Alliance for an Innovation-Driven Recovery

Commission on Taxation Submission

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1. Executive Summary

This submission is being collectively made on behalf of the Alliance for an Innovation-Driven Recovery (the "Alliance"), which is a coalition of five national organisations, all of whom have a shared interest in the growth of the indigenous high-growth tech start-up and scale-up sector in Ireland.

The Alliance comprises of **Scale Ireland**, which represents and advocates on behalf of the indigenous tech start-up and scale-up companies; **HBAN** Ireland's largest network of business angels and syndicates with over 15 angel groups across Ireland and abroad; **IVCA** the representative body for venture capital private equity firms on the island of Ireland; **Euronext** the leading pan-European exchange, covering Belgium, France, Ireland, Italy, The Netherlands, Norway, Portugal and the UK; and **TechIreland** an independent not-for-profit, on a mission to promote Irish and Ireland based innovation to the world, through data, content and community activities.

The Backdrop

As Ireland emerges from the pandemic, a key focus will be on rebuilding our economy, creating new high-quality jobs and increasing our economic activity and export-led growth over the medium and long term. We need to put in place strategic taxation measures to facilitate this growth, which will benefit Irish society and the economy over the coming decades. This comes against the backdrop of OECD concerns that Ireland has one of the lowest ratios of exporters to total enterprise numbers in the EU, with only 6.3% of SME employer firms engaged in exporting activity. This compares with 9.6% in France, 17% in the UK and 27% in Denmark. These findings were highlighted in the report of the SME Taskforce, which was commissioned by the Government and published on 21st January 2021.[1]

We are also entering a new global taxation environment, with corporation tax rates no longer being a strong determinant in attracting Foreign Direct Investment. Coupled to this, we have witnessed significant technological advances, the importance of which were underlined during Covid-19, with further substantial progress expected at a pace in the decades to come. So, it is vital that the Commission on Taxation adopts a strategic outlook to harness the potential of entrepreneurs in the indigenous tech start-up and scale-up sector, which has huge potential in terms of innovation, exports, regional employment, revenue generation and leadership skills for Ireland.

Indigenous tech start-up and scale-up companies will play a key role in our economic future over the next decade, and it is vital to create the right conditions and environment to ensure the sector can thrive. There are currently more than 2,000 indigenous tech start-up and scale-up companies employing 47,000 people around the country. "For each additional job in the average high-tech firm, five additional jobs are created outside that firm in the local community".[2]

85% of these companies offer business-to-business solutions and nearly all of them focus on export markets.[3] Irish tech start-up and scale-up are also located across the country, providing employment nationwide. For instance, 188 high innovation-driven companies based in Cork, 151 in Galway and 87 in Limerick. Several companies are also located in counties Clare, Kerry, Kildare, Louth, Waterford.

As these companies scale they become very resilient and have huge growth potential. Five Irish tech start-ups are classified as tech unicorns, and are valued at more than one billion dollars. Three of these companies gained this status during the pandemic, underlying their resilience and growth, and the global potential of their innovations.

1 Irish small business weak on exports, OECD says (irishtimes.com)
2 The New Geography of Jobs (Houghton Mifflin Harcourt, 2012) by Enrico Moretti
3 SME Taskforce Report (2021) p. 33

Vision to support the future of Irish enterprise through appropriate tax policy

We welcome this consultation as we believe that the overall vision of tax policy for Irish enterprise should be to ensure the future of Ireland as a great place to **start, scale and internationalise** a business.

Ireland benefits hugely from scaling industry, both economically - jobs, taxes, economic multiplier - and through the leadership it brings to the next generation of entrepreneurs. The economic multiplier of having these companies headquartered in Ireland, with their IP in Ireland, innovating from Ireland, and most importantly having their centre of economic interest in Ireland is critical for the future success of our country. Indigenous companies are more completely embedded than any foreign multinational will ever be and bring a corporate ambition, sectoral relevance and leadership that delivers to the next generation of entrepreneurship. Hence we need clear Government ambition and vision for scaling of Irish enterprise to a global level and we need a tax policy to support entrepreneurs in the important role they play in this.

We need to firmly put the needs and challenges of scaling enterprise and the founder entrepreneur, who has the ambition to scale to the top of our agenda. Entrepreneurs need to be supported and encouraged to go on to bring their companies to the next level while remaining rooted in Ireland.

Enterprises require access to long-term financing, talent and supportive tax policies in order to grow, improve their competitiveness and better integrate into local and / or global supply chains. A dynamic, efficient, and fit for purpose Irish tax policy can facilitate the provision of capital for Irish enterprise to enable them to start up, continue to grow, innovate and internationalise.

To achieve this, we believe further changes need to be made to our taxation system to support indigenous Irish enterprises and unlock their full potential, while also maintaining a balanced approach for the exchequer. Budgetary cycles often focus on short and medium term priorities. The Commission on Taxation is well placed to recommend a medium and long-term taxation strategy to help these enterprises reach their full potential for our economic prosperity, while ensuring they remain rooted in Ireland. This is an opportunity to ensure that when Irish entrepreneurs are deciding where to start or scale their business from, that Ireland provides the support they are looking for at all steps of the journey. If we fail at any step on this trajectory then we risk encouraging people to start here but then to move elsewhere as they grow and create value.

The Commission needs to look at measures to facilitate the availability of finance to high-innovation driven companies in Ireland. Wider participation from private investors should be more forthcoming. Examples include: initiatives to help companies on research and development activities as well as initiatives to assist access to talent. These can be assisted through amendments to the R&D Tax Credit scheme and KEEP share option schemes. A key challenge facing indigenous start-up and scale-up companies is their ability to retain and attract talent. Reform of the KEEP share option scheme will be vital in order to allow indigenous start-up and scale-up companies to compete for staff with companies in other countries, as well as multinational companies that are based here. This would also help to maintain high-quality tech jobs in Ireland.

Separately, the Employment Investment Incentive Scheme ("EIIS") should be made more accessible and user-friendly for both individuals and companies. This would help Irish companies to raise capital to scale faster, increase their exports in international markets, and create a positive impact on the Irish economy.

We also believe that a simple reduction in the CGT rate to 20% would also be an effective tool to encourage greater investment in SMEs, we are also supportive of further enhancements to the CGT Entrepreneurs Relief regime.

We also feel the establishment of a scaling division within Revenue would facilitate and support Irish companies to efficiently access support and incentives and alleviate some of the difficulties they are currently facing.

The Alliance welcomes the opportunity to outline its proposals to the Commission on Taxation.

2. Summary of our Key Proposals

2.1 Research and Development Tax Credits

The Finance Act 2019 introduced a series of targeted changes in relation to R&D Tax for small and micro companies, including increasing the rate for small and micro companies from 25 percent to 30 percent as per section 766(2) TCA 1997. However despite the passage of the Finance Act 2019 by the Oireachtas, these measures have yet to be enacted. This would have been of significant benefit to small and micro companies. The Alliance for an Innovation Driven Recovery strongly now believes the best possible way to facilitate and help early stage start-ups is to monetise the R&D tax credit in year one, which would have a huge impact on their operations during the initial loss making period.

1. Monetisation of the R&D tax credit in one year (for small and micro companies).
2. Increase the 15% subcontractor cap to 50%, particularly for SMEs.
3. Amend S.766, TCA 1997, to ensure that all costs incurred in engaging in R&D activities are allowed in the calculation of the R&D tax credit (e.g including appropriate allocationsof overhead and rental costs).
4. An increase to €125,000 in the science test exemption for companies in receipt of EI/IDA grants.
5. The R&D tax credit should include ongoing activities within SMEs (‘process innovation’, ‘organisational innovation’), to improve and enhance their business processes and products and in particular, the adoption of productivity and efficiency enhancing processes.

2.2 Reform of Share Options

1. Equity ownership under the KEEP scheme should not be linked to annual salary and the cap should be raised.
2. The KEEP scheme needs to provide greater certainty in relation to tax treatment if a company grows.
3. The KEEP Scheme must be simple, clear, and easy to implement.

2.3 Reform of EIIS

In order to ensure that EIIS is a vehicle that can a make significant impact in its role as a provider of risk finance to SMEs, we believe that the scheme should be redesigned to include the following:

1. Enable loss relief on investments under EIIS.
2. Seek an increase in investment limits under EIIS.
3. Standardise the investment period to four years for all qualifying investments.
4. Enhanced reliefs for investing in micro-companies.
5. Greater clarity and increased certainty for companies that they are eligible for EIIS and simplification of the process.

The introduction of a CGT exemption on all qualifying investments remains an overarching objective of the Alliance, but given the current circumstances, there is a strong imperative to focus on loss relief in order to incentivise more investors to be encouraged to put their capital at risk and ensure greater levels of investment in higher risk/lower asset backed ventures.

2.4 Lower rate of Capital Gains Tax for investment in SMEs

1. Introduce a 20% lower rate of CGT, to encourage investment in early stage and scaling companies (SMEs).

2.5 Improve CGT for Entrepreneurs

While we believe that a simple reduction in the CGT rate to 20% would be an effective tool to encourage greater investment in SMEs, we are also supportive of further enhancements to the CGT Entrepreneurs Relief regime. We believe that ambitious entrepreneurs and founders are critical to ensuring that SMEs get started in the first instance, and it is the entrepreneurs and founders that are critical to their success and ability to scale. In that context, we would propose the following:

1. Raise the lifetime cap of CGT Entrepreneur Relief (S.597AA, TCA 1997):
   Raise the lifetime cap on the relief to €10M, on a phased basis if necessary.

2. Enable "Entrepreneur relief" to be available on "scaling dividends".
   These would be dividends paid by scaling companies to entrepreneurs and founders, and would encourage entrepreneurs to "stick with a company" and continue to grow it, rather than selling out to secure a CGT return.

2.6 New Scaling Division with Revenue

1. Revenue should consider setting up a dedicated Scaling division to proactively assist the development of scaling companies in a manner that represents their potential long-term benefits to the Irish economy.

2.7 Sustainability

1. To explore the possibility of Scale Ireland and Enterprise Ireland working together to help educate HPSUs to form a sustainability agenda, which should be aligned with the UN SDGs.
2. To promote best practice in the sector, Enterprise Ireland could establish a *Sustainability for Growth Programme*. This would involve early stage start-ups who receive EI funding, gaining access and participating in the programme.
3. As part of this initiative, Scale Ireland and Enterprise Ireland could work together to help start-ups learn about KPIs in general and also in relation to sustainability.
4. Enterprise Ireland to publicly promote best practice with a clear sustainability statement, with specific targets in line with SDGs.

3. Key Proposals

3.1 R&D Tax Credits

The Finance Act 2019 introduced a series of targeted changes in relation to R&D Tax Credit for small and micro companies. The measures include:

- The R&D tax credit rate for small and micro companies was due to increase from the standard rate of 25 percent to 30 percent as per section 766(2) TCA 1997.
- The more favourable methodology to calculate the refundable R&D tax credit amount for small and micro companies as per section 766B(3)(c) TCA 1997.
- New section of legislation (section 766C TCA 1997) to enable small and micro companies to claim the R&D tax credits.

However despite the passage of the Finance Act 2019 in the Houses of the Oireachtas, these measures have yet to be enacted - which is of major disappointment to micro and small businesses who would have benefitted. These changes would make the R&D Tax Credits more attractive for start-up companies and reduce some of the barriers to claiming the credit.

Following consultation on state aid rules with the EU Commission, in December 2021, the Minister for Finance stated that *'Following initial engagement with the Commission it was determined it would be necessary to introduce some changes to the enhancements for micro and small companies to secure state aid approval. However, as the measures in their current form are enhancements to the existing general research and development tax credit this could pose a significant administrative challenge to taxpayers and Revenue if different criteria were to apply to two elements of a claim for the same research and development cost. Adding complexity and an administrative burden would be counter-productive to the aim of assisting small and micro companies. The Minister added 'on whether this is something I will progress further, at this point it will be difficult for me to fulfil the original commitment I gave on enhancing the research and development regime for micro and small companies given the issues I have just acknowledged.'*

The Minister also stated that he is *'now looking at other ways in which we might support innovation for small, innovative companies'*, and the Alliance for an Innovation Driven Recovery strongly believes the best possible way to facilitate and help early stage start-ups is to monetise the R&D tax credit in year one which would have a huge impact on their operations during the initial loss making period.

It is also noted that in reference to accelerating the refund, the Minister mentioned that only a small number of claimants sought to avail of the refund (31% looking at 2019 numbers, and 69% used the credit within the current accounting period).

Those companies that were able to use the credit in the current year would have been profit making companies with the ability to use their R&D tax credit against their corporation tax liabilities. Start-up or scale-up companies in the pre-profit phase will undoubtedly have comprised many of the 31% of companies seeking to secure a refund. Securing the refund in year 1, as opposed to over a 3 year period, would make a significant difference to those companies, most of whom are in a loss making position during start-up and scale up phase.

It is precisely these companies who would benefit greatly from an acceleration in the refund period, and this could be done without increasing the cost to the exchequer.

Proposal 1: Monetisation of the R&D tax credit in 1 year and the cash flow impact.

ISSUE: Monetisation of tax credit is an important part of the R&D tax credit regime for start-up companies, as in many cases they are in the initial development phase. Access to the R&D Tax Credit is an important part of the cash flow resources to these companies. The temporary measures to accelerate 2021 R&D tax credit instalment payments was appreciated and should be continued.

SOLUTION: Rather than a monetised payment in 3 instalments, it would be of significant benefit for small and micro companies if it was possible to pay out the refundable tax credit in 1, rather than 3 years. This would significantly improve cash flow for the company without necessarily increasing the cost to the exchequer.

Proposal 2: Cap on eligible subcontractor costs.

ISSUE: Many start-up companies don't have the level of internal labour resources required in relation to their development and have to engage contractors as part of their research and development work. At the moment, the R&D tax credit legislation only allows an amount of contractor costs based up to the greater of 15% of the company's qualifying internal R&D spend or €100,000.

SOLUTION: It would be beneficial if the 15% cap could be increased to 50%, particularly for small and micro companies.

Proposal 3: Amend Section 766, TCA 1997 to ensure appropriate overhead and other relevant costs are permitted in the calculation of R&D tax credit claims.

ISSUE: Revenue has taken the position that rent and many other overheads do not necessarily qualify in calculating the R&D Tax Credit. The concern appears to stem from the reference in S.766, TCA 1997, to qualifying expense being expenses "incurred wholly and exclusively in the carrying on of R&D". This position has developed overtime and it is now necessary to address the matter as it is inconsistent with the treatment over a long-standing period of time. It is also inconsistent with the Department of Finance's references as part of the prior R&D tax credit consultation processes on how the Irish R&D tax credit regime allows indirect costs incurred wholly and exclusively in the carrying on of R&D including building costs.

SOLUTION: Delete the reference in S.766, TCA 1997, to expenses "incurred wholly and exclusively in the carrying on of R&D" and replace it with something along the lines of "expenses incurred in performing R&D".

Proposal 4: An increase to €125,000 in the science test exemption for companies in receipt of EI/IDA grants.

ISSUE: The existing provision within Revenue guidance that allows companies in receipt of IDA or Enterprise Ireland innovation grants up to the value of €50,000 is a valuable and possibly underused provision of the R&D code. We believe there is the potential to considerably reduce the administrative burden on scaling companies and help de-risk the R&D scheme from their perspective.

SOLUTION: To further enhance the value of these provisions and to support companies growth potential in the sector we would like to see the cap pertaining in this area to €125,000 which would bring it in line with the average relief amount afforded to companies.

Proposal 5: The R&D tax credit should include ongoing activities within SMEs ('process innovation', 'organisational innovation'), to improve and enhance their business processes and products and in particular, the adoption of productivity and efficiency enhancing processes.

ISSUE: While the R&D credit is an important and appreciated tool used by the scaling tech sector the science test is narrowly defined and excludes research and innovation expenses incurred in bringing a product to market readiness.

SOLUTION: A broader definition of innovation, used elsewhere in the tax code, would be more reflective of the real challenge facing companies in the commercial marketplace and assist company development and progression in this critical sector of the economy.

3.2 Share Options

KEEP (Key Employee Engagement Programme) is a share option scheme introduced in Finance Act 2017 specifically for employees and directors of certain qualifying SME companies. It is subject to no income tax, USC or PRSI at the date of grant or exercise. Generally, a key employee must hold the option for 12 months prior to exercise and may exercise it at any time up to 10 years after the date of grant. Therefore, 2019 is the earliest year in which individuals may exercise their options to acquire shares in the qualifying companies. The aim of the KEEP scheme is “to help SMEs attract and retain talent in a highly competitive labour market[2]” It was designed to help early-stage Irish companies successfully compete with Multinationals to attract and retain key employees. Since start-ups are highly cash constrained, they rely on their ability to offer share options and ownership to attract talent. [9] [10]

So far, the KEEP scheme is failing to achieve its goal, and take-up of the scheme has been very low. Based on Scale Ireland’s research, as well as interviews with other stakeholders, we’ve identified how the KEEP scheme can be modified to better help startups compete for key employees: [11] [12] **Figures provided by Revenue (October 2019) show that companies granted qualifying share options to 87 key employees under the Key Employee Engagement Scheme during 2018 (the first year of the scheme)**. 2019 is the earliest year in which individuals may exercise their options to acquire shares in the qualifying companies.

Updated figures received from Revenue in December 2021 indicate a minimal level of uptake as the number of employees exercising KEEP share options in 2019 was less than 10 (the exact number of claims is not provided due to Revenue’s obligation to protect taxpayer confidentiality). The approximate cost of the scheme was approximately €0.1m.

In addition to the proposals below we would encourage the Government to give effect to the provisions in relation to KEEP contained in Finance Act 2019, which are yet to be the subject of a commencement order by the Minister for Finance. This should be a priority matter.

Proposal 1: Remove the link between equity ownership and salaries under the KEEP scheme (S.128F, TCA 1997) and raise the cap on share options

PROBLEM: Cash-constrained startups already pay below market salaries and cash compensation. Offering equity ownership is how they compensate for relatively low cash remuneration. Tying the market value of KEEP share awards to already low cash compensation and capping annual awards only ensures that the equity awards will also be below market, and therefore ineffective in helping startups compete for top talent. By enacting this rule, the government has guaranteed that Irish companies will never be able to compete for talent on a level playing field with bigger companies. Of course, if the compensation of such individuals is significant then that could bring about increased KEEP rewards, but that is not the case with start-ups.

SOLUTION: It is recognised that KEEP brings about reduced taxation for the employee and therefore an unlimited amount of remuneration in the form of KEEP compensation would not be appropriate. Therefore consideration should be given to introducing a greater cap, ultimately limiting share options to 20% of the total equity of a company for employees, and 2% of the total equity of a company for individuals that could be granted (on the date of granting) to employees under the KEEP scheme. It should not be linked to annual remuneration and the scheme should also be widened to include key people who play a pivotal role in a company and work less than 25 hours in a week. This would allow companies to utilise the scheme to attract the services of NEDs and key advisors.

IMPACT: This should allow the Irish start-ups to compete for technical and management talent at home and abroad. Further it would bring about a simplicity of explanation of compensation structures in attracting talent. Under the current KEEP scheme rules, the government has put domestic start-up enterprises at a disadvantage in their ability to compete for critical talent both inside and outside Ireland.

Proposal 2: The KEEP scheme needs to provide greater certainty in relation to tax treatment if a company grows.

PROBLEM: Current rules limit the value of KEEP share option awards such that the total market value of the issued but unexercised qualifying share options does not exceed €3,000,000 per company. This may punish company growth, which is entirely counter to the government's goal of supporting the growth and development of a strong domestic startup ecosystem.

SOLUTION: Consideration should also be given to increasing the limit of share awards available to a qualifying company to 20% of the total equity of the company. Further clarity is also needed on the 3 million cap under the scheme.

IMPACT: This would give certainty around the scheme as a company grows, make larger Irish companies eligible under the scheme, and therefore more attractive to employees.

Proposal 3: The KEEP Scheme must be simple, clear, and easy to implement.

PROBLEM: Early-stage startups do not have the appropriate staff, or the appropriately sized legal and accounting budgets to set up and implement a complex scheme like KEEP. For example, determining the market value of the shares is critical to the implementation of KEEP, but there is no clear or safe harbour guidance about how a startup can determine the value.

SOLUTION: Allowing for standard industry practices such as relying on the valuation of the most recent round of financing would give founders the simplicity, clarity, and certainty they need to implement KEEP. Alternatively, the valuation requirement should be replaced with a limit of 20% of the equity of the company that could be granted (on the date of granting) to employees.

IMPACT: Replacing the current valuation method will provide greater clarity to founders and will make the scheme more accessible to target businesses.

Proposal 4: Narrow the list of excluded activities

PROBLEM: The current definition of excluded activities excludes companies engaged in defined 'professional services', which appears to conflict with policy intent to promote the location in Ireland of higher value services, e.g. FinTech, InsurTech, and more generally trading activities which draw upon the skills of employees with professional services qualifications.

SOLUTION: Narrow the scope of excluded activities to align with the Government's understood policy intent of promoting Ireland as a location for higher value services, e.g. FinTech, InsurTech, BioTech, professional services, etc.

IMPACT: Allows a wider scope of businesses to be eligible to provide KEEP shares to employees, and compete with international employers for talent.

Proposal 5: Lack of liquidity in employee shares

PROBLEM: To compete with international employers for talent whose shares are readily traded on a stock exchange, SMEs require assurances that any arrangements to provide liquidity in the employee shares in the case of non-listed shares and to buy back shares in tranches from employees continue to be eligible for capital gains tax (CGT) treatment and are not inadvertently brought within the scope of income tax by reason of failure to meet the technical requirements of the share buyback provisions at S.176, TCA 1997 and related sections.

SOLUTION: Provide certainty that private companies can provide for share buy-out arrangements for KEEP shares held by employees other than a share buyback by the issuing company (which may not always be possible).

IMPACT: Providing certainty to employees that the shares are eligible for CGT treatment upon disposal and allowing employers to buy back shares in tranches will allow SMEs to genuinely compete with international employers for talent.

3.3 The Reform of EIIS - needs to be updated

While the aggregate value of deals in 2021 has increased, the deal count for 2021 according to KPMGs Venture Pulse for Q3 2021 declined to its lowest number since Q1 2020. The Irish Venture Capital Association's investment figures for 2021 to date show overall funding grew by 11% to €872m in Q1-Q3 2021, compared to €786m the previous year. However, despite growth in investments into companies below €5m, some concerns remain.

While seed funding, which typically represents first investments by equity investors, rose by 63% to €31m from €19m in the latest Q3 2021 IVCA data. This figure represents a turnaround on previous quarters in 2020 and 2021, which showed a significant decline in seed funding since the start of the pandemic. The implications of the decline in seed funding over the last number of years is illustrated by comparison with our European peers. A recent Pitchbook analysis showed that since 2016, European seed rounds are 4 times larger. However, in Ireland, during the same period seed funding has doubled, meaning that we are doing half as well as our European peers.

Year	2016	2017	2018	2019	2020
Avg Seed Rounds	€350k	€350k	€354k	€554k	€728k

Separately, TechIreland carried out a review of EIIS Investments over a ten year period from 2007-2018. This analysis is based on data from Revenue on investment raised between 2007-2018, under four key schemes: Business Expansion Scheme (BES); Employment Investment Incentive Scheme (EIIS); Seed Capital Scheme (SCS); Start-Up Relief for Entrepreneurs (SURE).[45] **Under 27% of investments have gone to High-Growth Start-ups and Scale-ups.**[6] The majority of investment (73%) under the four schemes has been focused on lower-risk businesses, as distinct from higher-risk, high-growth start-ups and scale-ups. This statistic is consistent for both the percentage of companies receiving investment and the percentage of money invested.

Proposals to Reform EIIS

The Alliance for an Innovation-Driven Recovery made an extensive submission to the Department of Finance in relation to its public consultation on EIIS. The Alliance also attended a two-day public consultation on reform of the scheme to help early stage start-ups attract vital private investment, and also to nurture a stronger culture of Angel and institutional investment in innovation-driven enterprises, which have huge potential in terms of innovation, exports and regional enterprise. We welcome measures announced in Budget 2022 to broaden the types of Investment vehicles that are eligible under the scheme, and also efforts to simplify the process. We have also outlined our key proposals below:

1. Provide loss relief on investments made under EIIS
2. Seek increase in investment limits under EIIS
3. Standardise investment period to four years for all qualifying investments
4. Enhanced relief for investing in micro-companies
5. Increase certainty for companies that they are eligible for EIIS and simplification of process

The Alliance has consistently sought in its various submissions to the government, to Incentivise more investments in SMEs, by providing an exemption from capital gains tax for all qualifying investments. This is still an overarching goal for the Alliance which we believe would incentivise private investment. However, in the short term, we are focusing on prioritising loss relief on investments under EIIS.

EIIS is a critical investment incentive scheme to foster equity-based risk finance for early-stage high-risk companies. In light of the difficulty in accessing funding for high-growth tech start-ups and scale-ups which has been heightened by Covid-19, it is critical that EIIS is reformed to ensure these companies can not only be sustained but scaled through private investment. We recommend several key changes to EIIS, as outlined in our EIIS Submission.[7] **These proposed changes to EIIS could help replace existing government financial support for start-ups with investment by private capital; thus reducing the net cost to the exchequer.**

Proposal 1: Provide loss relief on investments made under EIIS

Central to all of our recommendations is the critical objective of ensuring that more capital can be provided to Irish-based companies to enable them to grow and scale. In order to do that, it is imperative to encourage more individual investors to take the leap of faith required to enable them to invest their own money [or savings] in Irish companies. We believe that by providing loss relief on investments made under EIIS schemes, investors may be more willing to make investments that they may otherwise simply choose not to make.

If more individual investors can be encouraged to invest in companies through EIIS arrangements, companies will have greater access to funding. This recommendation would allow investors a form of loss relief on the loss-making investment and would put such shares on a similar footing to losses made on non-EIIS shareholdings from a Capital Gains Tax perspective. (It should be noted that this issue is one of long-term structure and one that will remain in a post-Covid environment).

[4] Revenue review of BES/EII/SCS shares issued 2007-2018
[5] EIIS Statistics 2011-2018
[6] Revenue.ie: BES/EII/SCS shares issued on or after 1st January 2007-2018
[7] EIIS Submission (25th November 2020) by the Alliance for an Innovation-Driven Recovery

PROBLEM: Investors know that if their investment in an EIIS company succeeds, then any gain arising on the disposal of their investment would be subject to tax. However, unlike the other shareholdings, there is generally no relief for any loss arising on disposals of EIIS shares, where the investment is not successful. Therefore, EIIS shares are treated less favourably from a Capital Gains Tax perspective than other investments. As you will be aware, CGT loss relief is provided for under the UK's EIS.

SOLUTION: Introduce CGT loss relief on failed or loss-making EIIS investments.

IMPACT: This would remove the difference in CGT treatment between EIIS and other investors. This would make EIIS investments more attractive to potential investors, thereby increasing the supply of capital to Irish based companies.

Proposal 2: Seek increase in investment limits under EIIS

As with point 4.1, the purpose of this suggestion is to ensure that funding sources available to companies are maximised. This proposal should also assist companies in streamlining the number of investors they need to attract to fund their development and may enable them to raise more meaningful amounts to accelerate their development. This will also likely reduce the costs associated with raising EIIS funding (which is also a concern we have addressed below – in recommendation [4.6]).

PROBLEM: The current maximum allowable investment in an EIIS company is €500,000. That has a 7-year retention period. The UK's EIS has a maximum allowable investment in an EIS company of €1m, with a shorter retention period. This difference in investment level makes Ireland's regime less competitive and makes it more difficult for companies to raise significant funds through EIIS; we discuss the retention periods in a separate point.

SOLUTION: Increase the investment limits to €1m per investor.

IMPACT: This would remove some of the differences between the Irish and UK systems and should enable companies to raise more significant amounts with fewer investors and administrative burden. It should expand the cohort of investors prepared to invest in companies under an EIIS, again increasing the pool of investors willing to invest in Irish based scaling companies.

Proposal 3: Standardise investment period to four years for all qualifying investments

PROBLEM: Finance Act 2019 amended the annual limit an investor can make from €150,000 per annum to €250,000 and €500,000. Where an investment of greater than €250,000 is made, the investor must retain the qualifying shares for seven years. The increase to the annual limits has been welcomed by the Alliance. With the economy currently contracting, there is a limited appetite by investors to lock in a substantial investment for a seven-year period. Where an SME is fortunate to attract an investor that can invest greater than €250,000 in a year, the seven-year retention period is a substantial barrier to invest.

SOLUTION: To incentivise investors to make investments greater than €250,000, we are recommending that the investment period for all qualifying investments up to €500,000 is adjusted to four years. It should be noted that as an alternative to investing €500,000 which attracts a seven-year retention period, investors can make an annual investment of €250,000 per annum for two years. As the investment amount is €250,000, the qualifying investment period is four years. As such, the investor can obtain the same quantum of relief of €500,000 over a two-year period but reduce the total investment period from seven years to five years. However, in the current economic environment and with the shortage of liquidity in the marketplace for SMEs, it is important that businesses can obtain the maximum funding upfront.

IMPACT: As such, reducing the investment period from seven years to four years for investments up to €500,000 will incentivise the investor to make a greater upfront investment. This would result in efficiencies regarding administration and the additional cost to the exchequer should be negligible, on the basis, it is simply bringing forward the relief to the investor by one year. This will also give companies the certainty required to execute their strategy knowing that the required funding is in place.

Proposal 4: Enhanced relief for investing in micro-companies

PROBLEM: Providing funding to businesses that are high-risk, high-potential, innovation-driven and early-stage is inherently riskier than investment in more established asset-backed enterprises. As the economy contracts, limited private sector funding is available and the appetite for riskier investment has substantially diminished. The EII scheme, therefore, needs to acknowledge that not all businesses that qualify for the scheme will be an equally attractive investment prospect to investors. To encourage investors to bear the additional risk of investing in high-risk start-ups and early-stage businesses, additional relief for the investor is required.

SOLUTION: Our recommendation is that the EIIS relief should be extended to provide a deduction for USC and PRSI purposes where the qualifying investment is in a "micro company". The Taxes Consolidation Act already recognises that the investor profile for micro-companies is substantially different from other SMEs eligible to participate in the EII scheme. It is proposed that the extended relief should be available to investors in micro-enterprises, within the meaning of Annex 1 of the General Block Exemption Regulation. A micro-enterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed €2 million.

IMPACT: By limiting the application of the extended relief to micro-companies, it should strike the appropriate balance of Exchequer cost while ensuring that such expenditure is also focused on smaller, higher risk, higher potential enterprises. Connected party rules could also potentially be amended for micro-companies to further incentivise enhanced relief.

Proposal 5: Increase certainty for companies that they are eligible for EIIS and simplification of process

PROBLEM: The need for certainty is essential in the operation of any tax relief. Currently, investors do not have certainty that investee companies will be able to retain EIIS status as they are subject to audit in subsequent years.

If the company subsequently is admitted to trading on an EU SME Growth Market (or equivalent) this would not result in the relief granted to investors under the EIIS being withdrawn.

A key issue for early-stage start-ups is the cost of capital. In Ireland, the cost of capital is unacceptably high. For start-ups, their cost of capital is driven by both the terms of investment and the time, effort and opportunity cost required to secure and manage the investor. As such, a streamlined EII process has the potential to reduce the cost of capital to innovation-driven enterprises and would be highly desirable. In the UK, tax advisers typically charge between £500 and £3,000 for completing an EIS application depending on the complexity of the company's circumstances, whereas in Ireland, the cost is on average €10,000 which is a deterrent to companies. In addition, a simplification of the rules around connected persons could be considered as part of the simplification process, and would bring about further certainty for applicants

SOLUTION: To provide companies with certainty, we are recommending that a company is provided with a final confirmation that it is eligible for EIIS investment where the information provided to the Revenue Commissioners is correct and complete. Separately, the Indecon report states that "An amended enterprise investment scheme should involve a simplified application process to facilitate efficient decision making and approval should focus on confirming the eligibility of companies." It goes on to state that "A simplified process involving less restrictive conditions should apply for start-ups that are raising limited investments."

IMPACT: This would only involve one stage in the Revenue approval process and would increase the confidence of investors. Reducing costs involved in an EIIS application would incentivise more investments into early-stage tech companies and ensure more companies avail of the government incentives

CGT exemption on all qualifying investments

The Alliance has consistently sought in its various submissions to the government, to incentivise more investments in SMEs, by providing an exemption from capital gains tax for all qualifying investments. This is still an overarching goal for the Alliance which we believe would incentivise private investment. However, in the short term, we are focusing on prioritising loss relief on investments under EIIS.

PROBLEM: In an address to the Institute of International and European Affairs, the Central Bank Deputy Governor warned that "Half of large corporations hold less than 8% of annual turnover in cash. Half of SMEs hold less cash and SMEs have less access to undrawn credit than their larger counterparts." Liquidity is a substantial issue for SMEs and COVID-19 has increased the risk of insolvency.

The knock-on impact of reduced liquidity on the economy is an increase in unemployment, reduced spending, reduced tax revenues and additional cost to the exchequer in the form of welfare payments. The pre-existing difficulty in accessing financing/ investment by SMEs has further reduced with the economy contracting. The appetite to invest in riskier assets, such as SMEs, has reduced substantially.

SOLUTION: We have previously seen the success of implementing a CGT exemption[8] to intervene when the Irish property markets were stagnating. In 2011, a CGT exemption for property purchased during the period 7 December 2011 and 31 December 2014 resulted in a substantial increase in the amount of both domestic and international exemption[9] to intervene when the Irish property markets were stagnating. In 2011, a CGT exemption for property purchased during the period 7 December 2011 and 31 December 2014 resulted in a substantial increase in the amount of both domestic and international investors into the Irish property market. We are recommending that in addition to income tax relief (see below), a capital gains tax exemption is introduced and should apply to all qualifying EIIS investments. The exemption would apply to disposals made after the expiry of the four year investment period. We are recommending the exemption is time-bound to balance the cost to the Exchequer with the current market failing to invest in riskier assets, such as SMEs, where access to liquidity is imperative for the business' survival. The reality is, many investors in SMEs do not actually realise gains on their investments. However, the lucky few do.

IMPACT: By providing a CGT exemption on gains made on the ultimate realisation of EIIS investments, the Government could provide an added incentive which might encourage otherwise reluctant investors to put their capital at risk.

[8] Section 604A, Taxes Consolidation Act (1997)
[9] Section 604A, Taxes Consolidation Act (1997)

Proposal 3.4: Lower rate of Capital Gains Tax for investment in SMEs

PROBLEM: Investment in early stage and scaling companies remains a significant challenge in Ireland. This can stymie the development and growth of those companies, which never really deliver the economic and employment potential they might otherwise be capable of. Alternatively, they reach their potential, with most activity and economic activity diverted outside Ireland.

SOLUTION: Encourage a broader range of investors to invest in productive (non property) SMEs by providing a carrot of a 20% CGT rate on gains which might ultimately arise on those investments.

IMPACT: Unlock significant additional funding/finance, and help direct savings accrued during the pandemic for early stage and scaling companies to enable them to grow ambitiously and fulfill their potential. With additional investors on board, the nexus of these companies is more likely to remain here in Ireland generating additional employment and economic activity. In addition, reducing the CGT rate on the disposal of non-property SMEs may facilitate greater liquidity and enhanced CGT yield to the Exchequer.

By international standards, investment in early stage and scaling companies remains a significant challenge here in Ireland. As a result, many companies have been stymied in their development and have not gone on to reach the economic and employment generating potential that they may have been capable of with additional investment. Other, potentially more ambitious companies, have gone on to secure investment from international investors, which has proved very positive for the companies themselves but as noted earlier, can result in the nexus or control of the company moving out of Ireland, and Ireland Inc significantly missing out on the positive dividends to be achieved by growing and scaling a company in and from Ireland.

Ireland's CGT rate of 33% is significantly higher than the rate of tax levied on gains in many other countries, being the fourth-highest among 35 countries in the OECD. Indeed in the 2019 OECD assessment of Ireland's policy framework it was highlighted how *"entrepreneurship activity could be being constrained by high rates of personal taxation and capital gains tax (CGT)"*. Reducing the rate, to say 20%, on disposals of shares in SMEs, would offer a "carrot" or positive encouragement to investors to redirect a greater allocation of their investments into Irish (non- property based) SMEs.

Indeed CGT only accounts for a small portion of Ireland's overall tax take (2.4% in 2021 -, €1.642m out of a total of €68.410m in 2021, up from 1.5% in the previous year when taxes were up over 19% in total). Reducing the rate that applies to investment in productive SMEs may also ultimately encourage greater liquidity in these assets, which could ultimately increase the CGT exchequer tax take.

Addressing the gap in investment in SMEs through tax incentives such as EIIS does make a difference (and we have some suggestions in that regard in this document) but the impact is modest. A step change to the investment ecosystem could be promoted via simple yet ambitious changes to the CGT system. For instance, the introduction of a lower CGT rate on gains on investments in SMEs, whilst leaving the 33% rate in place for gains in investment property, should encourage private capital to invest in productive assets capable of delivering greater employment and economic benefit to the country. In addition, incentive schemes that offer tax breaks for retail investors in SMEs have been utilised in other countries with some success, and a similar approach may be worth considering in the Irish context. These initiatives ought to boost financing for Irish SMEs from the investment community as well as retail savers, which would lead to an increase in economic output and jobs and greater sustainability in CGT taxes raised by the Exchequer.

3.5 Improve CGT for Entrepreneurs

While we believe that a simple reduction in the CGT rate to 20% would be an effective tool to encourage greater investment in SMEs, we are also supportive of further enhancements to the CGT Entrepreneurs Relief regime as we believe that ambitious entrepreneurs and founders are critical to ensuring that SMEs get started in the first instance and it is the entrepreneurs and founders that are critical to their success and ability to scale. In that context, we would propose the following:

Proposal 1: Raise lifetime cap of CGT Entrepreneur Relief (S.597AA, TCA 1997):

Raise the lifetime cap on the relief to €10M, on a phased basis if necessary.

PROBLEM: Lack of funding for early stage and scaling companies. Necessity to improve the "carrot" to help motivate and drive ambitious founders and entrepreneurs to grow and scale companies.

SOLUTION: Improve Entrepreneurs Relief by raising the lifetime cap on the relief to €10m, making a meaningful delta between the potential benefit of founding and scaling a company. Consider also introducing a "scaling dividend" along similar lines (ie cap of €10m at a tax rate of 10%) to encourage entrepreneurs and founders to stick with a business rather than selling out.

IMPACT: Entrepreneurs and founders would be more motivated to drive growth and scale companies, resulting in significant economic benefit to the State (through jobs, higher value economic activity etc), and ultimately higher tax take.

Proposal 2: Enable "Entrepreneur relief" to be available on "scaling dividends".

These would be dividends paid by scaling companies to entrepreneurs and founders, and would encourage entrepreneurs to "stick with a company" and continue to grow it, rather than selling out to secure a CGT return. We recommend that it would a 10% tax rate on dividends up to €10 million (this would not involve any doubling up and an overall limit of €10 million would apply to proposals 1 and 2).

3.6 New Scaling Division within Revenue

PROBLEM: Ensuring a consistent focus on policies which are relevant to scaling companies and which would incentivise more companies to scale is something which is difficult at present due to the diffuse nature of the structures internally.

SOLUTION: Creating a scaling unit within Revenue would allow for the pro-active assistance in the development of scaling companies in a manner that represents their potential long-term benefits to the Irish economy.

Further, the scaling division could assess tax compliance and cash flow costs for scaling businesses together with efficient use of Revenue resources thereby offering efficiencies in these areas e.g. reduced turnaround time in processing refunds where applicable. The scaling division will improve revenue consistency in dealing with scaling companies.

IMPACT: We have considered how this impacts scaling companies for instance in relation to R&D Tax credits.

For instance, the primary difficulty that scaling ventures experience with the R&D tax credit scheme revolves around the administrative burden involved in meeting the requirements of the Finance Acts and Revenue guidelines, offset against the potential benefits that accrue from doing so and penalties that might arise from doing so. It is generally accepted view within the advisory community that the administrative burden associated with the UK scheme is less onerous than that applying in Ireland.

The 2019 OECD review 'SME and Entrepreneurship Policy in Ireland' identifies this as an issue.[1] "SME involvement may be held back by difficulties in understanding how to use the scheme and the costs of preparing, filing and defending claims." Essentially, there is a risk reward matrix in play driven by a number of factors:

1. The potential benefits from applying from the R&D Tax Credit scheme are offset against the risks of experiencing a revenue audit or incurring penalties if the application for the credit does not meet the test. Fear of audit carries not just the risk attached to being found in error, it also accentuates the time commitment involved to successfully pursuing a claim. Moreover, fear of the brand damaging prospect of publication of name by Revenue is a strong driver too with fears expressed about possible implications for future funding terms. The potential benefits are also offset against the administrative burden involved in applying. Startups and scaleups are lean companies by definition. Many have no traded income and their existence revolves around advancing their product or software from one funding round to the next. Many will not have full time finance functions, rather relying on outsourced support, and staff may be engaged in a wide-ranging series of activities. One successful entrepreneur described the process as a 'time suck'.

2. The nature and changeability of Revenue guidance is also cited as an obstacle with excessive risk attached to self-certification of aspects of claims. For startups and scaling companies, the cost of external advisers is also a factor here. Many cited an inconsistency in Revenue approach and the demand that companies are required to operate to a Revenue timeline.

3. Anecdotal evidence would suggest that companies that should apply are dissuaded from doing so. While many report positive engagement with Revenue others feel that Revenue response can be variable. Meeting both the science and accounting tests for the R&D credit are serious challenges in this context. Many founders are simply dissuaded from doing so. The potential benefit arising from doing so seems small compared to the risks attached and this displaced activity from doing so.

[1] SME and Entrepreneurship Policy in Ireland, OECD, 2019.

3.7 Sustainability Proposals

The Alliance wants to ensure that start-up and scale-up companies have the opportunity to pursue best practices in relation to sustainability.

We want to ensure start-ups have the resources and expertise to achieve a carbon-neutral future, and to achieve this, we have made the following proposals which will incorporate a cost in terms of resources for Enterprise Ireland.

To explore the possibility of the Alliance and Enterprise Ireland working together to **help educate HPSUs to form a sustainability agenda**, which should be aligned with the UN SDGs.

To promote best practice in the sector, **Enterprise Ireland could establish a *Sustainability for Growth Programme*.** This would involve early stage start-ups who receive EI funding, gaining access and participating in the programme. As part of this initiative, the Alliance and Enterprise Ireland could work together to help start-ups learn about KPIs in general and also in relation to sustainability.

Enterprise Ireland to publicly promote best practice with a clear sustainability statement, with specific targets in line with SDGs.

Conclusion

This consultation is an opportunity to shape and future proof Irish tax policy to ensure that it supports Irish business at every step of their journey and that it accelerates the creation of strong indigenous enterprises from a base firmly rooted in Ireland.

A dynamic, efficient, and fit for purpose Irish tax policy can facilitate the provision of resources, talent and capital for Irish enterprise to enable them to start, scale, innovate and internationalise their business. The Alliance believes that the proposals outlined in this document will play a role in achieving this and nurture start-ups and scale-ups by giving them the appropriate environment and supports to position them to become global players whilst creating valuable IP, talent pools and revenue generating activities in Ireland. This is a long term investment for our country. It will create a resilient cohort of companies built to thrive for generations to come and play a key role in the future economy, taxation intake and employment levels in Ireland.

Our shared objective is for Ireland to be a great place to **start, scale and internationalise** a business.

Alliance for an
Innovation-Driven Recovery

Commission on Taxation Submission