Irish ProShare Association

Michael Noonan, T.D.
Minister for Finance,
Government Buildings,
Merrion Street,
Dublin 2.

14th July 2015

Via email: enterprisetaxreview@finance.gov.ie

Dear Minister Noonan,

Please find below Irish Pro-Share Association (IPSA) responses to questions posed in your Department's recent "Tax and Entrepreneurship Review: Public Consultation Paper, June 2015".

Our submission focuses on the ability for employee ownership to promote entrepreneurship. Not all questions posed in the paper are relevant to IPSA's proposal so we haven't responded to questions 5-8.

The tax system is critical in supporting entrepreneurship. IPSA believes the introduction of targeted tax incentives that promote and facilitate employee ownership in private companies could radically stimulate entrepreneurship in Ireland.

Tax incentives can and do encourage enterprise. Attracting, retaining and incentivising key talent is critical for any business to succeed. Privately owned businesses need to be able to compete with publicly listed companies for that key talent. Employee ownership is a proven tool for the attraction and retention of skilled staff. It can be the vital component of a remuneration package when a business is cash strapped and in competition for key talent from more established entities[1]. Employee share

[1] Burns (2006) found that 44% of respondents to their survey strongly agreed with the proposition that employee ownership makes employees more committed to company success and that innovation happens more effectively.

Lampel, et al. (2010) identified that employee owned companies perceive their ability to attract and retain talented employees and harness their innovation are strong advantages of the employee ownership model. Employee ownership is described as a "profound and distinctive enabler" of greater employee engagement, and MacLeod and Clarke (2009) proposed that there is a strong relationship between employee engagement and innovation.

Research by Lampel, et al. (2012) also found that employee owned companies tended to have a longer-term focus, attaching higher importance to "pioneering innovations" and "innovative ideas from staff" than non-employee owned companies.

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ownership in privately owned businesses allows employees to participate in the growth and success of the business and aligns the employees' goals with those of the business in order to achieve larger profits and by extension more tax revenue for government.

The current tax and regulatory environment as it pertains to employee ownership, is full of complexities and disincentives. The Approved Profit Sharing Scheme (APSS) and the Save As You Earn Scheme (SAYE) are mainly availed of by quoted companies and are not viewed as fit for purpose by smaller private companies. In order to encourage and increase the level of employee ownership in private companies IPSA believes the tax system should facilitate the transfer of shares to employees in a simple and tax efficient manner as applies in other competing economies[2].

1. What barriers to establishing enterprises exist in the current tax system?

The two biggest barriers in relation to providing employee ownership in private companies are: (a) that individual employees have to fund the immediate taxes; and (b) the complications inherent in the current tax system which acts as a disincentive for both employers and employees.

- In relation to (a), the fact that employees are required to fund taxes immediately i.e, income tax, USC and PRSI that arise for employees on the value of the shares acquired. In a typical scenario, an early stage company that attracts an employee with a competitive salary as well as shares with a nominal value of, say, €50,000 will be hit with a 52% tax bill or €26,000 in cash even though those shares are illiquid. This kills the attraction of using shares to attract staff immediately. To meet such a tax bill on founders' shares a founder or an employee owner may have to dispose of shares in the formative years of their private companies. This alone has hugely reduced the number of IPOs and the progression of Irish companies to world class standard.

- Regarding point (b), IPSA is of the view that the complex tax legislation currently in place has created layers of compliance considerations and bureaucracy which act as a disincentive for both employers and employees in encouraging and increasing employee ownership. If it is not possible to introduce a simple tax efficient scheme, then a middle-ground solution may be to defer the payment of the income tax, USC and PRSI liabilities on the acquisition of shares in a private company until a major 'event' such as an IPO or share disposal takes place. At that stage, employees would be able to realise funds to pay the relevant income tax, USC and PRSI liabilities, and at very likely at a much higher quantum than at the start-up phase.

Michie and Sheehan (1999) examined the relationship between adoption of various employee participation/representation mechanisms and expenditure on research and development. They found evidence that employee involvement is positively correlated with the likelihood of firms innovating.

[2] An example of an effective scheme is the Enterprise Management Incentive (EMI) that operates in the UK. For further detail see the response to question 2

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2) What existing tax measures are effective in supporting small businesses and encouraging entrepreneurs?

Unfortunately, unlike the UK Enterprise Management Incentive (EMI) scheme in the UK, there are very limited and generally ineffective existing tax measures that support entrepreneurs and private companies from an employee ownership perspective.

IPSA notes that the EMI scheme has been successful in facilitating the take up of employee ownership measure in UK start-ups. IPSA is aware of Irish start-ups who have moved their principal trading business to the UK in order to take advantage of EMI, rather than incorporate their enterprise here in the Republic of Ireland. This is clearly acting as a disincentive to job creation in the Republic.

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

The employee share ownership tax measures currently in place, primarily the Approved Profit Sharing Scheme ("APSS") and the Save As You Earn ("SAYE") Scheme are not effective in supporting small businesses and encouraging entrepreneurs.

- The schemes are rarely used by small private companies as can be seen from the list of Approved Profit Sharing Schemes and SAYE schemes on Revenue's website. In general, private companies view these schemes as complex, expensive and difficult to implement and administer. In addition, while income tax relief is available once certain conditions are met, the USC and employee PRSI are still charged on the appropriation of shares to a participant in an APSS and on the exercise of an option under an SAYE scheme.

- Therefore, there's still a requirement to fund a reduced tax liability in respect of each of these schemes and as outlined above, due to the absence of a ready market for shares, employees in private companies are forced to borrow funds (banks rarely lend against such assets) or, where available, use private funds to meet this liability. Money that could go to fund a wealth creating enterprise is therefore diverted to the Exchequer.

- These schemes can be effective for use by larger organisations and Public Limited Companies and indeed are a valuable and important part of many businesses remuneration packages. However, given that the all employee nature of these Revenue approved schemes, there is a limitation on the extent of the benefits that they bring. In addition, we would welcome the introduction of a new, simple and tax efficient share scheme, tailored for use by smaller private companies.

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Ex-ante evaluation of the proposed tax expenditure

1. What objective does the tax expenditure aim to achieve?

The objectives can be summarised as follows:

a) More indigenous companies being set up;
b) Higher growth rates within those employee owned enterprises;
c) Greater number of stock market listing attracting outside capital to industry;
d) More and better quality employment within the Irish economy; and
e) Increased opportunity for smaller shareholders to participate in Irish businesses.

- Budget 2015 states that Small and Medium-sized Enterprises are the "lifeblood of our economy and play a crucial role in economic and employment growth". Entrepreneurs realise that in order to grow their businesses they need to attract, retain and incentivise key personnel but usually cash generated within the business is used for further growth. Share plans can and should play a key role in giving employees a vested interest in the success of a business and in doing so aligning the interests of the employee and employer. Very importantly for a start-up, where shares are used, there is a limited upfront impact to cash flow for the business.

- Research shows that employees who participate in employee share plans are happier in their roles, have lower absenteeism rates and are more likely to remain in their current job, helping keeping teams in place. This gives increased productivity; a key components of growth in both economic and employment terms. In that context, it is important that share plans are accessible by Irish indigenous businesses in order to level the playing field and ensure that they can compete in attracting and retaining key personnel – an issue recognised by Enterprise Ireland amongst others.

2. What market failure is being addressed?

The market failures being addressed include attracting, incentivising and retaining key people in the business as a platform for future growth.

- Share plans are perceived by many Irish indigenous businesses to be complicated, costly, difficult and expensive to administer. The upfront tax, USC and PRSI cost make them unattractive to employees and employers. The employee is faced with an upfront tax cost and no additional cash flow prompting the business to provide an additional cash bonus giving rise to a funding issue for many cash strapped start-up businesses.

- Entrepreneurs regard the many rules regarding current reliefs as being too restrictive and not flexible enough to meet the commercial realities facing owner-managed businesses. An example of this is the requirement for clogged/restricted shares to be held via a Trust or other Revenue approved structure. On exit from the business due to IPO, sale or other disposal, punitive disposal taxes and the lack of a rollover mechanism hinders future investment of funds received and the creation of a new generation of entrepreneurs.

- Therefore, in return for employees assuming more risk in growing the economy, this tax expenditure seeks to remove some of the negative impact currently attaching to the use of share awards by private companies, e.g. the up-front tax costs on illiquid assets face by the employees and the additional bureaucracy faced by the company (it should not be forgotten that this has a disproportional negative impact on domestic private companies start-ups than no to multinational listed companies).

3. Is a tax expenditure the best approach to address the market failure?

Yes. One of the stated aims of IPSA is that everyone in Ireland should pay their correct and proper tax, but the question must be asked as to whether the current tax set up in this context is indeed correct and proper.

- Setting up a business or going to work for a start-up enterprise entails significant risk and many great business ideas never happen because of this risk when compared to the safety of taking or remaining in a stable employment position. For this reason IPSA believes that it is not appropriate to tax entrepreneurs in the same fashion as those employed by established enterprise. This is not a new concept as we already have differing rates of VAT depending on the social utility of the product, so we should not view general employment and entrepreneurship as one and the same thing and as such they should be taxed differently. By doing so IPSA believes that more businesses would be set up in Ireland.

- While it is clear to us that a change in tax treatment, especially in the context of employee ownership and equity based measures, this change need not be in the rate of tax applied (although this would be the most innovative and helpful approach) but simply changing the timing of certain tax payments would go along away to improving the system and encouraging uptake of employee ownership and bring about the soft benefits of enhanced growth, retention and innovation mentioned above.

- At IPSA we believe that there should be sensible fiscal measures directed at all forms of employee ownership and we recommend that specific measures should be designed to support companies at specific times in their business cycle (e.g. measures for start-up companies and business succession planning).

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4. What economic impact is the tax expenditure likely to have?

The 2012 Nuttall report commissioned by the UK Government showed that encouraging employee ownership leads to a significant positive economic impact.

As our proposed reforms are not yet put in place we cannot demonstrate an equal success, however, we are confident that our proposals would radically alter the culture of business in Ireland for the better by increasing the number of enterprises leading to greater employment and productivity. This is turn would lead to greater direct (corporation tax) and indirect tax income (Income tax, USC, PRSI, VAT, DWT, RTSO, Stamp duty and CGT) revenue.

5. How much is it expected to cost?

Much will depend on the tax treatment given.

In the UK, EMI gives capital gains treatment instead of income tax rates and this reduces the percentage of tax received, however, simply changing the timing of payment may be close to cost neutral. That said, it must not be forgotten that due to the complexity and risk involved in such schemes, the low up-take by companies reduces any exchequer income. Therefore it is not a straight conversion in that lower rates of tax may increase the frequencies of the up-take and produce more income for the State as a result.

Closing remark

In summary, entrepreneurship requires risk and if we are asking the founder and employees of start-up companies to put their future income at risk then we as a country and as a people should be willing to do the same.

Yours sincerely

Kind Regards

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Niall Kavanagh
Co-chair Irish ProShare Association & chair of the IPSA Private Company Sub-committee

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Co-chair Irish ProShare Association & chair of the IPSA Advocacy Sub-committee