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.

We acknowledge that in the context of Budgetary planning, the tax base is central to your discussion here today. Many bodies, domestic and international, 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 this year, all chimed on the matter. As we are aware, 80% of corporate tax receipts in 2017 came from foreign multinationals, and of the top 100 largest CT paying companies, only 10 were Irish.

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 across different aspects of enterprise policy, the need to address the productivity and prospects of Irish companies cannot be ignored. The transformative nature of technology and digitalisation on trade makes it an imperative.

The OECD[1] states that the resilience of the economy hinges on unblocking the productivity potential of Irish-owned businesses, while at the same time highlighting that most of them have experienced a decline in productivity over the past decade. It identifies several key challenges that should be tackled to enable Irish businesses to succeed and many have a tax policy or tax administration implication which we will address in a moment. The challenges include:

- Give entrepreneurs what they need to grow their businesses and get rid of what is stunting that growth.
- In Ireland that means tackling high regulatory barriers to entrepreneurship.
- In some cases, access to finance is holding individuals back from taking the step into entrepreneurialism. Efforts to improve the working of the banking sector are critical to correcting this.

The European Commission[2] also highlights productivity issues. Attracting foreign investment is not enough to ensure a positive impact on the domestic economy's productivity it states. 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 to reduce the productivity differentials with peers and large MNCs. Our tax policy on R&D regarding collaboration has fundamental limitations.

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

What Ireland needs

Irish businesses need to invest more deeply and more broadly if a step change in their performance is to be realised. The ability to raise finance for capital investment, human capital, employee skills and higher levels of investment in innovation and R&D will determine their future success. The role of our tax policy and tax administration system in creating the right environment cannot be overstated.

The role of tax measures such as EII, Entrepreneurs Relief and SURE, 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 must take place.

Before outlining the details of those polices and tax administration measures, some national and international research findings give us important context and insights.

Financing issues

ESRI research[4] on Irish SMEs finds evidence that their actual investment is below what would be expected given how companies are currently performing. The estimated magnitude of this 'Investment' gap is economically meaningful at just over 30% in 2016.

In addition, Irish companies remain mostly 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 bank products account for about 85 % of total external financing for Irish companies. There is significant scope for a more intensive use of non-bank financing which we will outline in our tax policy recommendations, especially around our capital tax environment.

There are concerns that financing constraints for SMEs are likely to deter them from exporting. In fact, research has shown that Irish companies reporting to have experienced financing difficulties are less likely to engage in exporting activities[8], a significant finding in terms of Brexit.

Innovation and R&D

The reasons as to why Irish SMEs borrow gives us an even deeper insight into Irish companies. According to the Central Bank's SME Market Report, Irish SMEs borrow for 'working capital' above any other reason[9]. Our SMEs are also below the EU average for borrowing for fixed investment. The percentage of Irish SMEs saying they borrowed for 'fixed investment' has decreased since the last Central Bank report - from 47% down to 42%. This contrasts with its Eurozone peers such as Germany, Austria and France where 57% of SMEs borrow for fixed investment.

In fact, German SMEs more frequently reported using financing for the development of new products, hiring of employees and refinancing of obligations than SMEs in 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

[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

of 30%. Irish firms need to invest more in their own research and development activities according to the OECD.

Managerial capability and human capital

The international body also stresses that money isn't the only kind of capital[10]. Companies need human capital, too and Ireland needs to think about how to raise the capacity of local businesses to absorb and implement new ideas and technologies. The Government's National Planning Framework also acknowledges the role of human capital, seeing it as "central to Ireland's success and our economic and social development". Both recommendations have resonance for our share option regime.

The ability of Irish SMEs to attract the right talent is also crucial to their future direction. At present, 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[11]. And there are further complications. Wages in multinationals are 64% higher than in domestic companies[12] 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[13] and so our share option regime becomes critical.

Tax Recommendations

The tax recommendations from the Institute are aimed at addressing many of the issues we have raised here today.

Given the severity of access to finance for Irish business, which requires much needed capital to innovate, to hire and train the best staff, we will first address the existing tax measures that promote investment:

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

Broadening the revised entrepreneur relief

CGT is a key determining factor for investment in the economy. It is unquestionably the tax that matters most to investors and that can influence their behaviour. Ireland's high CGT rate is one factor that is restricting external investment in Irish business. It is also creating "reluctant" business owners who may hold onto businesses beyond the point where they have capacity to grow them to the scale required for entry and expansion into export markets. In fact, Ireland's CGT rate of 33% remains the fourth highest in the OECD.

CGT – fourth highest in the OECD

Ireland's targeted 'revised entrepreneur relief' reduces the high CGT burden on business sales to a limited extent. But Ireland's CGT regime is uncompetitive when compared with the UK - the entrepreneur relief which should mitigate our high CGT rates locks out the important 'angel investors' who are willing to invest their money, experience and industry expertise in ambitious

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

young companies, a vital factor when we reflect on the need for productivity improvements in Irish businesses. Business angel investment in Ireland is low compared with other countries such as the UK, France, Germany and Sweden.

Need for an effective EII regime for Ireland

Another financing related measure is the EII. The EII income tax incentive, is an important source of finance for early stage and small businesses that have limited funding options available to them and very often must rely on financial backing from family and friends. It plays a vital role in scaling start-ups and small businesses to the next level of growth.

(1) There are a number of design features of the EII which are acting as 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)[14], under which the EII operates, are also having a significant impact on the operation of the scheme. The GBER has added 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. In addition, there is a tight and restrictive administrative process under the GBER which is stifling the use of this important tax relief aimed at helping small companies to raise finance.

The inclusion of the EII scheme within GBER is now locking businesses out of the opportunity to raise much needed capital investment, as the GBER provisions are being applied retrospectively to business plans prepared before its introduction.

The Institute believes that a full economic analysis of the impact of the GBER on the EII is merited and very much welcomes the current consultation being undertaken by the Minister for Finance, Paschal Donohoe at present. *(See attached Irish Tax Institute Submission on 'Consultation on Review of EII and SURE).*

Need for a workable KEEP share scheme for SMEs

We know from the OECD Economic Survey of Ireland that Irish companies need the best human capital and talent to increase managerial skills, innovation and R&D capability. Given the high personal tax rates, Irish SMEs need a workable share option scheme that can help them to attract the talent to drive and expand their businesses.

While we welcome the introduction of the new Key Employee Engagement Programme (KEEP), which provides an opportunity for SMEs to compete with listed companies to attract and retain such talent, the scheme contains some limitations which could significantly impact its feasibility and ultimately, its success in achieving its policy aim. Issues surrounding the qualifying criteria for individuals; the design of the remuneration limits and the narrow definition of a qualifying holding company under the scheme rules are creating difficulties for many SMEs to qualify for KEEP.

[14] 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.

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

Innovation plays a particularly crucial role in the development of smaller companies and this 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[15] undertaken by the Irish Tax 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 raise to 62% if there was more clarity around the criteria for qualification.

Of real 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.

The Finance Bill Process

To conclude, members of the Committee will be aware from our submission[16] in 2016 that one of the key challenges in the Irish tax policy making process at present is that insufficient time is available to scrutinise tax legislation once Government has announced the policies.

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 being published. 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 result would be a continuous flow of scrutinised law throughout the year that is then incorporated into the Finance Bill, reducing the risk of the policy objective not being achieved or unintended consequences arising.

As acknowledged by the IMF and OECD in their 2017 report on tax certainty *"…legislative and tax policy design issues are a major source of tax uncertainty, mainly through complex and poorly drafted tax legislation and the frequency of legislative changes."* [17]

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.

ENDS

[15] Irish Tax Institute Report "A future tax strategy to grown Irish indigenous exports", June 2017
[16] Irish Tax Institute Submission to the Select Committee on Arrangements for Budgetary Scrutiny – A Special Focus on the Finance Bill Process, June 2016
[17] Tax Certainty, IMF/OECD Report for the G20 Finance Ministers, March 2017