Irish Tax Institute

Irish Tax Institute Pre-Budget 2020 Submission

Just as tax policy played a major role in attracting large multinationals to Ireland, it can be used to incentivise the step change in productivity and innovation we now need from our indigenous companies.

Introduction

The cornerstone on which Ireland's economic success was built has been foreign direct investment (FDI). Chief among its building blocks has been our low corporate tax rate, introduced four decades ago, specifically to attract leading multi-national enterprises. In the intervening years, investment in education and skills as well as our access to the single market have helped to secure that investment. As a result, this small, open economy is one of the most advanced and globalised in the world.

Our highly productive multinational sector will continue to be a crucial part of the Irish economy, but the fundamental reappraisal of how to tax profits of global companies raises questions about the level of future corporation tax receipts. This reform process, in which the government is fully engaged, has some way to go, but as the Minister for Finance & Public Expenditure and Reform told the Institute's Global Tax Policy Conference in May 2019, changes are on the way over the next 18 months that will challenge Ireland's FDI business model.

So, we are back to the issue that we have been discussing since the Telesis Review in 1982: how to build productivity in our homegrown business sector. The Institute believes that just as tax policy played a major role in attracting large multinationals to Ireland, it can be used to incentivise the step change in productivity and innovation we now need from our indigenous companies.

The Institute supports the tax measures introduced in recent years to promote investment in SMEs, but they are not working as they should for this sector.

Our capital gains tax (CGT) Entrepreneur Relief excludes third party 'angel investors', who are sought after by economies all over the world, not only for their risk appetite but also for the experience and support they bring to small businesses. In Ireland, we ask them to pay a third of the return on their investment back to the State.

The lifetime limit for claiming the lower 10% CGT rate is €1m. The UK limit is Stg£10m. This is a competitive disadvantage we can fix. And with Brexit around the corner, we surely should. Indeed, all business tax measures should be internationally competitive and particularly, with those of our nearest neighbour.

The Employment Investment Incentive (EII) scheme for investors in early stage businesses is a good incentive. But, as the Indecon report[i] commissioned by the Department of Finance last year, pointed out, it could be improved. Allowing full tax relief in the first year of investment would make it more attractive to investors and the annual investment limit should be increased for longer-term investors. We also agree with Indecon that capital losses should be allowed under the scheme.

A major challenge for SMEs is attracting skilled workers. Tech start-ups are competing with multinationals who have deeper pockets. The Key Employee Engagement Programme (KEEP) share scheme introduced two years ago, was designed to address this problem but, so far, only 38 employees in ten companies have taken it up.

Finally, we have an attractive R&D tax credit regime. But it just doesn't work for most SMEs. Research conducted by the Institute found that 60% of businesses surveyed worried that a claim would be challenged by Revenue, while 40% said the cost of making a claim was a barrier.[ii]

The main beneficiaries of the R&D measure are multinationals who account for almost three quarters of the relief. Yet every authoritative advisory body, nationally and internationally is telling us that our indigenous companies need to invest in R&D.

At this critical juncture in industrial policy, we need an innovation incentive that is tailored for Irish companies so that they can grow and compete for new markets in a post Brexit world.

Tax expenditures to incentivise Irish entrepreneurs and start-up companies should not be treated with suspicion. The resilience of our economy at a time of growing uncertainty and risk depends on these risk takers. We should support them.

What international and domestic advisory bodies are telling us

There is agreement among economic commentators that Ireland is too reliant on the multinational sector and that we need to rebalance our economy by building productivity and innovation in our domestic businesses in order to achieve sustainable growth.

Here are some of the latest pronouncements from international and national advisory bodies:

National Competitiveness Council

"Since international competition to attract foreign multinationals is becoming increasingly strong, the long-term sustainability and competitive base of the Irish economy will depend more on the innovative performance of local business, their links with foreign-owned firms and the diversification across industries where both local and FDI-related firms operate. This should be the focus of Government policies." [iii]

OECD

"Labour productivity growth [in Ireland] was the highest among OECD countries over the period 2010-16, which was largely due to the activity of multinational enterprises (MNEs). Excluding MNEs, productivity developments among local Irish firms have been relatively modest, which needs to be addressed by fostering innovation and removing barriers to entrepreneurship and competition." [iv]

IMF

"Overall productivity is high in Ireland, but certain sectors are lagging: The multinational sector is highly productive, and small- and medium-sized enterprises are more productive on average than in the rest of Europe. However, productivity has been declining in transportation, accommodation, food services, and agriculture—the same sectors that are most exposed to Brexit. The government should seek to improve the enabling environment in these sectors, including through direct funding of research and development, training of workers, and quality infrastructure investment." [v]

European Commission

"The heavy reliance on a limited number of firms and sectors makes the Irish economy vulnerable to international economic shocks, including in trade and to the terms of the UK's withdrawal from the EU. Against this backdrop, increasing the productivity of domestic companies is crucial to strengthening the resilience of the economy and ensuring a sustainable growth." [vi]

What Irish business needs to grow productively

Access to alternative finance

Start-ups and early stage enterprises need access to external finance, including risk capital, to develop and grow. With our high rate of CGT, we need a tax system that rewards investment and entrepreneurship. Existing measures need urgent reform to make our business environment more attractive to third party investors.

Innovation and R&D

The existing R&D tax credit regime works for multinationals but is too costly and complex for small businesses. It should be changed to meet the needs of small and early stage businesses as well as larger, established concerns. Restrictions on outsourcing and collaboration under the tax credit regime is contrary to best practice internationally.

Skilled workers and managerial capacity

In an already tight labour market, Irish SMEs are competing with leading multinationals who can pay skilled workers up to 74% more than the domestic sector. In these circumstances, and given our high marginal rate of tax, an effective share-based incentive scheme is critical. The current KEEP scheme is not fit for purpose. European Commission research shows that employee financial participation is a driver of productivity and competitiveness for SMEs.

Business environment with tax certainty

In a turbulent international environment, businesses need tax certainty to enable them to make good decisions. This requires:
- clear tax rules,
- Revenue guidance,
- consistent tax administration, and
- effective dispute resolution mechanisms.

It is accepted internationally that tax policy and the tax administration regime can be a game changer in creating the right culture and environment for productivity growth and business innovation. If we want to make our indigenous sector a pillar of resilience in our economy, we need an effective, user-friendly tax regime.

Current tax measures for SMEs and entrepreneurs

- Ireland's targeted CGT relief for entrepreneurs
- The income tax incentive for individuals who invest in Irish business – the Employment Investment Incentive (EII) and the Start-up Capital Incentive (SCI)
- The income tax refund scheme available to individuals who start their own business - the Start-up Relief for Entrepreneurs (SURE)
- The employee share scheme for SMEs – the Key Employee Engagement Programme (KEEP)

The Institute broadly supports the policy objective of these measures but, as we have pointed out in submissions over the last couple of years (see Appendix), they contain flaws that are undermining their effectiveness. Given our high-income tax and CGT rates, it is essential that our incentives are best in class and with Brexit looming, they must be competitive.

Access to alternative finance

While access to finance from banks has improved over the last two years, there is a need to incentivise third party investment, particularly in start-ups where the level of risk is beyond the appetite of banks but where the productivity gain for the economy is high. It is important that our investor reliefs are attractive.[vii]

Broadening CGT Entrepreneur Relief

According to our members and entrepreneurs we have engaged with, the current design of this relief restricts the growth and development of small companies. It also puts Ireland at a competitive disadvantage with the UK, where the equivalent relief applies to the first Stg£10m. This means the overall effective tax rate on a gain of €10 million in Ireland is 30.7% compared with just 10% in the UK.

We recommend that the €1m lifetime threshold be raised to €10m to make Ireland competitive with other countries, including the UK, for international capital.

To qualify for the relief, an investor must spend at least 50% of the working week with the company for three out of the five years prior to disposal. This condition excludes angel investors who, typically, mentor and support several companies at a time. Angel investors would bring, not just their money, but their skills, experience and high-risk appetite to our indigenous enterprises. Locking them out is unfathomable, given, as pointed out by the OECD[viii], the deficit in managerial capability in Irish businesses.

We recommend that the legislation be amended to permit highly prized angel investors to avail of CGT Entrepreneur Relief.

Making the EII and SCI schemes more effective

The EII is aimed at incentivising investment in early stage and small businesses whose funding options are limited. Start-ups tend to be more innovative and competitive. Improving their access to investment will strengthen the resilience of our productivity base.[ix]

The Institute welcomed the recommendations of the Indecon Evaluation of the EII and SURE. Some were adopted in Finance Act 2018, including moving the application procedure to a primarily self-certification model and the introduction of the new SCI scheme to allow family members to make qualifying investments.

We urge that the remaining recommendations of the Indecon evaluation be adopted in Budget 2020:

- **the granting of full tax relief in the year of investment;**
- **increasing the annual investment limit for longer-term EII investors and higher risk sectors; and**
- **that capital losses should be allowable for such investors.**

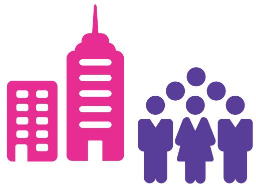
Self-certification will improve the EII application process, but further administrative improvements would restore investor confidence in the scheme.

- **Adequate resourcing in Revenue to deal with legacy cases, where delays in processing applications are creating uncertainty for businesses about their eligibility for the relief and as a result compromising their ability to raise EII funds.**
- **Dedicated full-time staff who understand the complicated rules of the scheme must be assigned to ensure consistency in dealing with applications.**
- **Further guidance from Revenue on its interpretation of key General Block Exemption Regulation (GBER) concepts would give taxpayers the certainty they need about their EII applications.**
- **An appropriate Revenue customer service standard should apply for EII applications.**

Extend SURE to the self-employed

The SURE income tax refund scheme for those who start their own business is restricted to former PAYE workers. Apart from discriminating against self-employed workers, this restriction acts as a significant barrier to its effectiveness.

The Institute recommends that the scheme be extended to self-employed workers who set up a new business.



Skilled workers and managerial capacity

Recent research has found a dearth of management skills in Irish businesses.[x] With pay in multinationals up to 74% higher than in the domestic sector,[xi] Irish indigenous businesses are fighting a losing battle to attract the high-skilled workers they need to make them more competitive. In our competitive pay and high-income tax environment, a well-designed share option scheme would help Irish companies to recruit the talent they need to boost productivity.[xii]

Making the KEEP share scheme work for SMEs

Just 38 employees in 10 companies have availed of the KEEP since it was introduced in January 2018. Clearly, this measure is not fit for purpose.

In two separate submissions last year, the Institute outlined the restrictions that were causing difficulties for SMEs: the design of the cap on share options and the narrow definition of a qualifying holding company under the scheme. We participated in the Department of Finance's recent public consultation on this important measure and we note that the proposals set out in the appendix to the consultation paper largely reflect our recommendations.

The policy objective of the KEEP - to help SMEs attract and retain key employees - is critical to sustainable economic growth.

We urge that the proposals in the Department's recent consultation paper be enacted in the forthcoming Budget.

New SARP regime to help SMEs attract overseas talent

The Special Assignee Relief Programme (SARP) is a tax measure that helps multinationals to attract talent from abroad. As the economy approaches full employment, Irish owned exporters producing products and services in knowledge intensive areas also need to recruit skilled workers from abroad.

Given the impeding departure of the UK from the EU and the critical need for Irish SMEs to diversify and develop new export markets post-Brexit, the Institute recommends that a SARP-type regime focused on SMEs should be considered.

Innovation and R&D

The main drivers of productivity are innovation and research and development (R&D). Yet recent research by the ESRI found that only 7% of Irish owned companies surveyed in 2016 had invested in these critical categories.[xiii] Both the OECD and the European Commission have urged increased investment in R&D and innovation by the public and the private sector. Ireland has an attractive R&D tax credit, but its main beneficiaries are multinational firms.

Administrative blockers and the cost of claims make it unattractive to homegrown SMEs. The Institute undertook some research in May 2019 as part of its response to the Department of Finance public consultation on the R&D tax credit. It found that Irish SMEs engaged in R&D believed a pre-approval process for first-time R&D tax claims with simplified documentation would greatly increase their likelihood of availing of the credit.

The restriction on outsourcing in the R&D tax credit flies in the face of international best practice, which promotes collaboration between businesses and particularly between enterprises and third level institutions. The exchange of knowledge and ideas is the very essence of innovation.[xiv]

The Institute believes the outsourcing restriction should be removed in line with government policy to foster collaboration between third level institutions and private business.

Overall, the Institute recommends that SME-friendly guidance be provided with step by step instructions on the claims process and practical case studies with tips on how to avoid common errors in the process.

Business environment with tax certainty

Political, economic and trade changes beyond our control make the current environment in which Irish business operates highly uncertain.

The OECD and the IMF [xv] have identified practical tools to ensure tax certainty for business through improved tax policy and law design, consistency among tax administrations and effective dispute resolution mechanisms.

Global turbulence now gives urgency to this issue. Irish businesses need certainty over their tax affairs. This can only be achieved through clear tax rules, consistent tax administration and effective dispute resolution mechanisms.

Public consultation

The Institute welcomes the practice of putting existing tax measures out for public consultation. We are enthusiastic participants even when the deadline for submissions is demanding. We also value the stakeholder consultation events that have taken place as part of the consultation processes this year. Discussion is healthy and listening to each other can only be productive.

The Finance Bill process

One of the key challenges in the Irish tax policy-making process is the legislative timetable. The window between the Budget and the publication of the Finance Bill is simply too narrow for the scrutiny that might detect potential unintended consequences of legislation.

Only in very exceptional instances, is tax legislation published in draft format in advance of the publication of the Finance Bill. By and large, the legislation is publicly available in mid-October and must pass through all stages of the Oireachtas and be signed by the President before the end of the year.[xvi]

This allows less than three weeks for consideration of often complex tax law from the date of publication to Committee Stage in the Dáil and only two months for the entire process to be completed and the law enacted. The issue is compounded when new tax provisions are introduced into the Finance Bill at Committee and Report stages. It is difficult to find a justification for the persistence of this archaic process.

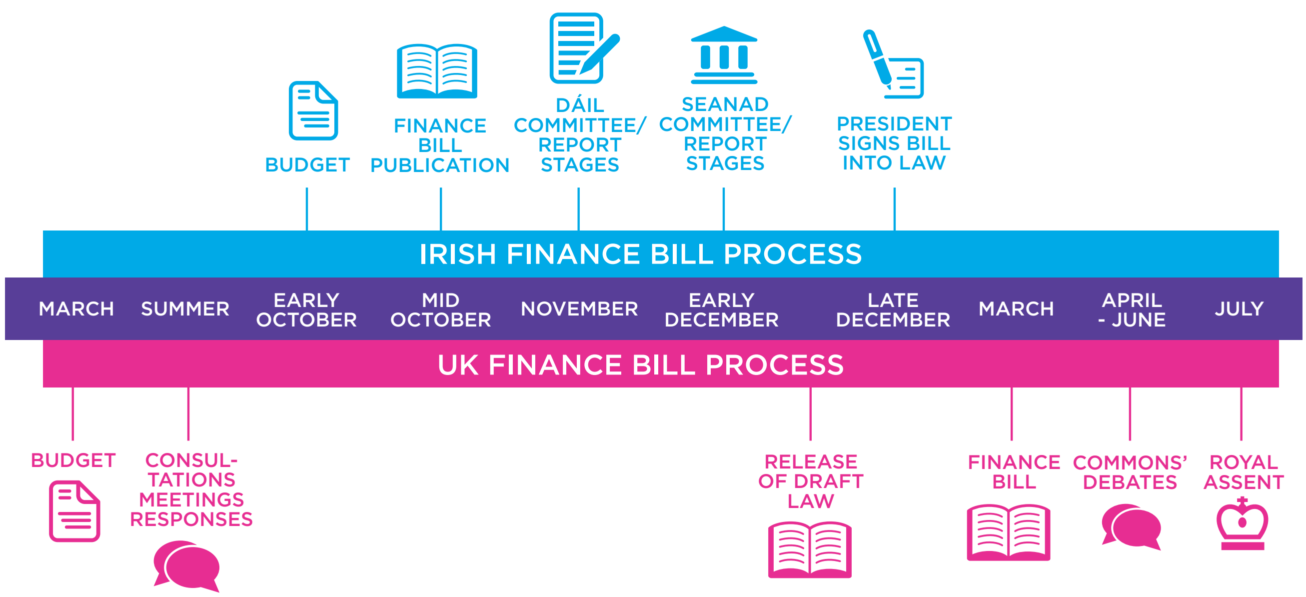
Apart from key income tax changes and other political or market sensitive matters, the Institute can see no reason why tax legislation should not be published for consultation in advance of the Finance Bill. In the UK, draft legislation is published five months in advance of their Finance Bill.

Need for effective dispute resolution mechanisms

According to the OECD and the IMF, an effective dispute resolution regime plays a critical role in establishing certainty for businesses. Where disputes arise over the facts of a case or the interpretation of the law, taxpayers may appeal directly to the Tax Appeals Commission.

However, there is a heavy build-up of cases in the appeals system, with taxpayers waiting years to have the disputed matter resolved.

While significant additional resources have now been given to the Tax Appeals Commission to alleviate the backlog, taxpayers, whose appeals are ultimately unsuccessful, are faced with penal interest rates because of the delays they have experienced. The Institute is calling for a 'stop' on interest for these taxpayers until the backlog can be resolved.



Conclusion

The Irish economy is running on or close to full tilt, while simultaneously facing serious external risks, chief among them the existential threat of Brexit. As the Department of Finance's Chief Economist recently said: it's a "difficult juxtaposition" that makes framing Budget 2020 extremely challenging.

At a time of such uncertainty, resilience is crucial. All the available economic advice is that the way to build resilience is to increase productivity in our homegrown businesses by fostering innovation and strengthening management practices.

To achieve this task, an essential lever at our disposal is taxation. We already use that lever through our existing business tax measures. The recommendations in this submission simply argue for changes that will make those measures more effective and accessible to business.

We have deployed taxation to build a high performing multinational sector. Now is the time to apply that same innovate approach to our own homegrown companies. Through the tax system, we can empower our entrepreneurs to make their contribution to continued growth in a broadly-based sustainable economy.

Appendix

The Irish Tax Institute has made detailed submissions to the Department of Finance on the matters raised in this document over the last year. These are:

1. ITI Pre-Finance Bill 2019 submission – 21 June 2019
2. ITI response to the Research & Development Tax Credit Review – 7 June 2019
3. ITI response to the public consultation on the EII, SURE, SCI schemes – 24 May 2019
4. ITI response to the public consultation on the KEEP – 24 May 2019
5. ITI response to the public consultation on CGT Entrepreneur Relief – 24 May 2019
6. ITI submission to the Minister for Finance Post-Finance Bill 2018 – 1 November 2018
7. ITI Pre-Budget 2019 submission – 10 August 2018
8. ITI Pre-Finance Bill 2018 submission – 30 May 2018

References

i Indecon Evaluation of the EII and SURE, October 2018.

ii Irish Tax Institute R&D Survey May 2019 – 93 respondents: 27 respondents were companies based in Ireland and 66 respondents were tax advisers who advise companies in making R&D tax credit claims. Survey findings included in the Institute's Response to the Department of Finance Research and Development Tax Credit Review, June 2019.

iii NCC Productivity Statement, November 2018.

iv OECD Jobs Strategy, December 2018.

v IMF Ireland Report, Staff Concluding Statement of the 2019 Article IV Mission, 10 May 2019.

vi European Commission Country Report 2019.

vii NCC Ireland's Competitiveness Challenge, December 2018.

viii OECD Economic Surveys Ireland, March 2018.

ix NCC Ireland's Competitiveness Challenge, December 2018 page 96.

x OECD Economic Surveys Ireland, March 2018.

xi European Commission Country Report Ireland, February 2019.

xii NCC Ireland's Competitiveness Challenge, December 2018.

xiii ESRI Exploring SME Investment Patterns in Ireland, September 2018.

xiv The Impact and Effectiveness of Policies to Support Collaboration for R&D and Innovation, The Innovation Policy Platform

xv 2019 Progress Report on Tax Certainty IMF/OECD Report for G20 Finance Ministers and Central Bank Governors.

xvi Under the EU 'Two Pack' rules. Before the 'two pack' rules, the window for scrutiny was four months under the Provisional Collection of Taxes Act.

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