

A REVIEW OF THE
EQUITY INVESTMENT
LANDSCAPE IN
IRELAND

Foreword

The Action Plan for Jobs 2012 under Action 3.41 requests a “review the equity investment landscape in Ireland with a view to introducing actionable steps (enterprise supports, tax, etc.) to support equity investment in productive firms”. It identified four parties to deliver the review: Forfás (nominated lead role), the Department of Jobs, Enterprise and Innovation, the Department of Finance and Enterprise Ireland.

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1. Executive Summary

1.1 Introduction

The Action Plan for Jobs 2012 under Action 3.41 requests a “review the equity investment landscape in Ireland with a view to introducing actionable steps (enterprise supports, tax, etc.) to support equity investment in productive firms”. It identified four parties to deliver the review: Forfás (nominated lead role), the Department of Jobs, Enterprise and Innovation, the Department of Finance and Enterprise Ireland. The timeline for delivery is by Q3 2012.

The presence of investment and investors is critical to restoring economic growth. A specific cohort of young innovative fast growing start-ups do not neatly fit into the traditional model of bank lending and therefore rely on equity finance. In addition, there is a range of more mature companies, where relatively high debt levels, suggests greater potential may exist to utilise equity to support further growth. Notwithstanding the opportunities, given the returns required to attract external equity investors and the unwillingness of many business owners to cede some control, the potential to attract equity is only feasible for a minority of firms. In a recent ECB SAFE survey, 68 per cent of Irish SME respondents stated that equity was not relevant for their firms¹.

The provision and use of equity is largely guided by the market and economy wide developments. Equity begins from the earliest stage of the business life-cycle with friends, family and founders investing at the pre-seed stage to business angels and venture capitalists investing in the seed and start-up phase right up to the latter stages through mechanisms such as trade sales and initial public offerings.

While these stages are not always clearly defined and discrete, this paper adopts the life-cycle approach of the firm where we define each stage, the types of equity sought and the nature of investors; assess key trends in the availability of funds; review actions taken to date to support equity investment; and set out actionable steps to support further equity investment in productive firms.

While many entrepreneurs voice concerns over the lack of equity funding, some investors cite the absence of enough viable projects as a key barrier to investment. Actions in this report are focused on enabling firms to take on equity investments, encouraging potential investors to invest and the development of equity networks/ markets.

Given considerable data limitations, the findings are based on an analysis of available data, research, steering group guidance, and consultations with national and international experts.

1.2 Recommended Actions by Life Cycle Stage

At an economy wide level, equity is growing in importance, as illustrated by the recent ECB SAFE survey and Central Bank research. Since Q3, 2009, ‘shares and other equity’ has become the dominant source of funds for Irish non-financial corporations.

Pre-Seed Stage

The pre-seed stage represents the earliest stage in the development of a business, when a business plan may be in development but no concrete steps have been taken to set up the

¹ ECB (2012), *Survey on the access to finance of SMEs in the euro area (SAFE)*, October 2011 - March 2012 - Background data, Q4 - Irish responses.

business. Generally, investment is confined to 'friends, family and founders' and amounts invested are relatively small. Given the informal nature of many investments, no economy wide data is available. However, firm-level survey data indicates that these informal investments are important for SMEs, in particular, for SMEs less than 5 years of age.

A range of State agencies support the development of nascent entrepreneurship from County Enterprise Board (CEB) support for micro-enterprises to Enterprise Ireland and Science Foundation Ireland (SFI) support for research. Encouraging entrepreneurship, through broader policy actions to enhance the volume and quality of the pipeline of entrepreneurs, are critical. As the recommendations are broader than pre-seed lifecycle stage, they are reflected in section 9, which assesses horizontal issues.

Seed Stage

Seed financing is designed to research, assess and develop an idea or initial concept before a company has reached the start-up phase. Business angels invest at this stage, building on the funding received from friends, family and founders. These private individuals usually invest relatively small amounts of money in return for equity. This investment is helping to bridge the equity finance gap, as venture capital is tending to invest at later stages. In addition, they often contribute their expertise in business management.

Despite growth, the business angel market in Ireland appears underdeveloped relative to the sector size in other countries and relative to the size of the Irish venture capital market. A range of programmes (e.g. Employment and Investment Incentive scheme) are already in place to promote business interest in equity and readiness for investment, to encourage investment, and to match firms and investors. The challenge at this stage is to encourage firms to consider equity investment as a viable funding option and to secure investment from investors. Potential also exists to capture the opportunities that arise from the growing interest in crowdfunding.

Recommended Actions

1. Promote greater public and private sector collaboration to enhance business interest in equity/quasi equity and firm readiness for investment:
 - Endorse the www.smallbusinessfinance.ie initiative. Encourage stakeholders to submit information and updates on equity initiatives and to promote the site (e.g. links on their own website).
(D/Finance SME Credit Committee with support of IBF and Chambers Ireland)
 - Build on the recent successful collaboration between Irish Banking Federation and the Consultative Committee of Accountancy Bodies - Ireland with the launch of 'Business Plan Guide'. Develop a complementary guidance booklet on alternative sources of finance - equity and mezzanine finance. To enhance the skills of SME professional advisors (e.g. accountants, solicitors, bankers) incorporate this material into the various training programmes.
(IBF, CARB-I and others)

2. To provide certainty and enhance the potential of the Employment and Investment Incentive (EII) scheme to encourage investment:

- Extend the EII scheme beyond the current deadline of 31 December 2013, with early application to the EU Commission to enable approval before the end of Q2, 2013.
- Fully exclude the EII relief from the high income earner restriction.
- Seek an expansion of the EU guidelines in the current EU negotiations (e.g. Regional Aid Map and Risk Capital Guidelines) so that all medium sized companies, including those in non-assisted areas, can qualify for investment under the EII scheme.
- Review of features of the UK Enterprise Investment schemes, particularly the exception for business angels and a scheme targeting the earlier seed stage in the lifecycle (the new Seed Enterprise Investment Scheme) with additional incentives.

(D/Finance)

The role of State investment in supporting seed funds is addressed in action 3. Action 6 seeks to capture the opportunities arising from crowdfunding.

Start-up Stage

At this stage, businesses are still in the creation phase or have just started operations. In addition to business angels, who are addressed in the previous stage, venture capital (VC) tends to enter during this lifecycle stage. Venture capital is only appropriate for a small proportion of start-ups (i.e. high-growth firms which are usually technology or science based companies with scalable, high-growth business models). Venture capital or private equity firms establish investment funds that raise capital from investors.

The Irish venture capital market is relatively well developed. Ireland was ranked fifth by the OECD in terms of venture capital investment as a percentage of GDP in 2009. Irish Venture Capital Association (IVCA) research suggests that investment trends have weakened somewhat in 2011/2012. In Ireland and internationally, challenges exist to encourage venture capitalists to invest in early stage and smaller firms where costs are proportionately higher and risks are harder to assess.

Enterprise Ireland has committed €153.5 million to seven venture capital and four seed funds since 2007 and an expression of interest process is underway to commit a further €20 million. A working group established under the Action Plan for Jobs (action 3.42) is assessing the need for the State to continue its support. The emerging finding of the working group established under Action 3.42 of the Action Plan for Jobs, 2012 is that continued State investment in Seed and Venture Capital will be required over the period 2013-2018.

Given weak returns and turbulence in financial markets, encouraging investors to invest in venture capital funds remains a challenge. A sufficiently developed venture capital market, which can build the critical scale and expertise, is needed to support investment and to avoid an early stage venture capital gap. Continuing development of the domestic venture capital sector and attracting international venture capitalists to Ireland increases the viability of Irish investment opportunities and increases the availability of smart capital. Actions proposed also include addressing some practical challenges in the taxation of VC manager's carried interest.

Recommended Actions

3. Given how close the industry is to the completion of the current funding cycle, it will be important that Action 3.42 of the Action Plan for Jobs 2012 is progressed and that decisions are made quickly in order to provide policy clarity to the venture capital market.

(D/JEI and Enterprise Ireland - APJ 2012, 3.42)

4. Implement a number of amendments to the Irish carried interest tax legislation to ensure that the legislation operates as intended in order to encourage venture capital investment in companies engaged in R&D and innovative activities. (Amendments are detailed in section 6.3.2)

(D/Finance)

It is not clear if any specific measures can be taken to encourage pension funds to invest in VC funds as pension funds must invest in the best interests of their investors. However, it is important that any efforts should not distort market decisions between investing in government bonds, infrastructure development or enterprise. While Employee Share Schemes were considered, no recommendation emerged.

Expansion/ Development Stage

At this stage, the business has reached or is approaching breakeven or may be already profitable. This is a period of high growth. Growth capital is needed to increase production capacity and sales power, to develop new products, finance acquisitions, and increase the working capital of the business. Some firms may already have been through many rounds of financing. Expansions can be funded using private equity and is often combined with debt.

Recent initiatives include the launch of the Enterprise Ireland's Development Capital Scheme and the National Pension Reserve Fund's development of a SME Equity Fund. The recommendation below seeks to take advantage of strong growth in corporate venturing (i.e. corporate venture capital investing in other firms and VCs). With corporates sitting on huge cash reserves, a record of 83 corporate venture funds was established last year, primarily in the US and in Asia.

Recommended Action

5. Integrate corporate venturing units into the deal-flow environment of commercial VC investments led by Enterprise Ireland to provide increased funding, facilitate investee company scaling and provide a potential exit mechanism. Consider the role of corporate venturing in the completion of action 3.42 of the Action Plan for Jobs, 2012.

(Enterprise Ireland and IVCA)

Transfer/Succession/Turnaround/Buyout Stage

This is the final stage of the life cycle examined. Investors making investments include industrial investors, existing management and broader investors through public offerings. The amounts invested are typically substantial.

A major challenge in Ireland and internationally is to encourage firms to attract funding for expansion without selling the business in its entirety - or at least not to sell too early. While the founder and/or other investors are logically seeking to realise their investments/ diversify

risks, as a unit of a larger (international) business, there is a risk that strategic functions in the Irish operation will move overseas.

The depth of equity markets and ease of access (e.g. costs) are important factors in considering initial public offerings. The collapse in value and the relatively illiquid nature of the Irish Stock Exchange is a challenge. Regulation also has a role to play - reforms are occurring in the US (JOBS Act) and the EU (including the UK). More broadly, public stock markets are being challenged as vehicles for raising funding by the rise of private equity and corporate debt instruments.

Currently, the majority of venture capital exits are through trade sales. Where investors wish to exit, significant challenges remain to encourage firms to IPO on Irish and international exchanges rather than exit by trade sale.

Recommended Action

6. To promote Initial Public Offerings and emerging alternative funding mechanisms:
 - Enterprise Ireland to continue and enhance engagement with Irish companies seeking to list on US exchanges and to maximise the opportunities from the recent US JOBS Act regulatory changes which may create new funding opportunities for smaller offerings and crowdfunding. *(Enterprise Ireland)*
 - Continue to engage with the European Securities Committee to ensure that the on-going work programme in relation to EU Directives balances the regulatory burden with investor protection and reflects the EU Small Business Act 'Think Small First' principle. *(D/Finance)*
 - In principle, Ireland should support proposals targeting SMEs to enhance their ability to access equity on an EU wide basis (i.e. development of a single European equity market). *(D/Finance)*
 - Recognising the significant challenges facing all exchanges and the Irish stock exchange in particular, it is important that the Irish stock exchange sets out a clear vision for the future as a market to support equity investments and the steps required to achieve this. This vision should consider the merits of demutualisation and forming joint ventures/ alliances with other exchanges, which could support critical mass and deeper liquidity. *(ISE and members, broader financial sector)*

1.3 Selective Horizontal Issues

In addition to the issues identified at various stages of the firm life cycle, a small number of broader themes also emerged.

No entrepreneurs, means no demand for equity. There are a broad range of factors which create a positive environment for entrepreneurs. To encourage the pipeline of new entrepreneurs, Irish culture and the business environment needs to value entrepreneurship as a positive choice, promote it within the education sphere and support the risk-takers who create jobs.

Recommended Actions

Pre-seed Stage:

7. Develop a national entrepreneurship strategy, building on 'Towards Developing an Entrepreneurship Policy for Ireland'.

(D/JEI lead role with EI, the CEBs, Forfás and D/Finance)

8. Extend the footprint of the various educational initiatives, which have been developed to support entrepreneurial capabilities. (Details outlined in section 9.1.2)

(D/Education and Skills)

9. Introduce an additional voluntary opt-in PRSI contribution to enable the self-employed (Class S) to qualify for the full range of benefits, including Job Seekers Benefit, in order to mitigate the downside risk of business failure.

(D/Social Protection and D/Finance)

Initiatives are underway at an EU level to encourage investment. The new Programme for the Competitiveness of Enterprises and SMEs (COSME) 2014-2020, with a planned total budget of €2.5 billion, will play an important role in stimulating improved access to finance for SMEs across the EU. Early pilot initiatives, which are of particular relevance, include the European (Business) Angel Fund and a sectoral focused pan-European fund-of-fund pilot initiative for VC and mezzanine finance.

Recommended Actions

10. Maximise the opportunities available to Ireland under EU programmes, particularly the upcoming EU Programme for the Competitiveness of Enterprises and SMEs (COSME) 2014-2020. There are COSME pilot initiatives being supported (e.g. European angel fund, sectoral focused pan-European fund-of-fund pilot) which could be leveraged to underpin national policy proposals.

(D/JEI)

Tax neutrality is used to describe a tax system that does not create a bias that could influence a taxpayer to choose one course of action over another. In other words, investment decisions are made on their economic merits and not for tax reasons, which can lead to costly misallocations of resources. For example, in the past, Irish tax policy supported investment in property over that in productive assets. Current tax policy encourages investments in passive assets (e.g. saving deposits) over investments in productive firms. Tax policy also encourages firms to take on debt rather than equity financing. A policy preference toward debt may in part account for the high levels of indebtedness in the business sector.

Recommended Actions

11. Reduce the tax rate on dividends to the rate applying to deposit interest.

(D/Finance)

12. Over time and in tandem with developments in other countries, efforts should be made to ensure a higher degree of tax neutrality on firms' debt/ equity financing decisions.

(D/Finance)

2. Introduction

The Action Plan for Jobs 2012 under Action 3.41 requests a “review the equity investment landscape in Ireland with a view to introducing actionable steps (enterprise supports, tax, etc.) to support equity investment in productive firms.” It identified four parties to deliver the review: Forfás (nominated lead role), the Department of Jobs, Enterprise and Innovation, the Department of Finance and Enterprise Ireland. A steering group was established to guide this project².

A range of initiatives have been developed to support the flow of credit to enterprises in the past three years³. This paper identifies actionable steps to support further equity investment in both established and start-up companies. In some cases, the lack of credit growth for established companies, results from existing over-indebtedness. The presence of previous debts may inhibit a firm from accessing credit for potentially profitable investments. Encouraging equity investment (e.g. business angels and private investors, venture capital and government equity and private equity) represents one possible mechanism supporting viable businesses to restructure their balance sheet. Indeed, innovative growing companies, who are a vital source of long-term economic growth, often require large capital up front, which is hard to obtain from conventional sources of debt finance. Such companies tend to have intangible assets, show a significant delay before generating revenues, and therefore tend to rely on risk finance (business angel and venture capital investments)⁴.

2.1 Importance of Equity Investment

Supporting equity investment is important, particularly for innovative high growth companies. In addition, there are a range of more mature companies, where relatively high debt levels, suggests greater potential exists to utilise equity to support further growth.

Following the financial crisis, equity investment that may have previously been crowded out by over ambitious bank lending could now resurface. The argument for a greater range of financing options is also strong. More varied financing options gives businesses greater choice, promotes competition amongst finance providers, potentially reduces cost, and leads to greater resilience in the financial system⁵.

In the event of a business performing well, equity holders will get a share of that return. However, in the event of cessation, ordinary shareholders are only entitled to the residual value once creditors and debt holders have been paid. Higher risk equity investment demands a high yield. Target returns for individual investments can be set quite high so that successful investments can compensate for losses that will inevitably arise on other investments⁶.

² Participant on the steering group are listed in appendix 1.

³ In addition to initiatives to support the banking sector, measures have been developed to build business banking relationships, train bank staff and increase lending. Measures have also been taken to expand access to equity funding.

⁴ The National Endowment for Science, Technology and the Arts (NESTA) (2011), *Consultation response to HM Treasury on Tax-Advantaged Venture Capital Schemes*, UK.

⁵ Department of Business, Innovation and Skills (2012), *Boosting Finance Options for Business*, TSO London, UK.

⁶ Department of Business, Innovation and Skills (2009), *The Provision of Growth Capital to UK Small and Medium Sized Enterprises* - Rowland policy review, TSO London.

In a recent ECB SAFE survey, 68 per cent of Irish SME respondents stated that equity was not relevant for their firms⁷. Equity finance is not suitable as the primary source of growth finance for the majority of SMEs for a number of reasons:

- The anticipated modest growth of many SMEs would not be sufficient to support such high returns.
- As due diligence costs tend to rise only moderately as firm size increases, fixed costs are high for small firms.
- The aversion that exists within the SME community to equity finance means that this is not always a suitable instrument⁸.

Equity investment is likely to be increasingly important to supporting economic recovery. It is well known that many businesses, particularly small businesses, find it difficult to raise large amounts of capital. The exact range of this funding gap (the amounts of growth capital which small firms find it difficult to access) is debated, but the existence of a funding gap is widely acknowledged⁹.

While many entrepreneurs voice concerns over the lack of equity funding, many investors cite the absence of enough viable projects as a key barrier to investment. Actions in this report are focused on enabling firms to take on equity investments, encouraging potential investors to invest and the development of equity networks/ markets.

⁷ ECB (2012), *Survey on the access to finance of SMEs in the euro area (SAFE)*, October 2011 - March 2012 - Background data, Q4 - Irish responses.

⁸ Department of Business, Innovation and Skills (2009), *The Provision of Growth Capital to UK Small and Medium Sized Enterprises* - Rowland policy review, London: TSO.

⁹ HMRC (2012), *Venture Capital Schemes Manual*, UK.

3. Overview of the Equity Landscape

3.1 Defining Equity

The OECD defines equity finance as “all financial resources that are provided to firms in return for an ownership interest. Equity investors have no guarantee that any specific amount of money will be returned. Rather, their return on investment will be determined by the success of the firm. They may sell their shares in the firm, if a market exists or they may get a share of the proceeds if the firm is sold¹⁰”.

Equity finance can be sub-divided into private equity and public equity:

- Private equity is equity capital provided to private companies, whose shares are not freely tradable in any public stock market¹¹.
- Public equity finance refers to investments made in companies whose shares are quoted on some form of stock exchange.

3.2 Overview of the Equity Market in Ireland

A lack of clear definitions and data in Ireland and internationally make it difficult to provide a comprehensive analysis of the equity market¹². Following an assessment of economy wide trends, the remainder of this section assesses trends in equity financing across the equity lifecycle.

At an economy wide level, equity is growing in importance. In a recent ECB survey¹³ covering the period October 2011 to March 2012, Irish company respondents needing equity investment increased by 12 per cent in the case of large firms surveyed and 3 per cent in the case of SMEs. However, for almost half of the respondents in each category equity was not relevant to their firms. In the previous six month period April 2011 - September 2011, some of the Irish respondents had used equity; 28 per cent for large companies and 11 per cent for SMEs.

Central Bank data can be used to assess the levels of equity in enterprise. In the business sector (i.e. the Non-Financial Corporation (NFC)¹⁴ sector) the major source of funding (54 per cent) is ‘shares and other equity’, as it has been every quarter since Q3 2009 (Figure 1). The second largest source of funding was loans, which accounted for 30 per cent of funding in Q3 2011. During Q4 2011, the business sector’s financial liabilities (i.e. sources of funding) in terms of shares and other equity grew by 2.1 per cent or €9.9 billion to reach €473 billion. The changes in liabilities can be influenced by transactions, as well as other changes (which include valuation changes and other changes in volume).

¹⁰ OECD (2009), *Financing High Growth and Innovative Start-Ups and SMEs: Data and Measurement Issues*, OECD Publishing.

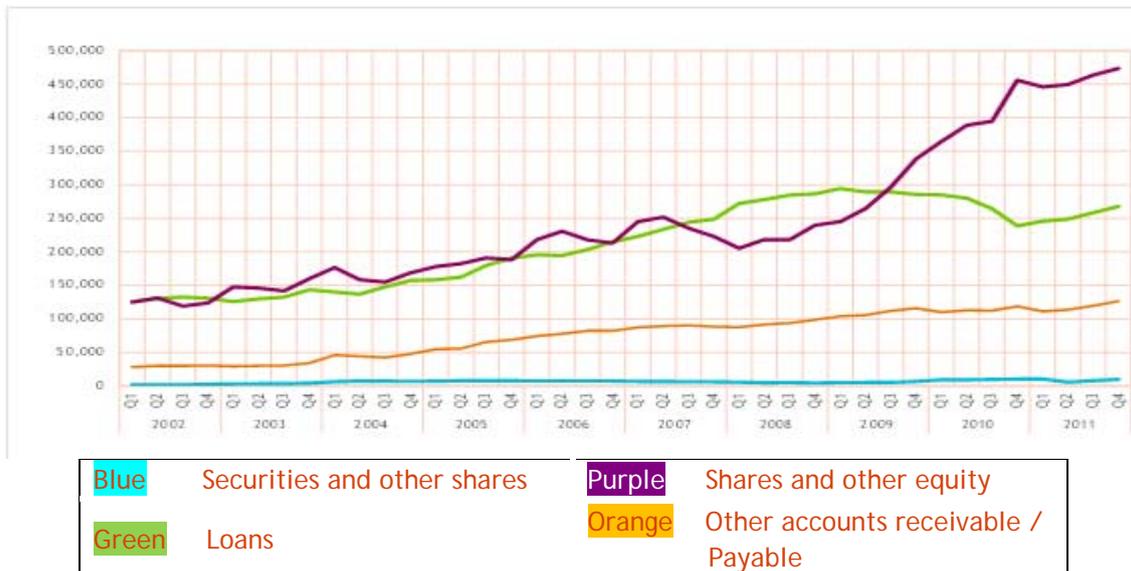
¹¹ There are several types of private equity funds including independent private equity funds, captive funds, bank funds, industrial funds etc.

¹² On-going work at the OECD and the EU Commission on equity finance should enhance national data collection and its international comparability in the future.

¹³ ECB (2012), *Survey on the access to finance of SMEs in the euro area (SAFE)*, October 2011 - March 2012 - Background data, Q5(c) - Irish respondent sample was 15 large firms and 485 SME firms.

¹⁴ Corporate bodies whose principal activity is the production of goods and non-financial services on a commercial basis. They include private companies and commercial public companies operating in Ireland. All non-incorporated corporations are classified under the household sector.

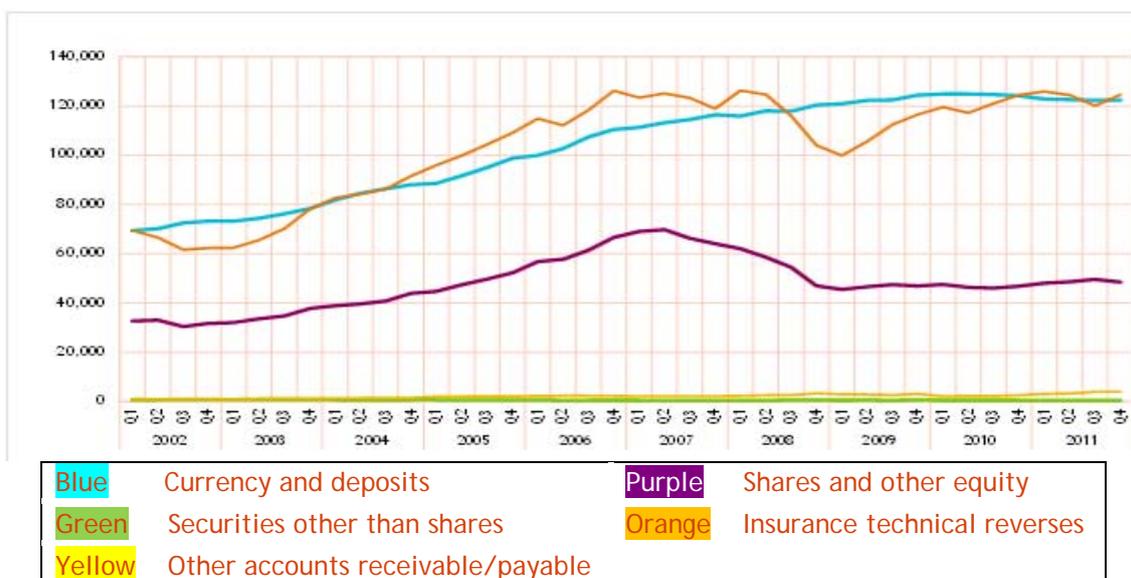
Figure 1: Non-Financial Corporations Sources of Funding Q1 2002 - Q3 2011 (€ millions)



Source: Central Bank (2012), Quarterly Financial Accounts for Ireland Q3 2011

Central Bank data also analyses the nature of Irish household assets. Shares and other equity account for just over €50,000 million of outstanding household assets or just over 17 per cent of total household assets (Figure 2). Given the open nature of the Irish economy, these assets may be invested in Irish and international equities. Again, these figures are influenced by transactions, as well as other changes (which include valuation changes and other changes in volume).

Figure 2: Household financial assets by asset type (€ millions)

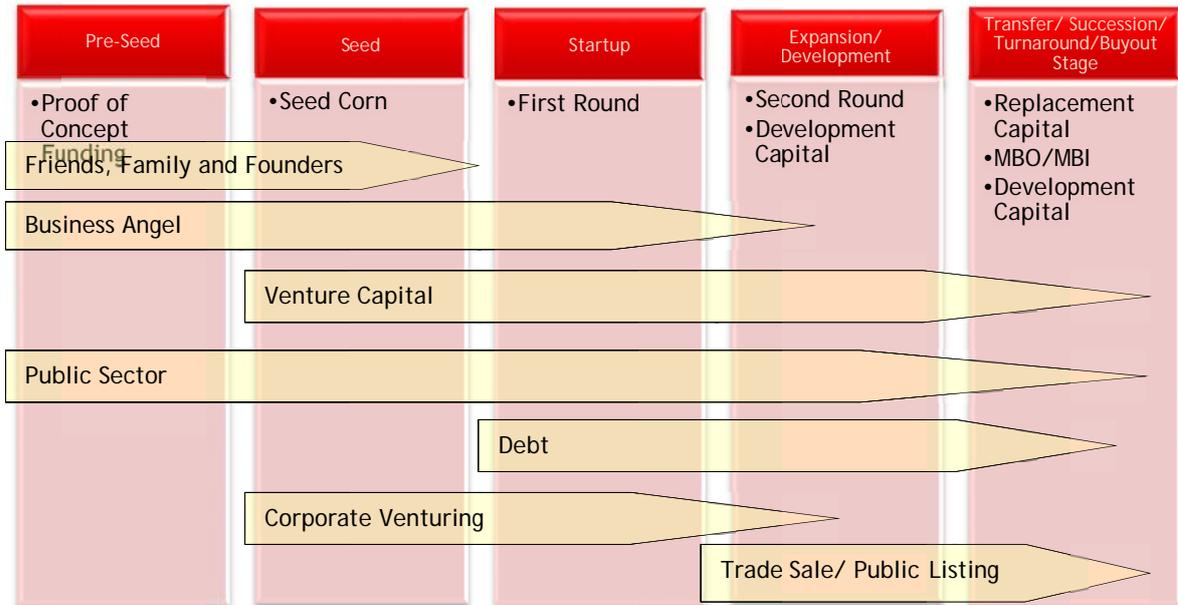


Source: Central Bank (2012), Quarterly Financial Accounts for Ireland Q3 2011

3.3 The Funding Life-cycle

In examining the funding needs of firms, the remainder of this report adopts the life-cycle approach of the firm (Figure 3) beginning with pre-seed stage, seed, start-up, expansion/development and finally transfer/succession/buyout stage.

Figure 3: The Funding Life-Cycle



Source: Adapted from Enterprise Ireland (2012)

It should be noted that the stages are not discrete; that there must be continuity of funding across the lifecycle and that investors must be able to enter and exit the market at various stages. It should also be noted that certain investors can be active at more than one stage and that non-equity funding sources (e.g. debt products, equity-debt hybrid products, etc.) play a key role at differing stages. Likewise, companies may not move in a linear fashion from one type of funding to another as they pass through the various stages.

4. Pre-Seed Stage Investment

The pre-seed stage represents the earliest stage in the development of a business, when a business plan may be in development but no formal or concrete steps have been taken to set up the business. In many cases, the financing needs of the entrepreneur are relatively low. In the US, in 2002, 41 per cent of the 500 fastest growing companies were founded with less than \$10,000 and 14 per cent of the 500 fastest growing companies with \$1,000 or less¹⁵.

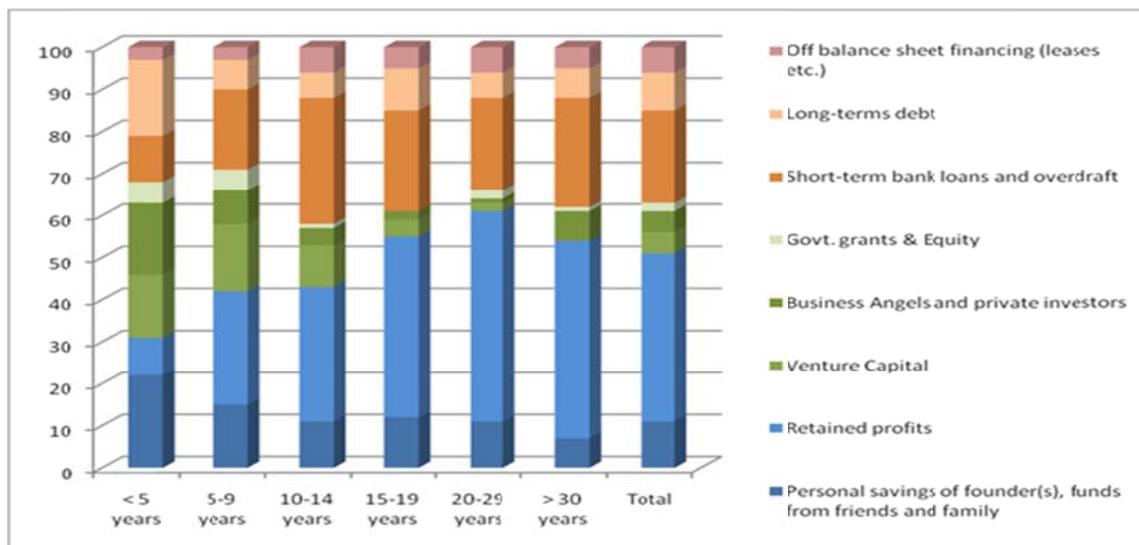
4.1 Current Market Trends

Generally, investment is confined to 'friends, family and founders'. Investors in this category can be driven by a desire to help the entrepreneur and/or for a return on investment. These investors can also invest at the seed and start-up stages in the firm's life cycle¹⁶.

Given the informal nature of many investments from friends, family, and founders, no economy wide data is available. The friends, family and founders category of equity is often underrated in part because data on investment activity and performance is lacking.

An overview of the main sources of finance for SMEs in Ireland¹⁷ shows the importance of friends, family and founders, in particular, for firms less than 5 years of age (Figure 4).

Figure 4: Source of Financing: % employed by respondents across age categories



Source: Data taken from Mac an Bhaird (2010) *Resourcing Small and Medium Sized Enterprises: A Financial Growth Life Cycle Approach*.

In terms of drivers of activity, the presence of an entrepreneurial environment is critical. No entrepreneurs means no demand for equity. Opportunity-driven entrepreneurship rather than

¹⁵ Sandler, D. (2004). *Tax Incentives and Informal Venture Capital*. University of Western Ontario, Faculty at Law, Ontario Canada.

¹⁶ OECD (2009), *Financing High Growth and Innovative Start-Ups and SMEs: Data and Measurement Issues*, OECD Publishing.

¹⁷ Mac an Bhaird (2010) *Resourcing Small and Medium Sized Enterprises: A Financial Growth Life Cycle Approach*, Springer-Verlag. Based on a study undertaken with a sample size of 299 out of an eligible population of 702. Survey sampled firms with between 20 and 250 employees.

necessity driven entrepreneurship is more likely to attract business angel and venture capital due to its growth potential. However, Global Entrepreneurship Monitor (GEM) data indicates that Irish entrepreneurial activity levels (new business ownership rate) have fallen in recent years, with 3.1 per cent actually opening and managing a business in 2011 compared to 4.3 per cent in 2008¹⁸. A greater share of entrepreneurship is necessity driven – 29 per cent in 2011 compared to 18 per cent in 2008.

While many entrepreneurs voice concern over the lack of equity funding, some investors cite the absence of enough viable projects as a key barrier to investment. The presence of entrepreneurs depends on a wide range of factors, mostly outside the scope of this study.

4.2 Current Policy Initiatives

The role of the County and City Enterprise Boards (CEBs) is to develop indigenous enterprise potential, to stimulate economic activity at local level and to promote micro-enterprises (10 or fewer employees). The CEBs can provide both financial and non-financial assistance to a project promoter, either an individual, firm or community group. The forms of financial assistance that are available include business priming grants, expansion/development grants and feasibility/innovation grants. Non-financial assistance can take the form of business advice and information services, management capability training and development programmes, e-Commerce training initiatives, etc. The CEBs also play an important role in assisting businesses and the development/ expansion of micro enterprises, helping to bring them to the stage where they can avail of the services of Enterprise Ireland.

A number of State agencies support nascent entrepreneurship by funding research through a spectrum of programmes including Science Foundation Ireland, the Higher Education Authority and Enterprise Ireland.

In terms of encouraging investment in productive firms, much has been done over recent years to move away from encouraging investment in property through tax incentives¹⁹.

4.3 Recommended Actions

As noted, investment levels at this stage are often relatively low. However, it is critical that the State continues to fund research and development. Encouraging entrepreneurship, through broader policy actions to enhance the volume and quality of the pipeline of entrepreneurs are critical. As the recommendations are broader than pre-seed lifecycle stage, they are reflected in section 9, which assesses horizontal issues.

¹⁸ New Business Ownership Rate: Percentage of those aged between 18-64 years in the population who are currently an owner-manager of a new business, i.e. owning and managing a running business that has paid salaries, wages, or any other payments to the owners for more than three months, but not more than 42 months.

¹⁹ Department of Finance (2011), *Economic Impact Assessment of Potential Changes to Legacy Property Reliefs*, concluded that the property reliefs, in general, outlived their usefulness and contributed to excess supply.

5. Seed Stage Investment

Seed financing is designed to research, assess and develop an idea or initial concept before a company has reached the start-up phase.

5.1 Current Market Trends

New businesses generally have founder investment before approaching outside investors and lenders. This is evidence of the entrepreneur's commitment and belief in their venture.

At this stage, external investors are mainly business angels, who are private individuals unconnected with the founder who invest relatively small amounts of money in new businesses in return for a share of ownership. They can also contribute their business management expertise and their personal network of contacts. They can invest on an individual basis or as part of a business angel syndicate. Individual business angels typically invest between €20,000 and €250,000. Business angels tend to invest in sectors where they have knowledge and expertise and maintain close contacts with the company, often asking for a seat on the board²⁰.

Business angels play an important role in early stage financing of entrepreneurial firms though definitional issues and the lack of data make it difficult to evaluate activity and performance.

Currently, the only data available is that collected from angel groups and networks. However, this data only represents a fraction of the market, termed the "visible" market. The majority of angel investment is undertaken on an individual basis and that information is private and therefore extremely difficult to measure. This comprises the "invisible" portion of the market²¹.

The estimated size of the visible and invisible business angel market and a comparison with the venture capital market is presented in Figure 5. It is notable that the total European and the US business angel markets are estimated to be of similar size to their respective venture capital markets.

²⁰ OECD (2009), *Financing High Growth and Innovative Start-Ups and SMEs: Data and Measurement Issues*, OECD Publishing.

²¹ OECD (2011), *Financing High-Growth Firms: The Role of Angel Investors*, OECD Publishing. In countries where there is a tax incentive for business angels, additional data can be obtained from the tax authority.

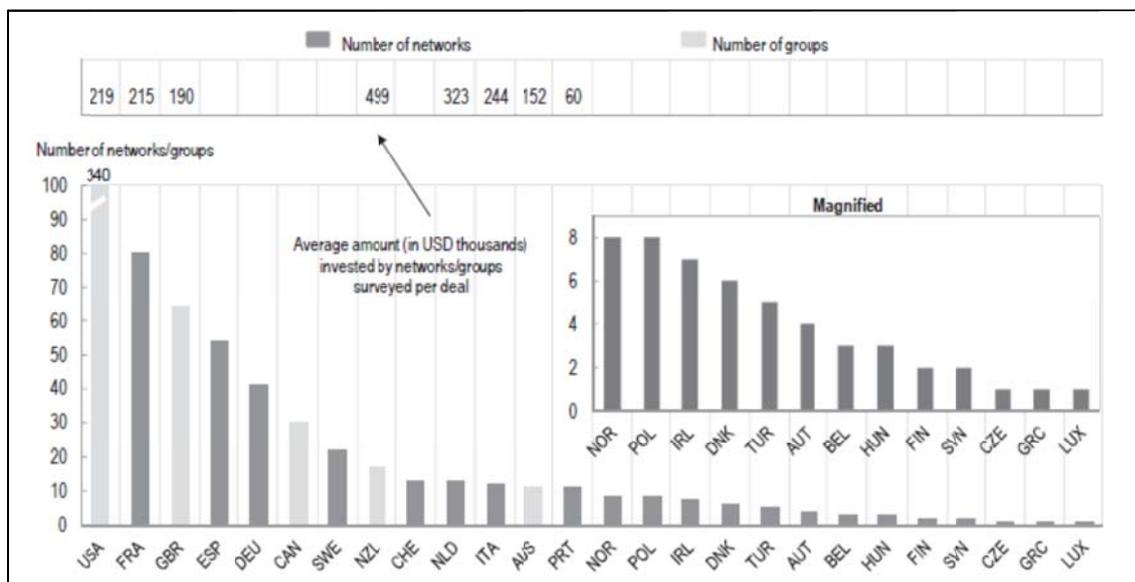
Figure 5: Estimates of the Angel Market and comparison with Venture Capital Market, 2009, USD million

	“Visible” angel market size (share of total angel market)	Estimated size of angel market	Total Venture Capital ²² market
United States	469 (3%)	17,700	18,275
Europe	383 (7%)	5,557	5,309
United Kingdom	74 (12%)	624	1,087
Canada	34 (9%)	388	393

Source: OECD (2011), Financing High Growth Firms: The Role of Angel Investors, page 45.
 Note: Irish data is not available.

From the international data that is available, it is clear that Ireland has a small visible angel network by comparison with other countries, ranked 16th of the 26 countries (Figure 6). However, the OECD identified that in 2010 there were seven angel groups/syndicates in Ireland at differing stages of development, which compares well relative to other small countries. Comparative data is not available on the amount invested in Ireland.

Figure 6: Total Number of Groups/Networks in Operation in Selected Countries, 2010

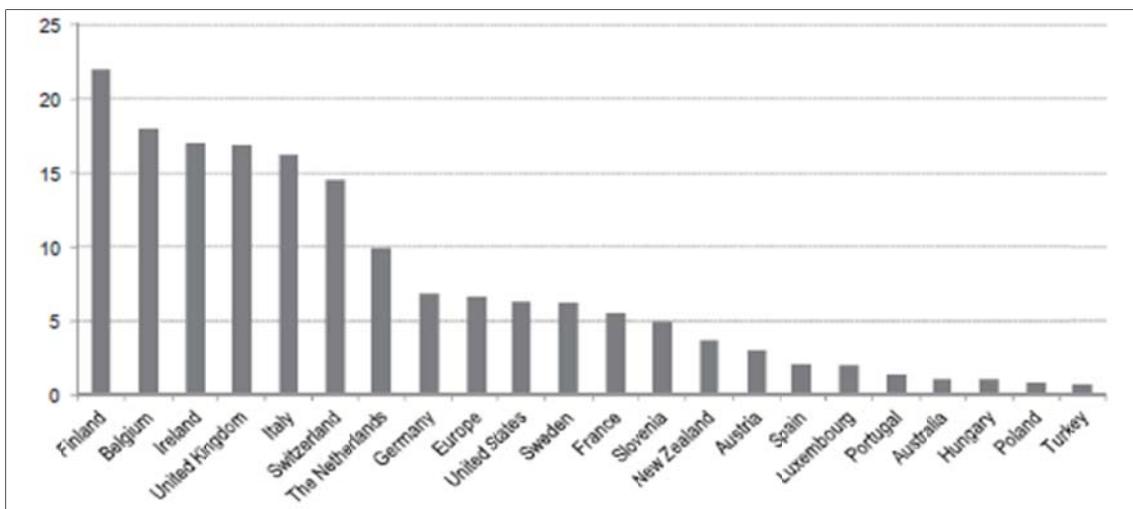


Source: OECD (2011) Financing High Growth Firms: The Role of Angel Investors

Irish business angel groups/syndicates are active. Ireland ranked third of the countries examined in terms of the average number of deals per group/ syndicate (Figure 7). Data on average amount invested per deal are not available for Ireland.

²² Venture capital market size includes VC investments in all stages of the life cycle.

Figure 7: Average Number of Angel Deals per Group/ Syndicate in Selected Countries, 2009



Source: OECD (2011), *Financing High Growth Firms: The Role of Angel Investors*.

Recorded business angel investment on the island of Ireland had a strong year in 2011. A joint initiative of InterTradeIreland and Enterprise Ireland, Halo Business Angel Network (HBAN) in partnership with the Irish Business and Innovation Centres (BICS) helped 29 companies raise €12 million. Mirroring international trends, this is likely to represent a small share of the total business angel market.

Despite growth, the business angel market in Ireland appears underdeveloped relative to the sector size in other countries and relative to the size of the Irish venture capital market. At the seed stage of the life cycle, challenges exist to encourage firms to consider equity investment as a viable funding option and to secure investment from investors.

- Many businesses (at this and later stages) are unwilling to access equity based on fears of losing control of the business. Control concerns dominate SME reluctance, with some preferring to sacrifice potential growth for assured autonomy. Attracting external investment can also require significant changes to their business model and corporate governance arrangements (e.g. for family owned businesses).
- The easy availability of bank debt prior to the financial crisis contributed to a strong reliance on debt funding - many SMEs lack investor readiness in terms of their understanding of and ability to access to various financing options.
- As a result of the financial and broader economic crises, many investors in Ireland and overseas have suffered strong losses. Aversion to risk has increased.
- Even where entrepreneurs and investors are present, challenges exist to bring them together efficiently (i.e. thin markets where there are few buyers and sellers, therefore assets tend to be more illiquid and prices can be more volatile).

5.2 Current Policy Initiatives

A range of initiatives are in place to promote business interest in equity and readiness, to encourage investment, and to develop equity networks, including an EU pilot initiative (refer to section 9.1.4).

5.2.1 Promoting Business Interest and Readiness

CEBs²³ run a number of investor readiness courses including the Hi-Start Management Development Programme which assist ambitious early stage growth focused companies to identify and build the foundations required to secure investment and Enterprise Ireland HPSU status as applicable.

In the private sector, the Irish Banking Federation and Chambers Ireland collaborated to create the Small Business Finance website (www.smallbusinessfinance.ie). Launched in February 2012, it seeks to provide a one-stop information source on financing for small businesses. The website follows the life cycle of a business and provides a description of the types of finance available with hyperlinks to relevant websites e.g. various State supports, equity information, etc.

For more advanced companies, Enterprise Ireland runs a range of programmes across the lifecycle, which support investment.

- Enterprise Ireland's Competitive Start Fund aims to accelerate the growth of start-up companies that have the capability to succeed in global markets. The fund is designed to enable those companies reach key commercial and technical milestones. The latest call for applications to the Competitive Start Fund closed in April 2012. This fund is open to applications from early stage companies from the following sectors: Internet, Digital Games, Software as a Service, Cloud Computing, Enterprise Software, Telecoms, Life sciences, Cleantech and Industrial Products. There have been 100 approvals to date, targeted to rise to 115 by year end.
- Enterprise Ireland's Innovative High Performance Start-Up (HPSU) fund supports the start-up and development costs of High Potential Start-Up companies offering equity investment on a co-funded basis.

Good management is central to making a company attractive to potential investors. Initiatives to improve management skills include:

- Skillnets launched a pilot management development network, branded 'ManagementWorks', in July 2012. In response to action 3.19 of the Action Plan for Jobs 2012²⁴, a suite of programmes will be offered to build the managerial capability of SMEs.
- Enterprise Ireland has broadened the numbers participating in their management development programmes (Action Plan for Jobs 2012 - 3.20)²⁵.

²³ Ongoing work under Action Plan for Jobs 2012, 2.2 will result in a new "one-stop-shop" micro enterprise support structure. The CEBs will be dissolved and replaced by the creation of a new Micro Enterprise and Small Business Unit in Enterprise Ireland that will work with Local Authorities to establish a new network of Local Enterprise Offices (LEOs) in each Local Authority. The new LEOs will combine the enterprise support service of the previous CEBs and the business support work of the Business Support Units in the Local Authorities.

²⁴ Further details are available in the Action Plan for Jobs 2012 Q2 progress report and the ManagementWorks website at <http://www.skillnets.ie/managementworks>.

²⁵ For example: In 2011, over 80 Enterprise Ireland backed entrepreneurship programmes took place. Leadership capability has been strengthened, through €31 million investment; e.g. Management Leadership Growth and Selling programme (over 100 hours) for 295 CEOs and leaders and shorter programmes undertaken by 789 executives, 110 companies were teamed up with international business accelerators and 347 business received Irish and international mentors. New initiatives introduced include the Management 4 Growth programme and the pilot leadership network for Chief Financial Officers.

5.2.2 Encouraging Investment

The Seed Capital Scheme, in conjunction with its associated scheme, the Employment and Investment Incentive, are income tax relief incentive schemes for investors:

- The Seed Capital Scheme (SCS) provides for a refund of income tax already paid by an individual, when he/she takes up full time employment for at least a year in a newly incorporated company and acquires at least 15 per cent of the issued share capital.
- The Employment and Investment Incentive (EII) - which replaced the Business Expansion Scheme (BES) in 2012, provides income tax relief for investors in companies involved in certain corporate trades. There is no requirement to work in the company.

Both schemes qualify as state aid and are subject to certain restrictions. Under the Action Plan for Jobs (action 3.43), the Department of Finance and Jobs, Enterprise and Innovation are required to promote the scheme and ensure the objectives of the scheme are being achieved and assess if any amendments are required.

Enterprise Ireland has also provided significant support to the seed and venture capital market. It aims to develop the venture capital market and improve access to finance by supporting some venture capital funds and assists companies in making contact with venture capital firms. By the end of 2010, seven venture capital and four seed funds were launched. Further details are outlined in section 6.3.1.

The EU Angel Fund is a new pilot initiative of relevance at this life stage. Further details are outlined in section 9.1.4.

5.2.3 Supporting the Development of the Market

Initiatives are in place to bring investors in contact with potential investment opportunities. A key objective of the Halo Business Angel Partnership is to develop and foster the growth of private equity and business angel activity across the island. This is done by matching private investors with pre-screened investment opportunities in start-up, early stage and developing businesses. Its goal is to stimulate angel investment, empower angel investors to build and maintain a portfolio of investments, and streamline the funding process for the entrepreneur.

Business and Innovation Centres (BICs) assist and provide advice to new business projects and access to seed capital to selected enterprises. The BICs play an important role by acting as a facilitator to the entrepreneur in finding practical solutions to problems in a responsive, non-bureaucratic way.

5.3 Recommended Actions

Given traditional reliance on debt funding, many businesses have limited awareness of equity products and the potential relevance of them for their businesses. UK based research highlights the perception of SMEs that equity finance is only available through the giving up control of their business²⁶. Demand for equity finance can also be constrained because of a lack of capabilities to construct offerings that do not give up control. Even if such offerings are known about, small firms do not see these as an option because of real or perceived costs in obtaining advice on how to structure such offerings.

²⁶ The Manufacturers' Organisation - EEF (2010), EEF response to the Government's Green Paper - Financing a Private Sector Recovery. UK.

5.3.1 Promoting Business Interest and Readiness

As many SMEs believe that equity is not a source of funding relevant to their firm, hence it is likely that many viable projects do not come forward seeking equity funding. It is important that businesses seeking external equity meet the requirements of external investors and that they can present a clear business plan to potential investors.

Enhancing interest and readiness by helping firms and their advisors (e.g. accountants, solicitors and bankers) understand the availability, advantages and disadvantages of equity and quasi equity options more fully, as well as the requirements to attract investment, would support the development of the equity market.

Potential exists to work with advisors such as accountants (as in the UK)^{27&28}, solicitors and bankers to more actively signpost information to discuss and guide their small business customers to alternative sources of finance - including equity and mezzanine finance²⁹. In the UK, the main accountancy bodies have agreed to work together to produce a scheme for business finance advisers to ensure that businesses get the required advice and access the funding that meets the needs of their business³⁰.

1. Promote greater public and private sector collaboration to enhance business interest in equity/quasi equity and firm readiness for investment:

- Endorse the www.smallbusinessfinance.ie initiative. Encourage stakeholders to submit information and updates on equity initiatives and to promote the site (e.g. links on their own website).

(D/Finance SME Credit Committee with support of IBF and Chambers Ireland)

- Build on the recent successful collaboration between Irish Banking Federation and the Consultative Committee of Accountancy Bodies - Ireland with the launch of 'Business Plan Guide'. Develop a complementary guidance booklet on alternative sources of finance - equity and mezzanine finance³¹. To enhance the skills of SME professional advisors (e.g. accountants, solicitors, bankers) incorporate this material into the various training programmes.

(IBF, CARB-I and others)

²⁷ AXA International (2011), *Report: Obstacles to Growth in 2012*, page 28 - AXA suggests that 76% of Irish firms used an accountant (versus 54% in the UK).

²⁸ ACCA UK (2010), *Financing a Private Sector Recovery*, ACCA, UK. The UK ACCA has noted that 'developing more accountants into active equity intermediaries would go a long way towards establishing equity as a viable option for financing SMEs'.

²⁹ Department of Business, Innovation and Skills (2009), *The Provision of Growth Capital to UK Small and Medium Sized Enterprises* - Rowland policy review, TSO London.

³⁰ Department of Business, Innovation and Skills (2012), *Boosting Finance Options for Business*, TSO London, UK.

³¹ Existing material and insights would be available from the UK accountancy bodies' initiative, the IVCA, the EVCA, the EU Commission and the Institute of Bankers' new Professional Certificate of SME Credit may assist.

5.3.2 Encouraging Investment

In terms of investor supports, section 6.3.1 addresses the potential future of the Seed and VC Capital Scheme in some detail. Its findings are particularly relevant for seed capital, given the clear market failures present.

The Business Expansion Scheme (BES) was revamped as the Employment and Investment Incentive (EII) scheme in Finance Act 2010 with greater targeting towards job retention and creation. The EII is open to trades generally, excluding a small number of specific activities. The current scheme is a state aid. It is important that EU Commission approval to extend this positive support for equity investment in SMEs beyond the current deadline of 31st December 2012 be obtained in advance of a Budget 2013 announcement to provide certainty on the medium term future of the scheme. Due to the lengthy time it has taken in the past to obtain this approval³², early application to the EU Commission is required so that companies and investors/ EII funds can be investor ready.

Under the scheme individuals that purchase ordinary share capital of unquoted companies, either individually or through an EII fund, can get income tax relief on their investment. The income tax relief is now 30 per cent in the tax year of the investment, subject to the high earner's restriction and a holding period of 3 years. A further 11 per cent relief will be available where it has been proven that employment levels have increased at the end of the holding period, or where the company has incurred expenditure on R&D.

The maximum investment (per investor) that can be tax relieved is €150,000 per annum. The 30 per cent portion of the EII relief (not the 11 per cent) is one of the specified reliefs for the purposes of the high earner's restriction. Therefore, the maximum investment threshold may therefore not apply for full income tax relief in a single tax year³³. The UK are proposing not to include their similar enterprise investment schemes in the proposed cap on unlimited income tax reliefs, because like the Irish EII the schemes are already capped³⁴.

There are also restrictions on the individual's relationship with the company; e.g. they cannot be connected to the company or have more than 30 per cent control³⁵. Under the UK Enterprise Investment Scheme, there is an exception. Where an individual's only connection with the company is as a director who is not entitled to remuneration, and had not previously been involved in carrying on the trade the company is carrying on at the time it issues the relevant shares, an investment may qualify for income tax relief³⁶. Any proposal that might emerge from a detailed review should be subject to an assessment of the risks of unintended behavioural changes.

Similar UK schemes have features that warrant further consideration.

³² Department of Finance (2011), *Employment Investment and Incentive - Ex-Ante Economic Impact Analysis*, Dublin - In 2007, the BES was not operational until August (9 months after the budget announcement), as the approval of the European Commission for the extended scheme was awaited.

³³ Revenue (August 2012), *Analysis of High Income Individuals' Restriction 2010*, Dublin - The amount of relief used in 2010 by those individuals subject to the high income earner restriction for investment in BES relief (69 cases) was €5.6 million. The average relief claimed per investor in 2010 was circa €80,000, which is the maximum amount of relief that can be claimed before the restrictions start to apply.

³⁴ HM Treasury / HM Revenue & Customs (April 2012), *Cap on unlimited income tax reliefs and (July 2012), Delivering a cap on income tax relief: a technical consultation*, UK.

³⁵ This does not apply to an individual investing in his or her own company under Seed Capital Relief Scheme.

³⁶ HMRC guidance (2012), *An Introduction to the Enterprise Incentive Scheme*, UK.

- To target companies earlier in the lifecycle, the UK introduced a new scheme - the Seed Enterprise Investment Scheme (SEIS)^{37&38}. The new scheme will be focused on smaller, early stage companies carrying on, or preparing to carry on, a new business in a qualifying trade. The scheme will make available tax relief to investors who subscribe for shares and have a stake of less than 30 per cent in the company. The income tax relief will be 50 per cent (versus 30 per cent under EIS). For the first year of the new scheme, the UK Government will offer a capital gains tax (CGT) holiday - gains realised on the disposal of assets in 2012-13 that are invested through SEIS in the same year will be exempt from CGT.
- Other considerable differences between the Irish and the UK schemes include³⁹:
 - No capital gains tax on gains where the investment is held for the holding period of three years and the income tax relief not withdrawn,
 - Shares in EIS qualifying companies will generally qualify for Business Property Relief for Inheritance Tax purposes.
 - There is a CGT deferral with a four year window to re-invest the deferred gain. There would be merit in limiting the potential unlimited and indefinite deferral.
 - Any CGT loss arising can be set against either the investor's income tax (in the year of disposal or the previous year) or capital gains tax liability.

In 2010, €36 million was raised from the BES (forerunner to the EII), having fallen sharply since its peak in 2007 (€127 million). But as the recovery gains traction and risk appetite returns, given the higher effective rates on earned income, it is possible that reliefs at the marginal income tax rate will become more attractive if the future of the EII scheme is certain and particular restrictions are reviewed.

2. To provide certainty and enhance the potential of the Employment and Investment Incentive (EII) scheme to encourage investment:

- Extend the EII scheme beyond the current deadline of 31 December 2013, with early application to the EU Commission to enable approval before the end of Q2, 2013.
- Fully exclude the EII relief from the high income earner restriction.
- Seek an expansion of the EU guidelines in the current EU negotiations (e.g. Regional Aid Map and Risk Capital Guidelines) so that all medium sized companies, including those in non-assisted areas, can qualify for investment under the EII scheme.
- Review the features of the UK Enterprise Investment schemes, particularly the exception for business angels and a scheme targeting the earlier seed stage in the lifecycle (the new Seed Enterprise Investment Scheme) with additional incentives.

(D/Finance)

³⁷ HMRC (2012), Seed EIS - Detail <http://www.hmrc.gov.uk/seedeis/index.htm>

³⁸ HMRC (2012), Seed EIS - Overview <http://www.hmrc.gov.uk/tiin/tiin600.pdf>

³⁹ Enterprise Investment Services Association (EISA), *Five Compelling Reasons for EIS*, <http://www.eisa.org.uk/>.

5.3.3 Supporting the Development of the Market

Technology is also enabling changes in the ways that deals are made. Crowdfunding has the potential to create a cultural shift towards enabling individual investors to invest in seed and start-up stage projects. “Crowdfunding involves an open call, essentially through the internet, for the provisions of financial resources either in the form of donations (without rewards) or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes”⁴⁰.

There are important differences between crowdfunding instruments, which range from donations, sponsoring, pre-selling, lending to equity. Intermediary services have also emerged to act as neutral facilitators for project initiators. Over 450 crowdfunding platforms (e.g. Kiva, Kickstarter, etc.) are operating globally⁴¹.

For projects that can garner attention (e.g. creative sectors), crowdfunding could become an informal financing mechanism to close the early-stage equity gap. As it seeks to raise small amounts of investment from a wide range of people, it could potentially complement business angel investor groups. In addition to providing finance, crowd funders are often early adopters of new products and are product advocates.

The crowdfunding model is at an early stage of development, therefore its place in the existing spectrum of instruments is being established. The recent US Jobs Act removed an impediment that will allow crowdfunding for all companies, without the requirement for SEC registration, subject to certain restrictions to provide appropriate investor protection⁴².

Recommendation 6 in section 8.3 seeks to access the opportunities that crowdfunding provides.

⁴⁰ Lambert/Schwienbacher (2010), *An Empirical Analysis of Crowdfunding*.

⁴¹ Crowdsourcing.org (2012), *Crowdfunding Industry Report: Market Trends, Composition and Crowdfunding Platforms*.

⁴² Consultation with Giuseppe Gramigna (Chief Economist, U.S. Small Business Administration), April 2012.

6. Start-up Stage Investment

At this stage, businesses may still be in the creation phase or have just started operations and may have not yet actually sold their product commercially. Start-up financing is often used for product development, hiring and training personnel and initial marketing.

6.1 Current Market Trends

Venture capital typically enters at this stage. Venture capital is equity provided by professional investment firms. Venture capital or private equity firms establish investment funds that raise capital from investors.

Venture capital fund managers invite institutional investors and individuals to commit to an investment fund for a set period, which will take equity stakes in high-potential companies following a clearly defined investment strategy (for example, size, sector, stage of development and/or geographical location)⁴³. International experience indicates that the entire length of the investment process for early-stage ventures is generally 6 to 7 years. Exit, typically through an initial public offering (IPO), trade sale, or secondary sale to another financial institution or fund, is the final stage of the venture capital cycle generally year 10.

Venture capital is only appropriate for a minority of start-ups (i.e. high-growth firms which are usually technology or science based companies with scalable, high-growth business models). Venture capitalists seek to invest in promising, high growth firms but given the risks involved, a large percentage of those firms fail. On average, 4 per cent of the portfolio generates more than 60 per cent of the returns⁴⁴.

Venture capital differs from business angel investment in a number of ways. However, in recent years, business angel syndicates have become more active in the start-up phase and are filling a gap left by venture capital funds that are tending to steer their investments towards lower risk, later stage ventures.

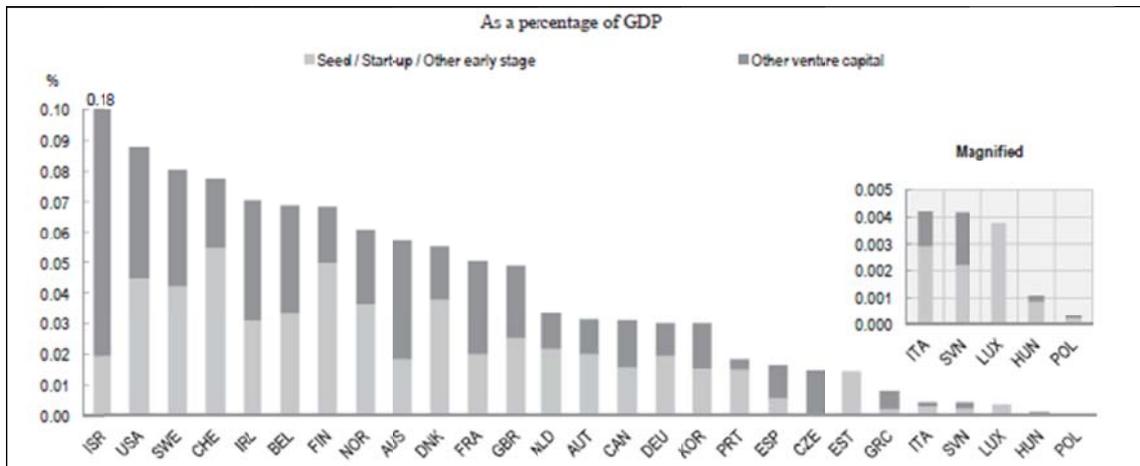
In terms of performance, the Irish venture capital market is relatively well developed, however it faces a funding challenge in the near term. In terms of venture capital investment as a percentage of GDP, the OECD ranked Ireland fifth of the countries examined in 2009 (Figure 8). More recent data from the IVCA suggests that the Irish VC sector has weathered the international recession relatively well (having raised funds before the current financial crises) but that investment levels have weakened somewhat in 2011/2012 in advance of the next fundraising round.

The US venture capital market is much larger than the European market in terms of the amount invested (Figure 9, right hand segment). While a greater number of deals are made in Europe, average deal size in the US is significantly higher.

⁴³ Kaufmann Foundation (2012), *We have met the enemy...and he is us* - Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and The Triumph of Hope over Experience.

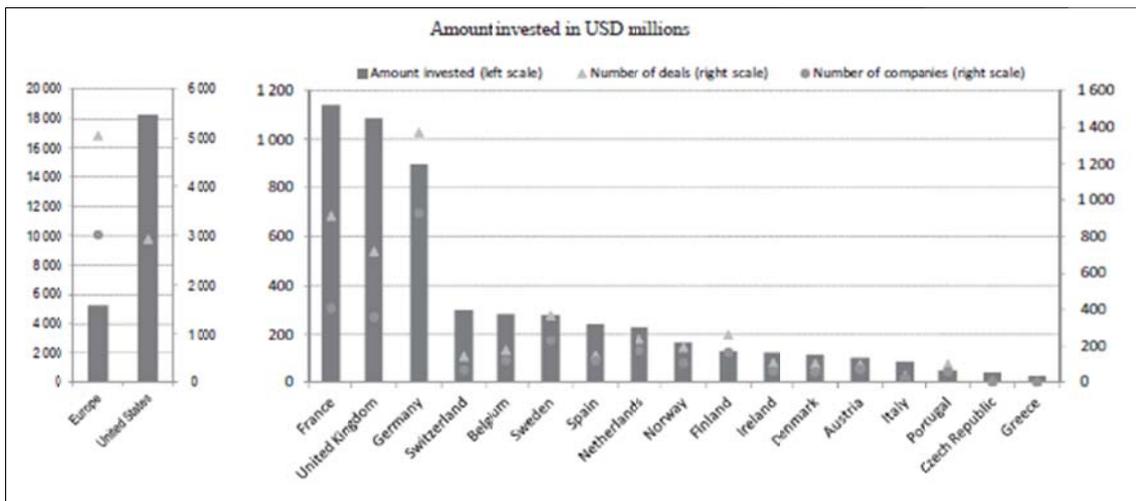
⁴⁴ OECD (2011), *Financing High-Growth Firms: The Role of Angel Investors*, OECD Publishing.

Figure 8: Importance of Venture Capital, in Selected Countries, 2009



Source: OECD (2011), Financing High Growth Firms: The Role of Angel Investors

Figure 9: Venture Capital Investments in Selected Countries, 2009



Source: OECD (2011), Financing High Growth Firms: The Role of Angel Investors

The international environment for the industry remains challenging with limited opportunities for company exits through trade sales and Initial Public Offerings (IPOs).

- In the first half of 2011, the US, which has a much more mature VC system compared to Ireland, experienced the lowest number of funds garnering commitments since the first half of 1995⁴⁵.
- The UK Department for Business, Innovation and Skills also note that the UK venture capital market has been heavily affected by economic conditions with a 31 per cent decrease in the value of investment in 2010 compared to the previous year⁴⁶.

⁴⁵ National Venture Capital Association (2011), *Venture Capital Industry Raises \$2.7 Billion in Q2 2011*, Press Release

- Israel, generally one of the leaders in international rankings for numbers of start-ups, patents, and VC investment, has experienced major challenges in raising VC in recent years. In 2010, no capital was raised and in 2009, only \$234 million was raised by Israeli VC funds⁴⁷.

Internationally and in Ireland, challenges exist to encourage venture capitalists to invest in early stage and smaller firms. The costs of preparing for an equity investment are not significantly related to the size of the deal and therefore make smaller deals more expensive. This favours larger transactions where risk is easier to calibrate and returns have been historically attractive.

Given weak returns and turbulence in financial markets, encouraging investors to invest in venture capital funds is likely to remain a challenge. A sufficiently developed venture capital market, which can build the critical scale and expertise, is needed to support investment - in particular to avoid an early stage venture capital gap.

To stimulate the venture capital market and enterprise development, numerous governments have invested public funds in private venture capital funds in order to leverage additional investment in growing businesses.

6.2 Current Policy Initiatives

At a national level, the state supports the development of the VC sector. Under the 2007-2012 Seed and Venture Capital Scheme, Enterprise Ireland committed to invest €175 million. By the end of 2010, seven venture capital and four seed funds were launched with €153.5 million committed by Enterprise Ireland. It is Enterprise Ireland's objective to commit €20 million more to successful applicants by the end of 2012 following a public call for expressions of interest. There has been €166 million committed by Enterprise Ireland under previous venture capital schemes (pre - 2007). A decision on whether to commit further funding will be required in the near future. A working group established under the Action Plan for Jobs 3.42 (Establish a working group to ascertain the need for the State to continue its support, on the same terms as the private sector, for the development of the domestic venture capital sector) is investigating this area in more detail.

In 2008, the Government established Innovation Fund Ireland with a view to attracting top calibre global international venture capitalists with an intention to establish a new and substantial presence in the Irish venture capital market and a willingness to invest a meaningful proportion of their venture capital fund in Irish companies or companies with significant Irish operations. Enterprise Ireland and the National Pensions Reserve Fund (NPRF) are working in partnership to implement the strategy and each has made €125 million available for investment. To date, three international venture capital fund managers have received an investment and established a presence in the Irish market. The presence of these funds in the Irish market increases access to smart capital for Irish companies as the equivalent of Enterprise Ireland's investment (\$25 million as of September 2012) must be invested in Irish companies or companies with significant operations in Ireland, at a minimum.

The European Commission is also working to support the creation of pan-EU funds that would primarily focus on the provision of equity and quasi-equity products to SMEs. The Commission

⁴⁶ Department for Business innovation and Skills (2012), *SME Access to External Finance*, UK.

⁴⁷ Israel Venture Capital Research Centre (2011), *IVC- KPMG Survey: Israeli Venture Capital Fund Raising - 2010*, Press Release.

proposed the establishment of a "European Venture Capital Fund" in December 2011, which would provide for uniform rules on the marketing of venture capital funds across the EU⁴⁸. The regulation would provide all managers of qualifying venture capital funds with a 'European marketing passport' allowing access to eligible investors across the EU⁴⁹. Eligible investors will be professional investors⁵⁰ and certain other traditional venture capital investors (such as high net-worth individuals or business angels). This initiative will support the raising of additional capital for SMEs, the creation of more specialised funds and reducing costs.

6.3 Recommended Actions

This section sets out recommendations to support the development of the VC sector through State co-investment and changes to carried interest legislation to encourage VC investments in Ireland. The potential to utilise pension funds was also considered. Employee Share Schemes were considered, but no recommendation emerged.

6.3.1 State Co-investment with VC

At this stage, businesses are still in the creation phase or have just started operations. In addition to business angels, who are addressed in the previous stage, venture capital (VC) tends to enter during this lifecycle stage. Venture capital is only appropriate for a small proportion of start-ups (i.e. high-growth firms which are usually technology or science based companies with scalable, high-growth business models). Venture capital or private equity firms establish investment funds that raise capital from investors.

The Irish venture capital market is relatively well developed. Ireland was ranked fifth by the OECD in terms of venture capital investment as a percentage of GDP. IVCA research suggests that investment trends have weakened somewhat in 2011/2012. In Ireland and internationally, challenges exist to encourage venture capitalists to invest in early stage and smaller firms where costs are proportionately higher and risks are harder to assess.

Enterprise Ireland has committed €153.5 million to seven venture capital and four seed funds since 2007 and an expression of interest process is underway to commit a further €20 million. A working group is assessing the need for the State to continue its support. The emerging finding of the working group established under Action 3.42 of the Action Plan for Jobs, 2012 is that continued State investment in Seed and Venture Capital will be required over the period 2013-2018.

Given weak returns and turbulence in financial markets, encouraging investors to invest in venture capital funds remains a challenge. A sufficiently developed venture capital market, which can build the critical scale and expertise, is needed to support investment and to avoid an early stage venture capital gap. Continuing development of the domestic venture capital sector and attracting international venture capitalists to Ireland increases the viability of Irish investment opportunities and increases the availability of smart capital.

⁴⁸ EU Commission (2011), New EU fundraising rules: boosting venture capital for SMEs and easing access to credit at http://ec.europa.eu/internal_market/investment/venture_capital_en.htm.

⁴⁹ This is a marked improvement over the existing rules in the area of asset management, in particular the 2011 Alternative Investment Fund Managers Directive (AIFMD). The existing passport provided under AIFMD is only applicable to managers whose assets under management are above a threshold of €500 million.

⁵⁰ As defined in the 2004 Markets in Financial Instruments Directive (MiFID)

3. Given how close the industry is to the completion of the current funding cycle, it will be important that Action 3.42 of the Action Plan for Jobs 2012 is progressed and that decisions are made quickly in order to provide policy clarity to the venture capital market.

(D/JEI and Enterprise Ireland - APJ 2012, 3.42)

6.3.2 Carried Interest

While Ireland has been consistently ranked as offering a strong tax and legal environment for private equity and VC⁵¹, the implementation of a number of legislative amendments to make operable the reduced rate of capital gains tax on carried interest would help attract additional venture capital, particularly from international VC fund managers.

Typically, the general partner⁵² in a VC fund contributes 1 to 5 per cent of the fund's initial capital and commits to manage the fund's assets. In return, the general partner earns (i) an annual management fees of typically in the region of 2 to 2.5 per cent of the value of the assets under management (ii) a share of the profits generated from the assets under management, which is called 'carried interest'. Carried interest is generally 20 per cent of the profit made by the VC fund in excess of a certain minimum rate of return, known as the hurdle rate, often at 8 per cent return⁵³.

Finance (No.2) Act 2008 put the tax treatment of carried interest as a capital gain rather than income on a legislative basis. In addition, where the carried interest is earned on investments by VC funds in companies engaged in R&D and innovative activities⁵⁴, a lower capital gains tax rate applies. The rate is 15 per cent for individuals holding an interest through a partnership or 12.5 per cent in respect of companies, compared to the current CGT rate of 30 per cent.

The policy rationale was to encourage the availability of capital for investing in start-up innovative companies to support future job creation⁵⁵. However, there remain a number of issues with the current legislation:

- Given the policy objective to attract VC funding for SMEs, it is unclear why individual investors not operating through a partnership or a company are excluded. This does not take account of the emerging trend of 'Super Angel' investors⁵⁶, which are increasingly investing in companies at the seed and early development phase.
- Companies just established are generally not investment ready. When the carried interest provision was introduced in 2009, it targeted companies set-up and commenced since 1 January 2009, rather than targeting companies at the appropriate lifecycle stage.

⁵¹ EVCA (2008), *Benchmarking European Tax and Legal Environment*, Brussels.

⁵² This would typically be a partnership or a corporation, which has opted to be taxed like a partnership (e.g. S Corporation) in the US or a Limited Liability Partnership in the UK.

⁵³ Peter R. Orszag (2007), *The Taxation of Carried Interest: Statement of Peter R. Orszag, Director, Congressional Budget Office, before the Committee on Finance United States Senate* (July 11, 2007).

⁵⁴ Innovative activities are defined as "new technological, telecommunications, scientific or business processes".

⁵⁵ Department of the Taoiseach (2008), *Building Ireland's Smart Economy*.

⁵⁶ Farhad Manjoo (Jan 2011), *How "Super Angel" Investors Are Reinventing the Startup Economy*.

- As VC funds invest in a portfolio of businesses at varying stages of the company lifecycle with multiple income streams, the incentive does not fit easily within the current fund structure.
- A minimum holding period of six years does not fit the VC fund investment in tranches on reaching agreed milestones approach. Research for the EU in 2001⁵⁷, highlighted that CGT reliefs for long-term holding were not appropriate for corporate venturing with a five year time horizon. The French Fonds Commun de Placement a Risques (FCPR) conditions have aspects worthy of consideration. The Hungarian Equity Guarantee Scheme (i.e. Start Capital) risk sharing clause which means that the fund gets a percentage of the proceeds is an alternative to clawback of the relief worthy of consideration⁵⁸.

The focus on the tax treatment of high income earners internationally has resulted in a number of countries looking at carried interest⁵⁹. As a result, the US has increased the CGT rate from 15 to 20 per cent^{60&61}. A number of European countries (e.g. UK, Sweden, some German lander) have or are seeking to reduce carried interest exemptions and increase rates.

The policy rationale for the Irish provision is to encourage the availability of capital for investing in start-up innovative companies to support future job creation by attracting fund managers to be based in Ireland thus making Irish opportunities more visible to them. Ireland needs to have a stable, clear and competitive tax offering to attract those individuals to base in Ireland.

4. Implement the following amendments to the Irish carried interest tax legislation to ensure that the legislation operates as intended in order to encourage venture capital investment in companies engaged in R&D and innovative activities:
 - Expand the scope of the relief so that it is not limited to start-ups to reflect that many VC funds commit to tranche investments in early stage and scaling companies that may be a number of years old once certain milestones are achieved;
 - Link the relief to the overall performance of the venture capital portfolio and not individual investments as this is the basis on which carried interest is calculated; and
 - Relax the holding period of six years in the legislation as companies can be successful in a shorter period and the VC fund may have the opportunity to divest. Aspects of identified French and Hungarian schemes merit consideration.

(D/Finance)

⁵⁷ Bannock Consulting Ltd (2001), *Corporate Venturing in Europe - Study for the EU Commission*, DGXIII EIMS 98/176, page 46.

⁵⁸ In the event the beneficiary of the Hungarian Equity Guarantee realises a capital gain on the disposal of the guaranteed investment or guaranteed venture capital fund during the term of the guarantee, a certain percentage of the realised gain is payable by the beneficiary to Start Guarantee Fund.

⁵⁹ Financial Times article (Feb 2012), *Pressure rises on Private Equity Bosses' Taxes*.

⁶⁰ The President's Framework for Business Tax Reform - A joint Report by the White House and the Department of the Treasury (2012), The Jumpstart Our Business Startups (Feb JOBS) Act (2012) and the President's Budget 2013 Proposal to Congress (Feb 2012). It important to highlight that the President's proposal is the start of the legislative process.

⁶¹ US Ways and Means Committee Ranking Member Sander Levin introduced House Resolution 4016: Carried Interest Fairness Act 2012 in February 2012. It important to highlight that the legislation process is very different in the US and Sander Levin has introduced two similar House resolutions in 2007 and 2009.

6.3.3 Irish Pension Funds Investment in VC

The National Pensions Reserve Fund (NPRF), managed by the National Treasury Management Agency (NTMA) on behalf of the National Pensions Reserve Fund Commission, has a current target strategic asset allocation of 10 percent private equity in 2012. The NTMA Annual Report 2011, highlighted that the Strategic Investment Fund will include a series of sub-funds targeted at commercial investment in areas of strategic significance to the future of the Irish economy including infrastructure, water, venture capital and the provision of long-term capital to Small and Medium Enterprises (SMEs)⁶².

The potential for private pension funds to invest in equity funds has already received attention. However, Irish private pension funds are experiencing considerable challenges:

- The age profile of the pension funds is increasing - highlighting the need to reduce risk, which would not be compatible with high risk asset classes.
- The temporary Pension Fund Levy, which is a stamp duty levy of 0.6 per cent applied to the market value of assets under management in pension funds and pension plans (approved under Irish tax legislation), raised €463 million in 2011⁶³. The temporary levy was introduced to fund the Jobs Initiative and will operate for a period of 4 years from 2011 to 2014. The Irish Association of Pension Fund Managers had suggested the establishment of an infrastructure fund where pension schemes could be requested to make a specific allocation as an alternative to the pension levy⁶⁴.
- Approximately 80 per cent of Irish defined benefit pension funds are in deficit.
- Regulation is incentivising the purchase of sovereign bonds in order to meet certain funding requirements of defined benefit pension schemes.

These challenges are mirrored internationally. The Mercer European Pension Fund Asset Allocation Survey (2012)⁶⁵ highlights the continuation of an investment trend away from domestic equities over the next 12 months. This trend is likely to be driven by pension funds with an aging profile lowering their investment risk profile, their poor financial position, and regulations that are incentivising the purchase of safer assets (e.g. sovereign bonds). While there is a trend towards increasing the alternative asset allocation, the most popular categories are hedge funds, emerging market debt and high yield bonds. This increase, albeit from a low base, in alternative investments was also confirmed in the IAPF Irish Pension Fund Asset Allocation⁶⁶.

In 1999, the Government obtained a commitment from Irish pension funds to invest in the domestic venture capital industry. The commitment was met by approximately €126 million investment during 1999/2000 by the Irish pension funds, but subsequently the level of investment reverted to previous levels⁶⁷.

⁶² NTMA (2012), Annual Report 2011 -, page 43.

⁶³ PQ [19294/12] 18th April 2012.

⁶⁴ IAPF (2011), Letter to the Minister for Finance - 29th April 2011.

⁶⁵ Mercer (2012), *Annual Pension Fund Asset Allocation Survey*.

⁶⁶ IAPF (2009), *Annual Asset Allocation Survey* - press release.

⁶⁷ Mulcahy, Diane (2005), *Angels and IPOs: Policies for Sustainable Equity Financing of Irish Small Businesses*, The Policy Institute at Trinity College Dublin - Studies in Public Policy: 16, Dublin, page 11.

When Ireland introduces auto-enrolment, as outlined in the National Pensions Framework (2010), there could potentially be a fund with a young age profile, which might meet the criteria for longer term higher risk investment. It may be in the best interest of those future pension beneficiaries to consider alternative asset classes.

The Irish Pensions Board has noted that there are no significant regulatory barriers to pension funds investing in venture capital. To protect pension fund beneficiaries, pension funds are not permitted to invest in own company shares. In addition, pension fund trustees have a legal fiduciary responsibility to invest in the best interest of the pension fund beneficiaries.

It is not clear if any measures can be taken to encourage pension funds to invest in VC funds. Investment by the pensions sector in Irish assets must be in the best interest of the pension fund beneficiaries. However, it is important that any efforts should not distort market decisions between investing in government bonds, infrastructure development or enterprise.

7. Expansion/Development Stage Investment

At this stage, the business has reached or is approaching breakeven, or may be already profitable and faces a major expansion opportunity. This is a period of high growth and capital is used to increase production capacity and sales power, to develop new products, finance acquisitions, and increase the working capital of the business. Some firms may already have been through many rounds of financing.

7.1 Current Market Trends

As the firm now has a track record, the range of funding options begins to broaden. However, the financial crises and the recession had made debt and equity providers more risk adverse. A range of investors is active at this stage:

- Growth capital (also called expansion capital and growth equity) is a type of private equity investment, most often in the form of a minority investment, in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets or finance a significant acquisition⁶⁸.
- Mezzanine finance is suited to SME growth because it occupies the middle ground between the lower risk and return of bank debt and the higher risk and return of equity investment. It shares features of debt, but typically provides compensation for greater risk taking on the part of the investor, through a small equity component or redemption premium⁶⁹; i.e. it can be expensive.
- Pure debt instruments can also play an important role in this stage. Corporate bonds are debt securities issued by publicly held corporations to raise money for expansion or other business needs. They typically pay a higher rate of interest than federal or municipal government bonds, but the interest earned is taxable.

Across Europe, the amount of funds invested in private equity growth capital has remained relatively stable over the period 2007-2011⁷⁰. In response to the economic crisis, many VC funds altered their investment strategy increasing their investment in growth opportunities, reducing the level of VC investment in earlier stage companies. In 2011, €5.1 billion was invested in 983 companies. €1.3 billion of this was invested in 127 companies in the UK and Ireland.

Limited data is available for Ireland. However, while Ireland's VC market is relatively well developed (0.026% of GDP versus a European average of 0.029%), the total private equity market appears far less developed (0.032% versus a European average of 0.337%).

⁶⁸ The French Private Equity Association (2005), *Private Equity & Venture Capital: A Guide for Institutional Investors*.

⁶⁹ Department of Business, Innovation and Skills (2009), *The Provision of Growth Capital to UK Small and Medium Sized Enterprises - Rowland policy review*, TSO London.

⁷⁰ EVCA Yearbook 2012, *Activity Data on Fundraising, Investments and Divestments by Private Equity and Venture Capital Firms in Europe*.

7.2 Current Policy Initiatives

In recent years, the State has provided a range of supports at this stage:

- The Development Capital Scheme was launched in April 2012 and issued a call to fund managers to signal their interest in establishing funds to invest in Irish SMEs. Under this new fund, the State through Enterprise Ireland will invest a total of €50 million in two funds with the target of leveraging a further €100 million from the private sector. The goal of this scheme will be to increase the availability of risk capital for Irish medium-sized enterprises engaged in manufacturing and technology, as well as high-growth trading services companies in Ireland - in specific sectors including engineering, food, life sciences, and electronics.
- Tailored company expansion packages for companies undertaking or planning to undertake an ambitious expansion that will create employment and grow sales in international markets are provided by Enterprise Ireland, funded by equity (using redeemable preference shares) and/or grants⁷¹.
- In June 2012, the National Pension Reserve Fund (NPRF) announced collaboration with Silicon Valley Bank, which will make \$100 million in lending available to fast-growing Irish technology, life science, cleantech, private equity and venture capital businesses.
- The NPRF is also developing a SME Equity fund to support private equity investment (non-VC) in Ireland. In addition to leveraging private funds, potential may exist to attract European Investment Fund (EIF) funding.

7.3 Recommended Actions

Recent initiatives from Enterprise Ireland and the NPRF have moved to support the development of this segment of the equity funding market and are welcome. In addition to these initiatives, potential exists to further support the development of corporate venturing.

7.3.1 Development of Corporate Venturing

Corporate venture capital refers to making equity or equity-type investments by non-financial corporations in private, entrepreneurial firms. The investment can be made either directly into the company, though the shares may be held in a separate entity, or by way of a corporate venture fund. Compared to traditional venture capital investors, corporate venture capital investors may be less concerned with financial returns and more concerned with the strategic value that the entrepreneurial firm may eventually bring to the parent organisation, but this varies on a case-by-case basis. In this way, corporate venture capital can be a form of business intelligence or exploration, whereby the parent organisation makes small bets in different technology areas without undertaking the operational or managerial burden of developing the ventures⁷².

The level of equity purchased is generally a minority holding. Some CVs have a seat on the board of investee companies. Corporate venturing is undertaken in a variety of ways:

⁷¹ In 2009 and 2010, Enterprise Ireland through the Enterprise Stabilisation Fund provided financial assistance in the form of preference shares for companies in Ireland to sustain and develop their business through the economic downturn. The total budget for this Fund for a period of two years was €100 million.

⁷² United Nations Economic Commission for Europe (2009) *Policy Options and Instruments for Financing Innovation*. <http://www.unece.org/fileadmin/DAM/ceci/publications/fid2.pdf>

- Direct investment in the company, generally not shown in the company's balance sheet or held in a subsidiary.
- In-house fund with a discrete set of fund managers and pool of capital (e.g. NovusModus); and
- Corporates also make venture capital commitments to independent venture capital fund managers, which have a shared sectoral interest as a limited partner, which gives them an insight into the emerging developments (e.g. NCB Ventures has a commitment from Diageo).

Lack of available capital in the current economic climate, has meant that corporate venturing is on the rise globally⁷³ - however CVs can be highly cyclical and returns have been mixed⁷⁴. In the US, corporate venturing capitalists increased their investment activity the three years prior to 2011, to participate in 15 per cent of all venture capital investment deals in 2011. With corporates sitting on huge cash reserves, a record of 83 corporate venture funds were established last year, primarily in the US and Asia, according to Global Corporate Venturing. Recent high-profile examples include General Motors, which set up a \$100 million VC subsidiary in 2010, and Google, which founded a \$100 million VC arm in 2009⁷⁵.

There are conflicting views on the developmental role of corporate venturing. While corporate venturing maybe an effective way of channelling foreign investment into a country and enabling larger indigenous firms to develop, many investing companies view corporate venturing as a tool for identifying acquisition candidates - with the potential to 'lose' growing innovative indigenous companies⁷⁶. The investing company also gets closer to emerging 'game-changing' technology and accessing an innovative culture that often fades as a company scales. However, the investee company gains not only funding, but also access to skills, enhanced capabilities and market knowledge. The company may also gain increased exposure and credibility with potential customers through the involvement of a high profile investor.

Corporate venturing can also support the development of the equity funding sector. The critical issue for CV units that emerges from the international research is ensuring that CV have the ability to access deal-flow; i.e. that they are aware of the potential deals and have the opportunity to get involved. Given the level of venture capital exits through trade sales, having a CV unit involved at the outset provides a possible exit mechanism to the State and venture capitalist (in the event of IPO not being deemed appropriate). It would enable the investee company to get the funding to gain the critical mass to potentially be a standalone unit and the CV unit would phase its investment.

CV is largely dominated by international players who make investment decisions across the globe. Some global CVs have exposure to Irish enterprises; e.g. Intel Capital, Johnson & Johnson Development, IBM, Abbott Ventures and Shire Ventures. There are also local CV units; e.g. ESB NovusModus (cleantech and renewable sectors). Some Irish companies that have benefited from CV investment include Powervation, Altobridge, Movidius, Opsona and BiancaMed.

⁷³ Scott, Mike (12th June 2011), *Corporate Venturing on the Rise Again*. *Financial Times*.

⁷⁴ Paul Brody and David Ehrlich (1998), *Can big Companies become successful venture capitalists?*

⁷⁵ Bryant, Chris (12 March 2012), *In search of outside inspiration*, *Financial Times*.

⁷⁶ E&Y identified that the Corporate Development Officer was second most cited CV reporting line, suggesting that many investing companies view corporate venturing as a tool for identifying acquisition candidates. Ernst & Young (2010), *Global Corporate Venture Capital Survey 2008-2009*.

A range of initiatives have been developed internationally to support corporate venturing.

- Supporting co-investment. Mirroring the broader VC sector, a key barrier seems to be access to suitable and high volume deal-flow⁷⁷. More state co-investment alongside independent or corporate venture funds would increase the number of start-ups in general⁷⁸.
- Tax incentives. The UK had a tax incentive for companies engaged in corporate venturing from 2000 to 2010. During the period 2,579 investee companies benefited from £132 million investment from 1,003 investor companies. However the scheme does not appear to have increased investment and may contain deadweight⁷⁹.
- Recent policy in France has been successful in bringing large corporations together into venture funds, generally sectoral funds, to support specific parts of the French economy. For example, in 2011, France Télécom-Orange and communications company Publicis Groupe jointly committed €150 million to a venture fund to back entrepreneurs setting up digital companies in France and the European Union.
- Similar sectoral focused pan-European fund-of-fund pilot initiatives are being supported by the EU Commission in advance of the EU Programme for the Competitiveness of enterprises and SMEs (COSME) 2014-2020⁸⁰. Further details are outlined in section 9.1.4.

5. Potential exists to encourage more corporate venturing investment in Ireland.

- Integrate corporate venturing units into the deal-flow environment of commercial VC investments led by Enterprise Ireland to provide increased funding, facilitate investee company scaling and provide a potential exit mechanism. Consider the role of corporate venturing in the completion of action 3.42 of the Action Plan for Jobs, 2012.

(Enterprise Ireland and IVCA)

⁷⁷ James Mawson (2012), *Corporate Venturing*, The Royal Society for the Encouragement of Arts, Manufactures and Commerce (RSA), commissioned by Global Venturing, UK.

⁷⁸ Bannock Consulting Ltd (2001), *Corporate Venturing in Europe - Study for the EU Commission*, DGXIII EIMS 98/176, page 47.

⁷⁹ No formal evaluation has been published but it was decided not to seek EU Commission approval for its extension. Statistics considered were published by HM Revenue & Customs - KAI Direct Business Taxes, VCT Statistics - based on claims data (CVS1 forms) received by November 2011).

⁸⁰ EVCA (2007), *Guide on Private Equity and Venture Capital for Entrepreneurs*.

8. Transfer/Succession/ Turnaround/ Buyout Stage Investment

The transfer, succession or buyout of a firm represents the final stage of the life cycle. These can arise for a number of reasons including the retirement of the head of a company, the disposal of a business unit by a large company, the repurchasing of shares held by family members, or when investors from previous stages of development wish to exit the business. Turnaround investments describe a situation where an established firm requires capital to address financial (e.g. high debt levels) or operational distress.

Both equity and debt are often used. For example, the existing management team (in the case of a buyout) or a new team, assisted by equity investors, can create and finance a holding company that then borrows debt to acquire the target company. The dividends produced by the target company then enable the holding company to repay its debt. The structure of this operation means that it generally applies only to an established company or business unit, with a positive and/or predictable cash flow.

The contribution of the private equity investors is not simply financial: they support the company management by bringing in their knowledge of the industrial sector, their network of contacts and their long-term commitment. The amounts invested are typically substantial and big investment funds have specialised in these operations for many years⁸¹.

Well-functioning stock exchanges are an important aspect of the development of innovative companies but the same challenges that innovative enterprises pose to prospective investors also limit their suitability for traditional stock exchanges⁸².

8.1 Current Market Trends

A range of investor types are active at this stage.

- Industrial investors: A trade sale (also referred to as mergers and acquisitions) refers to the sale of company shares to industrial investors.
- Management investors: The purchase of a company by its management team is becoming increasingly popular as an exit strategy.
- Other private investors: Leveraged buyout (LBO or Buyout), refers to a strategy of making equity investments as part of a transaction in which a company, business unit or business assets is acquired from the current shareholders typically with the use of debt.
- Public Investors: An Initial Public Offering (IPO) is the sale or distribution of a company's shares to the public for the first time. An IPO of the investee company's shares is one of the ways in which private investors can exit from an investment⁸³. IPOs are used to raise growth or expansion capital for companies that have capital

⁸¹ EVCA (2007), *Guide on Private Equity and Venture Capital for Entrepreneurs*.

⁸² United Nations Economic Commission for Europe (2009), *Policy Options and Instruments for Financing Innovation*.

⁸³ OECD (2009), *Financing High Growth and Innovative Start-Ups and SMEs: Data and Measurement Issues*, OECD Publishing.

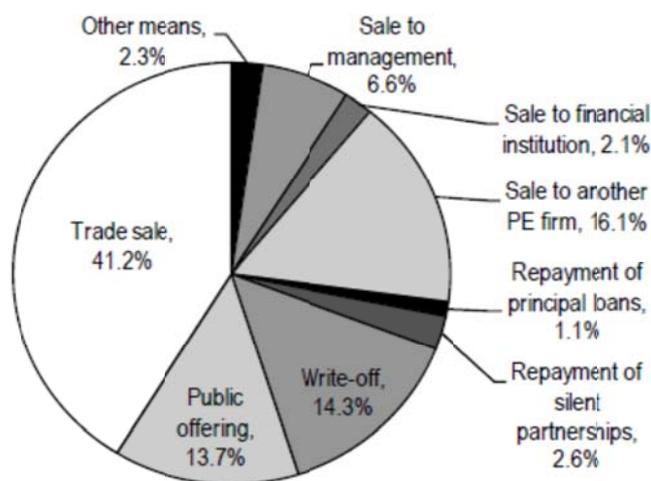
requirements that are too large or too costly for individual investors to provide⁸⁴. Typical stock exchanges that Irish companies have listed on include:

- Irish Stock Exchange - The Main Securities Market is the principle market for equity securities of more established Irish and international companies. The Enterprise Securities Market is for smaller growth companies.
- London Stock Exchange - the London Stock Exchange's Main Market is the world's most international market for the listing and trading of equity, debt and other securities. The Alternative Investment Market is the exchange's market for smaller growing companies.
- NASDAQ - the NASDAQ exchange specialises in providing a market for fast growing companies.

Experian data shows that during the first half of 2012, there were 147 merger and acquisition and equity capital market (e.g. flotation, rights issue and placements) transactions announced in Ireland, compared to 142 deals in the same period in 2011. The value of transactions also increased slightly, from €21.862 billion to €22.184 billion. Experian analysis indicates that deal flow has been driven by consolidation within the manufacturing and professional services sectors, and particularly by high levels of foreign investment. The volume of mid-market deals (€12 million - €120 million) has declined⁸⁵.

In terms of exits, the majority of venture capital exits in Europe are through trade sales, 41.2 per cent of exits were through this method in 2010 (Figure 10). The alternative exits were; sale to other private equity firms (16.1 per cent), write-off of investments (14.3 per cent), IPOs (13.7 per cent) and sales to management (6.6 per cent).

Figure 10: European Venture Capital Exits in 2010



Source: OECD (2011) Financing High Growth Firms: The Role of Angel Investors

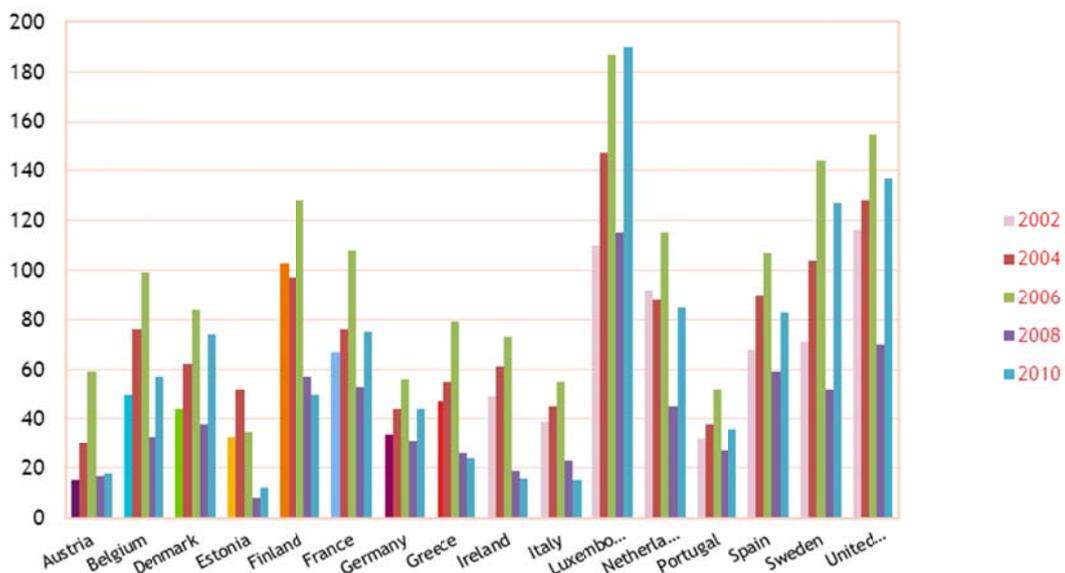
⁸⁴ United Nations Economic Commission for Europe (2009), *Policy Options and Instruments for Financing Innovation*.

⁸⁵ Experian (6th July 2012), Experian data reveals the latest M&A activity for Republic of Ireland, News Release.

Likewise, in the US, the number of IPOs has fallen dramatically since the dot-com bubble⁸⁶. Pre-1999, there were on average 547 IPOs per annum but this has fallen to an average of 192 IPOs per annum over the period 1999-2011. The US IPO Taskforce stated that “By one estimate, the decline of the US IPO market has cost America as many as 22 million jobs through 2009.”

Finally, it is important to review the public equity market. The Irish Stock Exchange provides a market for companies to raise capital in Ireland. However, the exchange has experienced a significant drop in market capitalisation since 2007, with the main market down from over €90 billion in 2007 to €49 billion in 2011.

Figure 11: Market Capitalisation as a percentage of GDP, various EU Countries



Source: World Bank

Stock market capitalisation as a percentage of GDP collapsed in Ireland between 2006 and 2008 and further worsened in 2010 (Figure 11). The decline in the exchange has been caused by a number of factors including the collapse in the domestic banks, the fall in value of many other companies listed on the exchange, a significant number of exits from the exchange, a weak pipeline of new entrants, and reduced international investor interest as a result of Ireland’s current economic situation.

More broadly, public stock markets in Ireland and overseas are being challenged as vehicles to raise funding by the strength of large exchanges, the rise of private equity and the use of corporate debt. However, the relative importance of the public market in Ireland is now far behind that of the UK and has weakened relative to a range of other countries.

8.2 Current Policy Initiatives

Given the mature and relatively well developed nature of the markets, there are more limited policy interventions at this stage. However, some of the earlier initiatives are

⁸⁶ The US IPO Task Force places the average cost of achieving initial regulatory compliance for an IPO in the US at \$2.5 million, followed by an on-going compliance cost, once public, of \$1.5 million per annum.

relevant in this lifecycle stage (e.g. Enterprise Ireland's development capital scheme, Innovation Fund Ireland and NPRF collaboration with Silicon Valley Bank). In addition:

- There are a range of tax reliefs that support the efficient transfer of businesses to the next generation (retirement relief, business relief and consanguinity relief).
- The main financing initiatives at EU level are the European Investment Bank's Risk Sharing Finance Facility (RSFF) for large and mid-sized companies and its recently launched Risk Sharing Instrument (RSI) equivalent for SMEs, as well as the High Growth and Innovative SME Facility (GIF)⁸⁷.
- European Commission fund-of-funds proposal under Horizon 2020⁸⁸.

8.3 Recommended Actions

A major challenge remains in Ireland and internationally to encourage firms to attract funding for expansion without selling the business in its entirety - or at least not to sell too early.

While the founder and/or other investors are seeking to realise their investments/ diversify risks, as a unit of a larger (international) business, there is a risk that strategic functions in the Irish operation will move overseas unless the business has reached a critical mass and would be capable of operating as a standalone unit. Of the 827 HPSU's supported by Enterprise Ireland to 2008, only sixteen followed an IPO strategy⁸⁹.

The depth of equity markets and ease of access (e.g. costs) are important factors in considering initial public offerings. The relatively illiquid nature of the Irish exchange is a challenge. Regulation also has a role to play in Ireland and overseas. The US IPO Taskforce (2011) concluded that the cumulative effect of a sequence of regulatory actions in the US, mostly aimed at protecting investors, have⁹⁰:

- driven up costs for emerging growth companies looking to go public, thus reducing the supply of such companies,
- constrained the amount of information available to investors about such companies, thus making emerging growth stocks more difficult to understand and invest in, and
- shifted the economics of the trading of public shares of stock away from long-term investing in emerging growth companies and towards high frequency trading of large-cap stocks, thus making the IPO process less attractive to, and more difficult for, emerging growth companies.

The Taskforce assessed the average cost of achieving initial regulatory compliance for an IPO in the US at \$2.5 million, followed by an on-going compliance cost, once public, of \$1.5 million per annum. The subsequent US JOBS Act (2012) made specific regulatory changes to reduce the impediment to small companies' capital formation in ways that are consistent with investor protection. These include:

- The creation of a new Securities and Exchange Commission (SEC) category - an emerging growth company (EGC) - which will be provided with up to five years temporary relief from certain SEC regulations, but will have certain internal controls

⁸⁷ Veugelers, R. (2011), *Mind Europe's Early-Stage Equity Gap*, Bruegel Policy Contribution.

⁸⁸ Veugelers, R. (2011), *Mind Europe's Early-Stage Equity Gap*, Bruegel Policy Contribution.

⁸⁹ Enterprise Ireland (2012).

⁹⁰ IPO Task Force (October 20, 2011), *Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth*.

over financial reporting and keeping audited financial statements to provide investor protection.

- Removal of the SEC regulatory ban that previously prevented small businesses from using advertisements to solicit investors.
- Allowing crowdfunding for all companies without the requirement for SEC registration, with certain restrictions.
- The maximum amount of capital offered in a 12 month period and the maximum number of shareholder before the company must register with the SEC registration has been substantially increased.

Following the US Jobs Act, the UK⁹¹ has developed a set of proposals with the London Stock Exchange to attract entrepreneurs and high-growth companies. Within the EU, reforms are also being considered. In particular, there are continuing efforts to support the creation of EU wide markets (e.g. see section 6.2 - EU passport) and to make markets more amenable to smaller firms. While these markets do not constitute significant sources of funds at present for Irish firms (vis-à-vis the US and the UK), they offer potential in the future.

Notwithstanding the current challenges facing the Irish stock exchange, there have been concerns for some time over the ability of the exchange to support Irish firms in raising capital. In 1996, while acknowledging the potential of the proposed new developing companies market on the exchange, Forfás noted that “at present the equity market is irrelevant to the financing needs of the vast majority of businesses”. Dominated by exploration stocks, the Enterprise Securities Market has not become a home to many Irish technology companies⁹². A number of Irish companies have instead listed on overseas markets. In 1999, Bacon questioned whether the current ownership structure of the exchange “can be considered optimal in terms of promoting future development”⁹³.

Recognising that many internationally orientated Irish companies preferred option is to raise capital overseas⁹⁴ - despite significant additional costs, a key policy goal should be to assist appropriate companies in preparing to launch on relevant foreign exchange. Consolidation in Europe also offers potential over time. The potential of the Irish market remains in question.

6. To promote Initial Public Offerings and emerging alternative funding mechanisms:

- Enterprise Ireland to continue and enhance engagement with Irish companies seeking to list on US exchanges and to maximise the opportunities from the recent US JOBS Act regulatory changes which may create new funding opportunities for smaller offerings and crowdfunding.

(Enterprise Ireland)

⁹¹ Department of Business, Innovation and Skills (20th September 2012), Bold action to open up London’s equity markets to high-growth companies, press release.

⁹² Membership of the ESM - <http://www.ise.ie/Equity-Issuers/Enterprise-Securities-Market/ESM%20companies/>

⁹³ Bacon, P. and Associates (1999), *Final Report: Strategic Development Options for Ireland’s Capital Markets in a Competitive Context*, Dublin: Bacon Associates.

⁹⁴ Chris Horn (2012). *Ireland must measure tech success in terms of Nasdaq IPOs*, Irish Times.

Continue to engage with the European Securities Committee to ensure that the on-going work programme in relation to EU Directives balances the regulatory burden with investor protection and reflects the EU Small Business Act 'Think Small First' principle.

- In principle, Ireland should support proposals targeting SMEs to enhance their ability to access equity on an EU wide basis (i.e. development of a single European equity market).

(D/Finance)

- Recognising the significant challenges facing all exchanges and the Irish stock exchange in particular, it is important that the Irish stock exchange sets out a clear vision for the future as a market to support equity investments and the steps required to achieve this. This vision should consider the merits of demutualisation and forming joint ventures/ alliances with other exchanges, which could support critical mass and deeper liquidity to best serve the needs of Irish growth companies.

(ISE and members, broader financial sector)

9. Selective Horizontal Issues

A number of other actions can be taken that cross the spectrum of the investment life-cycle without neatly fitting into any one stage.

- No entrepreneurs, means no demand for equity. There are a broad range of factors which create a positive environment for entrepreneurs. To encourage the pipeline of new entrepreneurs, Irish culture and the business environment needs to value entrepreneurship as a positive choice, promote it within the education sphere and support the risk-takers who create jobs.
- There is potential to access EU policy programmes and pilot initiatives which are underway or proposed across various stages of the funding lifecycle, which could be of relevance to Ireland.
- Tax neutrality is used to describe a tax system that does not create a bias that could influence a taxpayer to choose one course of action over another. In other words, decisions are made on their economic merits and not for tax reasons⁹⁵. In the past, Irish tax policy supported investment in property over that in productive assets. Tax policy also encourages investments in passive assets (e.g. saving deposits) over investments in productive firms. Finally, tax policy encourages firms to take on debt rather than equity financing.

9.1 Recommended Actions

9.1.1 Finalisation of a National Entrepreneurship Strategy⁹⁶

Entrepreneurship is one of the cornerstones of a modern, fully developed economy. The Small Business Forum (2006) recommended that the Government should adopt a national entrepreneurship policy.

Putting entrepreneurship high on the economic and social policy agenda can help Ireland meet a number of key challenges.

- The challenge to sustain growth: Entrepreneurship is a major driver of innovation, competitiveness and growth.
- The challenge to deepen competitive advantage: The most permanent source of competitive advantage in the knowledge economy is the capacity to create new firms and to innovate.
- The challenge to strengthen the enterprise base: Entrepreneurial activity strengthens the enterprise base not only through the creation of new businesses but also by stimulating improved performance in existing businesses.
- The challenge to create vibrant regions: Entrepreneurship drives regional development, delivers economic and social benefits to regions, and builds strong local communities.
- The challenge to achieve social inclusion: This is brought about when the opportunity of creating one's own business is offered to everybody, regardless of background or

⁹⁵ Commission on Taxation (2009), *Commission on Taxation Report 2009*, Government Publications, Dublin.

⁹⁶ Forfás (2007), *Towards Developing an Entrepreneurship Policy for Ireland*, Forfás, Dublin - material based on this report.

location, and when certain groups such as women and immigrants, who are under represented among existing business owners, become involved.

Finalising the national entrepreneurship strategy would provide a blueprint to drive entrepreneurship in a determined and coherent manner so as to harness the necessary resources - public and private - at national, regional and local level. The EU Commission have a public consultation in the field and are expected to announce an Entrepreneurship2020 Action Plan, most likely to be a proposal, by the end of 2012.

7. Develop a national entrepreneurship strategy, building on 'Towards Developing an Entrepreneurship Policy for Ireland'.

(D/JEI lead role with EI, the CEBs, Forfás and D/Finance)

In 'Towards Developing an Entrepreneurship Policy for Ireland, 2007' Forfás recommended that a national entrepreneurship strategy should be developed. In supporting the implementation of actions arising, the report recommended the establishment of a National Entrepreneurship Forum. The current Advisory Group on Small Business could be an appropriate consultative forum.

In the context of developing a national entrepreneurship strategy, two key areas where additional progress is required are in education and social welfare.

9.1.2 Supporting Entrepreneurship: Role of Education

Research to date has clearly identified the key role that culture and education plays in fostering a spirit of enterprise and strengthening the motivation and capacity of entrepreneurs and potential entrepreneurs. In previous research⁹⁷, a number of key areas to develop entrepreneurial capabilities were identified. Key recommendations and initiative taken to date are set out below.

- Involving the education system in reinforcing positive perceptions of entrepreneurship and improving the recognition of entrepreneurship as a career choice, among students, parents and teachers. For example, the Qualifax.ie website, which receives funding from the Department of Education and Skills, is a careers portal, which provides some information on entrepreneurship.
- Making enterprise education a more formal part of the education system (as put forward by the National Council for Curriculum and Assessment⁹⁸) and embedding entrepreneurship training in professional teacher training qualification and adopt innovative methods to do so. Short courses are proposed such as new 90-hour optional courses, which would be completed and examined in one year. The idea is that they would offer learners a wider range of curriculum choices. Enterprise is one of the first short courses for which there has been a consultation^{99&100}.

⁹⁷ Forfás (2007), *Towards Developing an Entrepreneurship Policy for Ireland*, Forfás.

⁹⁸ NCCA (2007), *Towards Learning an Overview of Senior Cycle Education*.

⁹⁹ National Council for Curriculum and Assessment website - Consultations / Short Courses.

¹⁰⁰ Joint submission (EGFSN/Forfas/NCC) to the NCCA consultation on the draft Leaving Certificate Enterprise short course submitted in 2011.

- Ensuring entrepreneurship is part of the third level curriculum for students from non-business and business courses alike. To date, initiatives include the Higher Education Authority funding of the DIT-led 'Accelerating Campus Entrepreneurship (ACE)'. The draft on Enterprise and Entrepreneurship Education, when finalised, will help to make the ACE initiative mainstream.
- Ensuring sustained funding of entrepreneurship education activities and for the nationwide implementation of enterprise projects in schools. In this area, the County Enterprise Boards and Junior Achievement Ireland are providing teacher recourses for entrepreneurship education at secondary level for these optional initiatives.
- Linking new knowledge developed by the researchers at third level to entrepreneurs who have the perception, skills and motivation to commercialise it. For example, the National Universities BiInnovate Fellowship Bootcamp in is a specialist medical device innovation training programme, modelled on the prestigious Stanford BioDesign programme. It is an intensive 10-month masters by research programme and Fellows are stipend supported by Enterprise Ireland.

8. Extend the footprint of the various educational initiatives, which have been developed to support entrepreneurial capabilities.

(D/Education and Skills)

9.1.3 Voluntary opt-in PRSI contributions for Entrepreneurs

Self-employed workers are liable for PRSI at the Class S rate of 4 per cent which entitles them to access long-term benefits such as State pension (contributory) and widow's, widower's or surviving civil partner's pension (contributory). While a self-employed worker may establish eligibility to assistance-based payments, in the means test for Jobseeker's Allowance the household income is assessed including the income of their spouse, civil partner or cohabitant. Mortgage payments are not deducted from earnings for means assessment purposes.

Ordinary employees who have access to the full range of social welfare benefits, including jobseeker's benefit, pay Class A PRSI. Employers and employee make a combined payment of 14.75 per cent under full-rate PRSI Class A.

In terms of benefits, the 2005 Actuarial Review of the Social Insurance Fund found that the self-employed contributor can expect to receive over 10 times what he contributes to the social insurance fund compared to the employee who gets 3 times what he and his employer contribute – despite the fact that the range of benefits available to employees is greater. But Ireland's changed economic circumstances has highlighted that the lack of support for a self-employed worker if their business ceases is a significant downside risk and not being eligible for automatic Jobseeker's Benefit has a negative impact on self-employed workers and their families. The 2010 Actuarial Review of the Social Insurance Fund provides estimated current annual effective PRSI contribution rate increases that the self-employed would need to contribute to fund varying levels of weekly pension payments with various additional benefits¹⁰¹, assuming take-up would be the same as the overall labour force. For example, the additional contributions needed to provide for a state pension (contributory) at €230.30 per week and Jobseekers benefit would require an annual effective rate of 15.9 per cent compared to the current annual effective rate of 3.7 per cent.

¹⁰¹ Department of Social Welfare / KPMG (2012), 2010 Actuarial Review of the Social Insurance Fund, section 10.5, table 10.9, on page 90.

While a system of separate arrangements for employed and self-employed workers within a social insurance context is common in European social protection systems, there are examples of voluntary opt-in for self-employed in other member states (i.e., where an individual makes additional payments for additional benefits). The social security system needs to better accommodate the increasing number of atypical workers and the many workers that will have changes of status throughout their careers to support an entrepreneurial enterprise culture. Given the financial implications of extending the range of benefits, an increased contribution rate may be required, in which case the voluntary nature of the opt-in will be important.

Canada's Economic Plan 2009 offered a voluntary opt-in for the self-employed to access to four types of special benefits to support workers when they experience an interruption in earnings due to illness, childbirth, parenting, or the provision of care or support to a gravely ill family member. In 2010, approximately 5,760 self-employed persons opted into the Employment Insurance program under this provision¹⁰². The Small Firms Association (pre-budget submission 2012) and the Irish National Organisation of the Unemployed¹⁰³ supported the introduction of such a measure.

The Department of Social Protection (Action Plan for Jobs 2012, 2.14) is examining the options with regards to extending benefit cover to the self-employed. Under the Tax and Social Welfare Commission's terms of reference, it is to examine issues involved in providing social insurance cover for self-employed persons to establish whether such cover is technically feasible and financially sustainable.

9. Introduce an additional voluntary opt-in PRSI contribution to enable the self-employed (Class S) to qualify for the full range of benefits, including Job Seekers Benefit, in order to mitigate the downside risk of business failure.

(D/Social Protection and D/Finance)

9.1.4 EU policy programmes and pilot initiatives of relevance

Initiatives are also underway at an EU level to encourage investment. The new Programme for the Competitiveness of Enterprises and SMEs (COSME) 2014-2020¹⁰⁴, with a planned total budget of €2.5 billion over the 6 years, will play an important role in stimulating improved access to finance for SMEs across the EU.

There are two early pilot initiatives, which are of particular relevance:

- **Business Angels:** The European Angel Fund is a pilot initiative (currently operating in Germany) to help business angels to increase their investment capacity by co-investing into innovative companies in the seed, early or growth stage. Links to section 5.2.
- **Venture Capital Funds:** There is a sectoral focused pan-European fund-of-fund pilot initiative.¹⁰⁵ With respect to equity, the Commission proposes to establish an Equity Facility for Growth (EFG). The EFG shall focus on funds that provide venture capital and mezzanine finance to expansion and growth-stage enterprises, in particular those operating across borders, while having the possibility to make investments in early stage enterprises in conjunction with the equity facility for RDI under Horizon 2020.

¹⁰² Canada's Economic action Plan at <http://www.actionplan.gc.ca/en>.

¹⁰³ Irish National Organisation of the Unemployed (2011), *Submission to the Tax and Social Welfare Commission*.

¹⁰⁴ EU Commission website at http://ec.europa.eu/cip/cosme/index_en.htm.

¹⁰⁵ European Investment Fund (2011), *EIF Corporate and Operational Plan 2012-2013*.

Support will be provided directly from the European Investment Fund (EIF) or by funds-of-funds or investment vehicles investing across borders. These will be established by the EIF on behalf of the Commission together with private investors and/or national public financial institutions.

10. Maximise the opportunities under EU programmes, particularly the upcoming EU Programme for the Competitiveness of Enterprises and SMEs (COSME) 2014-2020. There are COSME pilot initiatives being supported (e.g. European angel fund, sectoral focused pan-European fund-of-fund pilot) which could be leveraged to underpin national policy proposals.

(D/JEI)

9.1.5 Tax incentives towards investment in property investment over productive enterprise.

In the past, the State provided significant tax incentives for individuals to invest in property. In addition to excessively stimulating the property market, these incentives reduced the relative attractiveness and interest in investing in productive businesses.

Many of these property incentives are now closed or being wound down. The removal of tax exemptions, which incentivise investment in property rather than productive business activities, should enhance private investment in indigenous firms, enabling them to undertake the up-scaling required to access foreign markets.

In the future, when considering tax supports to enhance incentives for investment and job creation, incentives which support productive enterprise with the potential to trade internationally are preferable.

9.1.6 Higher rates of tax on the returns on investments in productive assets than for passive investments (e.g. deposit accounts).

Irish saving rates have increased considerably in recent years¹⁰⁶, driven by the need to pay down previous debts and an increase in pre-cautionary saving. While the banks face considerable funding difficulties, it is important that the tax system does not incentivise particular saving/ investment channels. In this respect, it is noticeable that the Irish taxation system (in common with others) favours investments in passive investments. When an Irish resident obtains income from savings or investments, in general, the individual is taxed as follows:

- For money on deposit in a financial institution (passive income), deposit interest retention tax (DIRT) is withheld at 30 per cent and paid directly to Revenue. DIRT is a final liability tax and interest that has been subject to DIRT is exempt from the Universal Social Charge, but it falls within the definition of total income for the purpose of PRSI.
- Where the individual buys shares in a company, the dividends are investment income. Dividends are withheld at source at the standard income tax rate (currently 20 per

¹⁰⁶ Central Statistics Office (April 2012), Quarterly Institutional Sector Accounts: The gross household savings ratio, which expresses savings as a percentage of gross disposable income, increased from 13.4 per cent in 2010 to 14.1 per cent in 2011. This compares to Eurostat, Quarterly Sectoral Accounts 2011 Q3 of household saving rate of 13.3% in the euro area and 10.9% in the EU-27.

cent)¹⁰⁷. Dividends from shares in Irish or foreign companies are liable to tax at the individual's marginal rate of income tax (often 41 per cent), which is paid generally by self assessment in an annual income tax return.

- Where an individual invests in property, the rental income is investment income. Rental income¹⁰⁸ from property is taxed at the individual's marginal rate of tax (often 41 per cent) on the net profit¹⁰⁹.
- Where an individual invests in funds (i.e. 'collective investments' where he or she does not have any control over the selection of the assets/property) the exit tax will be 30 per cent or 33 per cent in respect of monies received; tax is also paid every eight years¹¹⁰.

In the context of supporting economic activity, the tax rate on dividends should not be higher than the rate on deposit interest. In 2009, the Commission on Taxation (2009) recommended that 'the tax rate on dividends received by Irish residents should be reduced to the rate applying to deposit interest' (CoT proposal 7.9). They also noted that the measure should apply to ordinary shares and that safeguards should be included.

The rebalancing of the tax preference under the Irish tax system for interest on deposit incomes, took a step forward in Budget 2012 when the rate for deposit interest, capital gains and gifts/inheritorances were aligned at 30 per cent. More broadly, since January 2009, DIRT has increased from 23 to 30 per cent. The estimated costing of the proposal by the Commission on Taxation in 2009 was in the region of €53 million, which would require updating to reflect the increase in the rate to 30 per cent and the increased savings rate.

11. Reduce the tax rate on dividends to the rate applying to deposit interest.

(D/Finance)

To complete the Commission on Taxation's approach to the taxation of equity capital (dividends and capital gains), the rate for dividends needs to be moved to a final liability tax of 30 per cent withheld at source which would then be exempt the Universal Social Charge.

Finally, in budget 2012, the Minister for Finance announced further broadening of the base for PRSI to cover rental, investment and other forms of income from 2013. While this will bring equality of treatment, whether an individual is self-employed or has PAYE status, it will reduce the attractiveness of investing in productive assets vis-à-vis passive income for PAYE employees. If all individuals (not just the self-employed) had to pay PRSI on dividends, the administration will require careful consideration. Small investors might take the view that the level of possible dividends wouldn't be worth the potential administrative burden/cost of filing an annual income tax return and the volume in the self-assessment system may increase

¹⁰⁷ This is not applied where the relevant declaration has been completed for an exemption; e.g. non-resident.

¹⁰⁸ Exception where an individual qualifies for the rent -a-room relief under which they will not be subject to income tax, universal social charge or PRSI on the income received.

¹⁰⁹ The interest relief is restricted to 75 per cent and a rental agreement must be registered with the Private Tenancy Board in order to be eligible for the relief.

¹¹⁰ This is an anti-avoidance measure to counteract the continual rolling over of investments without a charge to tax arising.

with limited additional gain. Currently, receipt of rental income requires an individual to file an annual income tax return.

9.1.7 Incentives for firms to take on debt financing rather than equity financing.

The International Monetary Fund and others have highlighted that tax regimes in most countries encourage companies to finance themselves with debt rather than equity¹¹¹.

In general, most countries follow basic accounting rules in allowing a deduction from taxable profits for interest payments (subject in many cases to thin capitalisation¹¹² and anti-avoidance provisions). This is in contrast to dividends paid to shareholders, which are generally not tax deductible. In Ireland, interest expense incurred in arm's length transactions by companies for commercial purposes is deductible in computing taxable profits. It is also notable that stamp duties apply on the purchase of shares, subject to various exemptions, but not to debt.

This can create potential distortion in the financial structures of groups as the tax deduction for interest expense can lead to groups favouring debt finance over equity finance. A policy preference toward debt may, in part, account for the high levels of indebtedness in the business sector and market volatility.

Immediately, changing the tax treatment of debt (interest deductibility) and/or equity (e.g. adopting an allowance for corporate equity¹¹³) could have a significant effect on the tax base. It could also impact significantly on the effective tax rates faced by individual companies and sectors (e.g. aircraft leasing), and result in changes in relative competitiveness. This is an emerging discussion theme in international fora.

12. Over time and in tandem with developments in other countries, efforts should be made to ensure a higher degree of tax neutrality on firms' debt/ equity financing decisions.

(D/Finance)

¹¹¹ Financial Times (16th June 2009), *Tax Policies fuelled credit boom, says IMF*.

¹¹² Thin capitalisation provisions impose non-commercial restrictions on the entitlement to deduct interest on debt capital. Given Ireland's low corporate tax rate, companies might choose to borrow in jurisdictions where an interest deduction on a higher taxable profit (due to higher rate) would be more advantageous. Therefore, Ireland does not have thin capitalisation rules.

¹¹³ Bilicka, K. and Devereux, M (2012), *CBT Corporate tax ranking 2012*, Oxford University Centre of Business Taxation, UK. ACE has been introduced in Belgium, Italy and Brazil. The rationale for introducing ACE in Belgium in 2006 was to ensure that mobile international finance and logistics operations that had benefited from a corporate income tax exemption regime that the EU found anti-competitive, would be incentivised to remain in Belgium.

Appendix 1

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