth of shares can become eligible for exercise in a calendar year.

UK - Enterprise Management Incentives

EMI is a share option scheme which allows SMEs in the UK to grant tax-advantaged share options to employees for the purposes of recruitment and retention.

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 under EMI options to all employees. The shares must be in an independent trading company that has gross assets of no more than £30 million.

The grant of the option is tax-free and there will normally be no tax or NICs for the employee to pay when the option is exercised. There will normally be no NICs charge for the employer.

UK - Employee Shareholder Relief

The UK Government is planning to introduce a new "employee shareholder" status from 1 September 2013. Employee shareholders 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. At Budget 2013, it was announced that the first £2,000 of share value that anyone receives under the new status will be free from income tax and NICs.

4.6 Develop and implement a comprehensive "Roadmap for Entrepreneurial Activity and Investment"

The importance of Ireland's FDI offering is widely recognised and its benefits are consistently and well communicated by Government. We believe that the job-creation and growth potential of the indigenous sector warrants a similar strategy for encouraging domestic entrepreneurship and investment.

The IDA Ireland *Horizon 2020* strategy arose from a comprehensive review of its strategic direction in 2009. Horizon 2020 sets out specific FDI targets for Ireland for the period to 2020 in terms of employment figures, number of investments, target sectors for investment and sources of investment. We believe a similar wide-ranging strategy, a "Roadmap for Entrepreneurial Activity and Investment" consisting of tax and other measures, addressing the broad fiscal climate, and with clear targets for the medium to long term, should be adopted for DDI. This could support the European Commission's objectives as set out in its *Entrepreneurship 2020 Action Plan*.

We support the government's ongoing work on the development of a National Entrepreneurship Policy Statement and we believe that the outcome of that project should be an important element of a comprehensive DDI strategy.

Appendix I – Incentives for SME Businesses

1. Seed / start-up stage

- Deduction for pre-trading expenditure (section 82 TCA97)
- Corporation tax start-up relief (section 486C TCA97)
- R&D tax credit
- Reduced Employer PRSI rate (4.25%) for lower-paid workers

2. Expanding / exporting / mature stages

- Accelerated allowances for capital expenditure
- Foreign Earnings Deduction
- R&D tax credit and surrender option
- VAT 56A procedure
- Corporation tax relief for trading losses
- Jobs Plus Initiative for hiring employees