IVCA Pre-Budget Submission **2020**

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IVCA
Irish Venture Capital Association

Rebalancing the Economy to Power Indigenous SME's

FY 2017 V FY 2018

down 25%

9%

increase in number of businesses operating in the state

Urgent requirement to
increase available funding

Solution

Encourage private capital away from passive assets e.g. property to fund the future of Irish Industry and the productive assets that will rebalance the economy.

Executive Summary

We are currently experiencing a seismic period of global economic realignment. There are potential implications for the Irish economic model from proposed US tax reform, EU tax harmonization measures, and Brexit. Ireland as a small open economy will be disproportionately impacted by decisions made in other countries.

We are highly exposed to any realignment in the Global economy - foreign owned companies paid 77% of last year's corporation tax take.

The IVCA believes that the funding gaps our quarterly data has uncovered over the last 18 months illustrate a worrying trend for start up and scaling indigenous companies. This needs to be addressed; otherwise the flow of indigenous companies reaching their potential will be impacted over the next 10-15 years.

Recommendation

- We believe that measures to increase private sector involvement in funding the indigenous economy need to be prioritised to ensure a stable, long-term funding landscape.

Funding Gap: Seed & Start Up

IVCA data illustrates that in Ireland a funding gap exists at the seed and early stages. The last significant measure which positively impacted early stage investing was the Government mandated creation of AIB & BOI seed funds. Since these funds closed their first round investment cycles the proportion of seed funding deployed in Ireland has halved. Significant investment in seed funding is required to address this. Additionally, tax based incentives can balance investor risk and ensure that higher risk investments at seed and early stage are more attractive. The IVCA has submitted comprehensive proposals to the consultation of EIIS, SURE, CGT & KEEP schemes. Details can be found later in this document.

We would like to reiterate the points made in that submission, that a method of distinction should be developed to separate high risk and high potential innovation driven start-ups from more established asset backed enterprises. This category – possibly companies that are pre-revenue or pre-profit and less than three years old should have higher tax incentives applied to investment, in order to offset the higher risk. Consideration should be given to a more favourable CGT treatment for investment in genuine risk assets and activities that are productive rather than passive.

Funding Gap €5-10 million: Scaling

The value and volume of investments in the €5-10m range declined by 70% in 2018 driving the overall decline in Irish funding in 2018.

Investments at this level are typically deployed into scaling firms. Recent CSO figures show that there was almost a 9% increase in the number of businesses operating in the state. There is an urgent requirement to increase the level of equity finance available to fast growing firms. A lack of scaling investment is evidence that there is a need to attract additional sources of capital to the Irish market.

Government getting the value of its investment

2018 was a record year for venture capital globally, with €131 billion raised, exceeding the previous record of €100 billion achieved in 2000. Worryingly in the same period the level of venture capital raised by Irish companies fell by 25%.

The Enterprise Ireland Seed & VC scheme is an essential ingredient in the start up ecosystem in Ireland. Its continuation is critical to the provision of Venture Capital to Irish SME's. However, recent research by Emlyon Business school has stated "that government presence seems to be much more important than previously documented, as we find that the government intervenes, on average, in 42.2% of venture capital investments in Europe"

The IVCA believes that the full benefits of this Government investment will not be realised by indigenous SME's unless it is paired with measures aimed at mobilising additional private sector capital to Venture Capital as an asset class.

Why is Ireland different?

Institutional & Corporate Investment in Irish Start Up's

The relatively recent nature of Ireland's prosperity and it's roots in an FDI orientated open economy have resulted in a lack of depth in the type of institutional and corporate investors often seen in other European countries. There is a lack of domestic multinationals, which in other countries, typically deploy some assets in domestic venture capital funds or direct investment in start up's. In 2018 corporate venture capital activity in the United States represented 52% of total venture capital investment. Additionally, Ireland has significantly less well developed family office and endowment fund structures than other European countries, and the small size or property focus of most domestic pension funds has limited investment by in domestic private capital.

The general trend of moving from defined benefit to defined contribution schemes has meant those of a sufficient scale to have invested in the past (An Post, RTE), find it more difficult to do so now.

We believe an incentive mechanism needs to be found to unlock far greater asset allocation from domestic pension funds into private capital funds. This will ensure that existing state investment in the sector goes significantly further.

How to Unlock Private Capital to Finance Growth in Innovative Firms

Venture Capital increases the quality of innovation and has a far-reaching impact on competitiveness. Spin off effects on job creation, patent applications and economic growth have been well documented both internationally and locally in the IVCA Economic Impact Studies. Consequently, it is unsurprising that policy initiatives have been undertaken in other countries such as Denmark, the UK and Norway aimed at unlocking billions of private sector investment to finance growth in innovative firms.

Most Governments, the EU Commission and the EIF favour the creation of a fund of funds by the State, as a diversified vehicle to encourage private sector investment in venture capital. The IVCA has explored this concept in Ireland and we are certain that, with Government sponsorship, a successful fund of funds can be established in Ireland.

Auto-enrollment Pension Proposals and a Fund of Funds

Establishing a vehicle to unlock private investment and enable investment in pension funds is vital when we take account of the stated Government policy of establishing an auto enrollment pension scheme.

Historically the operation of a pension fund holds that the long-term savings of today's workers to be invested in businesses, providing more jobs and generating tomorrow's profits. The UK Government created the National Employment Savings Trust (NEST), as the default home for pension contributions under auto-enrolment, it currently holds, more than £3bn from nearly 7million members and their employers. A recent analysis of the holdings in Nest's flagship fund shows that all of the 10 largest holdings are in US and not UK based firms.

IVCA members in receipt of State investment through Enterprise Ireland are required to invest in Irish companies. This State mandate should extend to pension funds directly in receipt of Irish state funding or indirectly through tax reliefs.

The creation of an auto enrolment pension scheme is an important step to safeguarding the economic security of Irish citizens. It is important that the design of the scheme does not limit the additional economic benefits to the domestic economy that the deployment of significant sums of State money could produce.

The IVCA believe that any auto enrolment scheme should ensure that a portion of this pension saving supported by the state should be used to finance Irish jobs of the future. An established Fund of Funds will be critical to achieving this aim.

Conclusion

Now is the time for the Irish Government to make significant, cohesive, innovative and far reaching policy decisions, which will increase the number of start ups and ensure their ability to scale up in Ireland. IVCA members are immersed in the start up and indigenous SME ecosystem both in Ireland and throughout Europe, and have valuable experience and insights we would welcome the opportunity to play a role in rebalancing Irish economic development.

Specific Proposals made during EIIS, SURE, KEEP, and CGT Consultations

Employment and Investment Incentive Scheme

EIIS, and its predecessor BES, have over the years consistently proved to be of significant benefit to the economy as a whole empowering entrepreneurs and encouraging small business growth.

In recent practice most of those availing of the scheme tend to invest in medium sized companies between three and five years old, making them quite risk-averse. A preference for larger companies seems to be growing, as evidenced by a steady the increase in the average deal size since the introduction of EIIS.

The IVCA suggests the following measures aimed at rebalancing the risk and reward incentives for investors to deploy capital to higher risk innovative firms.

Recommendations

- A method of distinction should be developed to separate high risk and high potential innovation driven start-ups from more established asset backed enterprises.
- This category – possibly companies that are pre-revenue or pre-profit and less than three years old should have higher tax incentives applied to investment, in order to offset the higher risk.
- The scheme currently offers investors tax relief of 30% in year one and a further 10% in year four. 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.
- The entire relief should be made available to investors in companies less than three years old in the year of the investment. This would make investment in higher-risk startups much more attractive.
- Follow on Funding. The idea that follow on funding must have been forseen in the original business plan is restrictive, and consideration should be give to alternative metrics in order to allow EIIS participant companies secure follow on investment. Business plans by their nature change and having to foresee a further EIIS fund raise is often not possible. Our members have come across SME's who may have raised EIIS in 2011 and 2012 and cannot now because they did not foresee it in their business plan. This is a very restrictive clause and has reduced the number of companies, which can avail of the scheme.
- Recent amendments to the scheme necessitated to ensure compliance with European Commission General Block Exemption Regulations (GBER), mean that only independent private investors, within the meaning of GBER, are eligible for relief under EIIS. In reality, many start-ups within their first two years are in receipt of funding from family and friends. Consideration should be given to an additional alternative scheme, which will allow tax relief for investment from family and friends, and also remain compliant with GBER.
- Current approval processes should be simplified and the requirement should be that the company provides a business plan in order to be approved for EIIS.
- The four-year holding requirement for the investment should be reviewed. Feedback from investee companies is that this can be too short a turnaround time for the investee company to generate a return to the investor.
- Convertible Loan Notes should be allowed under EIIS, members often have situations where angel investors to avail of EIIS tax relief have to invest by way of ordinary shares but other investors want to invest by way of CLN for commercial reasons. Having two different instruments in a seed investment complicates the negotiations, the deal structure, and the cost and adds time to get a funding round closed.

Start-Up Refund for Entrepreneurs (SURE)

According to figures published by Revenue in 2017 only 59 entrepreneurs availed of the scheme in 2014. In order to increase the number availing of this support we make the following suggestions.

Recommendations

- Extend the relief to non-PAYE taxpayers
- Increase the investment limit from €100,000 to €250,000.
- Consider ways to grant tax relief upfront to assist cash flow rather than retrospectively.
- Pair the relief with a similar scheme to the Swedish leave of absence for entrepreneurship program. This entitles all full-time, permanent employees to take six months out to focus on their business, allowing them to return to their job — or a similar one — once the period is up.

KEEP

The KEEP scheme is designed to allow for the tax efficient granting of share options by SMEs in order to retain their key employees. While KEEP came into effect in January 2018, take up of the scheme by targeted SMEs has been minimal due to the restrictions imposed. The changes made earlier this year were welcome but in practice the biggest obstacle to KEEP to date has been the fact that the total market value of issued but unexercised share options that can exist per SME must not exceed €3million and despite the measures introduced in Budget 2019, this remains a significant obstacle to start up's and other SMEs in Ireland. This means that, in practice, many innovative start-ups are unable to compete on a level playing field with MNC's to attract high quality key talent.

Recommendations:

- Reconsider the €3 million outstanding grant options ceiling. This condition is restrictive and does not support the participation of start-up's in the scheme.
- Share buy backs need to be facilitated to assist with liquidity.
- Eliminate the restriction limiting the value of allowable option grants to 100% of an individual's salary. Start up salaries may not reflect the market, allowing enterprises to offer a significant equity stake will allow them to militate against a lower salary offer.
- Remove the requirement to pay CGT immediately when a company is acquired, in order to ensure that CGT is not payable until an individual as opposed to a company has actually made a gain.

Capital Gains Tax

In our view Ireland is losing potential revenue as a result of the very punitive CGT regime that is in place, which is driving some of our successful entrepreneurs to other jurisdictions. Gains from enterprises are productive gains and should have a different rate to passive, property or inheritance type gains. Not only is Ireland potentially losing revenue, there is also the danger if a successful entrepreneur goes to another jurisdiction for tax reasons they might be lost to the Irish enterprise ecosystem both as an entrepreneur and investor.

Recommendations

- As with the EIIS scheme a method of distinction should be developed to separate high risk and high potential innovation driven start ups from more established asset backed enterprises. This category – possibly companies that are pre-revenue or pre-profit and less than three years old should have higher tax incentives applied to investment, in order to offset the higher risk. Consideration should be given to a more favourable CGT treatment for investment in genuine risk assets.
- Increasing the cap beyond €1m in a lifetime to encourage greater aspiration by entrepreneurs for making more investments and in turn creating a culture of serial entrepreneurship. Ideally the lifetime cap should be raised to €10m in order to bring it into line with the UK rate.
- To generate greater liquidity in the ISE and assist in opening up the ISE as a potential source of capital for Irish SMEs, create a CGT exempt pool of capital that can be invested in the Irish Enterprise Securities Market. Sweden has shown how this can be done, last year Sweden, saw 115 IPO's take place across its four exchanges, the highest number of IPO's of any European country. Ireland in the same period had 3 IPO's. Sweden has Special Investment accounts, which are CGT free except for a tax of 0.25% per annum on the market value of the account.