Pre-Budget Submission

on behalf of the Irish startup sector

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"A startup is a company designed to grow fast."

- Paul Graham

founder of Y-Combinator
(the leading US startup accelerator)

1. Background to the Submission

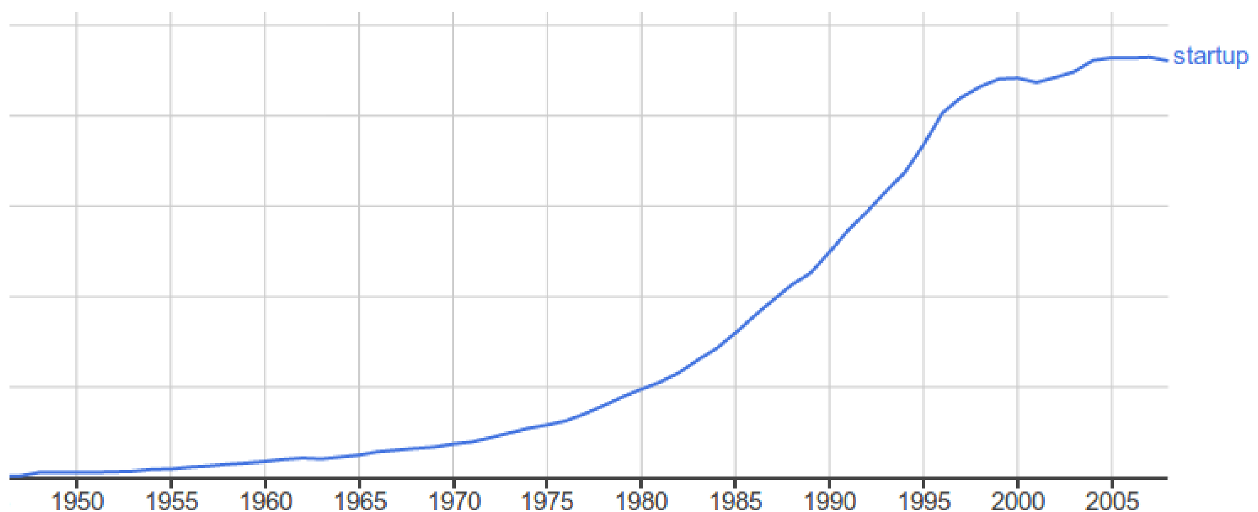
Who is #StartupIreland?

Ireland has a burgeoning community of high-tech startup companies focused on fast international growth. An ecosystem of regional, national and international grassroot organisations has emerged to help these startups share information, knowledge and resources. #StartupIreland is a not-for-profit organisation that connects these startup communities together.

Our grassroots-led activity enables us to understand how Ireland is developing as a startup hub, and identify the challenges that are holding our cities back. Our goal is to help address these barriers through our public policy work, and let startups build on Ireland's natural strengths to establish a global startup hub.

Although the majority of Ireland's technology startups are concentrated in Dublin, we have sought to make recommendations in this submission that will be to the benefit of to startups across the country.

What do we mean by "Startup"?



Source: Google Ngram viewer[1]

Although the term "startup" can be used loosely to refer to any fledgling business, it entered popular usage alongside the digital revolution. #StartupIreland is about this kind of

[1] https://books.google.com/ngrams

innovative high-impact export-focused company.

We recognise that small companies are an essential component of our economy, and want to be clear that we don't represent every company that is both small and new. We solely try to represent the new companies that don't intend to remain small for very long. Startups achieve this by basing their operations on the latest technology advances, permitting them to rapidly deliver their products or services into the global market with a minimum of capital.

This kind of company has very different needs than most other businesses, and accordingly should be treated specially. Startups do not think of themselves as small businesses, but as big businesses that haven't quite gotten there yet. Unlike traditional SMEs, startups implement business plans that have never been implemented before. Survival rates can be low but those that survive can capture entire new global markets. The founders of startups do not aim to create comfortable jobs for themselves, but to establish an important new technology company that will be strategically acquired or publicly listed, creating significant new wealth and jobs. After such a success, virtually every entrepreneur and shareholder goes on to re-invest in new ventures, promoting a virtuous circle of wealth and employment.

Unfortunately, it is in the nature of entrepreneurs to be short on time, short on money and to be focused on short-term survival. As a result they are chronically unable to represent their needs to government in a sustained, coherent way. #StartupIreland aims to fill this gap, interfacing with the entrepreneurial community at a grassroots level, assembling a clear vision of their strategic needs, and representing this to Government for the benefit of our society.

Why are Startups Important for Ireland?

We believe that the large emerging cohort of Irish-founded high tech companies can bring Ireland an unprecedented level of sustainable high-value employment and domestic wealth generation. Our success will be a function of the Irish policy and operational environment for startups, however a reasonable goal is the success of Israel, which shares a similar population and demographics.

Ireland's unique advantages can make it a nexus of innovation between the EU and the US. A healthy startup ecosystem creates a virtuous circle in which thousands of successful entrepreneurs reinvest in successive generations of new startups. Each wave of startups creates new wealth, and redistributes it through employees, reinvestment or taxes into the rest of the economy.

We do not propose that Ireland can be the next Silicon Valley, but we do believe that Ireland has a bigger role to play in the international technology landscape, and that we can have our own Silicon Valley scale companies. The question is not how do we get the next tech giant to open a HQ in Ireland, but how do we make sure that the next tech giant is Irish?

The Potential of Pro-Startup Policies

Government has a critical role to play in reducing the friction experienced by startups. Much of this friction is a result of policies that were crafted in another era with a different type of business entity in mind. For a positive example of what can be achieved when startup-friendly policies are implemented, we need only look to our nearest neighbours.

Since 2010 the United Kingdom has implemented a cohesive strategy to promote the development of startups. This included multiple significant tax incentives to encourage people to create and invest in new technology companies. In 2010, David Cameron announced the East London Tech City strategy[2], including targeted measures such as an entrepreneur visa and Intellectual Property review. In 2013 an "employee shareholder status" was officially recognised to clarify the tax treatment of employee incentives[3].

This strategy to foster high-tech innovation is working. London is now the leading startup hub in Europe, and its growth appears to be accelerating, attracting many of the leading venture capital firms and corporate innovation centres (such as Google Campus[4]).

At home, we see a growing trend of startup teams choosing to incorporate in Northern Ireland to gain access to improved tax treatment and incentivised private investors. This is clear evidence that startups founded in the Republic of Ireland are hungry for change and will benefit from targeted policies being incorporated into Budget 2015.

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[2] https://www.gov.uk/government/news/pm-announces-east-london-tech-city

[3] http://www.hmrc.gov.uk/employeeshareholder/

[4] https://www.campuslondon.com/

2. The Key Phases of Startup Development

#Vision2020 is #StartupIreland's strategic framework for transforming Dublin into a global tech startup hub by 2020[5] (presented to the Oireachtas Committee on Jobs, Enterprise & Innovation on July 8th 2014). To achieve this vision, consistent action is required at each key phase of startup development to remove unnecessary obstacles.

The key phases of startup development have been distilled by the Startup Commons[6], a global non-profit initiative. These phases are:

1. **Pre-Startup**. The founding startup team forms and a business plan is created.
2. **Startup**. The company incorporates, raises seed capital and employs an initial team. The team brings a product to market, but has no predictable meaningful revenue.
3. **Growth**. The company has figured out how to make money and is growing fast in a significant market. Its workforce expands and it makes the transition from startup to real business.

We have tied each of our recommendations below to the developmental phases that it supports.

Source: http://www.startupcommons.org

[5] http://startupireland.ie/vision2020/

[6] http://www.startupcommons.org/startup-key-stages.html

3. Summary of Recommendations

Ireland has accumulated a number of unintentional obstacles to entrepreneurs and startups. Luckily, there are many relatively easy-to-implement opportunities to reduce the friction experienced by startups as they progress through the startup development phases.

The table below summarises several recommendations that can improve the prospects of startups at low cost to the Irish exchequer. These are organised according to their relevant stage in the startup process, and discussed in greater detail later in this submission.

Page	Recommendation	Phase	Goals
7	PAYE Tax Credit	✔Pre-Startup	● Make entrepreneurship a more attractive choice. ● Support people becoming entrepreneurs.
8	Opt-in Class A PRSI	✔Pre-Startup	● Make entrepreneurship a more attractive choice. ● Support people becoming entrepreneurs.
9	CGT for Entrepreneurs	✔Pre-Startup ✔Startup	● Make entrepreneurship a more attractive choice.
11	Consolidate SCS, EII & Entrepreneurial Relief	✔Pre-Startup	● Increase access to early-stage capital.
14	Offset Convertible Debt Losses against Capital Gains	✔Pre-Startup	● Increase access to early-stage capital.
15	Share Option Taxation	✔Startup ✔Growth	● Attract and retain key employees. ● Increase startup success rate
18	Parental Leave	✔Pre-Startup ✔Startup ✔Growth	● Support female entrepreneurship.
19	Single installment R&D Tax Credit	✔Startup	● Permit companies to access R&D tax benefits when the cash is most needed.
20	Clarify R&D guidelines for software development	✔Startup ✔Growth	● Increase the survival rate of software-based startups

4. Detailed Recommendations

RECOMMENDATION:

Provide PAYE Tax Credit to Entrepreneurs

Relevant Startup Phase: **Pre-Startup**

Background

A typical founder is paid as a full-time PAYE employee of his/her own company, and normally has no other income. However, as proprietary directors, startup founders are not eligible for the PAYE tax credit. This means that they are taxed more than another employee on the same salary in their company. This is a specific disincentive that discourages people from becoming entrepreneurs.

Recommendation

Proprietary directors who are in full-time PAYE employment in their companies should be eligible to claim the PAYE tax credit.

RECOMMENDATION:

Opt-In Class A PRSI for Entrepreneurs

Relevant Startup Phase: **Pre-Startup**

Background

Startup founders are normally employed by their own companies and have a controlling interest, which means they are categorised into Class S PRSI. Under Class S they pay employee’s PRSI, but the company does not make an employer’s PRSI contribution. Although this is cheaper for the company, it is equally expensive for the individual.

The ramification of being in Class S is that the founder is not entitled to participate in various elements of the social insurance safety net, such as job seekers allowance, illness or dental/optical benefits. Women in Class S must also accrue more contributions to be entitled to maternity benefit.

Although many experienced entrepreneurs are happy to exchange lower company taxes for de-facto removal from the social safety net, Class S PRSI is a powerful disincentive to many potential entrepreneurs. The decision to start a new company is risky enough without also losing social insurance entitlements.

Recommendation

Allow proprietary directors to choose whether or not they avail of PRSI Class “A” or “S”.

RECOMMENDATION:

CGT for Entrepreneurs

Relevant Startup Phase: **Pre-Startup**, **Startup**

Background

The rate of Capital Gains Tax (CGT) in Ireland stands as one of the highest in the world at 33% (up from 20% in 2008). Both the founders and investors behind startup companies hope to derive the majority of their long-term income from the disposal of their shares, which means that both of these groups feel that their anticipated taxes have increased by 65% in the last few years. For these people, an increased rate of CGT acts as a disincentive to investment. Every potential startup must now promise even greater returns to compensate for the higher taxation overhead, resulting in fewer potential entrepreneurs and investors taking the plunge. For those entrepreneurs and investors who take the plunge and are lucky enough to make a return, high CGT leaves them with less after-tax capital to reinvest in new startups.

In practice, the punitive CGT rate means that a lot of startup investment is now performed through complicated holding companies. This has the simultaneous effect of (a) deterring all but professional investors from making investments, and (b) deferring the collection of tax by the exchequer.

We understand that CGT is an essential form of wealth redistribution in society. However, we believe that the current high flat rate CGT stifles investment in innovation in Ireland, and reduces the overall tax take. A more progressive CGT structure is required.

The United Kingdom has demonstrated a way forward. Introduced in 2008, "*Entrepreneurs' Relief*"[7] provided a reduced 10% rate of CGT on the first £1M in capital gains earned by a proprietary director during his/her lifetime from the companies he/she creates. This scheme has been so successful that the lifetime limit was raised to £5M in 2010, and then to £10M in 2011.

[7] Note that this scheme bears no similarity to the measure of a similar name in Budget 2014.

Recommendation

Ireland should implement a progressive CGT scheme along the lines of the UK's Entrepreneur Relief Scheme. The first €12.5M earned from startup investments by founders or private investors in startups should be taxed at a lower rate of 10%.

RECOMMENDATION:

Consolidate SCS, EII and “Entrepreneurial Relief”

Relevant Startup Phase: **Pre-Startup**, **Startup**

Background

The Employment and Investment Incentive (EII), Seed Capital Scheme (SCS) and Entrepreneurial Relief are the three major tax reliefs in place in Ireland to support startups. Unfortunately, the feedback from the community is that these schemes are not working in the intended way.

The *EII* scheme has not proven successful due to its complexity, the staging of tax relief over several years, a requirement that the company continues trading for 3 years (many startups succeed or fail faster than this), that employment levels increase over those 3 years, and various other restrictions.

The *Seed Capital Scheme* (SCS) permits founders to invest in their own startups and reclaim income tax from the previous 6 years against their investment. This scheme is suited to encouraging experienced staff from large companies to leave employment to start their own ventures. It is less useful to young entrepreneurs or serial entrepreneurs, who do not have the capital and tax history to benefit from the scheme.

Budget 2014 introduced the “Entrepreneurial Relief” measure (which has little similarity with the progressive CGT known as “Entrepreneurs’ Relief” in the UK). A better name for this relief would be “*capital gains reinvestment relief*”. The relief in its current structure is not of practical use to entrepreneurs or the majority of investors. The issues with it are more easily illustrated by the following example.

> Say an entrepreneur sells her business to a US technology giant in 2015, after many years of hard work on a living wage. From the sale of shares, she makes a capital gain of **€1M.** She is still immediately liable for CGT at **33%** and therefore has a net gain of **€670K**. To avail of full CGT relief, she must now **re-invest the entire €670K** in other qualifying startups. In the following years, should she make a net gain on her portfolio, then the CGT she is liable for can be reduced by half, to a maximum of **€330K** (the sum she was

originally taxed on the proceeds from her own company in 2015).

Criticism

This relief does not incentivise the present-day behavior of the vast majority of entrepreneurs, who have not yet sold a company. It's influence is limited to the minority of entrepreneurs who have sold a business and are considering future investments. Even for this group, the scheme suffers from two major problems:

The first problem is that the relief can only be accessed many years in the future, at least 3 years, but more probably on the 5 to 10 years timescale it takes for startup investments to mature.

The second major problem is that it is extremely unwise for an entrepreneur to reinvest all her capital into new startups. A wise entrepreneur will diversify, and will allocate only a fraction of her money for re-investing startups.

A More Realistic Example

A more realistic example is that the entrepreneur allocates 20% of her remaining 2015 capital (€134K) to startup investments. The best case scenario is that she makes an amazing 10X return only 3 years later. At this point she would receive €44K in CGT relief (€134K x 33%), reducing her effective 2015 CGT rate from 33% to 28%. Compared to the level of risk that she has taken on her new investments, this reward is both minimal and late, and will not significantly alter her investment behavior.

Comparison with the UK's SEIS Scheme

The United Kingdom has introduced a scheme known as the *Seed Enterprise Investment Scheme* (SEIS). This unified scheme overlaps in purpose with Ireland's *EII*, *SCS* and *Entrepreneurial Relief* schemes. It has already proven highly successful in its stated goal of "kickstarting the economy"[8].

SEIS allows private individuals to invest up to £100K per year into qualifying startups and

[8] http://www.seis.co.uk/

receive the following simple benefits:

1. **Upfront income tax** relief of 50% of the amount invested. For example, if £100K is invested, personal tax liabilities can be immediately offset by £50K.

2. **Full exemption from CGT** payable on any gains made from these investments.

3. Any capital losses incurred from the investment can be offset against capital gains **or income tax**.

4. To encourage people to participate, individuals can **reclaim 50% of capital gains tax paid** on disposals of other assets, if they invest those proceeds into qualifying startups. This is similar to the Budget 2014 Entrepreneurial Relief scheme, but is claimable immediately instead of being contingent on the profitable future disposal of the new investment.

Recommendations

The EII Scheme, SCS and Entrepreneurial Relief should be replaced with a single coherent scheme that provides the powerful incentives offered by the UK's SEIS. To maintain the key additional incentive of SCS, it should be possible for an entrepreneur who invests in a startup under the new scheme to receive relief on tax paid in previous years, not just the current year.

RECOMMENDATION:

Offset Convertible Debt Losses Against Capital Gains

Relevant Startup Phase: **Pre-Startup**, **Startup**

Background

It is increasingly common for startup companies to raise early stage capital from private investors in the form of convertible debt, which will convert into equity upon a subsequent priced equity round. In comparison to negotiating a priced equity investment round, issuing convertible debt is fast and simple, and avoids legal costs that add up to a large fraction of the investment value.

Unfortunately, the private investors face a major disadvantage: any loss they incur on convertible debt investments cannot be offset against their capital gains elsewhere. This deters many investors from funding young companies.

Recommendation

Permit the holders of convertible loan notes to offset defaulted convertible debt against capital gains.

RECOMMENDATION:

Share Option Taxation

Relevant Startup Phase: **Startup**, **Growth**

Background

The success of a startup depends on its ability to attract, retain and motivate highly skilled workers. Due to the IDA's success at attracting high levels of Foreign Direct Investment, most startups are now competing against international technology giants to hire local talented staff. Startups cannot offer salaries or benefits to compare with those larger companies, but there is one thing they can offer that the larger companies cannot: ownership by way of equity participation.

Not only can share ownership plans help startups attract the key staff that they could not otherwise afford, but it also promotes strong team dynamics and staff loyalty. In the United States it is typical for startups to allocate up to 20% of equity to an employee ownership plan upon their first major investment. This allows startups to incentivise extraordinary performance from its key employees during the critical transition through the startup and growth phases.

Shares received as a form of remuneration are correctly taxed as a benefit-in-kind. However, most startups do not aim to *remunerate* their employees with shares, but instead incentivise them with a stake in the *future* growth of the company.

Unfortunately, there is currently no good way for an Irish startup to offer an employee ownership scheme without triggering unfair taxes for the employee along the way.

The three major approaches in current use are outlined below, along with the associated drawbacks.

Approach A: Ordinary Shares

If a startup simply grants ordinary shares to a new employee as part of an incentivisation plan, then the employee immediately faces a taxable benefit-in-kind event. As the shares are

not liquid, the employee must spend her savings (if any) to pay the extra income tax. Therefore, a grant that was intended to incentivise the employee instead has the effect of costing her money.

Approach B: Growth Shares and Flowering Shares

Some companies are creating new share classes that offer little or no present day value to their holders, but provide the ability to benefit in future increases in share value. These shares can be granted to employees before they have a taxable value. However, when they are disposed of (e.g., when the startup is acquired), the rise in share value is taxed as a capital gain.

One approach is known as “growth shares”, which only pays its holder the disposal price minus the share price when it was issued. Another approach is “flowering shares”, which define commercial targets that must be hit before they can be disposed of (thus allowing the present-day taxable value to be discounted).

Although growth shares and flowering shares can technically achieve the goal of incentivising employees without triggering income tax, they suffer from some serious issues that make them impractical for most startups:

1. They are complicated to implement, and can easily generate legal costs to the startup in the €10,000 - €20,000 range.
2. Their complexity can deter both Irish and international venture capital investors from investing in the company during the growth phase.
3. Growth-stage investors may simply require that the extra complexity of this share class be removed before they invest, which results in employee resentment.

Approach C: Share Options

An alternative strategy is for a company to grant share options to employees under an unapproved share option scheme. These options trigger income taxation when they are exercised. This poses several problems for the employees:

1. If employees exercise their options during the startup and growth phases of the company, the rise in share price creates a large income tax burden that they must pay from their savings.

2. If all goes well and the startup is acquired, then the employees simultaneously exercise their options and sell the resulting shares. Unfortunately, the employees face income tax on the exercise of the options, instead of CGT on the disposal of the

shares. The employees therefore pay over half their gain in tax, while the other shareholders face only CGT.

In both of the above scenarios, the intended purpose of the share options – to incentivise the employees – is subverted. Instead of feeling rewarded by the business, they feel punished. In cases (1) the employees are faced with a large tax bill without receiving any cash to pay it with. In case (2) the employee is faced with paying much higher taxes than other shareholders participating in the transaction.

Recommendation

We recommend that exercising an share option to purchase shares in a startup company should not be a taxable event. The taxable event will then become the disposal of the purchased shares, which will be a capital gain.

This single measure resolves all the difficulties with share option incentive schemes, while still ensuring that all parties pay their taxes.

RECOMMENDATION:

Parental Leave

Relevant Startup Phase: **Pre-Startup**, **Startup**, **Growth**

Background

Mothers are currently entitled to 26 weeks maternity leave and an additional 16 weeks unpaid leave. Since only the mother can avail of this leave, many female entrepreneurs are forced to choose between having a company and having a family.

Recommendation

Maternity Leave should be redefined as “Parental Leave”, and should be sharable between a mother and her legal partner in order to enable increased levels of female participation in high impact startups.

RECOMMENDATION:

Single-installment R&D Tax Credits

Relevant Startup Phase: **Startup**

Background

Many high impact startup companies are innovating with new technologies and are eligible for the R&D Tax Credits. This credit is refunded in three annual installments following the accounting period in which the R&D work was performed.

A typical startup struggles with cashflow while it performs the research and development associated with its initial product. By the time that the startup can begin to benefit from R&D tax refunds, its cashflow difficulties will often have either disappeared, or put it out of business.

Recommendation

Increase the survival rate of startups by permitting them to claim refunds against R&D Tax Credits in a single installment, during the same accounting period that the R&D expenditure was incurred.

RECOMMENDATION:

Clarify R&D Guidelines for Software Development

Relevant Startup Phase: **Startup**, **Growth**

Background

A great many of Ireland’s high impact startups are engaged in the delivery of digital products and services. The core activity of most of these companies is software development, which is a highly experimental process. The current R&D guidelines are hard to interpret with respect to software development activities, resulting in many startups that avoid claiming the R&D tax credit when they may in fact be eligible, for fear of an expensive audit.

Recommendation

Launch a consultative process with Irish-based software startups to define clear guidelines on what development activities constitute eligible R&D, and specify an acceptable level of supporting documentation that fits within the modern software development process.