Ibec policy brief

ISSUE 01.16 · JANUARY 2016

Taxation of entrepreneurs – priorities for the next government

Author

Gerard Brady
Senior Economist
gerard.brady@ibec.ie

Web

www.ibec.ie/ambition

Twitter
Join the conversation
@ibec_irl #ibecambition

How can we encourage more entrepreneurship? What role can the tax system play?

Taxation of entrepreneurs and small business is an issue which has received a lot of warranted attention in recent times. Over the past decade policymakers, across the board, have lauded entrepreneurs as being central to developing indigenous firms which can compete globally. The signals we send through our tax system, however, differ greatly from the rhetoric.

Improvements have been made in Budget 2016 and all the major political parties are likely to address this in some way in their upcoming manifestos through commitments of varying forms. These commitments need to be followed through; with changes to taxation the single biggest step the next government can make to encourage more people go into business for themselves.

With the higher rate of USC for the self-employed and the higher rates of CGT introduced in recent years our tax system has gone in the opposite direction to much of enterprise policy. If we are truly serious about creating a high-skilled entrepreneurial economy the level of recognition which has been given to the issue needs to be backed by action.

Why are entrepreneurs important?

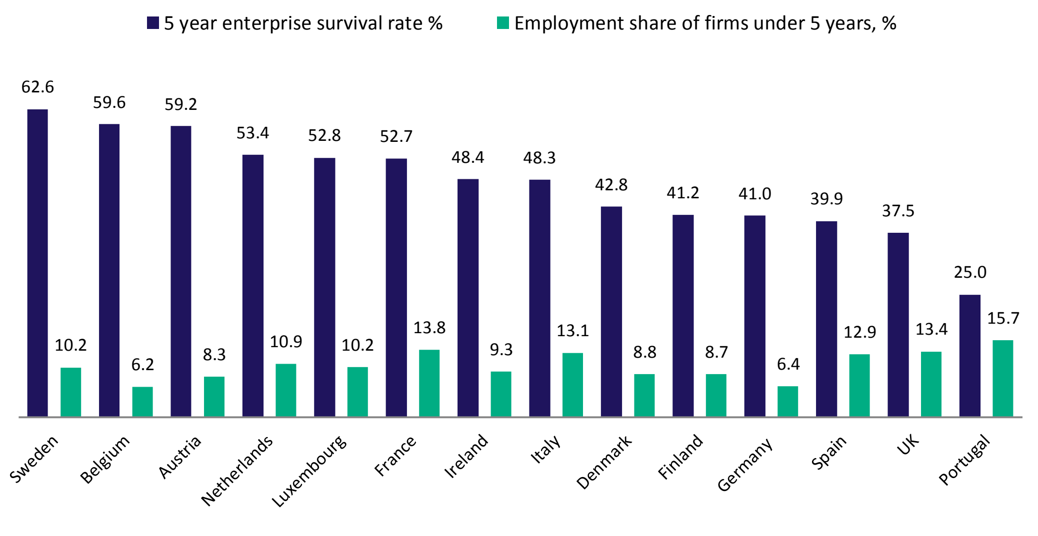
The importance of entrepreneurs and small business to Ireland's economy cannot be overstated. More than 98% of Irish firms employ less than 20 people. These companies employ 44% of the workforce.

Young firms in particular, account for the majority of employment growth. The most recent data shows that between 2008 and 2012 while the total number of private sector employees fell by 264,000, companies which were less than 5 years of age created 106,000 net new jobs; offsetting 40% of the job losses in the broader economy.

Despite this, it is clear that Ireland is overly reliant on a small number of large firms to produce the goods and services which provide the material basis for our standard of living. Less than 500 large firms account for over half of Ireland's GDP and 75% of its exports. This can be partly explained by our unique economic structure but of equal significance is the fact that not enough companies created in Ireland are able to survive and scale.

Ireland is a relatively easy country in which to start a business but Irish small firms face a number of challenges to their growth. These

Figure 1.
Young enterprise survival and employment (2008 – 2012)



include high legacy debts and costs, a small domestic market, an overreliance on bank funding, barriers to innovation and challenges accessing and competing for the right skills to help them grow.

Figures for recent years show that new enterprises have had an average 5 year survival rate of just 48.4%; less than one in two new companies formed in any given year are still trading half a decade after they form. This is before they begin to do any of the things the economy needs new firms to do such as growing their output, taking on more employees or selling into new markets.

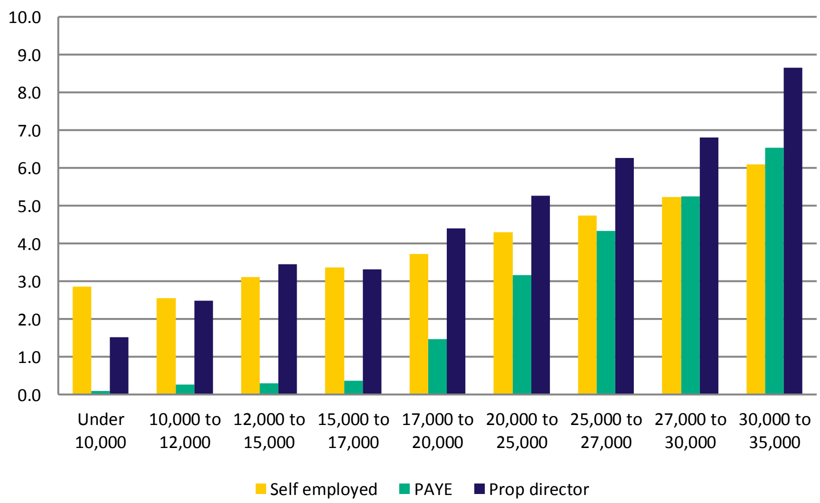
How can the tax system help?

As we have shown, entrepreneurs play a crucial role in the Irish economy. Many studies suggest that the monetary returns to going into business for yourself are little different on average than becoming an employee. This is despite the fact that entrepreneurs bear large financial risk, work longer hours (on average 10 hours more per week) and have less access to social welfare Hamilton (2000) for example shows that in the US the value to the median entrepreneur of a business lasting 25 years was 25% less than the value of a paid job over the same period.

It is Ibec's view that the Irish tax system, which today has very mixed signals for entrepreneurs, must transition toward one which acknowledges that fact. To achieve this we need to see changes which make it more attractive for people to take on the burden of risk, grow their companies and invest their time and money in the things which create jobs and wealth.

Targeted tax reforms focusing on entrepreneurship can support a more dynamic domestic enterprise base. This applies not only to the capital taxes but also income taxes. As a series of important papers by Carroll, HoltzEakin, Rider and Rosen (2000) in the US have shown, marginal tax rates faced by entrepreneurs have important implications for their decisions to take on staff, grow their firms and invest in physical capital. Reform of taxation of entrepreneurship can play an important part in encouraging more people to enter work for themselves, to hire others and to grow the Irish business base.

Figure 2. Actual effective income tax and USC rates for entrepreneurs, % (2013)



Income tax reform for entrepreneurs

Recent years have seen the introduction of a number of reliefs for entrepreneurs through the tax system such as the start-up relief for entrepreneurs (SURE), the start you own business relief and the entrepreneurs relief from Capital Gains Tax (CGT). These schemes have seen disappointing take-up, however, for various reasons ranging from excessive complexity to lack of visibility. Meanwhile the main tax heads which matter for entrepreneurs, CGT and income taxes, have gone up substantially.

When looking for a tax system which supports entrepreneurs the very first thing you would hope to see is that people who work for themselves or start their own business would pay no more income tax than a PAYE worker with the same income. This is not the case in Ireland. A selfemployed person or a business owner will pay more tax and USC than their PAYE counterpart on the same income.

There are two elements to this - the lack of a sufficient earned income tax credit and the 3% USC surcharge.

The notional reason for the 3% USC surcharge on self-employed is that self-employed persons can reduce their tax liability in other ways by claiming for expenses related to their business. This reasoning has never made any sense given that the expenses can only be claimed back in limited circumstances where they are 'wholly and solely' incurred in the operation of their business. In addition around half of the self-employed (proprietary directors) have little recourse to these expense claims at all as they are paid through the PAYE system the same as any other employee.

In addition, the PAYE tax credit allows an individual to earn €8,250 free from income tax. The lack of an equivalent earned income tax credit (EITC) for self-employed persons has in the past meant their effective income tax rates are often much higher than PAYE workers at the same level (see figure 2). This leads to a situation where, even with tax reliefs for business expenses available to self-employed persons accounted for, self-employed and proprietary directors at less than average incomes have much higher effective tax rates than PAYE workers.

While government has taken steps to correct this in Budget 2016 by introducing a small EITC this remains an obvious disincentive when considering going into business for yourself.

Along with removing the USC surcharge over time Ibec believes the next government should commit to introducing a modest EITC for all selfemployed persons equivalent to that available for PAYE workers.

How do we encourage investment in small firms?

The first thing any business person asks when deciding whether to invest in a business is what their rate of return will be. Tax plays a key role in this decision. During the crisis years CGT increased from a rate of 20% to its current rate of 33%. This means for every euro an entrepreneur makes in profit from starting, building and selling their business the government took one-third. This rate is the third highest in the OECD. As we have seen in previous sections the probability of getting a business to this point is low. The chances of an entrepreneur making a substantial profit even less.

Although the entrepreneurs CGT relief was improved substantially in Budget 2016 it remains of limited use to venture capital intensive high growth firms where an entrepreneurs share can be diluted below the 15% threshold quite quickly.

In addition, changes to the taxation of the selfemployed may help encourage people to set up a business, however, once in business small firms often face constraints on their growth. The most problematic of these in recent years has been a liquidity constraint.

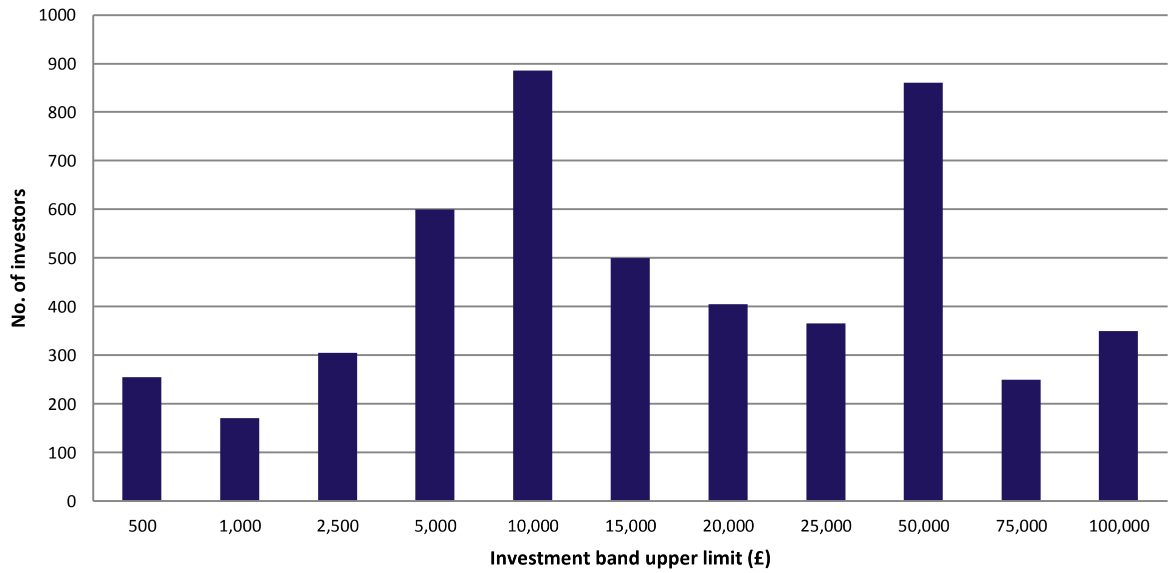
One scheme which helps firms to overcome this is the EIIS (Employment and investment incentive scheme). Although some clauses in it remain overly complex it works well for many companies seeking investment. It's major limiting factor, however, is that it attracts a small pool of 'traditional' investors who for the most part invest large sums in lower-risk mid-cap companies.

If we want to broaden the base of people investing in Irish business and allow smaller firms and startups to access crucial investment again recent experience in the UK can help guide reform.

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. Costing £58.5 million (€81 million) this scheme is targeted at a totally 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, almost half of the investments were of less than £10,000 showing the schemes ability to attract non-traditional investors into the market in small sums. This is partly due to the fantastic branding of the scheme and ease of use. Ibec believes a similar angel investment tax incentive should be introduced here for start-up firms and microenterprises in approved sectors.

Figure 3. SEIS (UK) investor profile



Skills and innovation for small firms

Irish economy wide R&D spending is equivalent to around 1.6% of GDP; this is compared with an EU average of 2.1% and leading EU countries spending of 3.3%. In order to realise our goal of 2.5% GDP spend on R&D by 2020 and a growing, exporting, indigenous enterprise base we need to make sure more small companies are innovating sooner.

The R&D tax credit has been a successful model in encouraging Irish companies to invest in R&D and create value in the economy. In line with international research an Ibec study showed that for every €1 given in tax credit to participating firms they spend in the region of an additional €1.25 on R&D over and above what they would otherwise have spent. Studies in the UK suggest this additional spend could rise as far as €3.60 in the long-run.

It is well established that smaller firms and start-ups in particular face funding constraints for R&D investments. Despite this the credit's take-up among smaller companies has been weak. Only 1% of companies with turnover less than €1 million use the R&D tax credit each year, compared with 12.5% above that mark.

Part of that has to do with the types of firms in each category but previous Ibec research has shown that it is largely down to the complexity of the scheme and cost of administration. An Ibec survey in 2013 found that among SMEs in R&D intensive sectors 31% of the firms saw the administrative burden involved as being the number one reason they had for not claiming the R&D tax credit. We recommend that a streamlined or 'credit lite' model should be developed for SMEs which would include the use of proforma templates for R&D project management and simple online cost benefit calculators.

Small firms and particularly start-ups also face problems attracting the necessary human capital and skills they need to grow. This is a particular problem due to the fact that staff in start-up companies typically will have low incomes, relative to the market, as the business builds. As a result, share options may well be a central if not the major part of the remuneration package for many employees in start-ups. In this sense the onerous taxation on stock options in these firms is a particular disincentive to leave more stable employment in larger companies to start or join a start-up firm.

Currently gains on stock options are taxed as income when they are exercised and additionally as capital gains when they are sold. As a result many employees (who are relatively cash poor) only exercise their options when the company is being sold, at that time paying 52% of what they receive in income tax and CGT. This is a once-off gain which few of them will ever make again.

The UK has recognised this with the introduction of the EMI (Enterprise Management Incentive) credit which in effect waives the income tax due on the gain between the granting and exercising of the option for employees within start-up and small firms; instead taxing them only on the capital gain from the sale of stock. A similar scheme is needed in Ireland and would make working in a start-up company much more attractive to many. In line with the UK this would have minimal cost in the short term and no substantial cost overall but would be a welcome targeted relief for entrepreneurs.

What should the next government's priorities be for the reform of entrepreneurs' taxation?

The improving economy will provide a real opportunity for the next government to strengthen the indigenous enterprise base through targeted measures. Central to this will be a necessary reform of how we treat entrepreneurs through the tax system. Ibec believes the next government should:

- **Equalise the personal tax treatment of the self-employed and owner managers with their PAYE counterparts making entrepreneurship a more viable career choice**

- **Make targeted changes to investment taxation which make investing in indigenous Irish business a much more attractive proposition for a broader cross-section of society**

- **Introduce a simplified R&D tax credit meaning that smaller firms are better able to overcome funding constraints on their innovative activity and R&D; in turn helping Ireland to reach an economy-wide R&D spending target of 2.5% by 2020**

- **Reform the taxation of share options making it much easier for high potential small firms to attract key talent when cash was tight and growing the proportion of our best and brightest willing to take the risk of working in a start-up**

Ibec policy team

Gerard Brady, Senior Economist

Gerard Brady is the Senior Economist in Ibec, Ireland's largest business representative organisation. His role involves engagement with policymakers on issues of importance to business and helping business navigate economic issues. Prior to joining Ibec Gerard worked as a lecturer in economics in University College Cork.

Gerard was the winner of the Foundation for Fiscal Studies Miriam Hederman O'Brien prize for research on fiscal policy in 2013.