Presentation by Irish Tax Institute to Oireachtas Budgetary Oversight Committee

Wednesday 13 June 2018

Chairman, members of the Committee, thank you for the opportunity to contribute to your deliberations on Budget 2019.

In the context of Budget planning, we know the tax base is central to your discussions. 80% of corporate tax receipts come from foreign multinationals, and of the top 100 largest CT paying companies, only 10 are Irish.

Many domestic and international bodies have warned repeatedly and consistently of the inherent risks in our tax base because of the concentrated nature of our corporate tax receipts. The Central Bank, the Irish Fiscal Advisory Council, the IMF, the OECD and the European Commission have chimed on the matter.

Focus on Irish Business

The consistency of the warnings around the volatility in our corporate tax receipts, is matched **only** by the consistency of the warnings on the need to focus on Irish owned businesses.

While much work has been done on enterprise policy, the need to address the productivity and prospects of Irish companies can't be ignored. The transformative nature of technology and digitalisation makes it an imperative.

The OECD[1] warns that the resilience of our economy hinges on unblocking the productivity potential of Irish businesses, they also highlight that most of them have experienced a **decline** in productivity over the past decade.

Several issues must be tackled if they are to succeed – and tax policy or tax administration issues will be central to making it happen.

OECD says we need to: -

Give entrepreneurs what they need to grow their businesses

[1] OECD Ireland Report 2018.

Get rid of what is stunting that growth.

In some cases, access to finance is holding individuals back from taking the step into entrepreneurialism.

The European Commission[2] also highlights productivity issues. The IMF[3] too has stressed the need for the productivity growth of Irish companies, including through greater support for innovation, and enhancing partnerships of SMEs with research institutions that would help improve productivity. Our tax policy on R&D regarding collaboration has fundamental limitations.

What Ireland needs

A step change is needed if we are to build on the brilliance and ability of Ireland inventors, entrepreneurs, start-ups – from our engineers to our software designers, to our food creators and financial services leaders.

We must seek to unlock our potential. Other countries have – and so can we.

Irish businesses need access to finance – and help and expertise to make the right and the best strategic decisions.

Finance for long term capital investment, human capital, innovation and R&D. This will determine their future success.

It is accepted in international report after report which we will discuss today – that tax policy can be a game changer in creating the right culture and environment.

The impact of measures such as EII, Entrepreneurs Relief, our CGT rates, the workability of the R&D regime for SMEs and the effectiveness of our new share options regime (KEEP) are central to the strategic gear shift that we need.

My colleague Anne Gunnell will outline in detail the issues within our most critical business policies – but some national and international research findings give us context as to why they are so.

[2] European Commission, Country Report Ireland, 7 March 2018.
[3] IMF Staff Concluding Statement of 2018 Mission, 14 May 2018.

Financing issues

ESRI research[4] on Irish SMEs shows that their investment is **below** what's expected. The 'Investment' gap is over 30% in 2016. We're falling short.

Irish companies remain heavily reliant on internal funds and on banks[5]. Close to 75% of their investment is financed using own funds, substantially above the EU average of 60%[6].

The share of SMEs applying for any banking product has been decreasing since 2015[7]. We know that the interest rates being charged are well above the Euro zone average.

There is a serious need to look at alternative financing options such as venture capital and angel investors – they are willing to undertake riskier investments.

But they come with the crucial ingredient that Irish businesses need, and other countries are availing of: mentoring, experience, international business contacts and a hands on advisory role.

While the tax system of other countries embraces angel investors – Ireland locks them out.

Considering Brexit – the financing constraints for SMEs are most relevant. Research shows its likely to **deter** them from exporting. It also shows that Irish companies reporting to have experienced financing difficulties are less likely to engage in exporting activities[8].

Innovation and R&D

The reasons as to why Irish SMEs borrow gives us an even deeper insight into Irish companies. According to Central Bank our SMEs borrow for 'working capital' **above** any other reason[9].

They're also below the EU average for borrowing for fixed investment.

The percentage of Irish SMEs borrowing for 'fixed investment' has decreased in recent times from 47% down to 42%.

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[4] ESRI, Measuring the Investment Gap and its Finance Requirements for Irish SMEs, 8 March 2018.
[5] European Commission, Country Report Ireland, 7 March 2018.
[6] EIB, 2017
[7] CBI 2017f
[8] Siedschlag, Di Ubaldo, Tong Koecklin, 2017.
[9] Source: Central Bank of Ireland, SME Market Report 2017 H2, 30 January 2018

This contrasts with its Eurozone peers such as Germany, Austria and France where almost 60% (57%) of SMEs borrow for fixed investment.

German SMEs more frequently reported using financing for the development of new products, hiring of employees and refinancing of obligations than SMEs (compared to the other large euro area economies).

It is no surprise then that amongst the German Mittelstand SMEs, more than 42% of them brought a product or process innovation onto the market in 2014, compared to an EU average of 30%.

The OECD says Irish firms need to invest more in their own research and development activities – they are drivers of productivity.

Managerial capability and human capital

The OECD also stresses the need for human capital, and Ireland needs to think about how to raise the capacity of businesses to implement new ideas and technologies.

The Government's National Planning Framework also acknowledges the role of human capital. There are issues to consider here in terms of our share option regime.

We know from research that managerial skills in many Irish companies are too weak to allow these businesses to identify and exploit the opportunities offered by the global companies on their doorsteps[10]. (I referred to the role of the Angel Investor earlier).

Wages in multinationals are 64% higher than in domestic companies[11] and the difference is 74% for multinationals of non-EU origin.

Under these circumstances Irish SMEs have difficulties recruiting and retaining skilled workers, hindering their growth and exporting potential[12] and so our share option regime becomes critical.

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[10] OECD Country Report Ireland, 2018.
[11] European Commission, Country Report Ireland, 7 March 2018.
[12] Hays, 2016; National Competitiveness Council, 2017.

Anne Gunnell:

Against that backdrop we cannot allow our tax regime to be a blocker of what is good.

We have dedicated agencies, educated talent, an expanded global footprint within our diplomatic service - and we have ability of our people. We must have tax policies to match.

Given the severity of access to finance for Irish business I will first address the existing tax measures that promote investment:

We have **two** major schemes.

- Ireland's targeted Capital Gains Tax (CGT) relief for entrepreneurs; and
- the income tax incentive for individuals who invest in Irish business – the EII.

I should stress that the backdrop of Ireland's high CGT rate makes analysis of the measures even more important.

CGT is a key determining factor for investment in businesses - it can help or hinder the process.

It is unquestionably the tax that matters most to investors and influences their behaviour.

Last year when we addressed you Ireland had the 4th highest CGT rate in the OECD. At 33%.

France was **then** at the top of the table.

This year President Macron - in his determined effort to attract more investment into French start-ups and tech companies - slashed the French rate to 30% - pushing Ireland into 3rd place.

A stark position considering what we are trying to do for Irish companies.

Our targeted 'revised entrepreneur tax relief' is then important in that it helps reduce the CGT burden on the sale of a business - to a **limited** extent.

But this tax measure is uncompetitive.

It compares poorly to the UK – making London a more attractive location for investors, the investors we badly need.

The relief applies to a £10m gain in the UK – in Ireland the gain is limited to €1 million. There is NO competition from an investor point of view.

As Olivia has mentioned the relief also locks out the important ‘angel investors’ who not only invest money but experience and industry expertise, a vital factor when we consider the deficit of managerial capability in Irish business as highlighted by the OECD.

While cities from Paris, Berlin, to Stockholm and Tokyo embrace angel investors – Ireland’s tax regime excludes them.

The **impact** - business angel investment in Ireland is **low** compared with other countries

Need for an effective EII regime for Ireland

The second financing tax measure for Irish businesses is the EII.

It encourages investors to place finance in early stage and small businesses that have limited funding options.

They very often rely on finance from family and friends. It plays a vital role in scaling start-ups and small businesses to the next level of growth.

While the EII is a welcome scheme – there are now many blockages within it.

(1) Several the design features are barriers to investment, such as splitting the tax relief into two tranches, the annual investment limit of €150,000 and the revised connected party rules following last year’s Finance Act.

(2) The EU State aid General Block Exemption Regulations (GBER)[13], under which the EII operates, are also having a significant impact on the scheme.

It adds to the cost and complexity of claiming EII.

It is particularly difficult for businesses seeking to raise a second tranche of EII funding and for businesses who wish to raise EII after they have been in operation for seven years.

There is also a restrictive administrative process which is stifling the use of the relief. The GBER provisions are applied **retrospectively** to business plans prepared before its introduction.

The Institute recommends that a full economic analysis of the impact of the GBER on the EII is undertaken and welcomes the current consultation being undertaken by the Minister for Finance, Paschal Donohoe at present.

Need for a workable KEEP share scheme for SMEs

As Olivia mentioned Irish companies need the best human capital and talent to increase managerial skills, innovation and R&D capability.

Given the high personal tax rates, a workable share option scheme that can help Irish SMEs to attract talent to grow their businesses is essential.

We welcome the new Key Employee Engagement Programme (KEEP), which provides an opportunity for SMEs to compete with listed companies to attract and retain such talent.

But the scheme contains **limitations** which could significantly impact its feasibility and ultimately, its success in achieving its policy aim.

[13] Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible internal market in application of Articles 107 and 108 of the Treaty.

Issues surrounding the qualifying criteria for individuals;

the design of the remuneration limits **and** the narrow definition of a qualifying holding company under the rules are creating difficulties for many SMEs to qualify for KEEP.

Encouraging increased R&D and Innovation – and collaboration with universities

Innovation is a central ingredient in the strategic plans for other countries when it comes to growing their SMEs.

The link between innovation and productivity has been highlighted by the OECD, IMF and the European Commission.

Ireland has an attractive R&D tax credit regime, but administrative blockers are weighing heavily on its success in terms of the low take-up among SMEs.

Research[14] undertaken by the Institute in 2017 found that only 35% of the companies surveyed, intended to use the R&D tax credit over the next 18 months, although this would rise to 62% if there was more clarity around the criteria for qualification.

Of huge concern - is the fact that the R&D tax credit regime restricts outsourcing and collaboration, a condition that is at odds with **best** practice international standards, which actively promote outsourcing and collaboration with the university sector.

In Germany, their incentives are aimed at collaboration and partnership with universities is king.

[14] Irish Tax Institute Report "A future tax strategy to grown Irish indigenous exports", June 2017

The Finance Bill Process

To conclude, members of the Committee will be aware from our 2016 submission[15] that one of the key challenges in our tax policy making process is the insufficient time available to scrutinise legislation announced in the Budget.

Apart from key income tax changes and other sensitive measures, we believe that tax legislation should be published for consultation in advance of the Finance Bill.

This could be done on an **issue by issue** basis throughout the year in the same way that consultation takes place on important policy matters, such as controlled foreign company rules, share options, the tax treatment of entrepreneurs. The IMF and OECD in their 2017 report on tax certainty said *"…legislative and tax policy design issues are a major source of tax uncertainty, mainly through complex and poorly drafted tax legislation."* [16]

Given the importance of all the anticipated complex changes to the Irish tax code over the next two years, arising from the EU Anti-Tax Avoidance Directives and the Mandatory Disclosure Directive and the Coffey Review recommendations, it is an imperative that we address this problem.

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[15] Irish Tax Institute Submission to the Select Committee on Arrangements for Budgetary Scrutiny – A Special Focus on the Finance Bill Process, June 2016

[16] Tax Certainty, IMF/OECD Report for the G20 Finance Ministers, March 2017