Commission on Taxation & Welfare
An Coimisiún um Chánachas ⁊ Leas

Progress Paper

Follow up on SMEs and Entrepreneurs

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For discussion

Meeting 18 presents an opportunity for members to further discuss how the COTW can work towards formulating recommendations on supporting SMEs and entrepreneurs. The importance of supporting economic activity has been raised at a number of meetings and there is wide agreement that Ireland needs to remain competitive and supportive in terms of its tax offering for businesses. Previous meetings have considered the various tax expenditures currently available to support economic activity and while members were broadly in agreement with the policy rationales behind these tax reliefs, there were concerns raised about their effectiveness in some instances. However, there was a divergence of opinion on how to best reform and enhance the tax system to address these concerns.

This paper presents broad based principles that could be used to guide the Commission in its work. Members are invited to give their collective view on this approach and what ways this proposal should be modified. The goal of the discussion at Meeting 18 will be to reach a consensus on priorities and areas of focus, and to agree how the Commission will progress towards making recommendations on supporting SMEs and entrepreneurs.

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1. Introduction

The COTW is committed to reviewing how best the taxation environment for SMEs and entrepreneurs can ensure that Ireland remains an attractive place to sustain and grow an existing business or to start and scale up a new business. Based on the discussions and observations of members to date, this paper summarises an approach for the COTW to take with regards to achieving this mandate on the terms of reference.

This paper largely focuses on tax expenditures for businesses. This is only one aspect of the wider business tax environment, which has been subject to ongoing debate over the corporation tax rate and Ireland's corporate tax strategy in particular. These topics are considered in the accompanying paper for Meeting 18 titled "*Corporation and International Tax Update – Ireland's Corporate Tax Strategy*".

2. Overview of discussions to date

2.1 Recap of meetings

The wider economic and tax environment for SMEs and entrepreneurs was first considered at Meeting 4 of the COTW, where we examined the current environment for SMEs and entrepreneurs in Ireland, existing tax and non-tax business supports available and Government priorities in the area including the 2021 SME Entrepreneurship Growth Plan[1]. This was followed up at Meeting 8 by a more in-depth look at various tax expenditures that exist for supporting economic activity, the policy objectives they are trying to achieve and the extent of expenditure reviews carried out to date, if any. These objectives included incentivising equity-based finance and innovation, supporting start-ups and entrepreneurs, enabling business continuation and attracting and retaining talent.

Table 1 Overview of tax expenditures for supporting economic activity

Category	Tax	Name of relief	Exchequer cost in 2018 (€ million)	Year introduced	Year of expiry	Year of last DoF Review
Incentivising equity-based risk finance	IT	EII	15	2011	2024	2021
		SURE	1	2015	2024	2019
		SCI	N/A, launched in 2019	2019	2024	None

[1] A Ministerial led implementation group was established and has met a number of times throughout 2021 with a view to progressing the various recommendations in the Growth Plan report. The report is available here.

Incentivising innovation	CT	R&D tax credit	355	2004	No expiry date	2019
		Knowledge Development Box	10	2016	2022	2015 (prior to introduction)
Supporting start-ups and entrepreneurs	CT	Start-up CT relief	6	2009	2026	2018
	CGT	CGT Entrepreneur Relief	92	2016	No expiry date	2020
Enabling Business Continuation	CGT	Retirement Relief	Data not available	1975	No expiry date	None
	CAT	Business Relief	190	1994	No expiry date	None
	CAT	Agricultural Relief	166	1976	No expiry date	2014
Attracting and retaining employees	IT, USC & PRSI	KEEP	0	2018	2023	2019
	ER PRSI	Employer PRSI exemption for shares	Data not available	*	No expiry date	2016
	IT	SARP	42	2012	2022	2019
	IT	FED	5	2012	2022	2019

Members agreed at Meeting 10, as part of the discussion on the Commission's approach to tax expenditures, that it would not be practical from an efficiency or timing perspective to review all tax expenditures. Instead, it was agreed that focus would be directed towards reviewing the most expensive and/or significant tax expenditures as relevant to topics being addressed in the terms of reference, as well as strengthening the overall process for the review of expenditures in the future. Members discussed how a robust and resilient tax expenditure review process could ensure that only effective tax expenditures are introduced and/or continued.

A number of other meeting discussions were also relevant in the context of supporting SMEs and entrepreneurship, including an examination of the taxation of income and capital, plus the taxation of the self-employed vs company owner managers at Meeting 12 and the treatment of share-based remuneration at Meeting 14.

The impact capital taxes have on enterprise is also being considered as part of the work of the Capital Taxes Subgroup. While the Subgroup will not be finishing its deliberations for another few weeks, it was felt that it is an opportune time for the wider COTW group to revisit the topic of supporting SMEs and entrepreneurs. The Secretariat will ensure the final position is reflective of both discussions.

2.2 Rationale for supporting SMEs and entrepreneurs

Members of this Commission are strongly in favour of supporting enterprise and SMEs and are broadly supportive of well targeted tax expenditures in order to facilitate this. There are a number of economic and societal benefits and reasons for this, with SMEs accounting for 99.7% of all Irish enterprises, being responsible for employing over two-thirds of Ireland's workforce and generating €354 billion (43%) of total turnover in the business economy[2].

Ireland has a two tiered economy and the pandemic has exacerbated the gap between domestic and export orientated firms. SME productivity has been relatively stagnant in recent years compared to the extremely productive large multinationals. The OECD has named prolonged use of low-productivity techniques, underinvestment in capital, weak management practices, insufficient digital technology adoption and limited direct entry into export markets as factors affecting productivity.[3] The OECD has also commented on Ireland's low business entry and exit rates relative to other OECD countries. Enterprise churn is often used as a proxy for business dynamism and the OECD has stated that a low enterprise churn is likely to adversely affect productivity growth, given a more limited resource reallocation from less productive firms to young innovative SMEs.

It has also been acknowledged that not all SMEs strive to be highly productive and innovative, or have the ability to scale up (due to lack of staff/resources), but that these businesses also add significant value to the economy as they contribute in other ways e.g. sustaining employment, provision of goods or services in rural areas, etc.

The Commission recognises this and believes that the tax system has a meaningful role to play in supporting a strong entrepreneurial culture and facilitating the creation and growth of small businesses. Members have specifically cited difficulties in accessing financing and competing with larger firms to attract and retain key employees as challenges to SME growth.

2.3 Policy objectives for SME tax expenditures

Meeting 8 of the COTW examined a variety of tax expenditures that exist for supporting SMEs and entrepreneurs, together with the policy rationales behind their introduction. Members widely endorsed most of these policy objectives, which can be broadly categorised as follows:

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[2] CSO, Business in Ireland 2019, 26 October 2021

[3] OECD, OECD review of SME and Entrepreneurship Policy in Ireland, October 2019

- **Raising equity** - assisting SMEs with raising seed investment and other equity based finance and fostering an investment culture
- **Supporting start-ups** - alleviating cash-flow constraints at the early phase of business development
- **Supporting employment** - including helping SMEs to attract and retain key personnel
- **Promoting innovation** - incentivising research, development and innovation. This also includes helping firms adapt to digital disruption and technological improvements.
- **Rewarding risk** - rewarding entrepreneurs at exit stage of a business
- **Enabling business continuation** - alleviating tax charges on the transfer of a business.

While in general members considered many of these as appropriate and desirable objectives for improving the productivity of enterprises, or, simply rewarding entrepreneurs or enabling business succession, it was noted that current tax expenditures were not always achieving these objectives for various reasons.

The Secretariat briefing paper for Meeting 8 examined the reviews that had been conducted to date, if any, on various tax expenditures. In the case of new reliefs, or newly amended reliefs, data is not yet available to inform an evaluation at this time. The paper highlighted a number of concerns raised in some of the tax expenditure reviews conducted.

- In particular, the reviews illustrated the difficulty in targeting tax expenditures to achieve particular purposes, without also benefiting those who have no need for the tax relief, who for example, may have already been able to raise equity finance, or conduct research and development, or invest in assets, etc. in the absence of a financial incentive. However, reliefs that are too targeted risk breaching State Aid rules, or being inaccessible to the taxpayers they are intended to support.
- The paper also called out some instances where multiple reliefs are trying to achieve similar aims (e.g. EII and CGT Entrepreneur Relief), or are effectively achieving a similar outcome (e.g. CGT Entrepreneur Relief and Retirement Relief), suggesting some duplication in the tax code.
- Many of the capital tax related reliefs are focused on reducing the tax burden for inter-generational transfers of assets, but may not always be achieving the desired effect of increasing economic activity or productivity. These represent some of the highest cost reliefs and shows the wider cost of forgone tax revenues through enabling inter-generational transfers of businesses and farms.
- A review of the Exchequer cost of various reliefs also showed the rising fiscal impact of tax expenditures over time, particularly where reliefs are not subject to a termination date, or

where the quantum of gain/income subject to relief is set at a very high threshold, or is uncapped.

Areas requiring further deliberation

Meeting 8 of the COTW did not result in a clear consensus as to how the Commission should articulate its position in the area of supporting economic activity. Ensuring Ireland remains competitive and supportive in terms of its tax offering for businesses was identified as a key objective.

Different members expressed views that some reliefs were overly complex, with the detailed qualifying conditions attached rendering the reliefs inaccessible or ineffective for many enterprises. Some members felt that certain relief thresholds should be made more generous and the list of qualifying individuals for reliefs expanded in order to encourage greater uptake.

In contrast, other members commented that some reliefs were overly generous, or poorly targeted such that there was a considerable level of inherent deadweight. The challenge SMEs face in competing with larger firms to attract and retain key employees was also discussed, but there was no clear consensus on how the tax system could be simplified or enhanced to assist with this issue.

3. Suggested COTW approach to supporting economic activity

Recognising the importance of a clearly articulated position for the Commission to take in this area, this section outlines a suggested approach for the COTW to take with regards to making specific recommendations on the broad approach to tax expenditures and potentially enhancing the tax environment for SMEs and entrepreneurs if appropriate.

3.1 Use of direct support vs tax measures

As set out in section 2.3, Government policy over time has given rise to some clear key policy objectives in relation to supporting economic activity (raising equity, supporting start-ups, employment and innovation, rewarding risk and enabling business continuation).

It is important to recognise that tax is not always the appropriate lever to assist in all of these instances and the targeted (or limited) nature of some of the schemes discussed to date recognise this position. The State also has a range of other supports, for example grant aid, direct investment vehicles and loan guarantee schemes, to also support each of these policy objectives. The policy landscape in this area has fundamentally changed since the last Commission on Taxation reported in 2009 and a wide range of non-tax initiatives have been introduced alongside the range of tax measures previously discussed. Direct financial subsidies are also often used as they have a strong policy rationale and can be targeted at firms with particular needs. As the Commission discussed in Meeting 10, tax expenditures tend to be far less easy to target and can be more regressive in that they apply largely to those who have sufficient taxable profits. Reliefs targeted at particular sectors or businesses are also subject to EU State Aid rules.

While it is not within the remit of this Commission to make recommendations on direct supports, it may wish to comment on circumstances where it may be more appropriate to use direct supports (grants or subsidies) instead of tax expenditures.

While recognising that direct supports are an effective lever, the COTW does agree that tax has a role in achieving policy objectives, mainly through:

1. Reducing the complexity and administration faced by businesses, both in terms of general tax compliance and in claiming tax expenditures. Ireland generally scores well internationally on ease of paying taxes[4], but in some instances the requirements for claiming and reporting tax reliefs are seen as overly complex. The COTW chapter on Administration will examine how the tax administration system should be modernised while ensuring it meets best international standards.
2. Only introducing or continuing well targeted and effective tax expenditures designed to address clear market failures.

3.2 General principles for economic activity tax expenditures

Given the breadth of the COTW's terms of reference and the limited time and resources available, the COTW is unable to conduct an in-depth evaluation of and propose specific amendments for every tax expenditure. Indeed, one recommendation emerging from discussions is the need for better collection of data to inform such evaluations, as currently there are significant gaps in the information available and in some instances it is not possible to even quantify the Exchequer cost of certain tax reliefs. In most instances this is not a situation that will be rectified in advance of this Commission delivering its report in July 2022.

[4] The World Bank– Doing Business, 2020

The number of tax expenditures that have been reviewed to date by government and the varying quality of those reviews has been considered by members. It was agreed at Meeting 10 that a more robust and resilient tax expenditure review process could ensure that only effective tax expenditures are introduced or continued, which the COTW chapter on Tax Expenditures will make recommendations on. Given the recommendation to have more timely, objective and informed reviews of tax expenditures prior to their introduction, continuation or abolishment, it may be contradictory of the COTW to recommend specific changes to individual reliefs without having undergone this same process. While it is not outside the scope for the Commission to make such recommendations, it is recommended that if commenting on a specific scheme there must be an objective justification for it.

That being said, members would like to make meaningful recommendations on how the tax environment can be enhanced for supporting economic activity. The COTW is taking a macro rather than a micro approach, looking at what can be done to maintain and improve productivity and competitiveness over the medium to long term. The Commission's recommendations will also need to consider on-going activity by Government in this area including the 2021 SME Entrepreneurship Growth Plan. To that end, the COTW's recommendations in this area could comprise general principles to guide achievement of this objective. This work is in tandem with the COTW subgroup on capital taxes which may also emerge with some recommendations that have direct relevance to this area.

Based on members' previously expressed views, example of guiding principles may include the following:

1. This Commission broadly endorses the variety of policy objectives being pursued by current tax expenditures in order to support SMEs and entrepreneurs, however, some supports are not effectively targeted. **This Commission believes there is a rationale for a re-prioritisation of existing schemes towards those which are designed to help new businesses in the early start-up phase and to help productive enterprises sustain or scale up their business**. The Commission believes that there is less of a rationale for broad based reliefs enabling inter-generational transfers or business continuation of firms that are not productive, or viable in the long-term without considerable tax intervention.

2. **Tax supports need to be focused, designed and implemented to achieve their intended objective**. **If this cannot be achieved using a tax expenditure (most importantly within State Aid rules), then consideration needs to be given to the use of alternative government supports**. For example, if the use of a CGT relief on disposal of a business (exit stage) is not the most appropriate lever to incentivise investment in a business (start-up, growth phase),

then policy could instead focus on the continued enhancement of existing income tax reliefs to support access to appropriately priced equity finance for innovative businesses. There also needs to be a clear link between qualifying conditions and the policy objectives. As an example, the start-up corporation tax relief is focused on employment generating firms and has a condition based on the amount of employer PRSI paid. The objectives and interactions of different tax measures should be considered as a whole, rather than in isolation.

3. **Tax expenditures should only apply where a market failure exists**. There needs to be an objective and justified reason for enhancement and continuation of tax expenditures in this area consistent with its proposed recommendations on the tax expenditure review process generally (see below). The Commission is satisfied that market failures currently exist in relation to the amount of investment and funding that is available to SMEs and the level of innovation and development activity that would happen in the private market in the absence of State intervention. The Commission supports enhancing and expanding supports that would help address these issues.
   - *Note: With regards to incentivising investment, the COTW could take a view on either endorsing the current approach of reliefs that target longer-term or active investors (e.g. by having a minimum holding period and/or working hour requirements) or suggest extending relief to short-term or passive investors (e.g. minority shareholders, angel investors)*.
4. **The design and administration of tax reliefs should be kept as simple, understandable and unambiguous as possible**. A key challenge for policymakers is balancing simplicity with the need to ensure rules are robust enough to **prevent misuse or aggressive tax planning** and that they are **compliant with State Aid requirements**.
5. **There should be sufficient quality data collected to inform evaluations of tax measures and reliefs need to be assessed against a robust cost/benefit model.**
   - Policy makers should have sufficient data and information available on all existing and proposed tax reliefs to allow for robust evaluation of the effectiveness of the measures under the tax expenditure review guidelines. This should also enable policy makers to respond appropriately to emerging take-up, costs and unintended consequences of measures to enable corrective action where required.
   - Furthermore, tax expenditures are a cost to the State in terms of revenue forgone and as a general rule reliefs should not be unlimited or uncapped. Some reliefs could be

more appropriately capped in order to better target the support at micro or smaller sized businesses, or the amount of relief reduced/removed where it is not being used for a productive use. That being said, there should be a sufficient and appropriate budget allocated to reliefs to ensure they are effective (subject to regular review).

4. Conclusion

Recognising the limitations on what level of meaningful in-depth evaluation can be conducted by the COTW on tax expenditures, the approach suggested is that recommendations will be principles based rather than recommending detailed reforms or technical adjustments to various tax measures. That said the Commission may choose to comment on a specific scheme if there is an objective justification for it. The work of the Capital Taxes Subgroup may emerge with recommendations on capital taxes that also impact SMEs and entrepreneurs. Any such recommendations will be incorporated into final discussions.

Members are invited to give their collective view on this approach and what ways this proposal should be modified. The goal of the discussion at Meeting 18 will be to reach a consensus on priorities and areas of focus, and to agree how the Commission will progress towards making recommendations on supporting SMEs and entrepreneurs.