Start Up Manifesto Support Document: tax and Social welfare changes.

Updated September 2016

Background.

Ireland's proposed Start up Manifesto sets out a range of actions that need to be undertaken by various players to maximise the number of innovative start-ups in Ireland and the proportion of them that go on to achieve significant success on international markets.

All of the actions items in the Manifesto are in the form of very brief outlines of the objectives that need to be achieved. A minority of the action items in the manifesto relate to Tax and social welfare changes.

This document sets out additional information and more detailed recommendations on the tax and social welfare related action items, in the manifesto.

STARTUP MANIFESTO RECOMMENDATION:

The state should revise the taxation of employee share options so as to assist Startups compete for top talent

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 often competing against international technology giants when hiring local talented staff. Startups cannot offer salaries or benefits to compare with those larger companies, nor can they offer generous relocation packages when seeking to attract talent from overseas. However, they can offer ownership by way of equity participation in a startup and this can be far more attractive than an equivalent share opion scheme in a more mature company.

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 a 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.

STARTUP MANIFESTO RECOMMENDATION:

To help retain and attract entrepreneurs, the State should continuously review Capital Gains tax rules for entrepreneurs in order to ensure that they are competitive with the best other startup locations

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.

This issue has been a bone of contention for some time and the Government recently made a small but inadequate improvement. As of January 2016, entrepreneurs having disposed of assets of a qualifying enterprise are eligible for a reduced capital gains tax rate of 20% up to a lifetime limit of €1m. However, this is still uncompetitive as compared to the capital gains relief scheme in the UK (detailed below).

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, (b) deferring the collection of tax by the exchequer and (c) diverting money that should be invested in Startups into expenditure on legal bills and other ongoing compliance costs..

We understand that CGT is an essential form of wealth redistribution in society. However, we believe that the current high rate of 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" 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.

In July 2016 the Tax Strategy Group within the Department of Finance published recommendations..... (see http://www.finance.gov.ie/sites/default/files/160711%20TSG%2016-09%20Capital%20taxes%20%28CAT%20and%20CGT%29.pdf)

Recommendation

Follow through on the government's commitment to lower this rate to 10% by 2017 (Summer 2016 Economic Statement). We additionally recommend that the lifetime limit be raised from €1M to at least €10m in chargeable gains earned from startup investments by founders or private investors in startups, more consistent with the UK's Entrepreneur Relief Scheme.

STARTUP MANIFESTO RECOMMENDATION:

The State should remove discrepancies in the social welfare and PAYE systems that penalize or appear to penalize self-employment, proprietary directors and startup failure

Two discrepancies need to be addressed one relates to PAYE tax credits and the other to the PRSI class oapplicable to Entrepreneurs, each is discussed separately below.

Provide PAYE Tax Credit to Entrepreneurs

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 full PAYE tax credit amount. 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

Follow through on Summer 2016 Economic Statement's commitment to fully equalise the PAYE tax credit for proprietary directors and self-employed who are in full-time PAYE employment by 2018.

Opt-In Class A PRSI for Entrepreneurs

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, especially job seekers benefit should the business fail.

Recommendation

Allow proprietary directors to choose whether or not they avail of PRSI Class "A" or "S"—(*Note: There is a commitment in the 2016 Summer Economic Statement to introduce a PRSI scheme for the self-employed, but it is unclear if it applies to proprietary directors or covers our recommendation for Class A opt-in.)*

STARTUP MANIFESTO RECOMMENDATION:

To facilitate female entrepreneurs of childbearing age to start companies the State should redefine paid maternity leave as parental leave and allow it to be shared between mother and father.

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, and a Startup often could not survive the absence of a founder for anything like 26 weeks, many female entrepreneurs are forced to choose between having a company and having a family. There has been a recent improvement in that from September 2016, fathers will be able to claim two weeks of leave paid at €230 per week. However, this does not resolve the problems faced by female entrepreneurs and still leaves Ireland's parental leave system far behind other OECD countries.

Recommendation

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

STARTUP MANIFESTO RECOMMENDATION:

In order to incentivise investment in Startups and to make Ireland internationally competitive for Startups, the State should overhaul and consolidate the Employment and Investment Incentive (EII), Seed Capital and "Entrepreneurial Relief" schemes

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 the new Irish 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:

Example

Say an entrepreneur were to sell 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). **Cora/Aidan do you have a more relevant example?**

Criticism

This relief does not incentivise the present-day behavior of the vast majority of entrepreneurs, who have not yet sold a company. Its 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 year 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 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 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.

Recommendation

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.

STARTUP MANIFESTO RECOMMENDATION:

Given that investments in Startups are often made in the form of convertible debt, the State should revise Capital Gains Taxation to allow investors in Startups to offset any losses from such investment against other capital gains

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.

STARTUP MANIFESTO RECOMMENDATION:

Given the intense cashflow problems faced by most Startups, the State should allow them to claim R&D tax credits in a single instalment

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. We understand that the reason given for not implementing this proposal is the impact of single-installment tax credits on the Exchequer. However, by targeting this reform exclusively at startup companies, it would greatly limit the effect on the Exchequer while providing small innovative companies with necessary cashflow and incentivizing them to invest undertake R&D within the state, which is the objective of the scheme.

START UP MANIFESTO RECOMMENDATION:

The state should ensure that the procedures Startups must follow to claim R&D Tax Credits are simple and straightforward.

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 R&D tax credit guidelines were updated by Revenue in 2015 to address previous concerns that had been raised about lack of clarity. This is welcome, however, as in all such situations, it will take time to see whether or not the clarifications have addressed the two key issues namely: have they simplified matters for those startups who do claim the credits and have they reduced the number of startups who avoid availing of the scheme because of its perceived complexity and the fear that an expensive audit may show that a claim made in good faith was not in fact eligible. Once the updated guidelines have been available for a period of time, it will be important to undertake a review and consultation exercise to determine whether recent improvements have addressed these issues.

Recommendation

Launch a brief consultative process with Irish-based software startups to review the clarity of the updated guidelines on what development activities constitute eligible R&D and what is the acceptable level of supporting documentation which fits within the modern software development process.