An Roinn Airgeadais
Department of Finance

Tax Incentives for SMEs
Tax Strategy Group – 19/05
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Contents

Tax Incentives for SMEs - Issues arising from Consultation

As part of the preparations for Finance Bill 2019, Tax Division undertook a stakeholder consultation process, including a public consultation event on 6 June 2019, on tax incentives for the SME sector.

During May 2019 a written consultation process was conducted in respect of the following income and capital tax measures:

Income Tax

- The Key Employee Engagement Programme (KEEP); and
- The Employment and Investment Incentive (EII) and related measures.

Capital Tax

- CGT Entrepreneurs' Relief.

Concurrently, the Division also progressed consultations with stakeholders in relation to the following in relation to corporation tax:

Corporation Tax

- R&D Tax Credit.

The public consultation event on Thursday 6 June 2019 afforded participants the opportunity to amplify and supplement their written comments and to participate in a discussion with Tax Division, Revenue and other interested parties.

It is intended that arising from the consultations, proposals will be brought forward for consideration by the Minister for Finance in the context of the forthcoming Budget and Finance Bill.

KEEP

Background

KEEP was introduced in Finance Act 2017, commencing from 1 January 2018, in response to a Programme for Partnership Government commitment to explore the mechanisms through which SMEs in particular can reward key employees with share options in a tax efficient manner.

Gains arising to the employee in respect of the KEEP share options are taxed at the time of share sale and subject to CGT rather than IT. This allows a differential of 16% or 19% in the rate of tax payable by the employee on the discount received as compared to the treatment of standard share option gains.

During the course of 2018, it became apparent that take-up for the scheme was likely to be lower than anticipated. (Taking account of the stakeholder representations that he received on the scheme) the Minister for Finance announced his intention to make changes to the design of the scheme in his Budget 2019 speech.

Finance Act 2019 provided for the following amendments to KEEP:

- the limit of €250,000 in any 3 consecutive years of assessment was replaced by a life-time limit of €300,000; and,
- The limit of 50% of the annual emoluments in the year of assessment was increased to 100% of annual emoluments.

Consultation

In total 17 submissions were received in response to the written consultation on the Key Employee Engagement Programme, from both industry bodies and small and medium sized enterprises.

Most submissions welcomed the introduction of KEEP as a tax efficient measure for SMEs to attract and recruit key employees.

The aspects of KEEP that were identified as working effectively were as follows:

- The deferral of tax until shares are sold;
- The application of CGT rather than income tax on disposal of shares;

- The savings for the employer with regard to employer's PRSI.

Among a large range of options, the most commonly suggested amendments which might be considered in relation to the scheme, in order of preference, were as follows:

- **Process of Share Valuation**: simplify the administrative obligations that companies must comply with regarding share valuation and provide greater certainty in relation to valuations;
- **Value of shares as a proportion of remuneration**; eliminate the restriction limiting the value of allowable option grants to 100% of an individual's salary;
- **Conditions relating to the Qualifying individual**; amend the employment conditions for the qualifying individual to allow greater flexibility in relation to the employee's working arrangements**;**
- **Group Structures/Definition of holding company;** 'qualifying individual' should be amended to allow an employee who transfers to a group company to retain their KEEP options;
- **Tax treatment of share buy-backs:** ensure that CGT treatment will apply in the case of a company buy-back of shares; and
- **New vs. existing shares**: allow existing shares to qualify for KEEP.

Process of share valuation

Under KEEP, share options must be granted at the market value of the same class of shares at the date of grant. The value of a shareholding in an unquoted company depends on many factors. For example, the value will depend on the business sector/industry, the net assets of the business, the profitability of the business and its future prospects in the marketplace.

The current Revenue position on share valuation is as follows:

> *"Revenue expects that in valuing the shares the company should use a valuation method which complies with relevant accounting standards. Revenue will not provide an opinion"*

Stakeholders stated that the current approach to share valuation is one of the first hurdles that a company encounters when trying to avail of KEEP. While KEEP can apply to a broad spectrum of companies, it is the high potential start-ups, who are frequently time and cash poor, that find the costs associated with such valuations to be difficult. Furthermore, if it later transpires that the market value used for KEEP was incorrect, the options cease to qualify for the scheme.

Stakeholders suggested:

- Further Revenue guidelines on how to value options;
- The existing 'best estimate' approach to PAYE shares could be adopted;
- A "safe harbour" approach to valuing shares could be adopted;
- Consideration should be given to the length of time a given share valuation remains valid for Revenue's purposes; and,
- In cases where a company has breached the market valuation limits (having made a reasonable attempt to determine the market value of the shares), ensure only the value of the share options in excess of the threshold market value at date of grant will be considered to be non-qualifying for the purposes of the scheme.

The Department of Finance preliminary view is that the above proposals would have administrative and regulatory implications. The issues involved will be further explored in the coming weeks.

Value of shares as a proportion of remuneration

The conditions regarding the maximum total value of share options that may be granted by the company to a qualifying employee, particularly the link between share options and the employee's total annual emoluments, is seen as restrictive.
Stakeholders stressed the need for flexibility and simplicity on this point.

Stakeholders pointed to the UK EMI scheme which was introduced in 2000. EMI has a limit of £250K of options awarded per employee with no obligation to have salary element to the remuneration package over a rolling three-year period.

They also referred to the recently approved Swedish scheme which imposes no annual restrictions on the amounts awarded, but simply restricts the award per employee to some €290K and over a three year period cash remuneration of circa €75,000 must be received by the employee.

One stakeholder observed that "in the start-up scene, the market preference for scaling SMEs would be to offer high equity rewards and comparatively lower salaries."

The Department of Finance notes that the relationship between remuneration and share options was addressed in part in Finance Act 2018 - the proportion of options to salary of 1:2 was amended to 1:1. Further changes towards removing the requirement that there be a cash element to remuneration may *give rise to tax equity concerns. However, the issue will be further examined in the coming weeks.*

Conditions relating to the qualifying individual

The case has been made that KEEP should be amended to accommodate part-time/flexible working arrangements in the interests of gender equality; currently the qualifying individual must work a minimum of 30 hours per week for the qualifying company.

With regard to the issue of part-time/flexible hours it has been suggested that we might adopt the UK approach whereby the employee works a set percentage of their working week with the qualifying company. For example, an employee who works 20hrs per week must devote 75% of their working week to the company (15hrs per week).

The Department of Finance takes note of the points made. Both the UK and Swedish schemes apply a minimum number of hours that must be worked per week- 25 hrs (or 75% of the working week) and 30hrs respectively.

Group structures / definition of holding company

Stakeholders contended that the current definition of a holding company for the purposes of KEEP is so narrow that it does not reflect the commercial reality of most corporate holding structures thereby excluding many SMEs from the incentive. Stakeholders argued that single companies are a rarity in the sector; there are many reasons for companies using more complicated structures and that the Swedish scheme and the UK's EMI do not exclude companies who use group structures. It has been suggested that the definition of holding companies be amended to that contained within the Revised Entrepreneur Relief (597AA(1)(a) TCA 1997).

Stakeholders suggested that where an SME operates through a group structure, an individual can satisfy the minimum working time requirements under KEEP through work carried out in more than one company in the group. To this end, it has been requested that the Entrepreneur Relief group-wide approach to defining a qualifying individual be adopted for the purposes of KEEP.

The primary concerns in relation to such a proposal are that a broadening of the scope of KEEP in such a manner might give rise to opportunities for tax *planning. The challenge is to provide an efficient and effective incentive while mitigating the potential for abuse.*

Tax treatment of share buy-backs

Currently, where an unquoted company buys back its own shares, the payment made to the shareholders may be subject to certain conditions being satisfied, not to be treated as a distribution. Capital gains tax treatment applies to the shareholder's disposal of shares. In order that such a purchase is not to be treated as a distribution, the company must satisfy the trade benefit test and the buy-back must not be a means to avoid a charge to tax

The current arrangements are seen by stakeholders as an obstacle in providing assured liquidity for the shares. One stakeholder observed that KEEP would not work unless there is a clear exit mechanism. The point was made that employees need to understand how they will get a return on their KEEP options (and what the tax treatment will be), given the limited market for such shares.

A suggestion was made that Revenue provide guidance stating that the buyback of shares acquired under KEEP can be expected to meet the conditions for the 'benefit of the trade test' as set out in the legislation. This guidance, in their view,

> "*would provide the certainty of CGT treatment on redemption/buyback of shares in order to meet the policy intent underpinning Revenue approved SME share ownership provisions. In addition, amendments could be made to the Irish Company legislation (as was implemented in the UK) to afford greater flexibility to companies wishing to effect a buy-back in conjunction with an employee share ownership plan."*

The primary concerns in relation to such a proposal are that a broadening of the scope of KEEP in such a manner might give rise to opportunities for tax planning. As with the previous issue, the key challenge here is to provide an efficient and effective incentive while mitigating the potential for abuse.

New vs. Existing shares

As part of the definition of a qualifying share option for the purposes of Section 128F TCA 1997, subsection a) confirms that the shares which may be acquired by the exercise of the share option are new ordinary fully paid up shares in a qualifying company.

KPMG said that the requirement of KEEP is that new shares are issued at the time of the grant of a KEEP share option Stakeholders argued that the requirement for new shares under KEEP denies SMEs the flexibility to set aside pools of shares in the company to be made available to key employees as they are recruited.

> *"By removing the requirement to have new shares, this would allow the company to appropriate and deliver existing shares to qualifying individuals. Delivery of existing shares to employees upon exercise of an option could also be appropriate in the circumstances of the departure of an employee and their replacement by a new recruit (e.g. where existing scheme shares are bought back from the departing employee by the SME)."*

The Department of Finance notes that the rationale for the 'new shares' rule was to allow for a clean slate in terms of share valuations and the base price of qualifying shares. Any change to the policy would need to be considered in the context of the share valuation process (and possible changes to it) as well as addressing the issue of abuse

Next Steps

The intention is to consider the above issues (which represent the priority issues for stakeholders) in detail and to develop proposals aimed at enhancing the effectiveness of KEEP in meeting its aims which can be put forward for consideration by the Minister for Finance in the context of the forthcoming Budget and Finance Bill.

Employment and Investment Incentive (EII)

Background

The Employment and Investment Incentive (EII) replaced the Business Expansion Scheme in 2011. It is a tax relief incentive scheme that provides tax relief for investment in certain corporate trades and is targeted at job creation and retention.

The annual exchequer cost is some €20m to €30m.

EII is subject to GBER and any proposals for change must be consistent with them.

The scheme allows an individual investor to obtain income tax relief on investments, up to a maximum of €150,000 per annum, in each tax year up to 2020.

Relief is initially available to an individual up to a maximum of 30% of the amount invested. A further 10% tax relief is available where it has been proven that employment levels have increased at the company at the end of the specified period (3 years) or where evidence is provided that the company used the capital raised for expenditure on research and development. The scheme is available to the majority of unlisted small and medium sized trading companies.

The scheme was reviewed in 2018 by Indecon Economic Consultants as part of the normal cycle of tax expenditure reviews undertaken in accordance with the Department of Finance Tax Expenditure Guidelines.

On foot of the recommendations contained in the 2018 Indecon Report, and the finding of the Inter-departmental Working Group on EII/SURE, the Minister for Finance approved changes to EII and SURE under the following headings for inclusion in Finance Bill 2018:

Administration: adjustment of the application procedure (EII and SURE) to a primarily self-certification model. This will address the most significant problem with the current design of the scheme relating to delays in the application process. The changes include the following:

- Providing that companies self-certify that they have met the “company conditions” (being those that the investor is not in a position to know for themselves), and that if they incorrectly self-certify then the clawback of any relief claimed will be on the company.

- Providing that the investor self-certify that they have met the "investor conditions" (being those that the investor is in a position to know for themselves). If the investor incorrectly claims relief because of these conditions, then the relief will be clawed back on the investor.
- Providing that companies may apply to Revenue for confirmation that they meet the more complex criteria (being those that come from GBER (Group Block Exemption Regulations): relating to restrictions on an "undertaking in difficulty" and those associated with having business plans).

Start-up Capital Incentive: Provision for a less-onerous regime for investor eligibility (connected persons) for very small enterprises (Start-up Capital Incentive - SCI).

Accessibility: A consolidated text and a range of technical and operational measures.

Extend: Extension of EII and SURE for a further year to the end of 2021 - the Indecon review satisfies the three-year review requirement in the Tax Expenditure Guidelines.

Consultation

Following on from the written consultation process, the following key issues were identified in relation to the EII scheme, for individual discussion:

Level of Relief: Full tax relief should be provided in the year in which the investment is made and gains in the value of shares should be subject to capital gains rather than income tax;

Higher investment limit: The annual investment limit should be increased from €150k for longer term EII investors and higher risk sectors, and capital losses should be allowable for such investors;

Micro scheme: Introduce a scheme for 'micro' SMEs similar to the UK's Seed Enterprise Investment Scheme including an enhanced investor return - 50% - based on the higher risk profile of micro-enterprises;

Operational aspects: Further simplify the application process and provide certainty that company meets the conditions for EII.

Level of relief

One stakeholder said that "in order to encourage investment in newer, riskier companies, we recommend the introduction of a preferential 50% rate of tax-relief for firms under three years old or pre-revenue". A 45% level of relief was also suggested.

Another stakeholder suggested that not only should the full relief be given in the first year but that any gains should be charged to CGT rather than income tax.

It was pointed out that as EII is currently structured the investment is treated as a type of debt with the company making a commitment to the investor to repay the investment at a capped upside after four years. It was also suggested that "feedback from investee companies is that this can be too short a turnaround period for the investee company to generate a return to the investor".

The Department of Finance takes note of these views. The intention is to calibrate the rate at which relief is given (and associated arrangements) so that support is provided to riskier enterprises who need it most and who might otherwise have greater difficulty in attracting capital funding.

Higher investment limit

Indecon, in its 2018 review of EII and SURE noted that individual investors are restricted to a maximum investment of €150,000 in each tax year. In Indecon's view:

> *"this impacts on the profile of investors and focusses investment on a larger number of smaller scale retail investors some of whom are possibly more focused on securing a tax break rather than becoming long term enterprises investors. Such small scale investors may see the EII as a scheme by which they are effectively lending funds to companies for a defined period in*

> *return for a tax break. While Indecon understands the reasons for the investor limit and for other personal tax limits, such an approach is likely to significantly increase the costs for enterprises and reduces the potential to build a group of longer term investors which could enhance enterprise development. As a result the cost/benefit ratio of the desired outcome in terms of support secured by enterprises compared to the tax costs is higher than would otherwise be the case."*

Indecon recommended that the annual investment limit be increased to between €0.5m and €2m for investors who invest shares for a period of 10 or more years, or who invest in shares that are not redeemable and have no company commitment to buy back the shares.

Another stakeholder suggested that EII should be removed from the list of tax reliefs subject to the High Income Earners Restriction.

These issues will be further explored in the coming weeks with particular regard to focusing the relief on smaller, higher risk, higher potential enterprises.

Micro-scheme

Several stakeholders called for the introduction of a scheme for 'micro' SMEs similar to the UK's Seed Enterprise Investment Scheme which allows greater involvement for connected persons where the sector and risk profile of the enterprise are particularly relevant. ITI suggested: *"(i)n our view, there should be a carve-out from the connected party rule linked with a control test, so that shares and share options granted to nonexecutive directors or other key employees will not automatically result in them being disqualified from being a qualifying investor."*

The following observation was also made:

> *"Introduce a more generous scheme, similar to the UKs SEIS for start-up co(mpanie)s. In the absence of a new SEIS scheme, it will be necessary to ease restrictions on connected parties (friends, family) for smaller tech co(mpanie)s in the scheme. Associates should be permitted to invest up to an aggregate amount of €250,000 in the first 24 months of establishment of a company employing fewer than 10 people."*

Another stakeholder made the following point:

> *"In addition, the UK has recognised the differential risk profiles between micro and medium-sized enterprises by introducing the Seed Enterprise Investment Scheme (SEIS) which provides more generous incentives for individuals investing in start-up firms. This scheme is targeted at a different category of firms than the UK's EIIS namely those very small and micro-firms which are newly formed. In this sense, it complements rather than competes with the EIIS scheme….The SEIS scheme also has the added advantage of being more attractive to small investors who can invest up to €100,000 in a single tax year over a number of companies. They receive a 50% tax credit on their investment which is sufficiently attractive to bring new investors to small firms with limited alternatives for funding. Additionally, they receive a CGT exemption on the sale of SEIS shares.*

The Department of Finance recalls the creation of the Start-up Capital Incentive (SCI) for those enterprises which satisfy the "micro" definition in GBER:

> *"a micro-enterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million"*

SCI provides for the participation of connected persons in follow own investments which can avail of the same reliefs as EII. In relation to higher levels of relief and/or higher investment ceilings for investments in smaller, higher risk, higher potential enterprises, the principles apply that regard must be had to ensuring an appropriate balance of Exchequer cost for the overall objectives of the scheme and that such expenditure should be a focused on smaller, higher risk, higher potential enterprises .

Operational aspects

A number of stakeholders raised concerns with the operation of the revised EII administrative regime and, in particular self-certification.

A stakeholder advised:

> *"the principal issue facing companies in relation to the EII Relief is administrative. It should be noted that self-certification*

> *involves an element of risk for taxpayers, and in this context, there should be a particular effort to reduce the administrative burden. As the fundamental premise of the EII Relief is to act as an important incentive for early stage companies, it should not be a requirement for applicants to obtain specialist tax advice to claim the relief."*

Others noted that the self-certification model posed a particular risk to EII fund providers in that it means that there is an inherent element of uncertainty in its fund products in that approval for EII for particular investments could subsequently be withdrawn by Revenue.

Another stakeholder suggested that by having online checklist, possibly through the Revenue On-line Service (ROS), that certifies company qualifies as declared might mitigate the risk to applicants.

The Department of Finance recalls the substantial changes to the scheme already provided for in Finance Act 2018 and that Revenue already provides an assessment of applicants' compliance with GBER requirements and as one of the most technical aspects of an application this significantly addresses compliance risk.

The primary issue here is the balancing of the level of self-assessment expected of EII applicants and the related costs and risks to them, with the capacity of Revenue to ex-ante ensure the compliance of the investor with the scheme requirements and GBER.

Next Steps

The above issues (which represent the priority issues for stakeholders) will be considered in detail over the coming weeks. Proposals will be developed and submitted to the Minister for Finance for consideration in the context of the forthcoming Budget and Finance Bill.

CGT Revised Entrepreneur Relief

Introduction

CGT Entrepreneur Relief was introduced in the 2015 Finance Act. It provides that a 20% rate of CGT applies in respect of a chargeable gain or chargeable gains on a disposal or disposals of qualifying business assets on or after 1 January 2016 up to a lifetime limit of €1m.

The 20% rate was reduced to 10% by Section 26 Finance Act 2016 in the case of disposals made on or after 1 January 2017.

In general a qualifying business is a business other than the holding of securities or other assets as investments, the holding of development land or the development or letting of land. Individuals only benefit from the relief.

The revised relief is currently subject to a formal external review. The relief was included as part of the formal consultation process carried out by the Department of Finance on a range of tax based SME supports and there was engagement with interested parties at an event in Trinity College on 6 June 2019.

This paper reflects the issues raised as part of the consultation process and can be grouped into four general categories:

- Changes to the lifetime limit
- Change to the operation of the relief
- Possible extension of the relief
- Interaction with other similar reliefs

Change to the lifetime limit

Requests for changes to the lifetime limit can be seen within the context of requests for a reduction in the rate of Capital Gains Tax. There have been calls for the development of a roadmap which would chart a timeline for a reduction in the rate of CGT. There have been calls for the introduction of a CGT rate of 25% or 20%. The possibility of introducing two rates of CGT where one would apply to for innovative or trading enterprises and a different rate for passive activity was also put forward.

The arguments around the current rate of CGT are dealt with in the paper on capital taxes.

The lifetime limit is currently €1m at a CGT rate of 10%. There have been calls for an increase in the lifetime limit from €1m to €5m, €10m or €15m either immediately or on a phased basis. The main points that were considered to favour such a change were

- Attraction of UK CGT lifetime relief of €10m discouraging return of individuals to Ireland or indeed encouraging the sale of businesses in the UK

- Greater activity in the economy and greater sales of assets leading to increased use of the relief

An alternative has been to propose a single rate of CGT ER at 12.5% with no life time limit. The option of introducing tapered relief where the rate of CGT of 10% would fall proportionately as long as the shareholder held the shares has also been proposed. This is aimed at encouraging longer term holding of shares with the incentive of a lower CGT rate. It is recognised that such an approach would require analysis as to the optimal rates/holding periods to apply.

It has also been suggested that an investor relief would be introduced at a 10% CGT rate with a lifetime limit of €1m.

The option of introducing rollover relief on the disposal of their shareholding which qualifies for CGT ER has also been suggested. Under this approach where the individual makes a disposal of their shareholding in the company which is subject to the reduced CGT rate, the gain could be deferred where the proceeds on disposal are invested in the establishment of another qualifying business.

Finally the possibility of extending Entrepreneur Relief to dividends and provide for same rate on divided income as for CGT ER has also been put forward. This is based on the view that the 10 per cent rate encourages sales of companies compared to the higher tax rate that applies to dividends and that equalising such rates would not create a financial incentive to sell a company.

Changes to the operation of the relief

The following issues are considered the most relevant from the consultation exercise:

- Amend the requirement on individuals to own at least 5% of shares (which are considered a particular disincentive in tech and bio tech sectors where the founder share are diluted due to the need to raise external capital) or indeed abolish the 5 per cent requirement

- Amend the rules that require payment of CGT until a gain has actually been received. This may occur in the case of earn outs where the actual receipt of the cash is dependent on future events. This is considered to tie up cash which could be potentially invested and can lead to levels of debt for entrepreneurs without access to the cash

- Introduce future use tests in regard to surplus cash thereby providing a clear basis for allowing cash reserves which are required for future business commitments to be regarded as relevant business assets for the purposes of the relief

- Amend the 50 per cent working time test where there is a requirement for an individual to be working in the company in a managerial or technical capacity as this is considered restrictive. This requirement is considered to restrict the ability of individuals to work in more than two projects at a time which undermines the ability of external investors to mentor a number of businesses at the same time

- Requests for change have been made to corporate holding structures:

    - Removal of the restriction where there is a dormant company in a group. This is driven by concerns that where a company has ceased to trade or where the trade has been transferred to another group company and the company cannot be wound up or liquidated due to company law requirements for the protection of creditors. This could be ameliorated by applying the trading test on a group-wide basis by adopting the trading test applied in section 626BTCA, 1997. An alternative approach may be to include holding companies where they retain negligible assets or who hold assets for the purposes of a trade carried out by one of the group members.

    - Removal of restriction that all subsidiaries must be 51% minimum subsidiaries to qualify for the relief

    - Amending of restrictions that prevent receipt of entrepreneur relief where the company/group holds investments or leases trading premises (possibly to other members of the group). The argument here is that businesses may invest cash rather than leaving it on deposit and businesses may purchase premises for future expansion but may rent such premises until these are required.

  - Clarify the legislation to ensure that the existence of a holding company does not prevent a claim for entrepreneurial relief where the holding company of a trading company is liquidated.

  - Amend the definition of eligible groups for the test to apply to the group as a whole rather than the individual companies within the group (where each of them has to pass the eligible test). It would not be possible to pass this test where there are holding companies or investment companies within the group.

  - Change the definition of a holding company to include an indirect interest of an entrepreneur held through a company which is controlled by them

- Allow for apportionment of relief when a company holds investments or earns rental income or alternatively full relief to be provided when such activities fall below a certain level.

- Amend the relief so that it provides recognition for periods of ownership by spouses for the purposes of the ownership test.

- Relief does not apply to assets personally owned by the shareholder but which are used by the company nor does it apply to assets used by sole traders or partnerships prior to incorporation. This approach is considered inconsistent with other reliefs such as retirement relief or business relief.

- Allow sales of land by farmers with long term tenants to those long term tenants to be subject to CGT ER rate of 10%.

Extension of the relief to external investors

There has also been interest in expanding the relief to external or passive investors. This has been sought as a general measure but specifically for such investors where they invest in tech, med tech, food and biopharma companies. The aim of thus is to allow for investment in companies where there is a need for substantial capital investment.

This issue links to the possible dilution of the 5 per cent ownership requirement where certain businesses require significant levels of capital at particular times in their life cycle.

Interaction with other similar reliefs

There was recognition of the importance of the capital taxes reliefs (CAT and CGT) in submissions received. There were calls for

- Specific standalone lifetime limits for CGT ER and retirement relief and in addition to improve the relief or links between entrepreneur relief and retirement relief

- Amend the €3m cap on transfers of business assets for individuals over 66 in respect of retirement relief

- Amend the current provision whereby the inclusion of investment assets for business operated through a company negatively impacts on the percentage share value that can qualify for retirement relief.

Conclusions

Any consideration of possible changes to the relief need to await the final report from the evaluation by the external contractor.

The introduction of two rates of CGT for specific activities (e.g. suggestion that such rates might be differentiated between innovation stage enterprises and others or passive investments compared to trading activity) would have to be carefully examined and there is always the issue of defining particular categories of activity that would or would not be subject to different rates; there is the danger of opening up tax planning opportunities and it would be necessary to avoid potential problems around state aid rules.

It is important also that changes are not introduced which could undermine the fundamental operation of CGT.

The extent to which it would be possible to change the lifetime limit is contingent on decisions around the Budget and available resources. Clearly the Exchequer cost of any increase in the lifetime limit is an important consideration and needs to be considered in the context of possible business or economic activity such a change might generate. While arguments have been advanced around the economic and business benefit of an increased lifetime limit, there is limited evidence available (other possibly than anecdotal) which provides a basis for comparing the Exchequer costs of an increase in the lifetime limit with economic or business benefits.

The Revenue Commissioner's latest estimates suggest that the cost of increasing the lifetime limit, in the absence of any of any behavioural changes would be the following

Lifetime Limit	€2.5m	€5m	€7.5m	€10m	€12.5m	€15m
Full Year Cost	€34m	€61m	€75m	€81m	€83m	€84m

The costing is based on returns filed for the 2017 tax year and does not take into account any behavioural change and the possible outturn may be higher given that this is a demand led scheme. The actual cost of the relief with a lifetime limit of €1m was €20.4m in 2016 (412 claims) and €81.2m in 2017 (873 claims) suggesting that any increase in the limit could be higher than estimated costs.

It is worth noting the statistical breakdown of the recipients of the relief. The following table is a breakdown by economic activity code (NACE) for each claimant of the relief.

Sector	Number	2016 claims amount	Cost amount €m	Number	2017* claims amount	Cost amount €m
Agriculture, Forestry and Fishing	42	6.1	0.8	89	14.0	3.2
Manufacturing	Less than 10	1.3	0.2	10	2.3	0.5
Construction	20	5.1	0.7	51	10.1	2.3
Wholesale and retail trade	18	3.9	0.5	60	24.7	5.7
Transportation and storage	Less than 10	0.3	0.0	12	0.8	0.2
Accommodation and food	16	5.7	0.7	31	11.0	2.5

service activities						
Information and communication	Less than 10	1.4	0.2	29	12.5	2.9
Financial and insurance activities	17	10.0	1.3	25	12.3	2.8
Real estate activities	46	25.7	3.3	123	74.9	17.2
Professional, Scientific and Technical Activities	64	19.0	2.5	130	43.8	10.1
Human health and social work activities	22	7.5	1.0	40	14.4	3.3
Other activities and sectors	19	5.2	0.7	40	9.2	2.1
Other including individuals with “director only” code	122	65.8	8.5	226	123.1	28.3
Total	**406**	**156.6**	**20.4**	**866**	**353.0**	**81.2**

***Provisional**

The table indicates the sectors which have benefited and the widespread availability of the relief.

While it may be premature to suggest possible changes until receipt of the external review, one possibility is whether it would be possible to have an increased lifetime limit with a narrower base of recipients with the aim of encouraging specific business activity or move away from a focus on passive investment– this raises the difficult question as to whether there is a need to incentivise all business sectors that currently potentially benefit from the relief and indeed the basis on which such a differentiation might be achieved. Any efforts to narrow the relief or apply it to specific sectors is likely to raise state aid issues.

The submissions received have suggested a range of legislative changes to the operation of the relief. Clearly not all the proposed changes could be accommodated and it is possible there may be options that could be considered for the 2019 Finance Bill. It would seem to the extent that there may be changes to the relief that these might be focused on amending some elements of the relief which are considered to prevent take-up or changes that could help expand business activity.

It is noted from the consultation process that the relief as currently in place in legislation is free from significant complexity and in this sense is considered more favourable compared to retirement relief. To the extent that there are any changes proposed to the relief, retention of the relative simplicity of the relief is favoured.

It is also important that the focus of the relief does not move away from the original purpose of the relief which was to incentivise the development and maintenance of business activity.

It is important that any changes to the terms of the relief minimise the extension of the relief to pure passive investment such as investment in property since it is not evident that such investment requires support in the form of a reduced rate of CGT.

Finally it is not obvious that the relief has to accommodate all forms of company structures and that businesses need to be mindful of the current requirements of the relief when planning or organising their businesses should they wish to take advantage of the relief at a future disposal of the business.

Research and Development Tax Credit

The Department of Finance is undertaking a tax expenditure review of the Research and Development (R&D) tax credit this year. As part of its scope, this review is committed to examining the interaction of SMEs with the tax credit.

A consultation process was held on the credit, to which 18 responses were received by 7 June 2019. These submissions are being examined and data analysis is ongoing.

This paper gives an overview of the credit and considers some potential policy options to support uptake of the credit by SMEs.

Background

The Research and Development (R&D) Tax Credit is an important feature of the Irish Corporation Tax (CT) system. The primary policy objective behind the R&D tax credit is to increase business R&D in Ireland, as R&D can contribute to higher innovation and productivity. More broadly, the tax credit forms part of Ireland's corporation tax offering aimed at attracting FDI and building an innovation-driven domestic enterprise sector. The credit enables Ireland to remain competitive when it comes to attracting quality employment and investment in R&D.

There have been a number of significant changes to the regime since its introduction, including the introduction of the 'repayable credit' in Finance (No. 2) Act 2008, the introduction of the key employee relief in Finance Act 2012 and the removal of the base year in Finance Act 2014. However the credit has remained largely unchanged in more recent years.

Features of the R&D tax credit

The R&D Tax Credit provides a 25% tax credit for all qualifying R&D expenditure.

The credit reduces the CT liability of the company for the accounting period in which the relevant R&D expenditure is incurred. Any excess credit can be carried back to the preceding accounting period. Following this, any remaining credit can be carried forward indefinitely for use against future CT liabilities, or can be claimed as a repayable credit.

The repayable element of the R&D tax credit is available to companies which have already offset current and previous year CT claims. The company may apply for a refundable credit in three instalments, over 33 months. The amount repayable in any accounting period is subject to a cap linked to corporation tax paid in the previous 10 years or payroll liabilities in the current and preceding period.

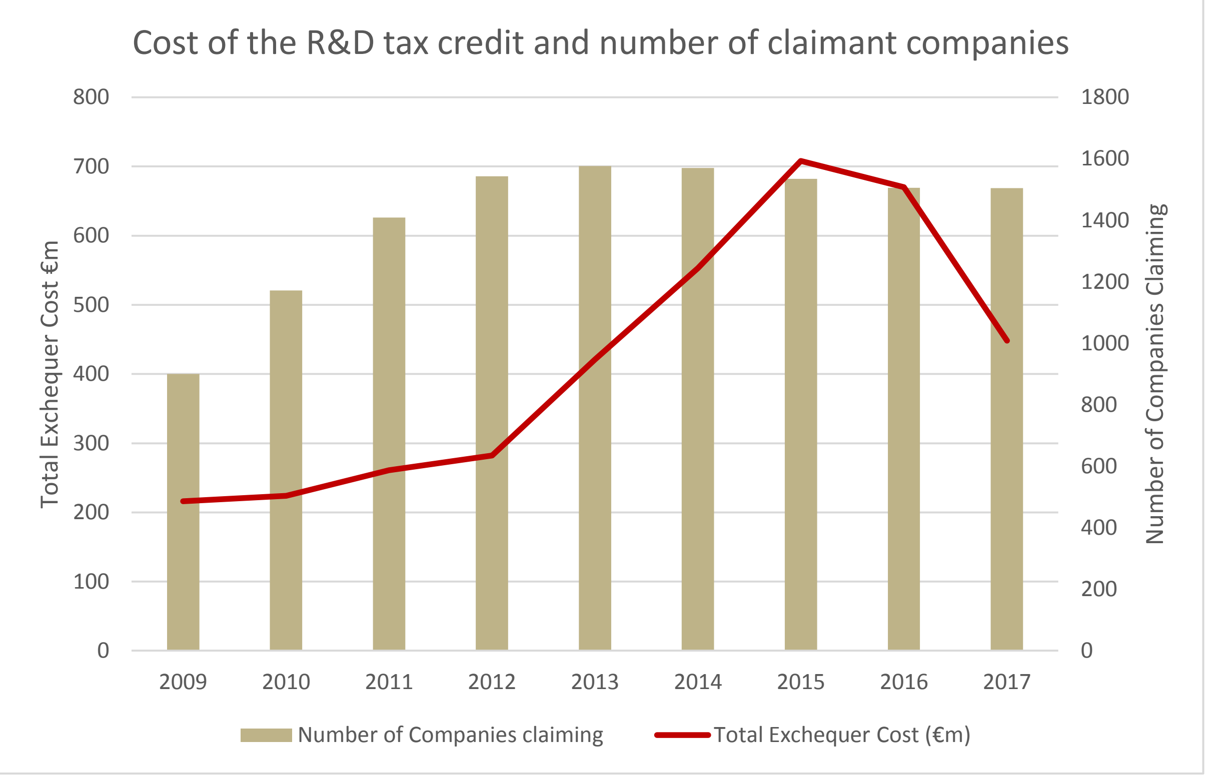
A company may claim a credit for sub-contracted qualifying R&D costs up to 15% of eligible R&D expenditure incurred by the company itself or €100,000 (whichever is the greater amount). For qualifying R&D costs sub-contracted to third-level institutes, a company may claim a credit of up to 5% of eligible R&D expenditure incurred by the company itself or €100,000 (whichever is the greater amount).

Companies in receipt of the R&D credit may also avail of a key employee provision. This allows for the transfer of the financial benefit of the R&D Tax Credit from a company to an individual employee. This key employee measure is designed to assist companies in the State to attract and retain employees with key skills in the field of R&D.

Cost

The cost of the R&D credit is continuously monitored by the Department of Finance. The cost of the scheme has risen since the credit's introduction in 200 and, due to the project-based nature of R&D activities, there can be year-on-year fluctuations in the overall cost of the credit. The cost of the relief peaked in 2015, at €708 million with 1,535 claims. The latest cost figures for the credit are from 2017, where the cost was €448 million with 1,505 claims. It is expected that the cost will increase again in future years.

The analysis below shows that the number of companies claiming the credit has been relatively consistent over the last 5 years, despite the greater fluctuation in overall cost.



Breakdown of the cost of the credit (€m)

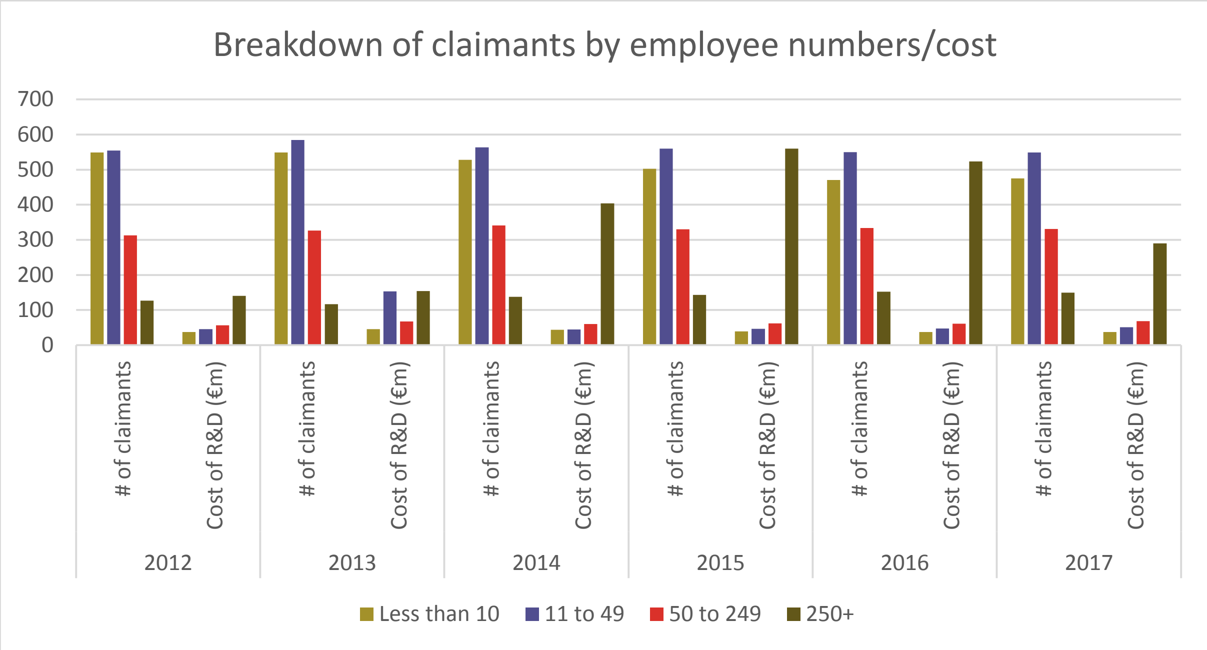
Year	2012	2013	2014	2015	2016	2017
Used in the current accounting period	142	182	227	349	434	297
Carried back to the previous accounting period	4	4	1	<1	<1	<1
Converted into 1st repayable credit instalment	54	133	146	86	52	55
Converted into 2nd repayable credit instalment	50	56	131	145	85	50
Converted into 3rd repayable credit instalment	33	46	49	128	99	47
Total cost:	283	421	553	708	671	448

The proportion of the credit claimed as repayable varies year-to-year – in 2013, 2014 and 2015, the amount of repayable credit issued exceeded the amount of the credit used in the current accounting period. In 2016 and 2017, the repayable credit has been less than the amount of the credit used in the current accounting period. This may indicate that companies engaged in R&D activities had greater profits in 2016 and 2017 to offset the credit against, rather than claiming a repayable credit. At present, figures for the amount of the credit being carried forward to future years are not being recorded.

While the credit must retain competitive and continue to encourage high-value added R&D activity in Ireland, the Department is conscious that the cost of the credit can fluctuate. As noted in the public consultation document, the Department is therefore considering options for collecting more data on current or prospective claims for the credit, such the amount of repayable credits pending and the amount of the credit carried forward unused for example, so as to facilitate future budgetary planning.

<u>Claimant Companies by Number of Employees</u>

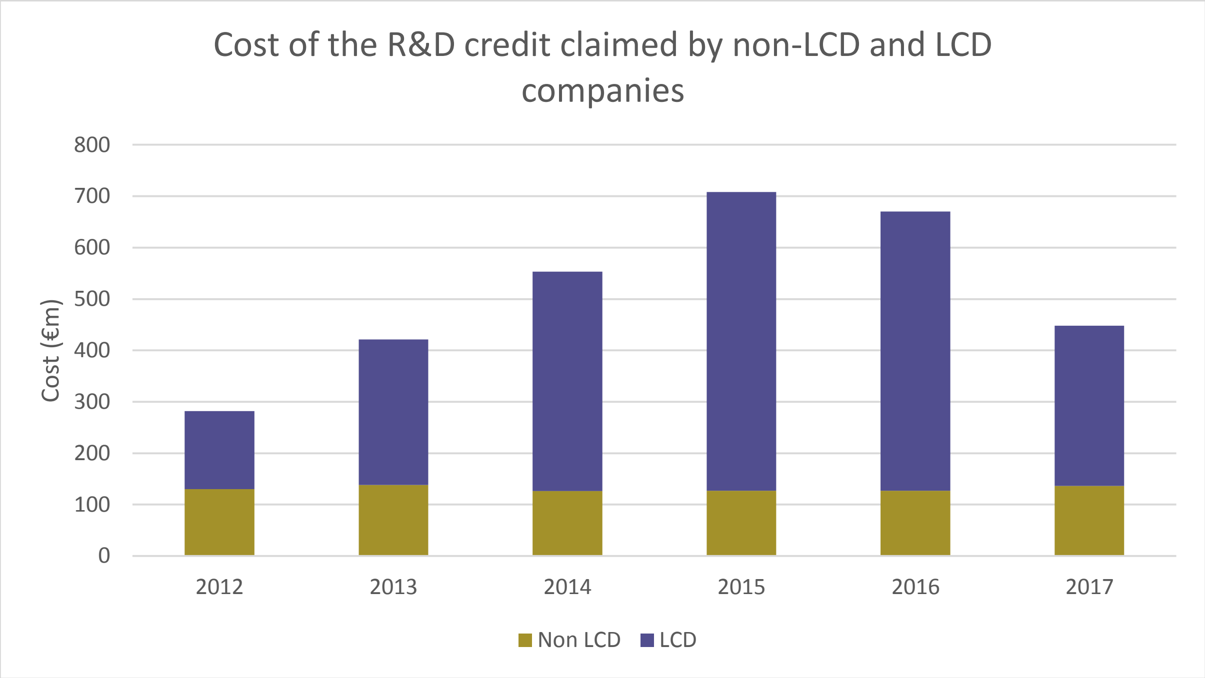
This chart shows the size of the companies claiming the credit by employee numbers, as well as their corresponding R&D expenditure. It should be noted that this data is compiled based on registered employees within a company and therefore does not factor in employees in associated group companies, where relevant. Unsurprisingly, larger companies (over 250 employees) spend more on R&D. There is consistently a large number of companies with 50 or fewer employees making R&D claims however, as noted above, this is subject to the caveat above in respect of group companies.

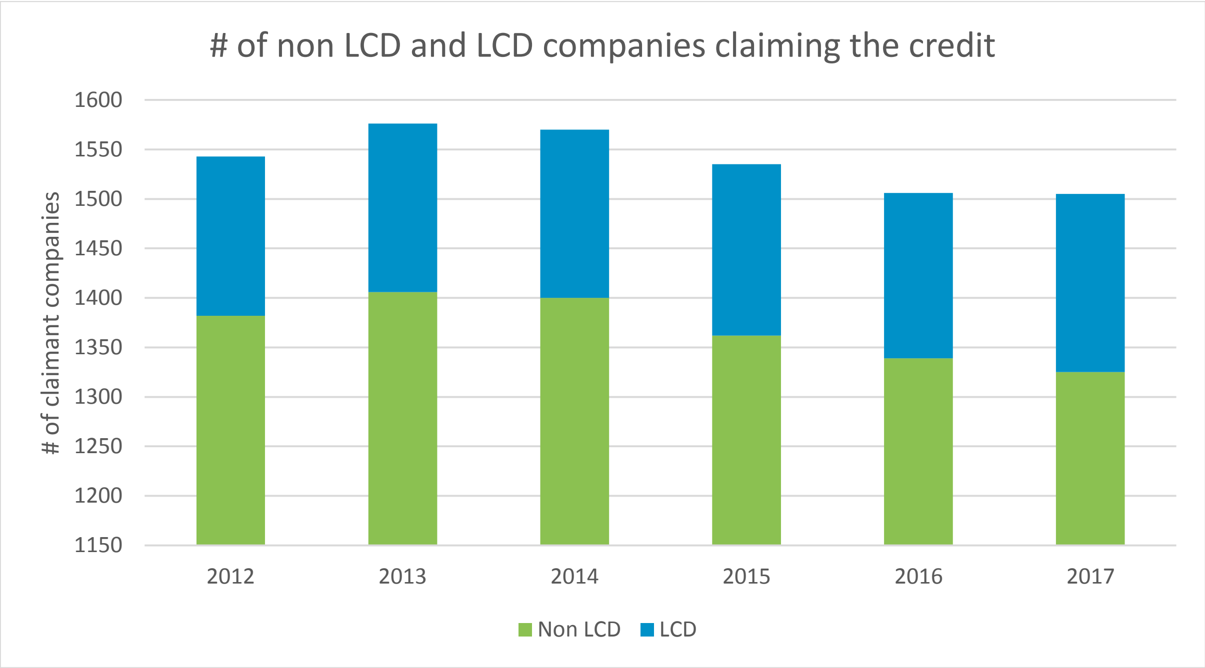


Claimant Companies by Size

Revenue data does not separately identify R&D Credit claimants as being either SME or non-SME companies. However, the charts below compare the number of Revenue Large Cases Division (LCD) companies and non-LCD companies who have claimed the credit. While companies that are outside the remit of LCD are not necessarily SMEs, the majority would be, therefore this data provides a proxy to estimate claims by SME and non-SME companies.

R&D can be an expensive process, and it is not unexpected that larger companies investing in R&D make up a large proportion of the costs of the R&D credit. The make-up of the companies claiming the R&D tax credit reflects the make-up of the companies carrying out R&D in Ireland. Most firms claiming the R&D tax credit are non-large cases (88% in 2017), but the majority of the value claimed (69.6% in 2017) is by large cases.


Cost of the R&D credit claimed by non-LCD and LCD companies
Cost (€m)
800
700
600
500
400
300
200
100
0
2012
2013
2014
2015
2016
2017
Non LCD
LCD


# of non LCD and LCD companies claiming the credit
# of claimant companies
1600
1550
1500
1450
1400
1350
1300
1250
1200
1150
2012
2013
2014
2015
2016
2017
Non LCD
LCD

Review and consultation

In line with the Department's Tax Expenditure Guidelines, large tax expenditures (costing more than €50 million per annum) are evaluated every 3 years to assess the continued relevancy, cost, impact and efficiency of the expenditure.

The previous comprehensive review of the credit was undertaken by the Department of Finance in 2016. This review found that the R&D tax credit was responsible for 60% of the R&D being conducted here, which represents a reasonable level of additionality. Furthermore, for every €1 in foregone tax revenue, more than €2.40 in additional R&D was being conducted.

The 2019 review of the R&D tax credit is ongoing, ahead of Budget 2020. As part of its scope, this review will examine the interaction by SMEs with the tax credit with a view to encouraging uptake of the credit by smaller companies, so support economic growth and the creation of high quality employment within the SME sector.

A consultation process was held, to which 18 response were received by 7 June 2019. These submissions are being examined and data analysis is ongoing.

Potential SME supportive policy approaches

While analysis of the public consultation submissions is ongoing, preliminary feedback indicates that stakeholders are positive overall about the R&D credit. Many advise that the credit is the reason why they (or their clients) are conducting R&D in Ireland, rather than in other jurisdictions. Others state they could not do R&D without the support of the credit. However, stakeholders cite the long administration process, the risk of an extended audit on claims and the upfront time and resource cost as barriers to claiming the credit.

The administration process appears to be a factor that particularly affects smaller companies, which may not have the capacity to absorb time and resource costs in the way larger companies can. This may lead to some SMEs ceasing to claim the credit for qualifying R&D they have undertaken, or an SME may not make an initial claim for the credit. At present, there are no specific provisions for SMEs in the R&D tax credit, but nor are there any restrictions for SMEs wishing to avail of the scheme.

The Department have received a number of suggestions which seek to enhance the regime for SMEs. Some of these aim to ease the administrative burden. Others would enhance the scheme for SMEs to undertake R&D. Some of these suggestions are outlined below:

PROPOSALS TO EASE THE ADMINISTRATIVE BURDEN OF THE CREDIT:

A: EXEMPTING SME R&D CLAIMS FROM THE SCIENCE TEST, WHERE THE SME HAS RECEIVED AN IDA/EI GRANT FOR THE SAME PROJECT AND HAS MET THE IDA/EI SCIENCE TEST REQUIREMENTS.

The credit may be claimed in respect of R&D activity that (i) seeks to achieve scientific or technological advancement, and (ii) involves the resolution of scientific or technological uncertainty. This is referred to as the 'science test'.

Many companies undertaking R&D will also receive a grant for qualifying R&D from a state body, such as Enterprise Ireland or the IDA, and as part of this process the scientific rationale for undertaking the R&D would also have to be demonstrated.

At present, Revenue's administration practice is not to challenge the science test where: a micro or small enterprise is undertaking a project in a prescribed field of science or technology; the project has been approved for an Enterprise Ireland, Horizon 2020 or IDA R&D grant; and the total R&D tax credit claimed by the enterprise for the project is €50,000 or less.

It has been proposed that an extension of this practice could be considered, for example to tax credit claims up to €100,000. The SME would still have to satisfy the other criteria, for example the accounting test and maintenance of records, in order to claim the credit.

B: PRE-APPROVAL OF R&D EXPENDITURE BY THE REVENUE COMMISSIONERS

At present, companies conduct R&D activities prior to claiming the credit. They must satisfy the science test as outlined above to receive the credit for the activities undertaken.

One proposal suggests that claims for the R&D credit could follow a similar process to grant approval from a state body – i.e. that SMEs could request Revenue pre-approval for planned R&D activities, specifically with regard to the science test qualifying criteria, thereby providing greater certainty that the credit would be forthcoming prior to incurring the expenditure. As with proposal A above, all other criteria for the claim would still have to be met.

With regard to this proposal, it would be necessary to allow scope for post-expenditure scrutiny by Revenue to ensure that the R&D work undertaken was in line with that originally approved. As such, it could be open to question if this approach would provide the required level of certainty for qualifying claimants.

C: ALLOWING A FIXED OVERHEAD COST FOR THE RELIEF, RELATIVE TO DIRECT COSTS

The R&D credit is calculated on the basis of eligible expenditure, including costs such as staff and R&D materials. At present, where claimant companies are engaged in other trading activities in addition to R&D, they may allocate a percentage of certain general overheads to the eligible expenditure claim, based on the proportion of R&D activities conducted. If selected for an intervention by Revenue, the claimant must demonstrate the basis by which they have allocated overheads. Once a reasonable method is outlined, this should be acceptable under Revenue guidelines.

Some claimants have indicated that this can be a time consuming and/or subjective process, and would prefer a more prescriptive method of apportioning general costs.

One proposal is for Revenue to specify a fixed overhead rate relative to direct costs. According to stakeholders, this would provide certainty to SMEs and ease the administrative burden in terms of documentation.

Questions to be addressed include whether this would be a mandatory fixed overhead rate or an option that claimants could elect in to. It may be difficult to reach an agreed apportionment rate that would be acceptable across claimants with diverse R&D and non-R&D activities.

Further consideration would also be required of the impact that this suggestion would have on legislation and on the administration of the credit.

ENHANCEMENTS TO THE CREDIT SPECIFIC TO SMES:

D: ALLOWING A FULL OR PARTIAL REFUND OF THE REPAYABLE CREDIT UPFRONT TO SMES RATHER THAN OVER THREE YEARS

It has been suggested that SME claimant companies should be allowed to apply for the full repayable amount of the R&D credit in one payment, rather than over three instalments as is the current system. This measure would improve cash flow for SMEs, decrease the amount of time the claim is in the system, and reduce administration burden. It has been suggested that earlier receipt of the repayable element could enable SMEs to undertake further R&D.

While this would not result in an additional overall cost to the Exchequer, there would be a cash-flow cost to the Exchequer due to the 2nd and 3rd repayable instalments of the credit being brought forward to the first year.

As noted above, the amount repayable in any accounting period is subject to a cap linked to corporation tax paid in the previous 10 years or payroll liabilities in the current and preceding period. It is possible therefore that, under these limitations, some SME companies, in particular start-up companies, may not have scope to receive the full credit in one year.

It could also be considered whether it would be appropriate to introduce such an option for SME companies, given that 88% of claimants in 2017 were companies not under Revenue's Large Cases Division, broadly indicating that they are likely to be SME companies. It may be appropriate to consider targeting any such measures more narrowly, for example at Micro/Small and/or Start-Up companies.

E: CHANGES TO THE LIMITS ON OUTSOURCING R&D TO OTHER COMPANIES (15%) OR UNIVERSITIES/INSTITUTES OF HIGHER EDUCATION (5%)

For the purposes of the credit, a company may claim a credit for sub-contracted qualifying R&D costs up to 15% of eligible R&D expenditure incurred by the company itself or €100,000 (whichever is the greater amount). For qualifying R&D costs sub-contracted to third-level institutes, a company may claim a credit of up to 5% of eligible R&D expenditure incurred by the company itself or €100,000 (whichever is the greater amount).

SMEs, as well as larger companies, have claimed that these limits are restrictive, given the nature of the Irish talent market. They have suggested that outsourcing allows companies to undertake R&D activities which might not be possible to do in-house due to limited expertise or the specialist knowledge required for particular projects.

If the limits were changed, SMEs may benefit from increased ability to undertake R&D in-house with the support of external sub-contractors. Alternatively, they may benefit from receiving sub-contracted elements of R&D projects from larger companies.

Potential considerations with regard to this suggestion include how increased out-sourcing limits would fit with the overall policy objective of supporting quality employment in the R&D sector; and whether there is potential for the value of R&D work in Ireland to be diluted if it is segregated into separate component elements.