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Public Consultation on the Role of the Tax System in Encouraging Entrepreneurship

Submission by Davy to Department of Finance

JULY 2015

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DAVY SUBMISSION TO DEPARTMENT OF FINANCE

Executive Summary & Table of Recommendations

Davy provides corporate finance and wealth management services to numerous Irish businesses and entrepreneurs. Our experience in advising them gives us a deep understanding of the various challenges and opportunities they face as entrepreneurs and business owners. Some of these challenges are related to the existing tax regime and have been exacerbated by the budgetary measures implemented in the wake of the financial crisis. These changes have arguably hit the domestic business sector disproportionately. We have attempted to highlight these issues in the course of our submission.

We are aware of various statistical studies in relation to the macro and micro level impact of various tax measures. However, on the basis that the Department of Finance will be aware of and have access to same, we have largely avoided relying on them in this analysis. Instead, we focus on the difficulties encountered by our clients in practice and the insights provided by various tax and legal advisors we work with.

Key Messages

In addition to our detailed responses to the consultation questions, there are three key messages we would like to emphasise:

1. **A supportive tax environment for domestic business and entrepreneurs will lead to increased investment and employment, leading ultimately to increased tax revenues. An unsupportive environment will have the opposite effect.**

2. **The current tax environment is at best unsupportive to domestic business. At worse, it serves as an active disincentive to i) start-up activity, ii) staff participation in business and iii) the growth of Irish enterprises into global champions.**

3. **Much has been made of the so-called "demographic time-bomb" and the need to encourage private pension provision as our population ages. The current tax regime contains many impediments for business owners who wish to build up a retirement fund outside the business. This leads many to have their entire asset base tied up in their business, causing them to be more risk adverse than is desirable from an economic growth perspective.**

We welcome this consultation process as a forum for sharing our experiences and those of our clients. We hope it will serve as a first step towards initiating much needed change in this area.

Table of Recommendations

The specific policy measures which might be considered in order to improve the existing tax regime for entrepreneurs are summarised in the table below. They are grouped according to stages in the business cycle.

Start-up / Financing Stage	i. Increase the ease / tax-efficiency of providing both equity and loan finance to start-ups. In particular, rework EIIS and Seed Capital Scheme to make them more useful in practice; ii. Most start-up funding for SME's comes in the form of loan capital. The regime for loan financing could be more favourable e.g. tax deduction for interest payments / ability to convert to equity / relief on losses; iii. Explore the concept of tax-efficient pooled funds whereby Irish investors could invest in diversified portfolios of Irish businesses (as opposed to investing their surplus monies in offshore funds). **Targeted Outcome:** ➢ **Improve the funding environment for new businesses, therefore increasing start-up activity.**
On-going	i. Remove 3% differential in Universal Social Charge ("USC") between employed and self-employed; ii. Reduce marginal rate of tax (including PRSI and USC) to the psychologically important tipping point of 50% or less. This would help reward and attract talent; iii. Make the dividend regime for SME's effective in practice i.e. reduce the rate of tax to reflect the productive enterprise from which these profits are derived. At present, many business owners view a sale or liquidation as the optimal way to realise value from the business rather than enjoy the strong cash flow it provides over time as they continue to grow and develop it – see comparative table in main body of report. iv. Take steps to restore confidence in private pension provision to allow business owners to build financial security outside of the business. This has been adversely affected by the pension levy and other measures introduced in recent years. v. More favourable rate or regime for employee participation in business. Current Revenue-approved schemes are unattractive and of limited application; consider special CGT rate on gains.

	Targeted Outcomes: ➢ **Remove inequalities between employed and self-employed;** ➢ **Make it more attractive to sustain and grow a business rather than work towards a sale;** ➢ **Facilitate attraction and retention of talent;** ➢ **Allow business owners build up a pension nest egg outside the business.**
Exit *Sale* *Next-generation transfer*	i. Bring rate of CGT on sale of business in line with international norms e.g. 10% in UK, tapered rates in France; ii. Improvements to Entrepreneurial Relief to make the application of the relief less remote and more quantifiable in advance; iii. Removal of age-related cap on retirement relief to next generation transfer. Simplification and alignment of CGT/CAT retirement reliefs. **Targeted Outcomes:** ➢ **Bring CGT regime for entrepreneurs in line with international norms;** ➢ **Recognise and reward those who take risk in order to build productive enterprises;** ➢ **Allow businesses to grow and thrive beyond the ownership of the original entrepreneur.**

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Detailed Response

Role of Tax System – Our View

The role of an effectively functioning tax system includes the generation of sufficient tax revenues to fund public services and the achievement of certain policy objectives. A challenge for legislators is to balance these sometimes competing goals and to look for ways to incentivise desired behaviours. Ideally this should lead to increased activity, growth and by extension increased tax returns.

On the other hand, if the tax regime for a given activity, sector or category of individual is (or is perceived to be) too punitive i.e. leaning too far in the direction of revenue collection at the expense of incentivising activity, then a tipping point can occur whereby activity falls off. The counter-productive result of such imbalance is that less tax is collected and policy objectives are not achieved.

Regime for Entrepreneurs and Business Owners

It is our submission that a tipping point has been reached in the context of the tax regime for domestic business and entrepreneurs, whereby a combination of high rates and ineffective reliefs are actively serving as a disincentive to entrepreneurial activity.

The problems in the current regime are a function partly of historic imbalances (in the tax and welfare regime of employed vs self-employed), and a historic lack of a coherent thought process in relation to the tax policy for domestic business. More recently, the need to restore the public finances in the wake of the financial crisis led to increases across most tax heads, with the self-employed and domestic businesses arguably being hit disproportionately.

As a result, we are left with a system whereby the amount of tax collected at many stages of the business life-cycle (funding, expansion, exit) is high by international standards. In addition, many of the reliefs and incentives designed to encourage entrepreneurial activity are at not operating optimally. Furthermore, the tax regime and political environment does not facilitate business owners building up private pensions, one of the few avenues for reducing the risk associated with having their entire asset based comprised in the business.

Bottom Line

The issues outlined above affect individuals' willingness and ability to start up or maintain a business in Ireland. This has a knock-on impact for employment levels, the commercial climate generally and, ultimately, the tax revenues derived from business and its related activities.

Consultation Questions & Our Responses

QUESTION 1
The primary role of the Irish tax system is to raise revenue to fund public services. With this in mind, the Minister for Finance invites interested parties to make submissions regarding the following general questions:

1. What role, if any, should the tax system play in encouraging entrepreneurship?

RESPONSE
A stated policy objective of current and past governments is to foster a supportive environment for domestic Irish businesses and for entrepreneurs. This is in recognition of the various direct and indirect taxes collected at different stages of the business life cycle and of the level of employment created by domestic SME's (over 70% of jobs in Ireland are created by this sector). While attention often focuses on the 12.5% corporation tax rate for trading businesses, in reality this is but one facet of the regime and there many other significant taxing points which can occur at a business and personal level.

The tax regime at these points can have an impact on:

i. whether a potential entrepreneur is sufficiently motivated to embark on a venture in the first place;
ii. whether the business can attract sufficient and appropriate loan or equity capital at start-up or expansion stage;
iii. whether the business can attract and retain talent, and sufficiently incentivise its employees e.g. through salary, employee incentive schemes etc.;
iv. whether the business can be transferred to the next generation without tax being a major impediment to its continuance;
v. whether the business can be sold in a manner where the entrepreneur is encouraged to "go again" with a new venture.

These are crucial questions in terms of the viability and sustainability of any business, and if the tax regime is not supportive then entrepreneurs may well conclude that the rewards are not worth the risks involved in building a business. Alternatively, larger companies or more established entrepreneurs may engage in sophisticated tax-planning in order to manage what they perceive to be an unfair tax burden. The end result of this is both a net loss to the exchequer and an uneven playing field between new entrepreneurs and large and established businesses.

Ultimately a thriving entrepreneurial culture and business environment will relieve pressure on the welfare system, both through decreases in unemployment and increases in revenue receipts.

QUESTION 2
What barriers to establishing enterprises exist in the current tax system?

RESPONSE
It is our submission that the current tax system does not sufficiently recognise the risks involved in setting up a new business and the precarious nature of business finances in these early years.

All businesses need capital at the start up stage. However, at present the tax system is of limited assistance in helping business access funding.

Examples of current issues include:

i. **Loan Finance: I**t is no longer possible to deduct interest payments against income tax, affecting entrepreneurs who borrow money to invest in their own businesses.

ii. **Loss Relief on Loan Capital:** if the business fails, this loss is not available against capital gains.

iii. **Third-party Finance:** a large portion of Irish wealth is comprised in bank deposits and property – for private investors, there are no effective channels to apply these funds to productive activities.

iv. **EIIS scheme:** low uptake suggests that it is not having the desired impact. There are conflicting views on whether the payback period is too long (for the investor) or two short (for the company). One way to increase attractiveness may be a more favourable CGT rate on the ultimate disposal of the investment.

v. **Seed Capital Scheme:** does not include those who were previously self-employed.

QUESTION 3
What existing tax measures are effective in supporting small businesses and encouraging entrepreneurs?

RESPONSE
In our view, the following measures have been effective in supporting business and entrepreneurs, although in some cases it appears that larger, international companies benefit disproportionately:

i. **12.5% corporation tax** rate has been an undoubted success and the current government's commitment to retaining is to be welcomed;

ii. **Research & Development credits** and the **Intellectual Property regime** for those involved in appropriate sectors;

QUESTION 4
What existing tax measures are ineffective in supporting small businesses and encouraging entrepreneurs? How could such measures be improved or should they be abolished?

RESPONSE
i. **EIIS Scheme:** low uptake in this regard is proof of ineffectiveness. It is submitted that this is due to the restrictiveness of the conditions and the level of administration around the relief.

   A more favourable dividend or CGT regime for sales of productive businesses might serve as a greater incentive to investors.

Alternatively or additionally, a more favourable regime for loan capital would be welcome. For example, allowing an interest deduction for loans taken out to investing in trading companies and providing loss relief on loans where businesses fail.

ii. **Seed Capital Scheme:** this should be expanded to cater for those who were previously self-employed.

iii. **Employee incentive schemes:** Revenue approved share option and employee participation schemes do not serve as a real incentive for attracting and retaining staff.

The income tax rate applicable to the exercise of share options should be re-examined, as should the CGT rate on the ultimate disposal of shares.

iv. **Retirement relief / Business Property Relief:** The age related cap is preventing transfers to the next generation, with some families deciding to hold until death to avoid CGT. The relief for CGT is not aligned to the relief from CAT which can sometimes lead to anomalies / difficulties with inter-generational transfers.

v. **Entrepreneurial relief** in practice is only relevant for successful serial entrepreneurs. Even for this category of individuals, realisation of the relief may be too uncertain and remote to serve as a real incentive to enterprise.

INCOME TAX

QUESTION 5
Given the difference in the treatment of the self-assessed and PAYE taxpayers in terms of pay & file, tax credits and allowable expenses, is there scope for greater alignment?

RESPONSE
The tax and welfare regime for the self-employed compares unfavourably to comparable jurisdictions internationally and also to the regime in place for employees.

Some suggestions in this regard:

i. **High income tax regime:** Ireland has one of the most progressive income tax regimes in the OECD for those on higher levels of income. This serves as a disincentive to employment and growth. The marginal rate of income tax for both employees and self-employed should come down to or below the psychologically important rate of 50%. The earning level at which the marginal rate of tax kicks in should be increased – this is very low by OECD standards.

ii. **Tax regime for dividends:** In practice the payment of dividends from SME's is rare due to the 52% / 55% income tax rate. This can lead to a focus on exit mechanism (sale, liquidation, buybacks) as a means of realising value from the company. **See Appendix 1 for comparative table on share sale vs ongoing payment of dividends.** Ideally the regime should facilitate the ongoing sustainability of profitable businesses. For example, the Commission on Taxation Report (2009) recommended reducing the tax on dividends in line with the DIRT rate (which was then 23%).

iii. **Universal Social Charge:** The 3% USC differential between employed and self-employed has no justification in practice and should be removed.

iv. **Pensions:** Most self-employed people or business owners are solely responsible for their own pension provision. The regime should acknowledge this and facilitate some diversification of personal balance sheet for this type of individual. In our experience, public confidence in the security of private pensions has been badly damaged by measures such as the pension levy. A public commitment stating that there will be no further levies on the capital value of pension funds would be welcome.

CAPITAL GAINS TAX

QUESTION 6
Given the targeted nature of CGT entrepreneur relief under Section 597A of the Taxes Consolidation Act 1997 and the requirement to satisfy EU State aid rules, what changes could be made to the relief in that context to make it more effective in supporting small business and entrepreneurs

RESPONSE

The relief as it currently stands only benefits successful serial entrepreneurs. Even within that relatively small category, there are further restrictions – it essentially only benefits those who have built and sold not one but two successful businesses. There is an excessive time lag and too many uncertainties in between to serve as a real incentive for entrepreneurial activity.

A lower rate of CGT for those selling their own business e.g. in the UK a 10% rate applies up to a cap of €10M; tapered rates apply in France etc. might be more effective.

QUESTION 7
What specific aims and rationale would underpin such changes to the relief?

RESPONSE

A change to the CGT rate would bring Ireland more in line with Ireland and the UK, and would serve as a real incentive to those considering embarking on entrepreneurial activity. A CGT rate change would also recognise the risk involved in attempting to build productive enterprises and create employment.

The product of a more entrepreneur-friendly tax regime would be increased business activity with the consequential increase in employment and tax take.

CORPORATION TAX

QUESTION 8

Section 486C of the Taxes Consolidation Act 1997 provides relief from corporation tax for certain start-up companies. The relief was extended in Finance Bill 2014 until the end of 2015 to allow for a comprehensive review of the measure in 2015 in line with the New Guidelines for the Evaluation of Tax Expenditures. The Department would welcome detailed submissions from interested parties in respect of Section 486C.

RESPONSE

The link to PRSI may limit the benefits of the relief as typically in the start-up phase businesses have fewer employees. The new carry forward provisions are to be welcomed.

Appendix 1 – Sale of shares v payment of dividends

The current tax treatment of dividends and the treatment of share sales as distributions means that a business sale can be a much more attractive way for an entrepreneur to realise funds and de-risk their personal balance sheet rather than to extract the excess cash generated by the business in the form of dividends and to continue to grow and run the business. See illustrative example below of a share sale compared to payment of dividends in terms of after tax proceeds to shareholders.

Option 1 - Sale of business by shareholders to realise funds

Profit	1,000,000
Tax @ 12.5%	125,000
Profit After Tax	875,000
Sales Multiple	10x
Expected Sales Proceeds	8,750,000
CGT @ 33%	2,887,500
After tax proceeds	5,862,500

Option 2 - Payment of dividend to shareholders of surplus cash generated by business

Profit	1,000,000
Tax @ 12.5%	125,000
Profit After Tax	875,000
Dividend to shareholders	875,000
Marginal Income Tax @55%	481,250
After tax receipt by shareholders	393,750
Equivalent years of dividends to meet sales proceeds	15 yrs

About the Davy Group

Established in 1926, the Davy group is Ireland's leading provider of wealth management, asset management, capital markets, and financial advisory services. Davy is headquartered in Dublin, with offices in London, Belfast, Cork and Galway. Employing over 570 people, we offer a broad range of services to private clients, small businesses, corporations and institutional investors, and organise our activities around four interrelated business areas – Wealth and Asset Management, Capital Markets, Corporate Finance and Research.

Davy's Wealth and Asset Management business looks after over €15bn on behalf of Irish and international clients. Davy has acquired three businesses in the Wealth and Asset Management area and has a stated plan to continue to grow both organically and through acquisitions. Davy is Ireland's leading wealth manager providing a financial planning led private client service backed up by global investment portfolios driven by a proprietary investment process.

As the leading broker in the Irish market, we accounted for over 43% of all dealings in Irish equities on the Irish Stock Exchange in 2014*. Davy is a primary dealer in Irish Government Bonds and acts as manager on the majority of Irish corporate bond issues. We advise 67% of companies on the Irish Stock Exchange, including 8 of Ireland's top 10 listed companies*. We are Ireland's leading ESM and AIM adviser, representing approximately 73% of companies quoted on the ESM market*, and 17 companies quoted on the AIM market of the London Stock Exchange**.

Davy is responsible for over 70% of funds raised on the Irish Stock Exchange over the past four years* and we have been consistently recognised by the world's top names in financial services for the quality of our research and service.

** Source: Irish Stock Exchange*
*** Source: London Stock Exchange*