2006 Review

of the

Business Expansion Scheme

and

Seed Capital Scheme

Department of Finance

in consultation with the

Department of Enterprise, Trade & Employment

and the

Office of the Revenue Commissioners

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Executive Summary

Business Expansion Scheme

The Business Expansion Scheme (BES) is an incentive to private investors to invest long-term equity capital in companies, particularly new and smaller ones, operating in certain sectors of the economy, which would otherwise find it difficult to raise such funding. The scheme was first introduced in 1984 and has been reviewed several times since then. Qualifying companies include companies engaged in certain manufacturing and services activities, tourism, research and development, companies constructing and leasing advance factories, and certain music recording activities. The aggregate amount that a company can raise currently is €1 million, subject to a maximum of €750,000 in any one six-month period. (A separate company limit of €1.27 million exists for advance factories.) Provided that an investor holds his/her investment for a minimum period of 5 years, the BES provides individual investors with tax relief, at their marginal tax rate, in respect of investments of up to €31,750 *per annum* in qualifying companies. The BES is provided for in Sections 488-508 of the *Taxes Consolidation Act 1997*, as amended. It expires on 31 December 2006.

Seed Capital Scheme

The Seed Capital Scheme (SCS) was introduced as part of the BES in 1993 to encourage individuals currently or formerly in employment to establish new business ventures. An unemployed person or a person who was made redundant may also claim the relief. To qualify for a tax refund an individual must invest in his/her own business. The size of the refund depends on the amount of the individual's investment. For any particular year, the refund is limited to the tax the individual has paid in previous years, subject to a limit of the tax paid on €31,750 *per annum* with an overall limit for the previous six years of the tax paid on €182,240. The scheme is open to the same categories of companies as the BES with the exception of companies constructing and leasing advance factories. Like the BES, the SCS is provided for in sections 488-508 of the *Taxes Consolidation Act 1997*, as amended. It also expires on 31 December 2006.

Cost

In 2005, the latest year for which statistics are available, €38.3 million was raised under the BES scheme, at an estimated cost to the Exchequer of €16.1 million. In the same year, €3.4 million was raised under the SCS, at an estimated cost to the Exchequer of €1.3 million.

Review

As part of the on-going policy of reviewing tax reliefs to ensure that such reliefs meet their socio-economic objectives, it was decided that both the BES and SCS should be reviewed prior to their due expiry date and that the findings of the review would inform the Minister for Finance on how the schemes have operated to date and assist in making decisions in relation to the future, if any, of the schemes beyond 2006.

The present review has been carried out by the Department of Finance in conjunction with the Department of Enterprise, Trade & Employment and the Office of the Revenue Commissioners. The review took account of the findings of the report of the Small Business Forum, *Small Business is Big Business,* the *Survey of SME Finance/Equity* carried out by Forfás, and the PWC report *Strategic Advisory Services – Enterprise Ireland Seed and Venture Capital Funds Programme 2006*, as well as a range of submissions from interested parties.

EU Approval

As the schemes are approved State aids, their continuation and the changes proposed require the approval of the European Commission in accordance with the *Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium Sized Enterprises.*

BES Survey

During Summer 2006 the Department of Finance carried out a survey of 1,391 companies that availed of the BES since 1997. The aim of the survey was to identify the types of companies that generally avail of the scheme and to determine the nature and extent of the benefits of the scheme to such companies. Of the 1,391 companies surveyed, 491 (35%) responded. Of these:

- 58% were categorised as engaged in manufacturing, 12% in tourism, 22% in international services and 8% as other;

- 95% had raised equity under the BES in the past ten years. In terms of actual money raised, just over three-quarters of the companies surveyed raised less than €500,000. However, 32% of companies required more than €500,000 worth of equity; 28% were successful in raising amounts in excess of this amount.

- Over 90% of companies said that the scheme should be extended and that both the overall company limit and the individual annual investor limit should be increased. 62% of respondents saw a requirement for additional equity under the BES for their company in the next three years. 19% of these felt that they would need between €1 million and €2 million, while 10% would want in excess of €2 million.

Conclusions and Recommendations

The Review concluded that there is a strong case that the BES and SCS should be continued given:

- the clear market failure in providing equity capital for small firms in their start up and early development phase;

- the evidence of how vital the schemes have been in the past for such firms and the continuing needs in this regard;

- the potential return to the economy from indigenous Irish companies;

- the clear support for continuation from a large number of representative and other bodies in the public and private sector.

It is further suggested that:

- an extension of seven years to the end of 2013 be granted. This would give improved certainty to all those involved. A review could take place after five years;

- the lifetime company limit be increased to between €1.5 million and €2million, having regard for the needs of those companies which have already raised close to the limit as well as the renewable energy sector;

- the annual investor limit be increased significantly. Any new limit should apply only to the BES and SCS as the risk involved for investors is much higher than in property based reliefs and other schemes.

Section 1 - Introduction

1.1 The Business Expansion Scheme (BES) was introduced in 1984 as an incentive to private individual investors to invest long-term equity capital in small and medium-sized enterprises, particularly start-up and smaller ones, operating in certain sectors of the economy, which would otherwise find it difficult to raise such funding and would instead have to rely on loan finance, which in turn can be difficult for small and start-up companies to obtain.

1.2 The Seed Capital Scheme (SCS) was introduced in 1993 to encourage individuals currently or formerly in employment to establish new business ventures.

1.3 In *Budget 2004* it was announced that both the BES and SCS would be extended until 31 December 2006. As part of the on-going policy of reviewing tax reliefs to ensure that such reliefs meet their socio-economic objectives, it was decided that both the BES and SCS should be reviewed prior to their due expiry date and that the findings of the review would inform the Minister for Finance on how the schemes have operated to date and assist in making decisions in relation to the future, if any, of the schemes beyond 2006.

1.4 As the schemes are approved State aids, their continuation and the changes proposed require the approval of the European Commission in accordance with the *Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium Sized Enterprises*[1].

1.5 Both schemes have now been reviewed by the Department of Finance in conjunction with the Department of Enterprise, Trade & Employment and the Office of the Revenue Commissioners. This is a report of that review.

1.6 This report examines both schemes, the policy objectives underpinning them, the extent to which they have been availed of, and how they have operated to date.

1.7 As part of the review of the BES, the Department of Finance carried out a survey of the 1,391 companies that have availed of the scheme since 1997. The aim of the survey was to identify the types of companies that generally avail of the scheme and to determine the nature and extent of the benefits of the scheme to such companies. The findings of the survey are presented in this report.

1.8 The report assesses the cost of both schemes to the Exchequer and the known impact of the schemes on the sectors where the tax relief has been available.

1.9 The report considers the arguments for continuing the schemes, including the findings of the report of the Small Business Forum, *Small Business is Big Business,* the *Survey of SME Finance/Equity* carried out by Forfás, and the PWC report *Strategic Advisory Services – Enterprise Ireland Seed and Venture Capital Funds Programme 2006*, as well as a range of submissions from interested parties.

[1] OJ C 194, 18.8.2006, p. 2.

1.10 Finally, the report considers options for changes that could be made to the schemes to ensure that they continue to meet their overall policy objectives, improve their effectiveness and provide value for money.

Section 2 – Development of BES and SCS

Development of the Business Expansion Scheme

2.1 Prior to the introduction of the Business Expansion Scheme in 1984, the Government had considered that there was a need for it to create a more positive environment for investment in industry to strengthen and broaden the industrial base in the State. It concluded that investment of equity capital in industry was required.

2.2 The history of investment in the State up to 1984 had shown that entrepreneurs were reluctant to invite outside investors to invest in their companies and thus such companies tended instead to try to meet their capital requirements through borrowings where possible. In addition, small, start-up companies with no track record were less likely to attract would-be investors seeking secure investments as well as returns on their investment.

2.3 The introduction of the BES was viewed by the Government as being one measure that could contribute to a more positive environment for investment in industry. It was hoped that it would provide taxpayers with an incentive to put money at risk by providing long-term equity capital in small and medium-sized enterprises (particularly start-up and smaller ones), operating in certain sectors of the economy, which would otherwise find it difficult to raise such capital. The Government decided that capital generated by the scheme should, in the first instance, be directed solely to those industries which had already been identified as being in the national interest and most in need of building up. These were the manufacturing companies and service companies which qualified for IDA grants and the 10% rate of corporation tax.

2.4 To qualify for the relief the company has to provide evidence that the money subscribed is, was, or will be used to enable the company to:

- undertake one of the qualifying trading operations as specified, or to enlarge its capacity to do so;
- engage in, or assist in, research and development, the acquisition of technological information and data, the development of new or existing products or services;
- identify and develop new markets for its products and services and to develop its existing markets; or
- increase its sales of products or services.

Each of the above activities must be carried out with a view to the creation or maintenance of employment in the company.

2.5 The scheme, which was originally intended to operate for a three year period, has been reviewed and continued at intervals since then. In recent years, the scheme has been amended to focus it more sharply on helping small and start-up companies to raise equity finance.

2.6 In 1989 general operational leasing activities and financing/re-financing services were removed from the scope of the relief and arrangements that provided investors with safe or guaranteed exit mechanisms from the BES were specifically prohibited. In 1991 hotels and shipping – which were highly asset backed and involved little risk – were removed from the relief. (As part of the 1989 changes, self-catering accommodation in urban areas had also been removed). The changes in 1989 and 1991 and other fine-tuning in subsequent years have been designed to re-focus the BES on the essential original intention, i.e. to assist smaller projects to raise equity finance.

2.7 *Budget 1998* reduced the aggregate amount that a company could raise under the BES from €1.27 million (£1million) to €317,500 (£250,000). The cost of the BES to the Exchequer had been increasing considerably, with the figures for 1997/98 indicating that a total of €117.7 million (£92.7 million) was raised at a cost of €56.5million (£44.5 million). However *Budget 1998* allowed companies raising funds solely in connection with the construction and leasing of advance factory buildings to continue to raise up to €1.27 million (£1 million). This exception was made because of the unique nature of advance factories and the fact that advance factories are designed to try to address the disadvantages faced by communities in attracting employers to the regions.

2.8 In 2001, the Department of Enterprise, Trade & Employment carried out a review of the BES for the period 1997 to 2001. The main conclusions of that review were that:

- for the tax years 1997/98 to 2000/01, 43.5% of all BES projects were raising amounts up to €63,500 (£50,000), and 17.8% were raising between €63,500 (£50,000) and €127,000 (£100,000). This compared with 49.2% and 17.5% for the period 1984 to 1997;

- manufacturing activities (67.8%) made up the largest number of projects, followed by international services (15.3%) and tourism (13.9%). This compared with a 1997 survey where manufacturing accounted for 78.7%, tourism 13.1% and international services 6.1%;

- the survey showed that just under half of the money raised (48.8%) and the number of approvals (45.9%) for amounts up to €127,000 (£100,000) were in respect of companies incorporated since 1995, i.e. new companies and companies at an early stage of development;

- the survey also showed that 74.7% of BES funding and 77.4% of the number of approvals for sums up €127,000 (£100,000) were in respect of companies in the 1-20 employee category;

2.9 The overall conclusion drawn from the 2001 review was that the BES continued to be an important source of finance for small and start-up companies.

2.10 Following the 2001 review, it was decided that both schemes would again be extended for a further two years until 31 December 2003 during which time the Department of Enterprise, Trade & Employment would carry out an Equity Capital Survey to determine if there was under-provision of early-stage risk capital to small and medium enterprises. In addition, the aggregate amount that a company could raise under both schemes was increased from €317,500 to €750,000.

2.11 The scheme was reviewed again in 2003. The conclusion of that review was that there was a strong business case for extending the scheme to the end of 2006. In reaching this conclusion, the findings of the 2002 Equity Capital Survey conducted by the Department of Enterprise, Trade & Employment were taken into account. That survey highlighted that:

- small and medium enterprises found the raising of equity difficult;
- start-up companies were perceived as being unattractive to investors, high risk, and unable to provide the necessary collateral;
- small companies were still finding it difficult to attract equity funding, particularly for amounts less than €250,000;
- the BES was an important funding mechanism for indigenous industry.

2.12 In support of the case or extending both the BES and SCS beyond 31December 2003, account was also taken of findings from other research and of consultations with Enterprise Ireland and a number of representative bodies. All the organisations consulted stressed that they considered it essential that both schemes be continued.

2.13 In Budget 2004 the Minister announced that the scheme was being extended for three years to 31 December 2006 and that the company limit was being increased to €1 million, subject to a maximum of €750,000 in any one six-month period.

Development of the Seed Capital Scheme

2.14 The Seed Capital Scheme was introduced in the *Finance Act 1993* to encourage individuals currently or formerly in employment to establish new business ventures. An unemployed person or a person who was made redundant may also claim the relief. To qualify for a tax refund an individual must invest in his/her own business. The company must be engaged in BES type activities, e.g. manufacturing, software development, tourism projects.

2.15 Unlike the BES, the tax refund in the case of the SCS is based on earnings in previous years. It is not unusual for seed capital projects also to seek BES funds at the same time or, more usually, later on as the project develops, but the same overall company limit applies.

2.16 To qualify for the relief, applications must be approved by a certifying agency. The aim of such certification is to minimise any possibility of displacement.

2.17 In 1999 the Department of Enterprise, Trade & Employment undertook a review of the SCS. The review took the form of a survey of the businesses that had benefited from the scheme. The main conclusions drawn from the review were that:

- the SCS was a well focused tax incentive in that it provided Exchequer support at the very earliest stage in project development to individuals who wished to establish their own business enterprise;

- the scheme had been clearly successful in (a) helping to generate employment, and (b) assisting successful business ideas to get off the ground, which might not have succeeded in the absence of the scheme;

- the scheme was cost effective from the Exchequer's point of view. For a small outlay on a *per annum* basis the Exchequer was making an important contribution in assisting in the start up of many new business operations, a large proportion of them hi-tech operations;

- one of the principal reasons why the scheme had been successful was that the funding provided through tax rebates, although modest in amount, nevertheless facilitated the leveraging of additional funding from established financial institutions;

- the support under the scheme had been particularly important for indigenous start-up businesses commencing operations in the software and telecommunications areas;

- it was important that this scheme should continue for the future, as it was clearly a significant factor in assisting the start up of business ideas with potential, particularly in the hi-tech field, many of which would have had severe difficulty in becoming established without support from the scheme.

2.18 The scheme has been extended in line with the extensions to the BES.

Section 3 – Outline of the Current BES and SCS

Outline of the current BES

3.1 The Business Expansion Scheme is an incentive to private investors to invest long-term equity capital in companies, particularly new and smaller ones, operating in certain sectors of the economy, which would otherwise find it difficult to raise such funding.

- The BES is open to people who pay Irish income tax.

- The scheme allows an individual to obtain income tax relief on investments up to a maximum of €31,750 *per annum*. Relief is available at the investor's highest rate of income tax. An investor who cannot obtain relief on all his/her investment in a year of assessment, either because his/her investment exceeds the maximum of €31,750 or his/her income in that year is insufficient to absorb all of it, can carry forward the unrelieved amount to following years up to and including 2006 subject to the normal limit of €31,750 on the amount of investment that can be relieved in any one year.

- In order to qualify, investments must be in companies engaged in certain innovative and creative activities including those in the manufacturing, internationally traded services, tourism, certain music recording activities and research and development sectors.

- The investee companies must be unquoted (except in the case of companies listed on the Developing Companies Market).

- Investors must purchase new ordinary share capital in the company. Shares cannot carry any preferential rights. There must be no condition which would eliminate the investor's risk. The maximum investment by all investors in any one company or group of companies is €1 million, subject to a maximum of €750,000 in any one six-month period.

- In the case of a company engaged in the construction and leasing of an advance factory, however, the maximum investment in any one such company is €1.27million.[2]

- The maximum limit that a company may raise under the scheme is a once-off limit. Thus, once a company has raised up to the maximum limit, it may not raise any further funding under the scheme.

[2] An advance factory building is a factory building whose construction is promoted by a local community group and constructed without any prior commitment that a lease for its use will be entered into by any person. The promotion and creation of employment in its own locality must be the principle, or one of the principle, objectives of the local community group. Advance factories may not be located within 20 miles of Dublin and a maximum of 6 such factories may be approved each year.

- Relief can be claimed immediately in the case of established companies or after four month's trading in the case of new companies.

- If the company is not trading at the time the shares are issued, it must commence trading within two years of the share issue. If the company is mainly involved in research and development activity relating to the approved trade, it must commence trading within three years of the share issue.

- Shares must be held by the investor for a minimum period of five years.

3.2 The BES may also be availed of by companies to which the SCS applies, but the same overall maximum limit that a company may raise, whether under one or both of the schemes, applies.

3.3 Full details of the scheme are set out in Revenue Leaflet IT 55 which is available on the Revenue Commissioners website at www.revenue.ie.

Designated Investment Funds

3.4 Investment in a company may also take place by means of a Designated Investment Fund. A Designated Investment Fund is a fund which has been designated by the Revenue Commissioners in accordance with the rules laid down in Section 508 of the *Taxes Consolidation Act 1997*, as amended. Essentially, these rules ensure that the fund is properly established and audited in the interests of the investors. A designated fund comprises the subscriptions of a number of investors. The fund will be likely to invest in a number of companies. Broadly speaking, each investor will get a share in each company in proportion to the value his or her subscription bears to the total size of the fund.

3.5 Investing in a Designated Investment Fund allows an investor to spread his or her investment over a number of ventures and to have expert advice to appraise the relevant projects. A fee will normally be payable by the investor to the fund manager. In addition, an entrepreneur who seeks equity from a fund can concentrate on his or her venture rather than devoting time to persuading a number of investors to invest in his or her company.

3.6 Each fund must prepare a prospectus which must be approved by the Minister for Enterprise, Trade and Employment under Section 5 of the *Designated Investment Funds Act 1985* and which must include, *inter alia*, particulars of fees, remuneration or other charges to be levied in respect of the management of the fund. As with investments made on an individual basis, however, there is no guarantee that they will succeed and responsibility for the risk associated with the investment rests entirely with the investor. The prospectus must make this clear in a manner that is satisfactory to the Minister for Enterprise, Trade and Employment.

3.7 The role of the Revenue Commissioners is to (a) designate a fund if the Commissioners are satisfied that the fund meets the conditions set out above, and (b) ensure compliance with the requirements of the legislation, e.g. in relation to the qualifying activities carried out by qualifying companies in which funds are invested.

3.8 The Irish Financial Services Regulatory Authority (IFSRA) must approve fund managers in accordance with the *Investment Intermediaries Act 1995*.

3.9 Ultimate responsibility for assessing the *bona fides* of a particular fund rests with the investor.

Outline of the current SCS

3.10 The Seed Capital Scheme is aimed at employees, unemployed persons or those who have been made redundant and who are interested in starting their own business.

- An employee who leaves employment and invests by means of shares in a company which carries on a new business may claim a refund of income tax paid in previous years. An unemployed person may also avail of this facility.
- All the income tax paid over six years can be reclaimed, if the investment is sufficient.
- An individual can select the tax years for which to claim refunds from any or all of the six years prior to the year of investment. The investment must be claimed up to the extent of the individual's total income in each of the selected years, subject to a maximum of €31,750.
- For each of the selected years, the refund is limited to the tax paid, with an upper limit in any year of the tax paid on €31,750.
- The refund may be claimed immediately the company starts to trade.
- If BES relief has already been received for any of the six years selected the amount of the relief available in that year is the difference between €31,750 and the amount of the original BES investment.
- A refund may be obtained in this manner for two investments in the company made within a three year period. Both investments, however, must be made in the same company and both must be made on or after 2 June 1995. The individual's total investment is subject to an overall maximum refund of the tax paid on €182,240.

3.11 Full details of the scheme are set out in Revenue Leaflet IT 15 which is available on the Revenue Commissioners website at www.revenue.ie.

Section 4 – Cost and Take-Up of the Schemes

4.1 The latest available statistics from the Revenue Commissioners for investments approved under the BES and SCS and the cost to the Exchequer for the tax years since 1997/98 are set out below.

Business Expansion Scheme

4.2 Table 4.1 summarises the total amount approved each year under the BES, together with the estimated cost to the Exchequer, as well as the number of approved investments and investors.

4.3 In *Budget 1998* the aggregate amount a company could raise under the BES was reduced from €1.27 million (£1 million) to €317,500 (£250,000). This followed a period of growth in the cost of the scheme to the Exchequer, with a total amount of almost €118 million being approved in 1997/98 at a cost of over €56 million. In *Budget 2002*, following the review of the BES and SCS by the Department of Enterprise, Trade & Employment, the aggregate amount that could be raised was increased to €750,000. This amount was increased to the present limit of €1 million in *Budget 2004*.

Table 4.1: BES Investment – main features by year

Tax Year	Total Amount Approved	Estimated Exchequer Cost	No. of Approved Investments	No. of Investors
1997/98	€117.7m	€56.5m	556	4,187
1998/99	€68.3m	€31.5m	441	3,814
1999/00	€65.5m	€30.2m	459	4,078
2000/2001	€36.5m	€16.7m	269	2,035
2001*	€34.2m	€15.1m	246	2,015
2002	€47.6m	€20.2m	340	2,277
2003	€39.7m	€16.7m	274	2,052
2004	€50.1m	€21.1m	320	2,599
2005	€38.3m	€16.1m	253	1,650

4.4. Table 4.2 gives details of BES investments by size during this period. Just over half of companies were approved for amounts up to €250,000, while 32% were approved for amounts between €250,000 and €500,000, and 17% for amounts in excess of €500,000.

* Short tax year

Table 4.2: BES Investment by Size for the period 1997/98 to 6 April 2006∅

Amount Approved	No. of Companies	% of Total	Value of Investment	% of Total
€0 - €50,000	200	15	€5.6m	1
€50,001 – €100,000	205	15	€15.2m	4
€100,001 – €200,000	213	15	€31.2m	8
€200,001 – €250,000	79	6	€17.8m	4
€250,001 – €500,000	443	32	€143.0m	35
€500,001 – €1,000,000	161	12	€119.4m	29
>€1,000,000	63	5	€75.9m	19
Total	**1,364+**	**100**	**€408.1m**	**100**

4.5 Manufacturing accounts for the majority of BES investment in terms of both the number of companies involved and the total value of investment, followed by international services and tourism. Details of BES investment by sector are given in Table 4.3.

Table 4.3: BES Investment by Sector for the period 1997/98 to 2006 (6 April 2006)∅

Sector	No. of Companies	% of Total	Value of Investment	% of Total
Manufacturing	840	61	€248.2m	61
International Services	325	24	€90.3m	22
Tourism	159	12	€62.2m	15
Other	40	3	€7.4m	2
Total	**1,364+**	**100**	**€408.1m**	**100**

Seed Capital Scheme

4.6 Table 4.4 summarises the total amount approved each year under the SCS, together with the estimated cost to the Exchequer from 1997/98 to 2005. The total cost to the Exchequer during this period was just €14 million.

∅The information on the years 1997/98 to 1999/00 has been taken from a different information source than the tax cost information for technical reasons.

+ By the time the Department of Finance survey discussed in Section 5 was carried out later in 2006 the number had risen to 1,391.

Table 4.4: SCS amounts raised and Exchequer cost by year

Tax Year	Total Amount Approved	Estimated Exchequer Cost
1997/1998	€3.9m	€1.4m
1998/1999	€4.9m	€2.0m
1999/2000	€2.5m	€1.0m
2000/2001	€2.5m	€1.0m
2001*	€2.8m	€1.2m
2002	€3.4m	€1.4m
2003	€5.5m	€2.3m
2004	€7.7m	€2.7m
2005	€3.4m	€1.3m

Table 4.5: SCS Investment by Sector for the period 1997/98 to 2005

4.7 Table 4.5 gives details of companies benefiting from SCS by sector. As with the BES, manufacturing constitutes the biggest beneficiary of the SCS, with manufacturing companies accounting for an average of 47% of SCS approvals.

Tax Year	Manufacturing	Services	Tourism	Other	Total
1997/98	47	31	4	3	85
1998/99	58	37	4	1	100
1999/00	43	9	0	2	54
2000/01	24	15	5	3	47
2001*	27	19	0	0	46
2002	34	35	3	0	72
2003	29	58	0	2	89
2004	28	72	0	7	107
2005	20	30	0	7	57

* Short tax year

Section 5 – 2006 BES Survey

5.1 As part of the present review, the Department of Finance conducted a survey during Summer 2006 of 1,391 companies which had availed of the BES. There was a good response to the survey, with 491 companies out of the 1,391 surveyed (35%) responding[3]. Full details are set out in the Appendix.

Company Profiles

5.2 Of the companies which responded, 58% are categorised as engaged in manufacturing, 12% in tourism, 22% in international services and 8% as other.

- There is a good spread amongst the various manufacturing categories, although manufacture of food and drink, with 16%, is the most common.
- Over one third of the tourism companies come under the heading of hostels, camp sites, holiday centres.
- 73% of the international services companies come under the heading of computer services or software development.

5.3 The average number of years companies have been established is 3.5. The breakdown is as follows:

- Companies established less than 1 year: 1%
- Companies established between 1 and 5 years: 28%
- Companies established between 6 and 10 years: 42%
- Companies established between 11 and 15 years: 12%
- Companies established between 16 and 20 years: 10%
- Companies established more than 20 years: 7%

5.4 The average number of employees is 5.5. The breakdown is as follows:

- Companies with zero staff (mostly advance factories): 8%
- Companies with 1 to 5 staff: 37%

[3] Of the 1,391 companies surveyed, 149 are known to be in liquidation. A further 80 survey questionnaires were returned with notes to the effect that the companies were unknown at that addressed or had moved.

• Companies with 6 to 15 staff	24%
• Companies with 16 to 30 staff	17%
• Companies with 31 to 50 staff	9%
• Companies with over 50 staff	5%

5.5 63% of the companies have annual sales of less than €1 million. 16% have sales between €1 million and €2 million, while 21% have sales in excess of €2million.

5.6 56% of companies have export sales, with 25% exporting more than 50% of their sales.

5.7 75% of companies regard themselves as developing or growing or considering expansion.

Financing

5.8 In terms of money raised through the BES, almost three-quarters of the companies surveyed raised less than €500,000. However, 32% of companies required more than €500,000 worth of equity. 28% were successful in raising amounts in excess of this amount.

5.9 The most common other sources from which companies attempted to raise funds were through bank loans, other private investors and State grants.

Impact of the Scheme

5.10 The most common ways in which companies were affected by the BES were that they became more ambitious to grow and were able to launch new or improved products or services.

5.11 For those companies which could not raise all of the finance they had hoped to through the BES, the most common problem was working capital and cash flow constraints, followed by becoming more dependent on bank finance.

5.12 While fewer than half of the companies gave reasons why they were unable to raise the funding required from BES, of those which did the most common reason given was that companies were considered high risk by financial institutions and potential investors.

5.13 By far the most common action taken by companies which could not obtain all the funding they wanted from the BES was to obtain a bank overdraft or loan.

Performance of BES Investments

5.14 Many companies stated that it was too early to say what the return was on investment provided, with some companies saying they had not provided a return so far but that they intend to do so in the future. In total 59% of companies which responded on this issue indicated a return of 0%. On the other hand, returns on investments ranged up to and above 30%. Moreover, nearly 70% of companies said that, to the best of their knowledge, their investors are satisfied or very satisfied, while 55% considered that investments in their companies compared more favourably than, or about the same as, other investment opportunities.

Future Requirements of Companies under the Scheme

5.15 Over 90% of companies said that the scheme should be extended and that both the overall company limit and the individual annual investor limit should be increased. A large number of respondents (62%) saw a requirement for additional equity capital under the BES in the next three years. 9% of these felt that they will need between €1 million and €2 million, while 10% want in excess of €2 million.

Section 6 – Options for the Future of the Schemes

6.1 There is considerable support for the continuation of the schemes, including from:

- Enterprise Ireland;
- the Small Business Forum;
- the Department of Arts, Sport and Tourism;
- the Irish Software Association;
- IBEC;
- the Wind Energy Association .

In addition, almost all companies surveyed expressed the view that the schemes should be extended and that both the overall company limit and the individual annual investor limit should be increased.

6.2 A number of factors need to be taken into account when considering whether or not the schemes should be extended beyond their expiry date of 31 December 2006:

- the importance of the small and medium enterprise sector in Ireland to the overall success and continuing growth of the Irish economy in terms of output, competitiveness, employment, etc. The Small Business Forum found that small businesses were a key element of the Irish economy and were important for a variety of reasons. Its report showed that 97% of businesses operating in Ireland today employ fewer than 50 people. A quarter of a million small businesses in Ireland employ a total of 770,000 people in total, which represents more than half of the total private sector, non-agricultural work force;

- commitments in the ***Towards 2016*** partnership agreement in relation to Enterprise, Innovation & Productivity, Science, Technology & Innovation and other areas, particularly the Manufacturing Sector. In this regard, the Government, employers and trade unions acknowledged the critical role played by manufacturing in the development of the Irish economy and, recognising the challenges facing the sector at present, and that all three parties have a role to play in meeting these challenges, committed themselves to taking the measures required to ensure that manufacturing continues to play a central role in the Irish economy in the future. Manufacturing represents the largest sector that avails of BES funding with 61% of the total number of companies investing over the period 1997/98 to 2005 being classified as manufacturing.

- the European Commission's policy of encouraging Member States to develop policies to encourage investment in risk capital for small and medium enterprises, as set out in the *Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium Sized Enterprises*, and the philosophy underlying the strategy for developing the EU risk capital market, which attributes primary importance to an environment that is favourable to creating and sustaining new and innovative business. The schemes accord with the Lisbon Agenda, and in particular guideline No. 15 which is aimed at promoting a more entrepreneurial culture and creating a supportive environment for small and medium enterprises. Specifically, Member States are encouraged to improve access to finance, in order to favour the creation and growth of small and medium enterprises, in particular micro-loans and other forms of risk capital.

6.3 There is a range of evidence highlighting market failure in the provision of equity capital available to small and medium enterprises. Such companies continue to report difficulty in accessing venture capital at the start-up and development stages. In particular, feedback from the survey carried out by the Department of Finance as part of the present review indicates that many companies believe that the BES and SCS have proved vital in providing the necessary risk capital required to establish small and medium-sized companies and in developing such companies already established in Ireland. Many companies assert that they would not have been able to raise the equity capital elsewhere and consequently would have failed without access to BES and SCS funding. This is indicative of a market failure in equity investment for smaller businesses.

6.4 In June 2006 the Department of Enterprise, Trade & Employment commissioned Forfás to conduct a survey of small and medium enterprises in order to establish the conditions they face in accessing external finance and equity capital. The *Survey of SME Finance/Equity* indicates that, while the climate for raising finance/equity has improved, it is still more difficult to raise finance/equity for smaller companies than for larger ones, and for start-up and development phase companies than for companies in other stages of development.

6.5 The findings of the PWC Report *Strategic Advisory Services – Enterprise Ireland Seed and Venture Capital Funds Programme 2006* recognised that there is still an equity gap for SMEs at the very early stage. This study went on to say that such a gap might become more pronounced should the State cease to intervene. According to the report it is undoubtedly true that raising finance is a difficult and time consuming business for many young firms with an insufficient commercial track record or status, due to their brief histories, and evidence suggests that access to finance remains a frequently cited issue for small businesses.

6.6 Findings from a review by Enterprise Ireland of a number of High Potential Start-Ups which was carried out as part of the present review of the schemes indicate that higher levels of growth in employment, exports and turnover are evident where companies have raised BES funding compared with companies that have not raised BES funding.

6.7 It should be borne in mind that the annual cost of both schemes to the Exchequer, in an overall context, is not hugely significant given the potential return to the Irish economy from the companies involved. The cost of both schemes combined was in the region of €17.4 million in 2005.

6.8 It must be recognised, however, that extending the schemes will give rise to a cost to the Exchequer. Moreover, it could be argued that extending the schemes should be resisted on grounds of equity, as it will chiefly be of benefit to those on high incomes seeking to reduce their tax liability.

6.9 On balance, however, and taking account of the arguments and findings put forward above, it is clear that there is a strong case that the schemes should be extended beyond 31 December 2006.

6.10 Should a decision be taken to extend the schemes beyond 31 December 2006, a number of questions arise:

(i) For how long should the schemes be extended?

(ii) Should the overall company limit of €1 million per company be increased?

(iii) Should the individual annual investor limit of €31,750 be increased?

For how long should the schemes be extended?

6.11 In the past, when both schemes have been renewed, extensions have generally been for periods of two to three years. However, it has been argued that three years is too short a timeframe and that allowing a longer extension of the schemes would help provide more certainty as to the future of the schemes and make them more attractive to investors, companies and those seeking to set up designated BES funds. The schemes have been regularly reviewed and each time the conclusion has been the same – a significant market failure exists due to the high risk associated with start-up business and this results in persistent difficulties in securing early stage capital; this market failure justifies continuing fiscal support.

6.12 An extension of five years to the end of 2011 would give improved certainty to all those involved without the need for the Exchequer to enter into a seven year commitment. A review could then take place after which an extension of a further two years to 2013 might be warranted.

6.13 The Department of Enterprise, Trade & Employment, Enterprise Ireland, the Small Business Forum and a number of other representative organisations and individual companies favour extending the schemes by seven years. This would be in line with the *Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium Sized Enterprises* which apply from 1 January 2007 and which run for seven years until 31 December 2013. The additional years would also give increased certainty. If this option is chosen, a review might be appropriate after five years.

Should the overall company limit of €1 million per company be increased?

6.14 There are a number of companies which have already raised up to the €1million limit and could benefit from further BES funding. Raising the limit may also encourage further economic activity and also encourage designated funds to re-enter the market for providing funds for companies. The number of designated funds has been decreasing in recent years. Designated funds have the advantage of spreading the risk for investors as the fund will be likely to invest in a number of companies. However, there are significant costs involved in establishing and managing such funds; a higher company limit (and longer timeframe for the schemes) may serve to balance these costs.

6.15 There have been calls from a variety of areas to increase the overall company limit from the current €1 million. Proposals range from €1.5 million to €2 million, with one organisation seeking an increase to €5 million.

6.16 As already stated, the purpose of the BES and SCS is to assist small and medium enterprises in raising long-term risk capital, particularly companies at the start-up and early development stage. The focus of the schemes may, however, change if the limit is increased significantly. While an increase in the range of €1.5million to €2 million would not raise significant concerns, any higher increase might incentivise less risk-based trades to find ways of availing of the schemes, particularly if combined with a much higher investor limit. There is then a danger that this could lead to the perverse result that longer and better established firms would use the BES to attract financing that would otherwise go to smaller, less well established businesses.

6.17 To date the European Commission has not insisted on Ireland meeting the cumulation of aid rules set down in the *Communication on State Aid to Risk Capital* (SARC)[4]. The only condition is that a company cannot raise more than €750,000 of the permitted €1 million in a six-month period. The revised *Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium Sized Enterprises* allow for a company to raise up to €1.5 million in a twelve-month period. However, it is understood that if the scheme were to continue, even without any changes, the Commission would seek the application of the cumulation rules. This would affect companies raising funds under the BES which also receive funding from Enterprise Ireland and other sources. Rules to allow for cumulation would be required. Cumulation would have the impact of restricting the amount of Exchequer resources that a company might avail of, be it by way of grant or direct tax benefit. As companies eligible for grant assistance are likely to continue to avail of such grants in the first instance, cumulation restrictions are most likely to make the BES and SCS less attractive. It will also reduce the cost of the scheme to the Exchequer (compared to one without cumulation).

6.18 In addition, while the schemes could apply to both small and medium-size firms in the start-up phase, the European Commission may insist that the schemes apply in the development phase to medium-size firms in the assisted areas only. If,

[4] OJ C235, 21.8.2001, p. 3.

however, market failure in relation to equity financing of medium size firms in non-assisted areas can be demonstrated, to its satisfaction, the Commission may not insist on this. In this regard the Forfás *Survey of SME Finance/Equity* provides evidence that confirms that access to finance is still an issue for medium-sized companies in the Dublin/ Mid-East area.

6.19 Statistics available from the Revenue Commissioners continue to show that the majority of companies raised well below the €1 million limit. Nevertheless, the survey undertaken by the Department of Finance shows that 28% of investments are for amounts in excess of €500,000 and 6% in excess of €1 million. As mentioned earlier, 62% of companies surveyed have indicated they will need access to equity capital in the form of BES in the future (if the scheme continues). Of these, 19% have indicated they wish to raise in excess of €1 million while an additional 10% wish to raise in excess of €2 million.

6.20 The Government is committed to supporting the development of renewable energy where possible. The Minister for Communications, Marine & Natural Resources has raised the Government's target of renewable generating capacity to 15% by 2010. One way of reaching this target would be through the BES and SCS by establishing a separate overall higher company limit for renewable energy companies. A separate limit could possibly be justified on the grounds that there are significant set-up costs for such companies compared with other manufacturing activities or service-type activities. The Irish Wind Energy Association has highlighted the complexity of developing wind energy projects, not just in terms of securing planning permission but also a connection agreement and a power purchase agreement. It has sought a limit of €2 million.

6.21 The evidence points to the need for an increase in the lifetime company limit generally to about €1.5 million. Indeed, there may be justification for a limit of €2 million to accommodate those companies which have expressed an interest in raising up to that amount. In the case of renewable energy, supporting this sector as discussed above could be done by a special separate company limit of €2 million.

6.22 The Revenue Commissioners have estimated that the cost of increasing the lifetime company limit to €1.5 million would be in the region of €8million in a full year. Increasing the limit for renewable energy companies alone to €2 million would add €1 million to the cost, while increasing the limit for all companies to €2 million would cost about €15 million in a full year.

Should the individual annual investor limit of €31,750 be increased?

6.23 There have been calls to increase the current annual investor limit of €31,750 which has not been increased since the BES was introduced in 1984. Proposals range from €50,000 to €250,000.

6.24 In 2006 there was one designated fund only operating in the Irish market. The costs involved in operating funds, together with the series of reductions in the company limit, may have influenced the development of this situation. It has been argued by the enterprise development agencies that increases in the investor limit and the company limit will result in an increase in the number of fund providers; this would be a positive development bringing welcome competition, driving higher risk investments and lowering the cost of service delivery by the funds for companies.

6.25 It has also been argued that the introduction of the new restriction on the ability of high income individuals to reduce their taxable income, which applies with effect from 1 January 2007, should mean that the current low limit on the BES and SCS is no longer necessary and that the Exchequer position would be protected even with an annual investor limit of €250,000. Against that, it can be argued that such a high investor limit, in conjunction with a higher company limit, could give rise to tax planning.

6.26 The current limit is a common limit on passive investment that is a feature of many tax schemes, including property based reliefs and other schemes. However, it is accepted that these schemes vary widely in scope and risk profile. Since the common limit was set in December 1997 it has restricted the potential of high earners to reduce effective tax rates on their employment income. Increasing the current annual investor limit for the BES would, in all probability, lead to demands to increase the limit in other schemes, with significant cost implications as a consequence. It has been argued, however, that such demands should be resisted on the grounds that a higher limit for the BES and SCS can be justified because the risk involved for investors is much higher than in the property based and other schemes.

6.27 It is true that the value of the investor limit has been eroded over time and there is a case for significant increase. Increasing the limit to more modern day levels would reduce the number of investors that a company must attract to raise its target funding and thereby reduce the administrative burden on the company in doing so. Companies would be able to concentrate more on their trade than on raising funds. This in turn should be of overall benefit to the Irish economy.

6.28 The enterprise development agencies consider that a significant amount of investment is being undertaken by a distinct class of investor in many areas but not the BES scheme. In general they consider that high net worth individuals have a greater appetite for risk, while the current low personal BES and SCS investment limit is arguably more attractive to middle income investors who are much more risk averse and who tend to invest any higher amounts in more asset-backed investments. Increasing the limit will, in the opinion of the agencies, attract these high net-worth individuals to the schemes.

6.29 On the basis of these arguments, a significant increase in the annual investor limit seems justified. Any new limit should apply only to the BES and SCS, however, as the risk involved for investors is much higher than in property based reliefs and other schemes.

6.30 If the limit were increased by reference to movements in the Consumer Price Index since 1998, a limit of approximately €41,000 would apply. An increase to about €65,000 would not only double the existing limit but would also be significantly in excess of an increase in line with the CPI. An increase to about €150,000 could be regarded as bringing the limit up to modern day requirements. While there have been calls for increases to levels approaching €250,000, there is a danger that, in combination with a substantial increase in the company limit, this would give rise to tax planning and potential for abuse.

6.31 The Revenue Commissioners have estimated that the cost of increasing the investor limit to €65,000 would be in the region of €5 million. Increasing the limit to €124,000 would cost about €9 million, while an increase to €150,000 would cost about €10 million. An increase to €250,000 would cost in the region of €12 million.

Conclusions and Recommendations

There is a strong case that the BES and SCS should be continued given:

- the clear market failure in providing equity capital for small firms in their start up and early development phase;

- the evidence of how vital the schemes have been in the past for such firms and the continuing needs in this regard;

- the potential return to the economy from indigenous Irish companies;

- the clear support for continuation from a large number of representative and other bodies in the public and private sector.

It is recommended that:

- an extension of seven years to the end of 2013 be granted. This would give improved certainty to all those involved. A review could take place after five years;

- the lifetime company limit be increased to between €1.5 million and €2 million, having regard to the needs of those companies who have already raised close to the limit as well as the renewable energy sector;

- the annual investor limit be increased significantly. Any new limit should apply only to the BES and SCS schemes as the risk involved for investors is much higher than in the property based reliefs and other schemes.

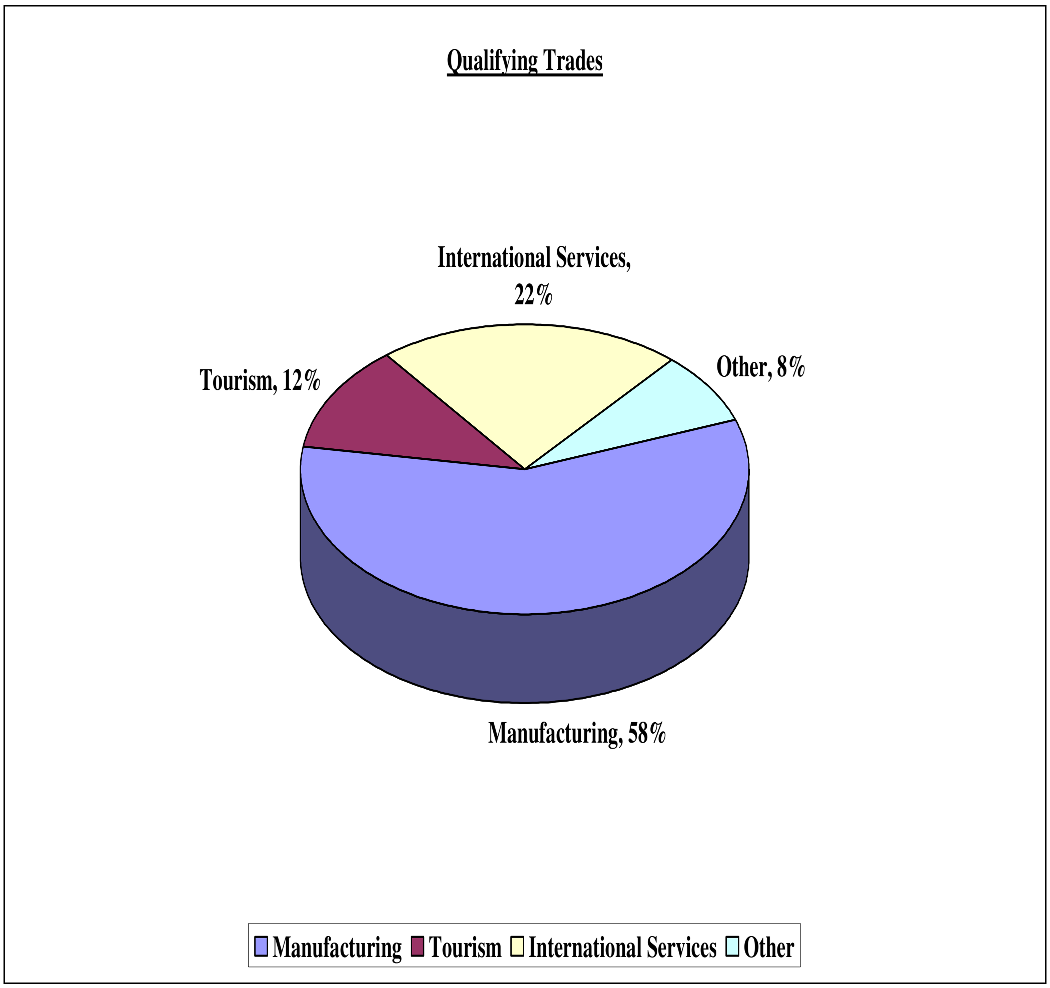
Appendix – Results of 2006 BES Survey

During Summer 2006 the Department of Finance carried out a survey of 1,391 companies that had availed of the Business Expansion Scheme since 1997. Of the companies surveyed 491 (35%) responded. The results of the survey are set out below.

Not all questions were answered by all companies. Accordingly, the details of responses to the various questions in the survey are expressed as a percentage of the number of companies who responded.

Part 1: Profile of the Company

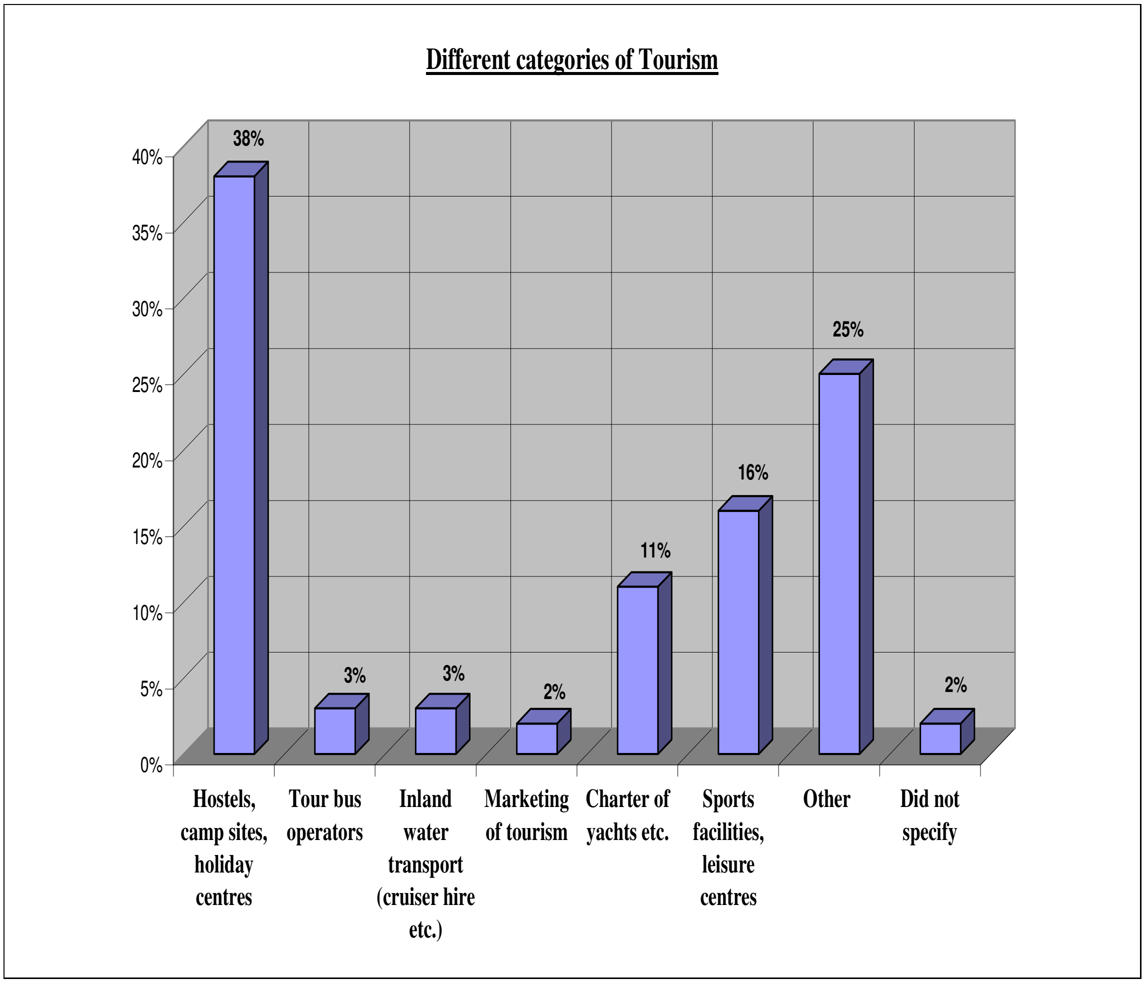
Question 1: Under which qualifying trade did your company qualify to raise BES investment/funding?



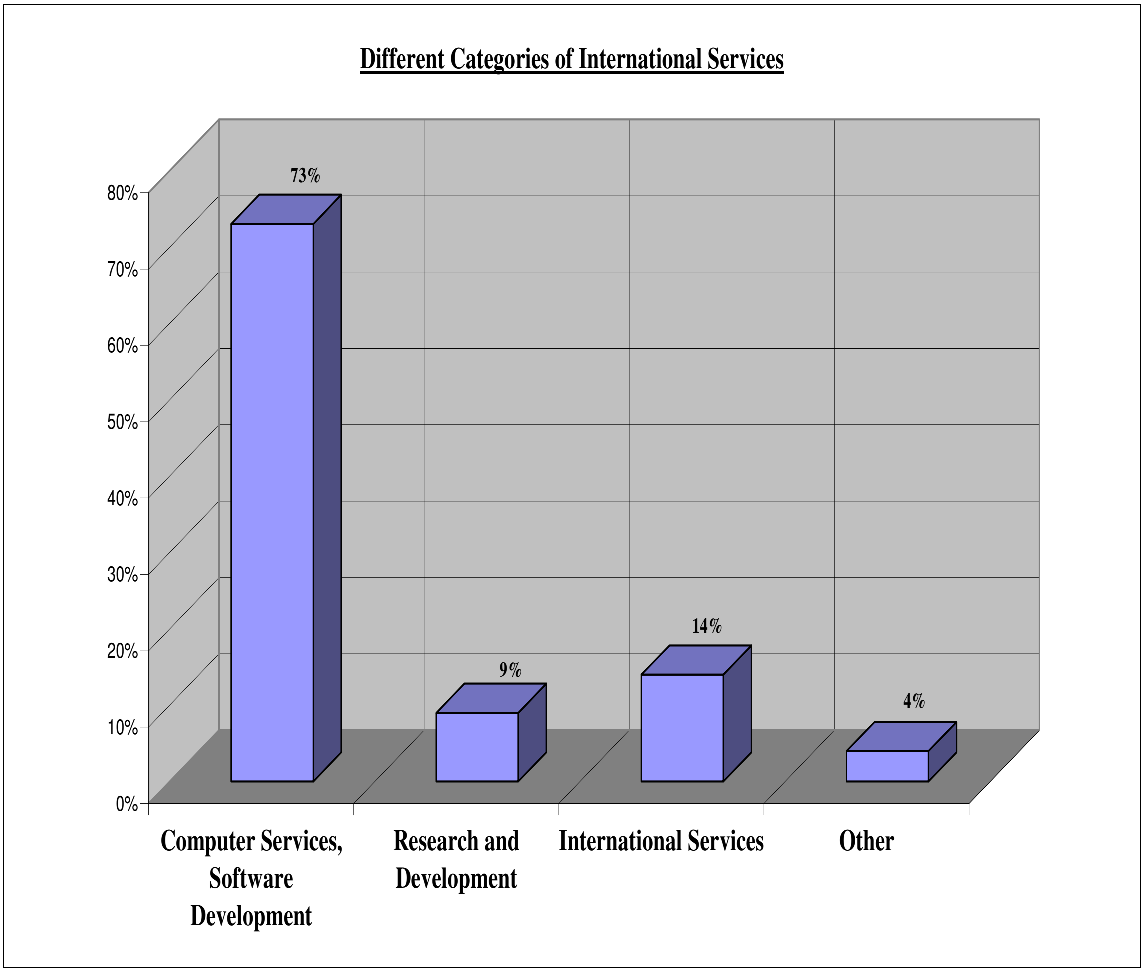
Question 2: If your company qualified under the category of "Manufacturing", which of the following most appropriately describes the activity carried out by your company?

Options	% of Companies
Manufacture of non-metallic mineral products	1%
Manufacture of chemicals	4%
Manufacture of metal articles (furniture etc)	8%
Mechanical engineering	5%
Electrical engineering	2%
Instrument engineering	2%
Manufacture of food and drink	16%
Manufacture of textiles	1%
Manufacture and process of wood and timber	9%
Manufacture and process of rubber and plastics	4%
Manufacture of medical devices	4%
Manufacture of other goods	12%
Advance factories	4%
Other	22%
Did not specify	6%

Question 3: If your company qualified under the category of "Tourism" which of the following most appropriately describes the activity carried out by your company?



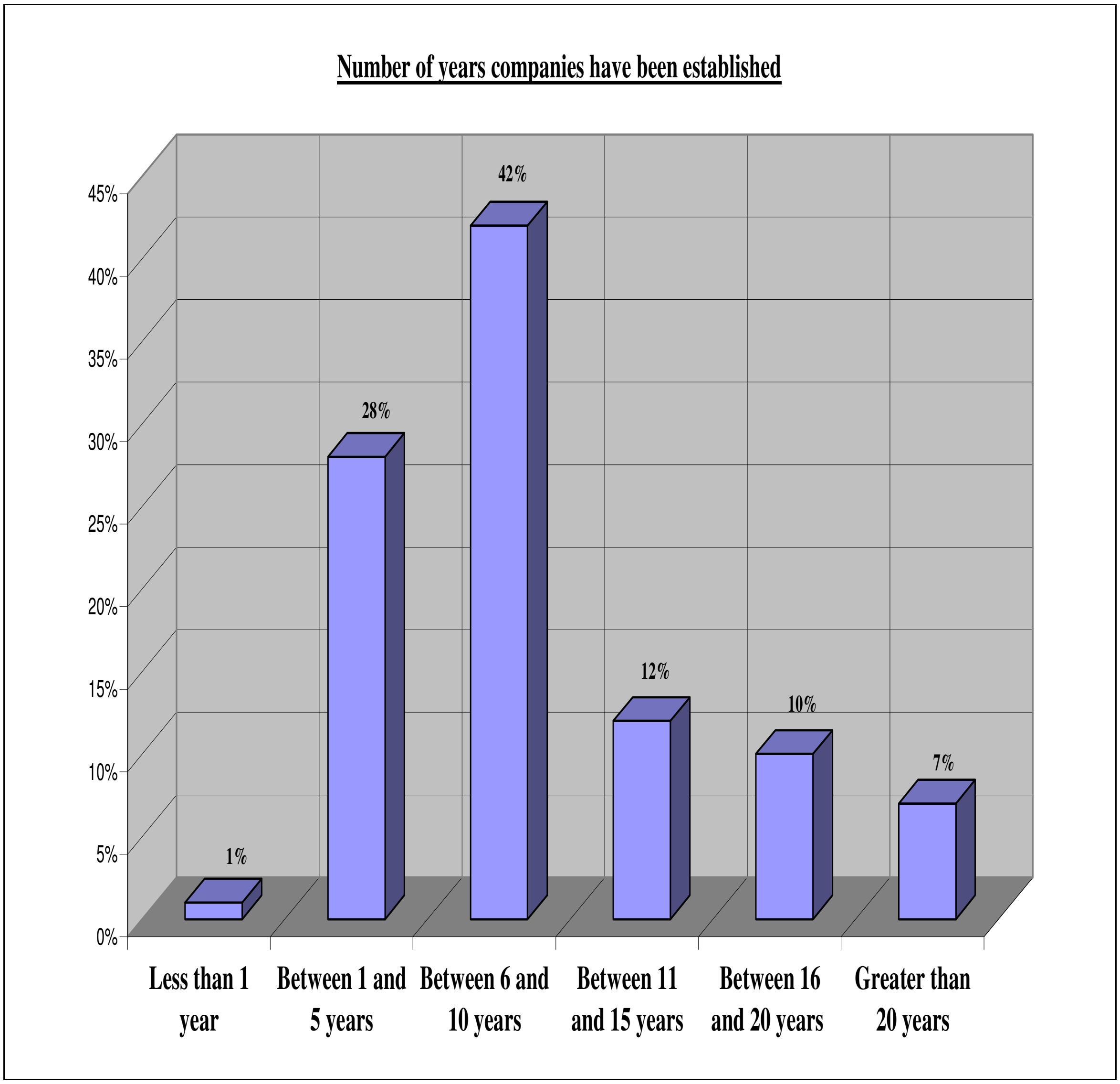
Question 4: If your company qualified under the category of "International services", which of the following most appropriately describes the activity carried out by your company?



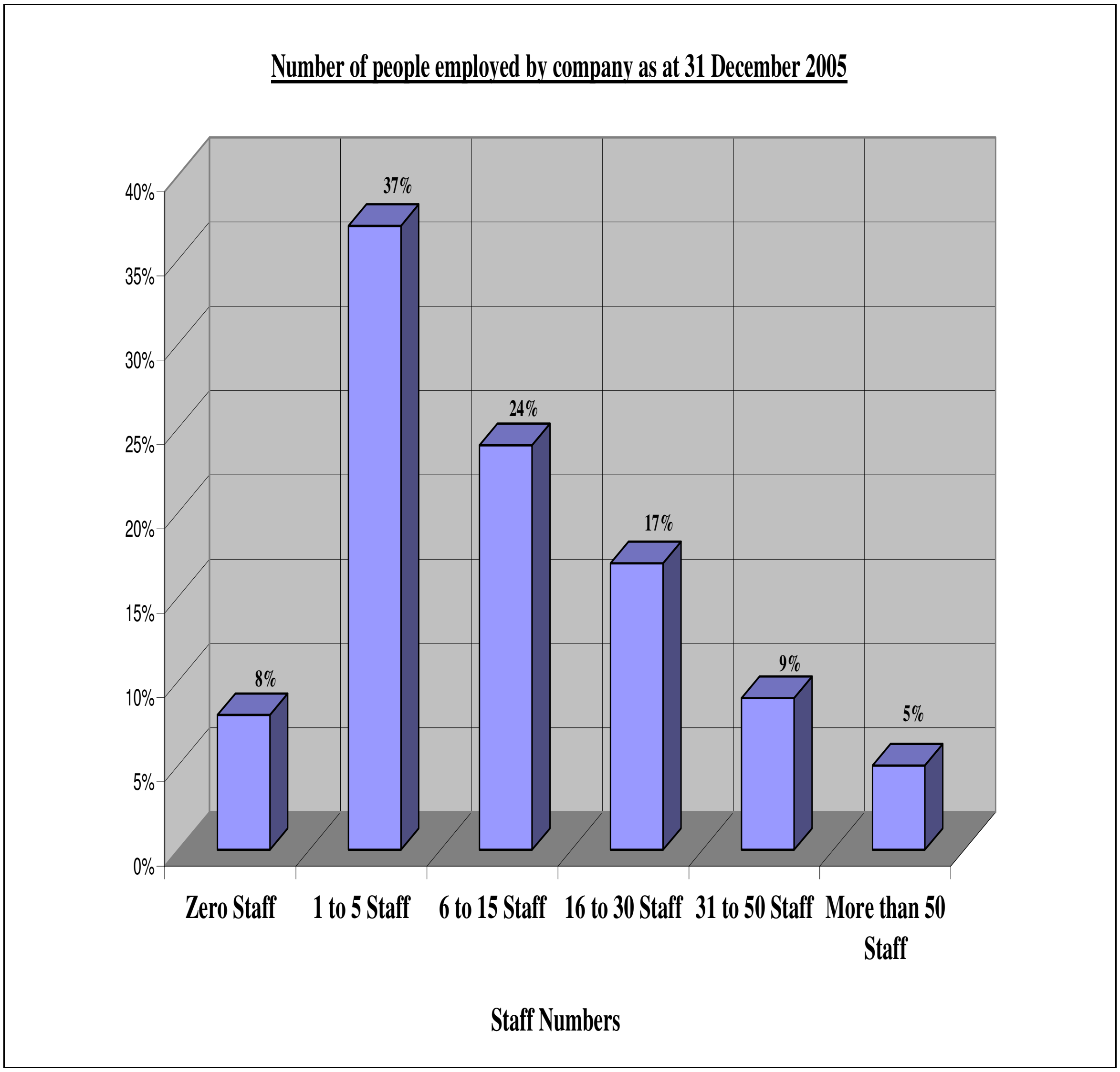
Question 5: If your company applied under the category of "Other", how would you describe the activity carried out by your company?

Only 40 companies (3%) responded under this heading. The majority of activities listed were more appropriate to the categories of manufacturing, tourism and international services.

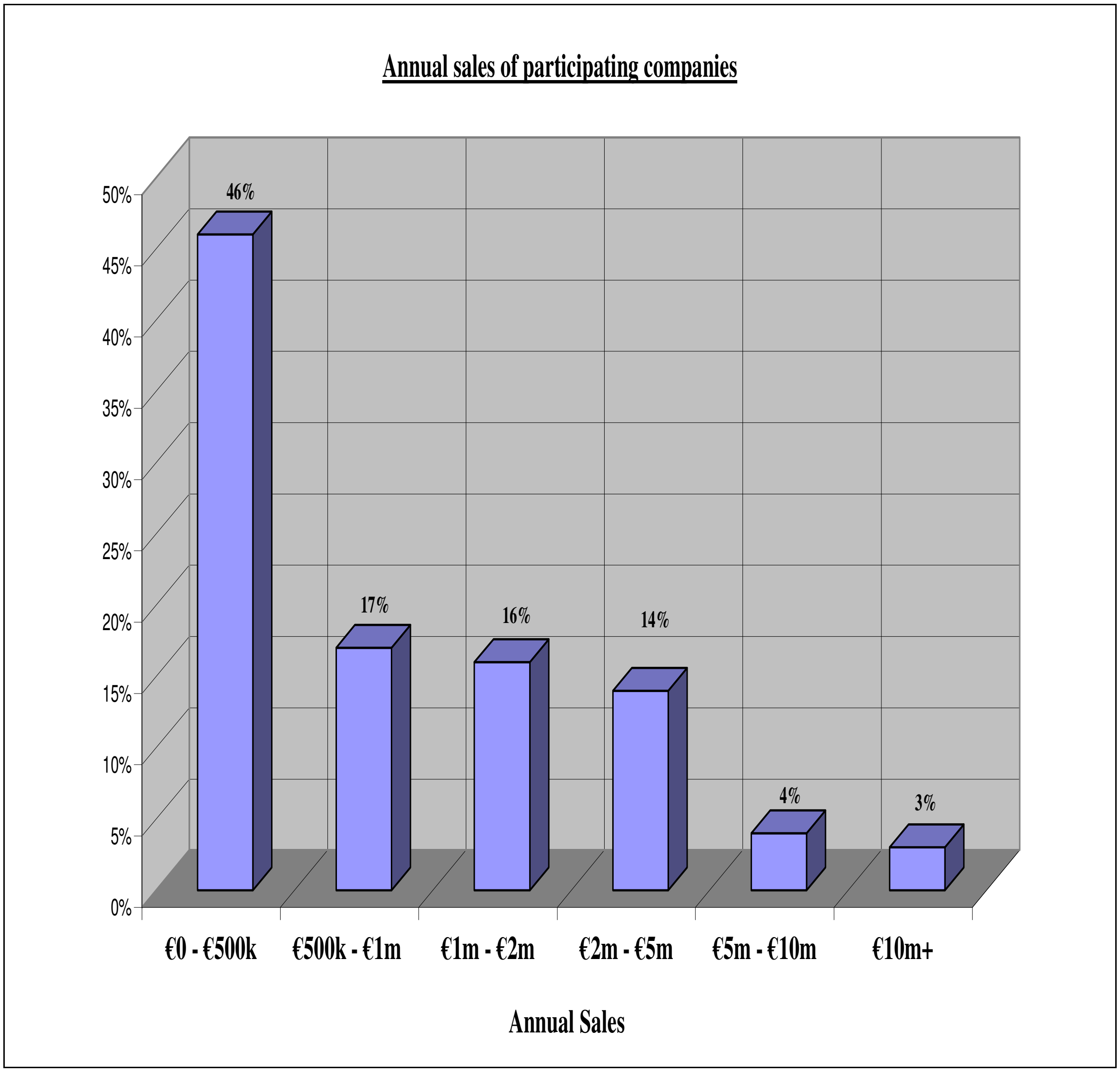
Question 6: How many years has your company been established?



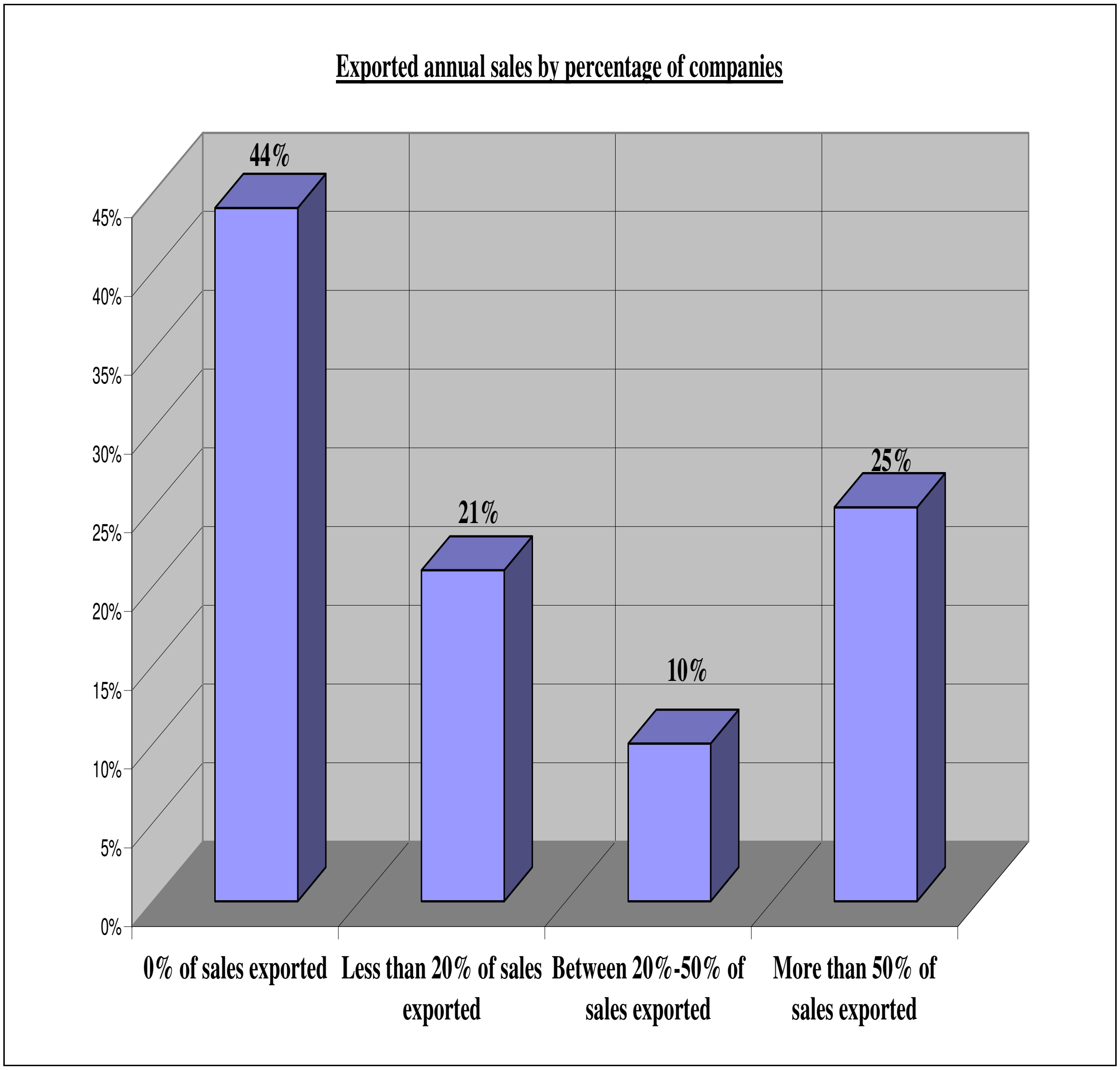
Question 7: How many people were employed in your company as at 31 December 2005?



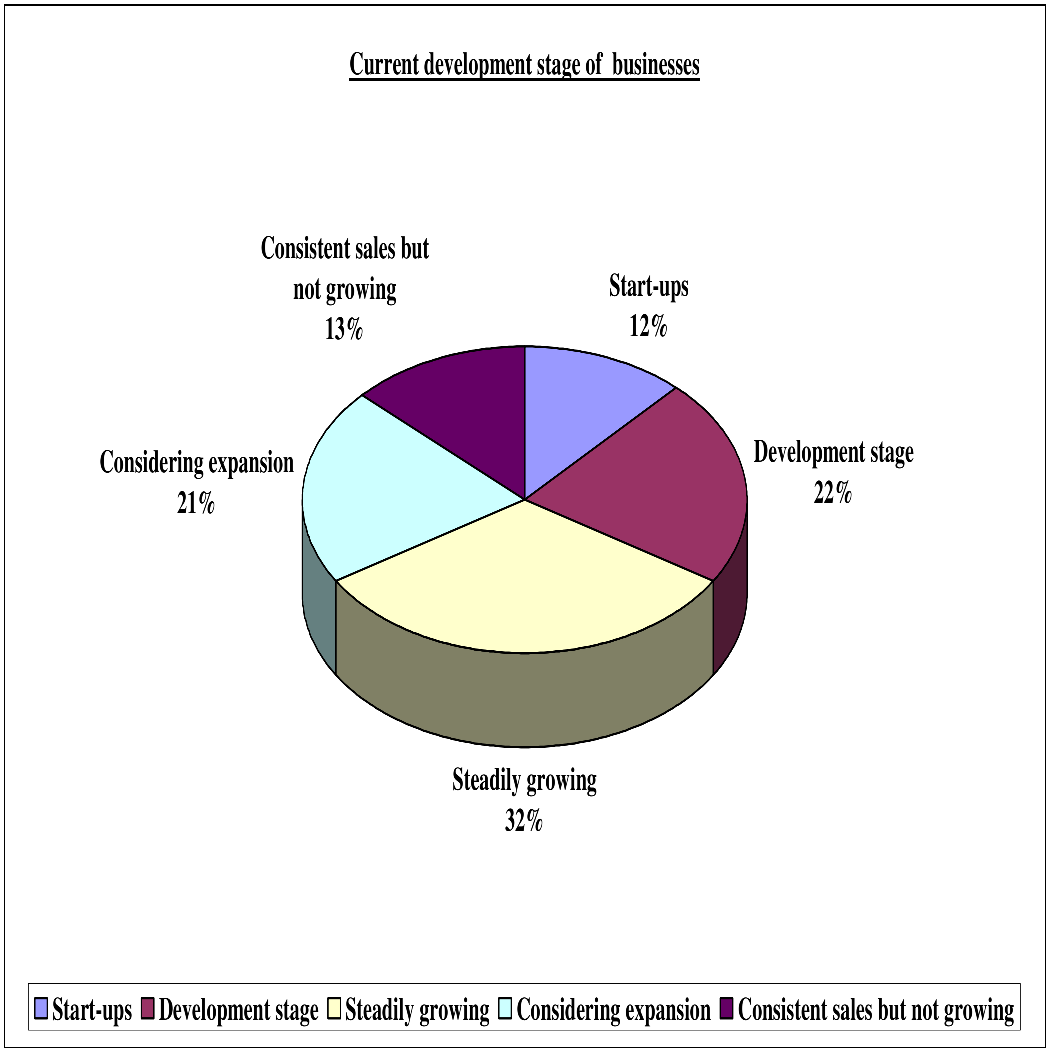
Question 8: What were the annual sales of your company in 2005?



Question 9: What percentage of your annual sales do you export?

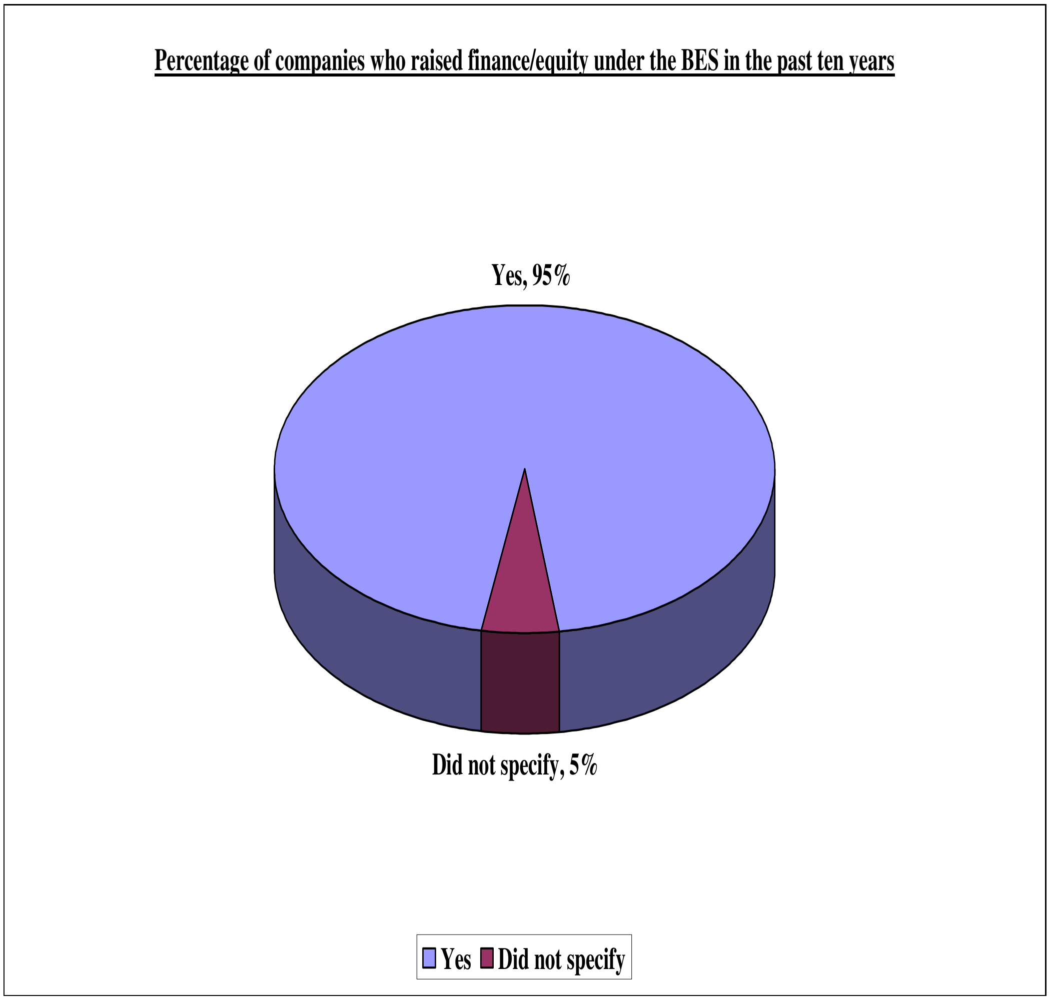


Question 10: Which of the following would best describe the current development stage of your business?

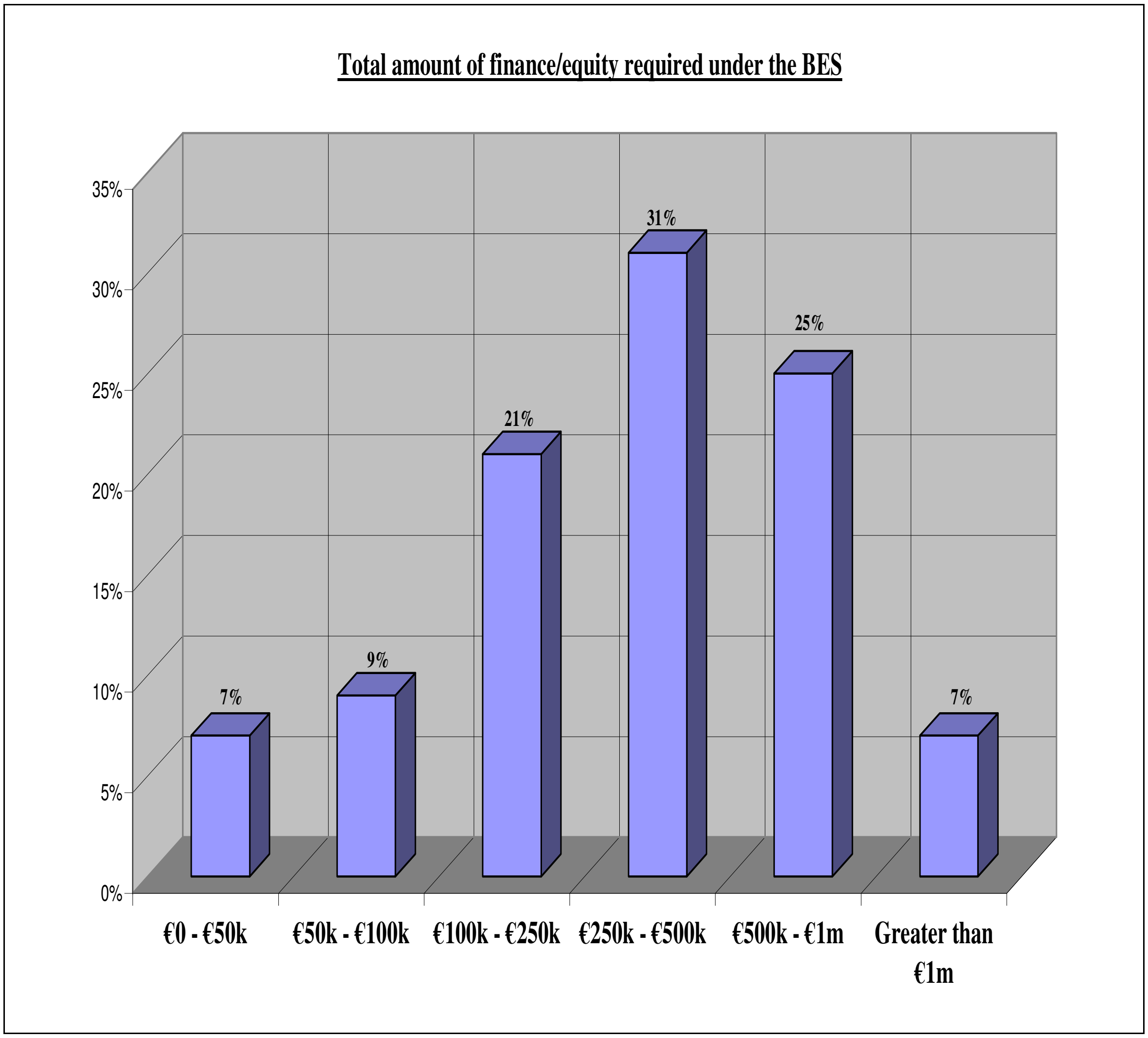


Part 2: Financing

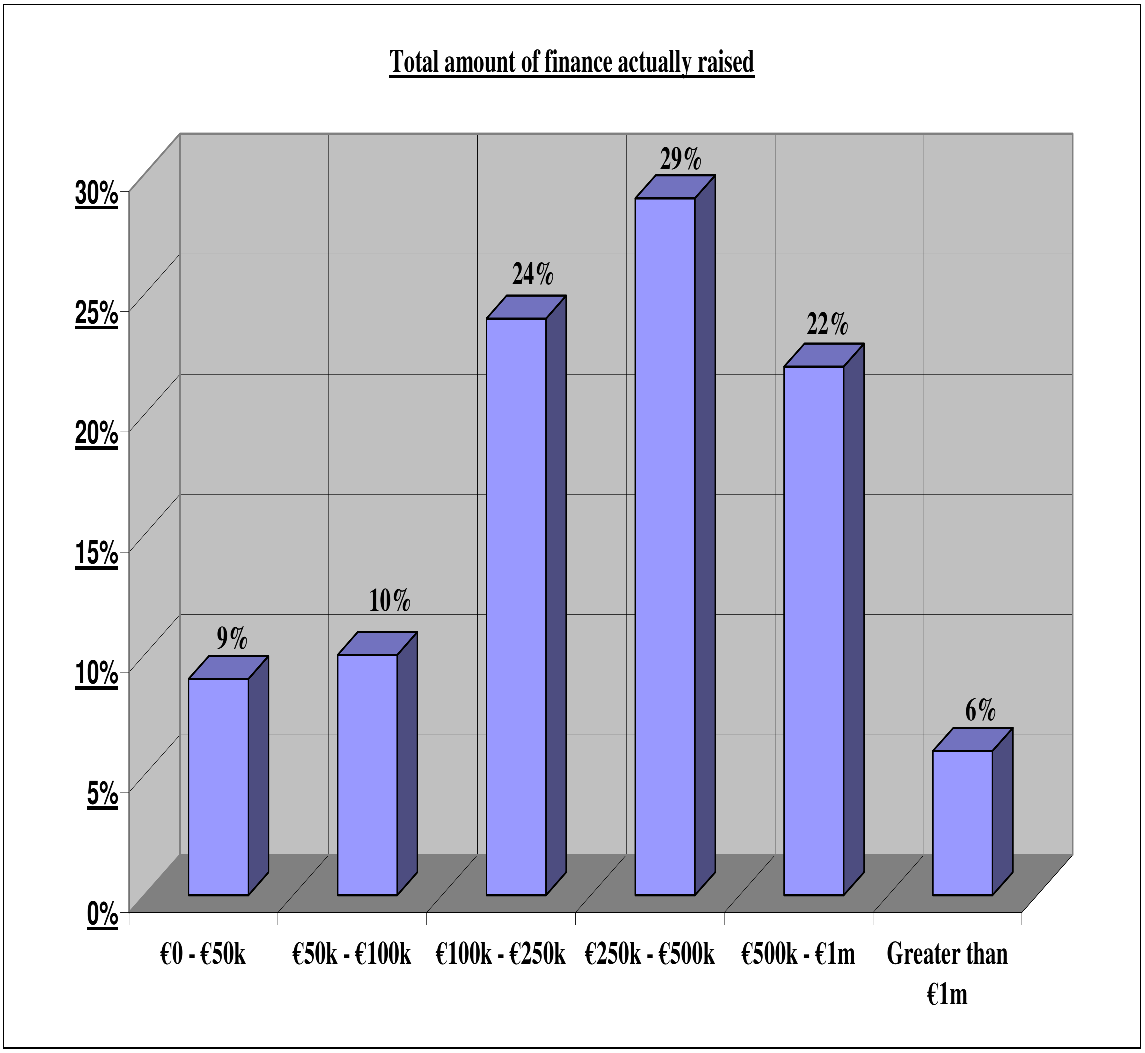
Question 11: Did your company raise finance/equity under the BES in the past ten years?



Question 12(i): If yes, what was the total amount of finance /equity required under the BES?



Question 12(ii): What was the total amount actually raised?



Part 3: Impact of the Scheme

Question 13: In addition to the BES, from which of the following sources did you attempt to raise/actually raise funds?

Respondents were offered a range of choices and asked if (a) they had attempted to raise finance, (b) had actually raised finance, and (c) what percentage of the total finance required had been raised from each source. The options offered were the Seed Capital Scheme, Seed Capital Venture Funds, family and friends, other private investors (including directors' loans), leasing/hire purchase, State grants, bank loans/mortgage/overdraft.

The most common sources from which companies attempted to raise funds were banks loans, other private investors and State grants.

Question 14: Which five of the following options in your opinion are the most important in describing the ways in which your company has been changed or affected as a result of raising finance through the BES?[5]

Options	% of Companies
Became more ambitious to grow	52%
Increased company workforce	40%
Strengthened management team	21%
Improved quality of products/ services	40%
Invested more in R&D	34%
Launched new /improved products/services	47%
Increased capital expenditure	39%
Changed/improved marketing activities	27%
Bought in additional expertise	16%
Improved efficiency in other ways	16%
Innovated in other ways	7%
Freed up finance for other development	25%
Improved skills of non-management workforce	5%
Levered in further development finance	21%
Acquired intellectual property to exploit	4%
Reduced costs	14%
Reduce company's debt	19%
Other	7%

[5] While companies were asked to rank their choices 1 to 5 in order of preference, many simply ticked five boxes.

Question 15 (i): If you did not raise all of the finance/equity required under the BES, in what way did that impact on the development plans of your firm?

Affects	% of Companies
Unable to finance R&D	13%
Unable to update technology/equipment	12%
Unable to finance the purchase of land and buildings	7%
Unable to invest in marketing and advertising	14%
Unable to hire new employees	15%
Working capital and cash flow constraints	30%
Became more dependent on bank finance	25%
Had to find replacement financing elsewhere	22%
Other	2%

Question 15(ii): If you failed to raise BES finance/equity, which of the following describe the reason you were unable to raise the finance /equity?

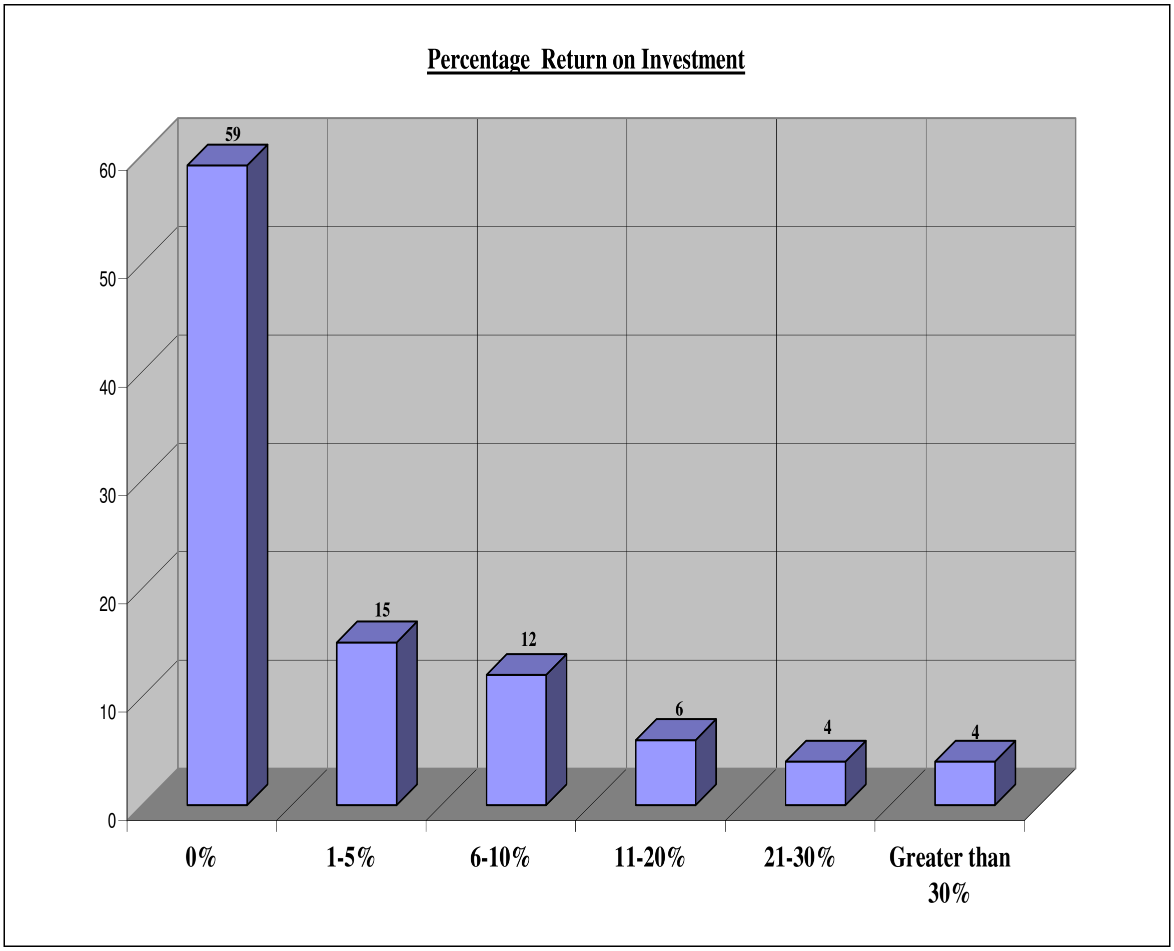
Options	% of Companies
Lack of collateral requirements	5%
Considered high risk by financial institutions and potential investors	15%
Lack of network with potential investors	6%
Unclear business plans	1%
Lack of track record	8%
Amount of finance/equity not attractive to investors	7%
Other	2%

Question 16: What other action did your company take?

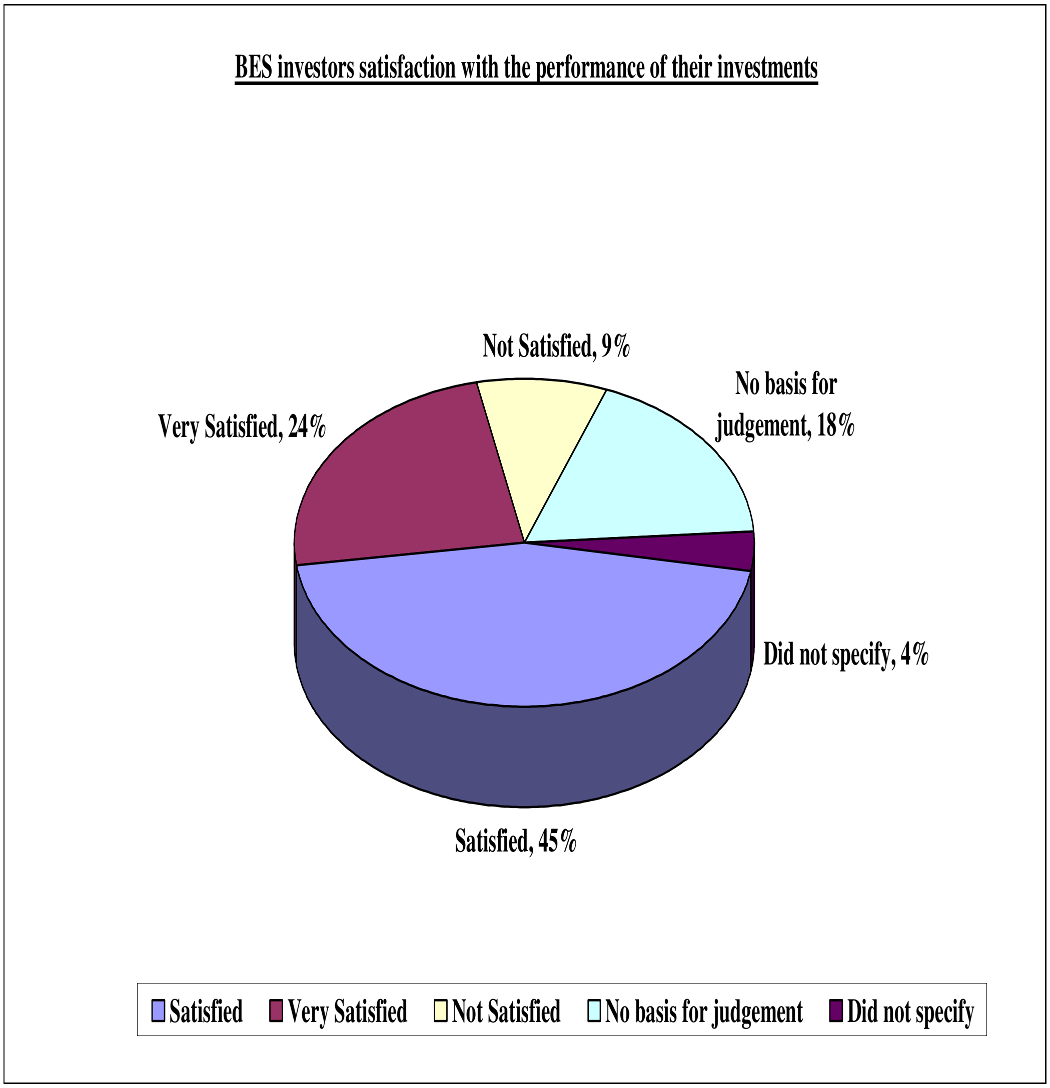
Options	% of Companies
Obtained bank overdraft or loan	46%
Sourced external funds /other investment	17%
Used non-BES private investment	22%
Tapped other sources of venture capital	5%
Used business angels	5%
Other	5%

Part 4: Performance of BES Investments

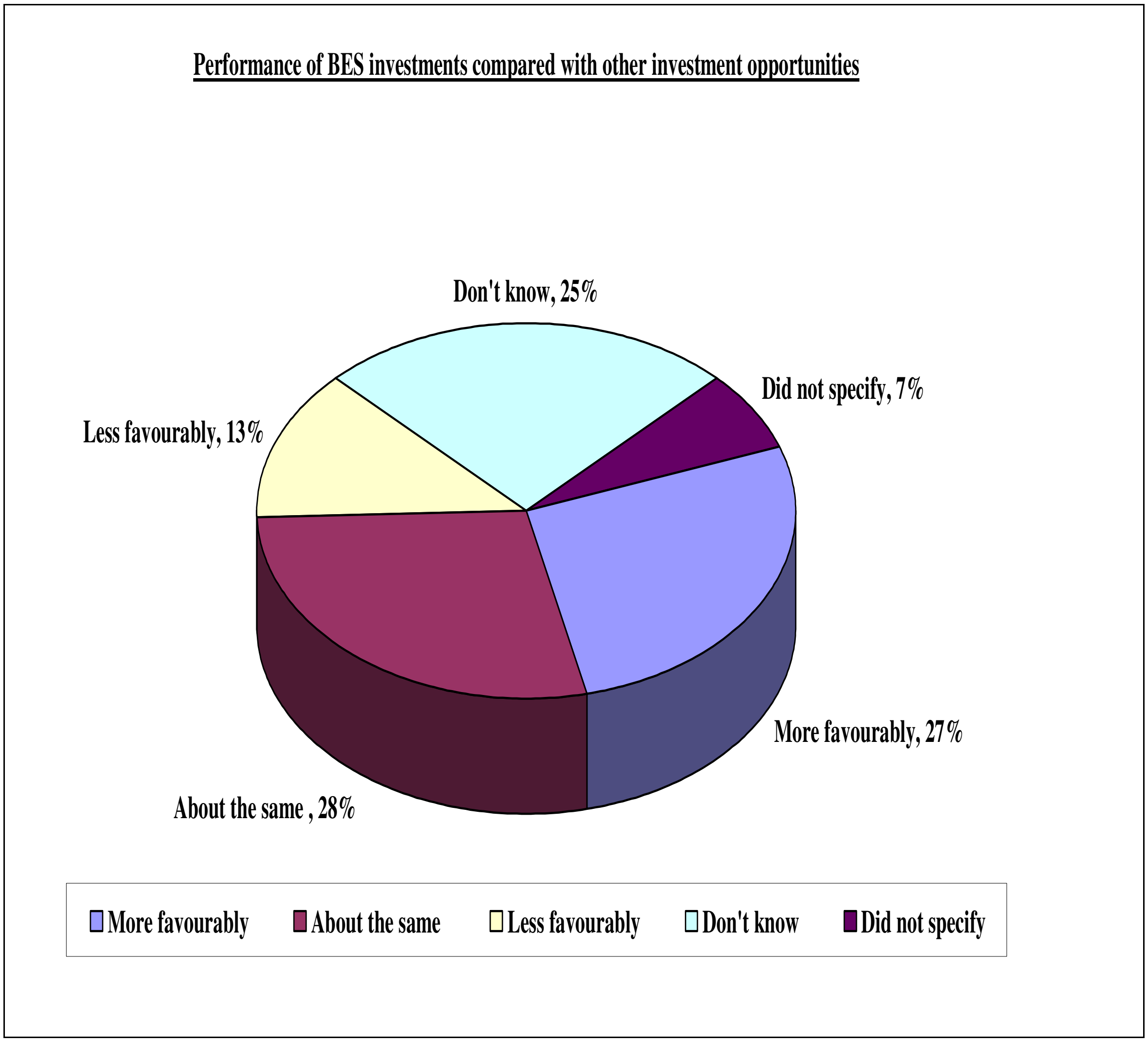
Question 17: What percentage return on investment, if any, did your company provide?



Question 18: To the best of your knowledge, are the BES investors in your company satisfied with the performance of their investment?

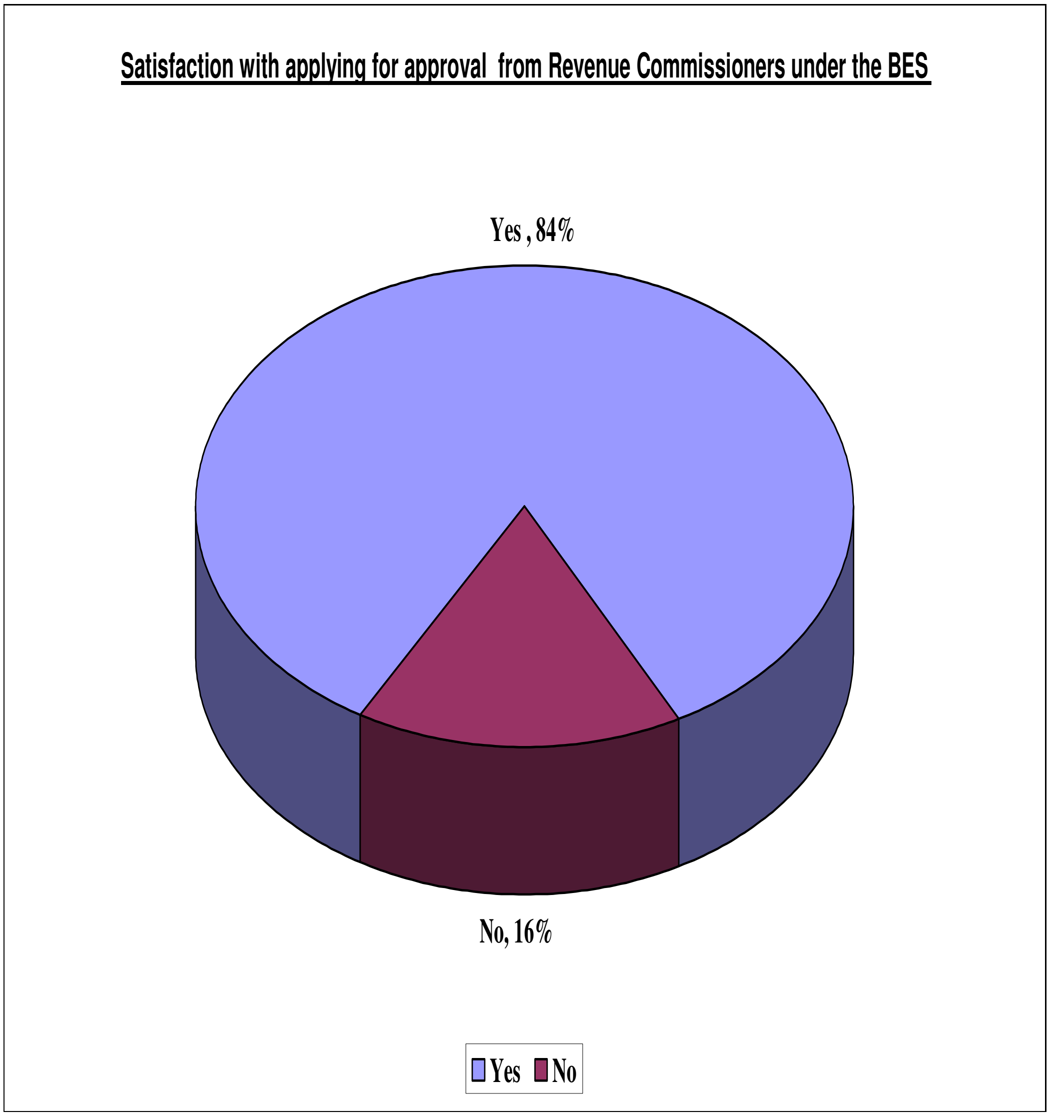


Question 19: In your view, how well are the BES investments in your company performing compared with other investment opportunities?



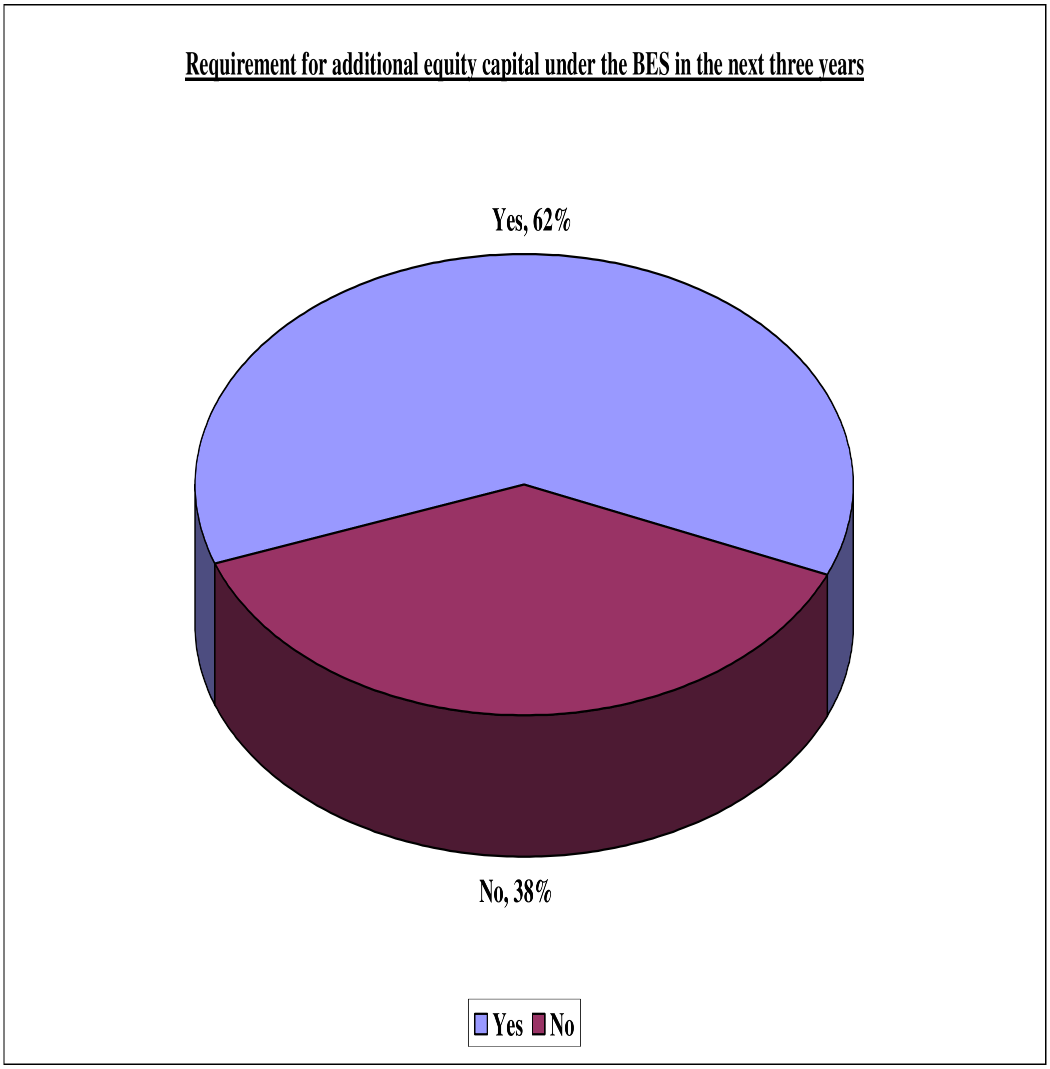
Part 5: Applying for the BES

Question 20: Did you find applying for approval from the Revenue Commissioners under the BES user-friendly?

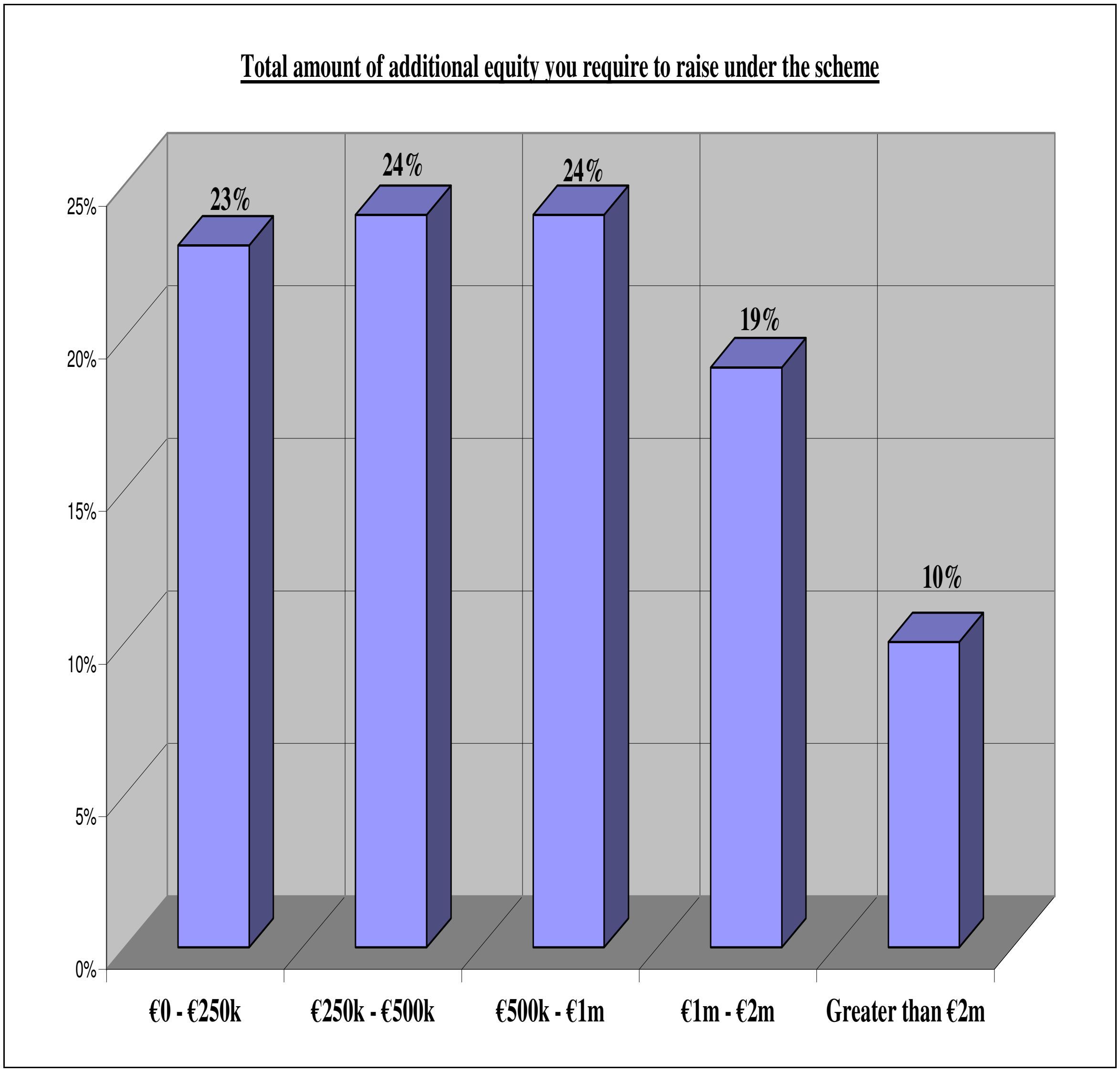


Part 6: Future Requirements of Companies under the Scheme

Question 21(i): Does your company see a requirement for additional equity capital under the BES in the next three years?



Question 21(ii): If "YES", please indicate the total amount of additional equity you require under the scheme?



Question 22: Please make any comments you wish on using the BES/SCS to finance your business and /or any recommendations on improvements to the scheme.

Question 23: Are there any other comments you wish to make in relation to small business financing?

Replies to these questions indicated that over 90% of companies who responded were supportive of the BES and hoped that it would be extended. Most stated that it had proved very beneficial as it provided an invaluable source of finance, particularly in relation to the start-up businesses. A large proportion felt that BES financing was a major factor in the growth and development of their companies. Many suggested that without the scheme their companies would not exist today.

Less than 10% had difficulty with the current structure of the scheme, finding it complicated and time consuming. Another criticism was that a significant portion of funds raised go to professionals to administer the scheme.

The following were the most common recommendations on improvements to the scheme:

- Increase the company limit. Proposals ranged from €1.5 million to €5 million. (However, some respondents felt that increasing the limit would prevent smaller companies from benefiting);

- Increase the investor limit. Proposals ranged from €50,000 to €250,000.

In addition, many suggested the following:

- Simplify procedures. Make the approval process simpler so that companies can go through it themselves. Provide more information in an easy to understand format for first-time BES investors. Reduce the amount of paper work involved. Speed up the process of getting tax relief.

- The schemes should continue to focus on manufacturing and financing innovative research and development and should continue to keep away from asset-backed development.