EIIS Submission

on behalf of the "Alliance for an Innovation-Driven Recovery"

Introduction

High-growth tech startups provide critical skilled employment in communities right across the country. However, at an early-stage of development these companies have limited funding options open to them. In most cases, these businesses run significant negative cash-flows as they invest upfront in innovation, and as such are unable to access debt. **Equity funding is therefore a critical source of investment for these types of companies.**

Ireland has historically had low availability of private "angel stage" funding for early-stage tech companies and a high cost of capital. While the Employment and Investment Incentive Scheme (EIIS) was intended to help incentivise the flow of private capital into early-stage businesses in general, it is not well designed to incentivise investment in innovation-driven companies where the risk is higher.

EIIS: a critical lever to address capital market problems exacerbated by COVID

As a result of the COVID-19 pandemic there has been a notable reduction in the availability of capital in Ireland, particularly for early-stage companies that require angel stage funding (see below). Additionally, companies are facing protracted sales and payment cycles, resulting in major cash flow challenges for early-stage companies.

These trends are damaging viable companies, leading to the loss of high-skilled employment, and an increased reliance on Government liquidity support.

By introducing temporary enhancements to EIIS, the Government can increase both the amount of private investment in Irish tech companies and the number of people investing, ensuring more early-stage companies can access growth capital.

As the new government works to drive recovery, these proposed **changes to EIIS could help replace existing government financial support for startups with investment by private capital; thus reducing the net cost to the exchequer**.

Data from H1 2020: Reduced capital available for early-stage tech companies

Recent data from TechIreland for the first half of 2020 (H1 2020) shows that while there has been an increase in the total amount invested, there has been a **significant reduction in the number of early-stage deals**.

The total amount invested was an impressive €545million in the first six months - but the vast bulk of the investment went into mature businesses that are scaling their exports and employment. That is great to see, and a vindication of the nurturing that those businesses received at an early stage. However, there has been a significant drop in the number of early-stage businesses – those tech startups that rely on business angels to get to their first Seed Round.

The number of investments less than €500k was down 40% and the number of investments between €500k and €1million was down 60% over the same period in 2019. Data from IVCA and KPMG Venture Pulse show a similar trend.

See the full report **here**.

1. CGT exemption on all qualifying investments made during H2 2020 to end 2021

Incentivise more investments in SMEs by providing an exemption from capital gains tax for all qualifying investments made during the period 1 July 2020 to 31 December 2021.

Problem: In an address to the Institute of International and European Affairs earlier this year, the Central Bank Deputy Governor warned that "Half of large corporations hold less than 8% of annual turnover in cash. Half of SMEs hold less cash and SMEs have less access to undrawn credit than their larger counterparts." Liquidity is a substantial issue for SMEs and COVID-19 has increased the risk of insolvency. The knock-on impact of reduced liquidity on the economy is an increase in unemployment, reduced spending, reduced tax revenues and additional cost to the exchequer in the form of welfare payments. The pre-existing difficulty in accessing financing/ investment by SMEs has further reduced with the economy contracting. The appetite to invest in riskier assets, such as SMEs, has reduced substantially.

Solution: We have previously seen the success of implementing a CGT exemption1 to intervene when the Irish property markets were stagnating. In 2011, a CGT exemption for property purchased during the period 7 December 2011 and 31 December 2014 resulted in a substantial increase in the amount of both domestic and international investors into the Irish property market. We are recommending that in addition to income tax relief (see below), a capital gains tax exemption is introduced and should apply to all qualifying EIIS investments made during the period 1 July 2020 to 31 December 2021 (the "**Covid Emergency Period"**). The exemption would apply to disposals made after the expiry of the four year investment period. We are recommending the exemption is time bound to balance the cost to the Exchequer with the current market failing to invest in riskier assets,such as SMEs, where access to liquidity is imperative for the business' survival. The reality is, many investors in SMEs do not actually realise gains on their investments. However, the lucky few do.

Impact: By providing a CGT exemption on gains made on the ultimate realisation of EIIS investments made in the Covid Emergency Period, the Government could provide an added incentive which might encourage otherwise reluctant investors to put their capital at risk.

2. Standardise investment period to four years for all qualifying investments

Incentivise larger investments in SMEs by reducing the investment period from seven years to four years for investments of greater than €250,000 per annum.

Problem: Finance Act 2019 amended the annual limit an investor can make from €150,000 per annum to €250,000 and €500,000. Where an investment of greater than €250,000 is made, the investor must retain the qualifying shares for seven years. The increase to the annual limits has been welcomed by Scale Ireland. With the economy currently contracting, there is limited appetite by investors to lock in a substantial investment for a seven-year period. Where an SME is fortunate to attract an investor that can invest greater than €250,000 in a year, the seven-year retention period is a substantial barrier to invest.

Solution: To incentivise investors to make investments greater than €250,000, we are recommending that the investment period for all qualifying investments up to €500,000 is adjusted to four years. It should be noted that as an alternative to investing €500,000 which attracts a seven-year retention period, investors can make an annual investment of €250,000 per annum for two years. As the investment amount is €250,000, the qualifying investment period is four years. As such, the investor can obtain the same quantum of relief of €500,000 over a two-year period but reduce the total investment period from seven years to five years. However, in the current economic environment and with the shortage of liquidity in the marketplace for SMEs, it is important that businesses can obtain the maximum funding upfront.

Impact: As such, reducing the investment period from seven years to four years for investments up to €500,000 will incentivise the investor to make a greater upfront investment. The additional cost to the exchequer should be negligible on the basis it is simply bringing forward the relief to the investor by one year.

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1 Section 604A, Taxes Consolidation Act 1997

3. Enhanced relief for investing in micro companies

Introduce greater incentives for 'Early-stage Innovative Companies' – extend relief to apply to USC and PRSI for qualifying investments in micro companies.

Problem: Providing funding to businesses that are high-risk, high-potential, innovation-driven and early-stage is inherently riskier than investment in more established asset-backed enterprises. As the economy contracts, limited private sector funding is available and the appetite for riskier investment has substantially diminished. The EII scheme therefore needs to acknowledge that not all businesses that qualify for the scheme will be an equally attractive investment prospect to investors. To encourage investors to bear the additional risk of investing in high-risk startups and early-stage businesses, additional relief for the investor is required.

Solution: Our recommendation is that the EIIS relief should be extended to provide a deduction for USCand PRSI purposes where the qualifying investment is in a "micro company". TheTaxes Consolidation Act2[2] already recognises that the investor profile for micro companies is substantially different to other SMEs eligible to participate in the EII scheme. It is proposed that the extended relief should be available to investors in micro-enterprises, within the meaning of Annex 1 of theGeneral Block Exemption Regulation. 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 €2 million.

Impact: By limiting the application of the extended relief to micro companies, it should strike the appropriate balance of Exchequer cost while ensuring that such expenditure is also focused on smaller, higher risk, higher potential enterprises.

4. Allow other investment vehicles to qualify for tax relief on EIIS investments

Extend the type of investment vehicles that qualify for relief on EIIS investments to include private equity partnerships.

Problem: Under the terms of the EIIS legislation, the Revenue Commissioners can designate a fund a "designated investment fund" which can, once authorised, be used as a collective investment vehicle which can invest in qualifying EIIS companies, the investors in which secure EIIS relief. A fund will only be designated where certain conditions apply,including cases in which the fund is established under irrevocable trusts for the sole purpose of investing in qualifying companies.This is essentially restricting the type of private equity funds that can invest in qualifying EIIS investments, thus cutting off an important potential supply of funds to early-stage companies.

Solution: To broaden the scope of investors eligible to claim EIIS relief, and thus increase the supply of funds to early-stage companies, we are recommending that other investment vehicles, such as private equity partnership, should qualify for tax relief on EIIS investments.

Impact: This will increase the range of collective investment structures which can access EIIS tax relief and will generate much needed funding for SMEs at this time.

5. Increase certainty for companies that they are eligible for EIIS

Confirmation that a company is eligible for EIIS investment should be final if the information provided is correct and complete.

Problem: The need for certainty is essential in the operation of any tax relief. Currently investors do not have certainty that investee companies will be able to retain EIIS status as they are subject to audit in subsequent years.

Solution: To provide companies with certainty, we are recommending that a company is provided with a final confirmation that it is eligible for EIIS investment where the information provided to the Revenue Commissioners is correct and complete.

Impact: This would only involve one stage in the Revenue approval process and would increase confidence of investors.

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2 Section 503, Taxes Consolidation Act 1997