

THE BUSINESS EXPANSION SCHEME IN IRELAND

Jim Stewart*

Introduction

"This business start-up scheme will be unique, not only in this country, but among our main trading competitors. It will be a striking new incentive to channel investment into small businesses." *Mr. Lawson (former UK chancellor), Budget Speech, March 10 1981.*

"We are, however, aware that high risk, start-up businesses are most unlikely to be popular. Consequently, we've concentrated upon identifying market sectors which avoid these problems." *Business Expansion Scheme Offer for Subscription by Chancery PLC 29th January 1990.*

These two contrasting statements illustrate the gap between what the Business Expansion Scheme (BES) was intended to do in the U.K. and, several years later, the reality of how this scheme is used. A similar development has occurred in Ireland. The Budget Statement of January 30th 1991 states:

"It was never the intention that the BES should provide income tax relief for investment in secure asset-backed ventures involving little risk. But the reality is that this is frequently how it's operating."

This paper examines the operation of the BES in Ireland, which was largely copied from the U.K. scheme but with some important differences. As in the U.K. the main flow of BES investments to date is into asset backed low risk, property type investments. But in contrast to the U.K., where the BES has recently been extended indefinitely, tax relief for BES investors is due to terminate in the tax year ending April 1993.

The purpose of the present paper is twofold. First, it seeks to show how the BES, hailed as a major benefit to small business, spawned several major tax avoidance schemes; secondly, it provides a preliminary assessment of the effectiveness of the BES in Ireland in its non-tax avoidance role. The scope of this assessment is restricted because of limited information relating to firms that receive BES finance. Information provided by the Revenue Commissioners shows the number and type of company receiving BES funds and the total cost in terms of tax foregone but not, for example, names of individual firms receiving BES funds. In addition to data provided by the Revenue Commissioners, this paper also relies on published information produced by

* The author would like to acknowledge the financial assistance of the Foundation for Fiscal Studies. He has also benefitted from discussions with numerous individuals relating to the operation of the BES, and would especially like to thank his colleagues William Kingston and Gerry McHugh of Trinity College, together with John Kelly of the Central Bank and Norman Gillanders of the Revenue Commissioners.

investment funds, prospectuses and BES companies. It is interesting to note that when the BES legislation was first introduced in Ireland the scope for using BES for tax avoidance was recognised. The then Minister for Finance (Mr. Dukes) stated:

“Too many incentive schemes have been exploited for tax avoidance purposes and we must ensure that the present scheme is not abused” (*Senate Debates*, May 15th 1984).

Institutions dominate the flows of savings in the economy. There are a number of reasons for this. One reason is fiscal privilege. In addition institutions may have investment biases against high risk firms and in particular small and new firms. Hence in the U.K. the BES was introduced in 1981 to counter these biases. The BES from a personal taxation viewpoint is an attractive investment. The IFS in the U.K. (Hills, 1984, p. 9) concludes that the degree of fiscal privilege for BES investment was nearly twice that of the nearest alternative (a life insurance contract).

The BES, was first introduced in Ireland in 1984 and was generally hailed as innovative and worthwhile. Indeed there were many who argued for an increase in the size of investment allowable as a tax deduction, which was set at £25,000 per individual, and the extension of the scheme from manufacturing to trading sectors.

The BES in both the U.K. and Ireland has also provided considerable scope for tax avoidance. So much so that in Ireland, the bulk of BES investment for the tax year ending April 5th 1989 was invested in what could be described as tax avoidance schemes. The prevalence of these BES based tax avoidance schemes resulted in several amendments to the BES legislation contained in the 1989 Finance Act. For the year ending April 1990 BES funds have been largely used as a type of deferred loan, generally to property type companies with a maturity of five years, and with the capital repayment guaranteed by a bank. Not surprisingly the 1990 Finance Act contained restrictions to limit this type of investment. However the prospect was that in the period to April 5th 1991 most BES investment would again be in asset backed schemes, until the Budget Statement of 31st January 1991 announced major restrictions in an attempt to “focus the scheme more effectively” by excluding asset backed schemes. These restrictions were incorporated in the 1991 Finance Act, with some exceptions for companies who had already entered contractual arrangements.

A Comparison of the BES in Ireland and the U.K.

When first introduced in 1984 the Irish BES was similar to the U.K. BES, the main difference was that the Irish BES was restricted to manufacturing and certain other grant aided activities (mostly software companies). However since then there have been a number of important changes in both the U.K. and Irish schemes.

In the U.K. the BES idea originated as an aid to business start ups in 1981, and in 1983 the scheme was extended to “established unquoted trading companies”. Every Budget until 1990 has modified the scheme:

- the 1984 budget announced that farming would cease to be a recognised trade for investment;
- the 1985 budget excluded property development, but included research and development companies;
- the 1986 budget excluded from the scheme companies which were engaged in holding goods of a kind which may be collected (for example, wines, antiques, and wholesale trades who do not sell their goods to retailers) and companies with high asset backing in terms of land and buildings (ship chartering companies were included);
- the 1987 budget enabled film production companies to benefit to a greater extent and also changed the timing of tax reliefs;
- the main change to the U.K. BES occurred in 1988 when the scheme was extended to companies letting residential property and the amount of investment in any one company was restricted to £0.5 million;
- the 1989 budget announced the abolition of interest relief on funds invested in BES companies;
- the 1990 budget announced a limit on companies, other than those chartering ships and letting residential property, to £m 0.75.

In summary, until 1987 the main thrust of changes to the BES in the U.K. was the exclusion of certain activities, to improve targeting. The announced intention of the U.K. BES was to counter incentives to invest in low risk activities, property and house ownership, life insurance and pension entitlements, and to encourage investment in small and new companies operating in high risk areas. However the changes announced in the 1988 budget statement undid a lot of the restrictions introduced in 1985-87, in that investment in property was encouraged, albeit with the restriction that the property must be for letting. Thus property investment in the U.K. is encouraged by the very scheme designed to reduce the relative attractions of property investment¹. BES investment in year ending April 5th 1990 in property amounted to £Stg. 370 million (*Financial Times*, 21/3/90, p. 20) and this is likely to represent the bulk of BES investment in the U.K. for that year. Other sources indicate that non-property BES investment in the U.K. is currently negligible (*Financial Times*, 11/9/90, p. 14).

In Ireland the Business Expansion Scheme (initially referred to as the Business Development Scheme) was in the first instance restricted to manufacturing firms and other firms recognised for grant aid from the Industrial Development Authority (such as computer software firms). The 1987 budget announced its extension to activities in the tourism sector, like investment in hotels, and to certain shipping activities – for example the purchase of ships. In a separate measure in 1987, companies referred to as ‘Trading Houses’ which sold goods in export markets also qualified under the BES.

Considerable changes to the BES in Ireland were contained in the 1989 Finance Act, though not announced in the budget. These changes were designed to restrict the use of the BES as a tax avoidance scheme. The best known and largest example, SIL

(Shannon International Leasing) hinged on a definition of manufacturing contained in the 1981 Finance Act (section 39A). This section defined all trading activity on the Shannon Industrial Estate (with certain minor exceptions) as manufacturing. Hence leasing and finance companies were defined as manufacturing and became eligible for BES finance. The 1989 Finance Act excluded leasing and financial services from the BES. A second group of tax avoidance schemes stemmed from the extension of the BES to the tourism sector. This allowed residential property to qualify for BES investment provided it was available for rent. The 1989 Finance Act excluded residential property in the larger urban areas from eligibility for BES investment, and an upper limit of £2.5 million was placed on investment in each firm receiving BES funds.

The 1990 Finance Act in Ireland withdrew tax relief for interest on funds borrowed for new BES investments, and stipulated that tax relief would not be granted where it "could reasonably be considered" that all risk has been eliminated. Finally, the 1991 Budget Statement announced that the BES would no longer apply to shipping, hotels, guest houses and self catering accommodation, that the total amount that could be raised would be limited to £0.5 million per firm, and that any one individual tax payer could invest a maximum of £50,000. These changes were largely implemented in the 1991 Finance Act, except that the lifetime ceiling was raised to £75,000. In addition restrictions were introduced on multiple company structures designed to circumvent the £0.5 m. limit, and BES funds must be used to purchase shares rather than for lending on.

The BES involving leasing on the Shannon Industrial Estate raised £23 million. If a marginal tax rate of 58 per cent is assumed, this one scheme cost the exchequer £13.3 million, and resulted in seven Jobs (*Annual Report of the Comptroller and Auditor General, 1989*). Other asset backed schemes have resulted in some building activity, but it is difficult to justify tax concessions for residential property given the substantial tax concessions already in existence. It is also possible that some residential property BES projects may also have benefited from tax concessions designed to improve the availability of the rented housing sector (section 23 developments). In addition there are a number of BES projects designed essentially to finance assets such as ships and whisky stocks, at a lower cost than they would otherwise have incurred. Again such schemes are likely to result in little direct job creation. In addition the diversion of scarce managerial resources into tax avoidance schemes is likely to be detrimental to prospects of economic development.

The 1989 and 1990 Finance Acts reduced the scope for using the BES for tax avoidance and the 1991 Finance Act restricts the sectors in which BES investment may take place to those existing in 1987. In spite of these restrictions it is likely that future Finance Bills will have to address further tax avoidance schemes arising from BES legislation. One reason for this is the difficulty in targeting sectors or firms which fiscal legislation is intended to benefit. The tax system is complex and hence tax concessions must also be complex. There is always the danger that legislation may interact with previous legislation resulting in tax concessions being used in novel or unintended ways.

The problem of targeting also arises in other areas, for example social welfare payments.

The BES was designed for investment in risky firms; although the number of known failures is low, investment 'failures' may be disguised by repeated injections of capital. Revenue Commissioners data shows that 53 BES firms were in liquidation/receivership up to Sept. 1990, and 47 of these were in manufacturing². One reason why failure rates are low is that most BES investments involve little or no risk. The elimination of risk has been achieved in two main ways:

(1) *Repurchase of shares*

A number of BES investments had buy back provisions in the year ending April 5th 1989 effectively limiting the investors risk. For example AIIB Investment Fund (1988) had a provision by which AIIB would repurchase shares at a fixed price after five years. The 1989 Finance Act contains a provision that BES relief will not be granted where shares are repurchased at other than the market price. This provision limited 'guaranteed buyback' schemes.

(2) *Asset backed Schemes*

(a) One 1989 BES prospectus states:- "Recent innovations in the BES area have now allowed BES fund managers to structure investments so as to substantially reduce the risks previously associated with this type of investment. By combining the tax relief available under the BES with asset-backed low risk investment, it is now possible for investors to generate guaranteed net returns of over 19% per annum". This was to be achieved by investing 40% of the funds in guaranteed investments, where at least the initial net investment is guaranteed to be returned. Most of these property backed investments became eligible for BES funds as a result of changes in the 1987 Finance Act which extended the scheme to qualifying tourist traffic undertakings³. The investment strategy of one fund (Riada & Co. 1989) specifically excludes start-up companies or companies in what are described as speculative sectors. Instead the fund aims to invest 50 per cent in "low risk, asset backed investments, while the other 50 per cent will be invested "in growth oriented companies with an established trading history".

(b) BES funds have also been used to set up firms whose assets are then controlled or used by another firm. The relationship between the two firms is specified in a contract. One example is a BES firm set up solely to mature whisky. The whisky is bought from a distiller on a cost plus basis and sold back to the distillery after three or more years on a cost plus basis. The prices can thus be set to guarantee a particular rate of return to investors. Similar schemes have been established to finance ships. The ships are owned by the BES firm but managed and controlled by another firm. These 'captive firms' are low risk, because they are asset backed. The main risk is whether the assets financed maintain their value. The rate of return is relatively certain, given some assumptions about costs, and may also be partly determined by the controlling

firm. The formation of 'captive firms' using the BES is in reality another way of financing assets. In some cases BES firms are established with a large minority shareholder, which has the option of purchasing the remainder of the shares after five years.

(3) *Loan Guarantee Schemes*

For the year ending March 1990, restrictions in the 1989 Finance Act ending the guaranteed buyback led to a restructuring of BES investments. The BES vehicle provided a loan to the investing company; a bank then guaranteed the repayment of this loan, by agreeing to provide a loan to the investing company in five years, thus ensuring that BES investors funds could be returned. In essence banks were providing a deferred loan. Most of these 'deferred loan' type investments related to hotel and leisure complexes. Two related schemes raised a total of £5m. for a free range pig project, and in this instance BES financing was reported as being a replacement for 'section 84' loans which were more costly because of restrictions announced in the 1990 budget (*Sunday Tribune* 25/3/90). From the perspective of the lender of funds (a bank) such investments provide secure collateral. While the 1989 Finance Act removed certain activities from qualifying for BES funds (in particular leasing) it did not eliminate the advantages of 'deferred loan' type financing. The 1990 Finance Act has attempted to do so by incorporating a clause that BES relief will not be allowed if there is any arrangement "which could reasonably be considered to eliminate the risk" involved in a BES investment. But in spite of these restrictions several 'deferred loan' type schemes were advertised prior to further restrictions announced in the 1991 Budget enabling investors to receive minimum rates of return.

Thus, as in the U.K., the Irish scheme was used to channel funds to low risk asset backed projects to the exclusion of high risk projects. The longest established BES Fund managers in Ireland, Equitas, describes itself as "now one of the leading BES investment specialists involved in tourism related projects" (*Irish Times*, March 7 1990).

Funds Raised

Table 1 below shows the total number of companies approved for BES investment, and funds invested for the years ending 5th April 1985 to 5th April 1990.

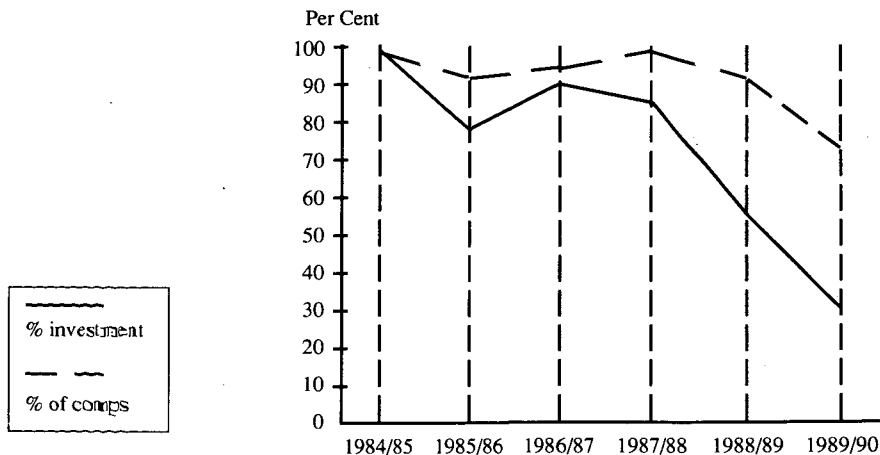
It shows that up until April 5th 1990 727 BES investments had been made amounting to a total of £m 125.6. Because some companies have raised BES funds on more than one occasion the total number of firms receiving BES funds is smaller at 584. Table 1 also shows the estimated amount invested in the year ending 5th April 1990 amounted to £78 million, of which one scheme accounted for an estimated £23 million (SIL). For the year ending 5th April 1991, a similar amount is likely to have been invested (individual schemes identified by the author are estimated to have raised approximately £45 m.), but there is likely to have been a reduction in the amount raised in the year ending 5th April 1991 (to be invested in the year ending 5th April 1992).

Table 1: BES Funds Invested to April 1990

	TOTAL FUNDS RAISED	NUMBER OF FIRMS
1984/85	0.9	6
1985/86	4.4	42
1986/87	6.9	91
1987/88	9.9	161
1988/89	25.5	188
1989/90	78.0	239

Source: Revenue Commissioners. This data refers to the period when the funds were invested, as distinct from the period when the funds were raised from investors.

Figure 1 shows the changing sectoral distribution of investment. The manufacturing, computer software, and food processing sectors share of BES investment amounted to approximately 30% in 1989/90, whereas in the first four years of the scheme over 70% of total funds went to these sectors. The bulk of BES funds are now invested in "asset backed" projects, tourism, shipping, and for 1989/90 leasing. Figure 1 also shows that the number of companies receiving funds in Manufacturing etc. remains around 70%, indicating that the amount received by each company is far lower than that in the "asset backed" sectors.

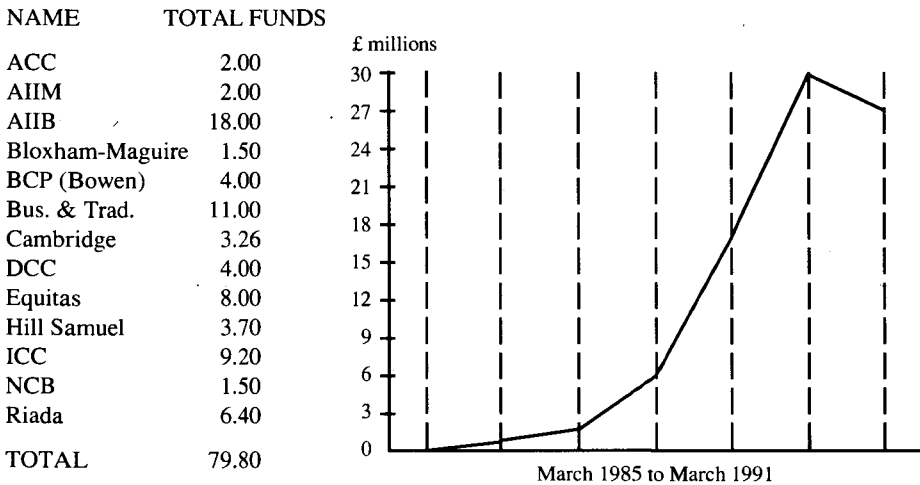
Figure 1: Share of BES Investments in Manufacturing, Software, and Food Processing Sectors 1984/85 to 1989/90

Source: Revenue Commissioners.

There are two main ways funds are raised using the BES: (a) via an institution which then in turn invests in various companies, or (b) by a company directly. For some of the larger amounts raised a particular stock broking firm may organise the issuing of a prospectus, advertising and raising funds. As discussed already in some cases raising funds via the BES has been accompanied by a stock market quotation. This latter aspect would appear to be unique to the Irish scheme. It thus likely that the bulk of funds raised via the BES in Ireland are done so through a financial institution.

Figure 2. shows the estimated distribution of BES funds in Ireland and also shows a graph of the amounts raised through time.

Figure 2: BES Managed Funds 1985-1991



This table includes only those funds identified. There may be other funds apart from these. Hence the data shown here should be regarded as a minimum amount. This data refers to the period that cash was subscribed by investors as distinct from the period that firms undertake investments.

The total of BES funds allocated by financial institutions includes both managed funds and direct placements and hence will be substantially larger than the total shown in Figure (2). For example Equitas had invested over £8 million by way of direct placements by April 1990. A.I.I.B. is likely to have placed the largest amount by direct placements (one BES direct placement alone amounted to £23 m.). The Bowen Group has also been extensively involved with direct placements (for example Parkes Hotel, Lansdowne Hotel and Mount Errigal Hotel), and had allocated £15 m. by March 1991.

Up to April 1990 584 firms benefited from BES schemes. Thirty-five of these are estimated to have received £62.16 m. (Table 2). Hence the average that each firm received, excluding these 35, is fairly small at £115.5 thousand. The 1989 Finance Act

limited the size of BES investments to a maximum of £2.5 million. However there are examples of related projects each raising £2.5 m (Master Pork Ireland and National Pork Farms). Cooley Distillery raised £2.5 million, and other related companies have raised over £4 million over a number of years (Whiskey Manufacturing, Brosna Whiskey, Kilbeggan Whiskey, Tyrconnell Whiskey). In the year ending 5th April 1990 several schemes raised £2.5 million (six of which were hotels).

Table 2: Amounts Raised By Individual Companies Under the BES Up to 5th April 1989 and August 1991

Name	To April 89		To August 1991
SIL Commercial Finance	23.000	SIL Commercial Finance	23.000
Parkes Hotel	4.250	Parkes Hotel	4.250
Irish Continental Gr.	3.942	Irish Continental Gr.	3.942
Cooley Distillery	2.500	Mount Errigal Hotel	3.350
Galway Irish Crystal	2.500	Aerospace Industries	2.875
Granuaile Shipping	2.100	Granuaile II	2.750
Whiskey Manu.	1.700	Whiskey Manu.	2.660
Fitz. Silver Spr. Activity Centre	1.450	Knockpride Investments	2.610
Strongbow	1.340	Cooley Distillery	2.500
Red Castle Hotel	1.300	Galway Irish Crystal	2.500
Superwood Holdings (R)	1.247	Ballyvara	2.500
Country Club	1.240	Brandon Hotel	2.500
Oglesby and Butler	1.150	Cheese Co. of Ireland (Deel Vale)	2.500
Blugas	1.050	Connemara Coast	2.500
Cavan Crystal (1988)	1.000	Grand Hotel	2.500
Charlotte Lodge Apartment	1.000	Hibernian Hotel P.	2.500
Coastal Shipping	1.000	Master Pork Ireland	2.500
Kiliney Court Hotel	1.000	National Pork Farms	2.500
Churchview Properties	0.941	Peninsula Holdings Hotel	2.500
Mount Errigal P.	0.850	Sailaway Sailor	2.500
Liazon Trading House	0.850	Value Stallions	2.500
Livada	0.750	Waterford Castle Hotel	2.500
Celtic Seafoods	0.650	Liazon Trading House	2.470
Tara Meats	0.542	Granuaile Shipping P.	2.456
Sunday Tribune	0.518	Central Hotel	2.300
Container Eng.	0.500	SGS Marine	2.000
Equitech	0.500	Visual Art	2.000
Kingspan Veha	0.500	Clifden House	2.000
Sakai Teo	0.467	Longfields	1.500
Software Manufacturing Consultants	0.451	Rock Bit (Mincon)	1.500
Ethos Medical Group	0.400	Trident Hotel	1.500
Trintech	0.400	Wishton	1.500
Aerospace Industries	0.375	Fitzpatrick's Silver Springs	1.450
Artic Environmental (L)	0.350	Georgean House	1.450
Cara Greeting Cards (R)	0.350	Cavan Crystal	1.350

L denotes 'in liquidation', R 'in receivership'.

The current maximum any company can raise in any one year was reduced to £0.5 million in 1991. One company (Aerospace Systems) raised £2.5 million using five companies to raise £0.5 million each. The 1991 Finance Act contained provisions to prevent the use of multiple company structures to circumvent the £0.5 million limit. Table 2 shows the dominance of hotel/leisure projects. It is also interesting to note a number of projects associated with larger groups.

Up to April 5th 1990 managed funds accounted for approximately 19 per cent of BES funds invested⁴. This compares with 60 per cent of BES finance (excluding farming) reported in a study of BES investment in the U.K. for the years ending 5th April 84 and 85 (Peat Marwick, 1986, p. 48). A later study by Mason, Harrison and Harrison (1988, p. 16) found a decline in the number of BES funds in the U.K. There was also an associated rise in the number of "prospectus issues". The proportion of BES investments through managed funds in Ireland is small, largely because of the growth of direct investments.

The Cost

It has been argued elsewhere that finance from BES funds in the U.K. is costly to the eventual recipient of the funds (Stewart 1984) and this is also true in the Irish case. Funds raised via a fund have two sorts of costs, apart from the cost of tax relief: the cost to the subscriber; and charges levied on the company receiving the investments. Table 3 shows these costs for a number of funds.

Table 3 shows considerable similarity in the charges which investors must pay. The main variation lies in whether options are granted to the fund manager or not, and the date on which those options may be exercised. For the longest established fund (Equitas) the trend has been for an increase in charges to investors over time, with a reduction in fees charged in 1991. For example, the second Equitas fund had an initial management charge of 5% plus an arrangement fee of 1%, plus options of up to 4% of share capital; whereas the seventh Equitas Fund had a "brokerage" fee of 6%, plus an arrangement fee, plus fees on its own account, plus options up to 5% of the ordinary share capital, plus costs associated with realisation of investments. In general there was a reduction in charges of 1% for the period ending 5th April 1991 compared with the previous period.

Table 3: Fees Charged by Funds March 1991 (1990 in brackets)

	Investor	Firm
A.I.B. 2, 3 & 4	Management fee of 5% Placement Commission 1% Interest on uninvested funds Fees for realisation of investment options over shares	Negotiation fee or arrangement fee Fees for services
Business & Trading House 3rd Fund 1991	Management fee of 5% Placement Commission 2% Interest on uninvested funds Fees for realisation of investments	Negotiation fee or arrangement fee Fees for services
Equitas 7	(Management fee of 5%) Interest on uninvested funds Brokerage fees of 6% (2%) Fees for realisation of investments options up to 5%, within 7 years	Arrangement fee Fees for advice or assistance
Riada & Co. 1991	(Management fee of 3%) Brokerage fee of 5% (3%) Interest on uninvested funds options up to 10%; no time limit realisation fees	Negotiation or arrangement fees Directors fees Fees for advice or services
Hill Samuel 1990/91	Management fee of 3% (5%) (Annual fee of 1.5%) Interest on uninvested funds options up to 10 %; no time limit realisation expenses	Arrangement fee Fees for advice or assistance
Warrington 1989/90	Management fee of 5% Placement Commission of 1% Interest on uninvested funds options	Arrangement fee Fees for advice or assistance provided by a director
Cambridge 1990/91	Management fee of 5% (6%) Interest on uninvested funds options up to 10%. no time limit realisation fees	Negotiation or arrangement fee Fees for advice or assistance provided by a director
ICC 1991	Management fee of 5% Placement Commission of 1% Interest on uninvested funds options up to 10%; no time limit realisation fees	Arrangement fee Fees for advice or assistance provided by a director
DCC 1989/90	Fee of 6% Interest on uninvested funds options up to 10% within 10 years realisation fees	Negotiation or arrangement fee Monitoring fees

* All fees are subject to VAT at 25% up to 1989, and then 23% for 1990, and 21% for 1991.

2 Most offer documents also state that "investee companies" may be charged for professional services by other companies within the group managing the funds.

3 The exercise price (where stated) for call options is the price at which the fund invested in the company.

The following example uses the Black-Scholes model, and the following assumptions are made: the risk free rate of interest is equal to 10%, the standard deviation is 0.3; the exercise price is £1.00 and is the same as the initial cost per share. The current value of the option can be estimated at approximately £0.65. (see Pinches, 1990, ch. 11). Hence call options for most of the funds examined here involve considerable dilution of BES investors shareholdings, or conversely could be considered an extra cost.

Another feature of costs is that low risk investments (property, and other asset backed ventures) seem to have lower costs associated with them. The largest amount raised to date was for a leasing company (S.I.L.) with a guaranteed repurchase of shares after five years, which charged 2.5%. Most "deferred loan" type schemes had charges of 5% (plus VAT).

Fees charged to investee companies are never disclosed, and may be of 'what the market will bear' type. In addition there may be other fee payments for professional services arising where the fund managers are part of a group (for example A.I.B. or B. of I.).

In some cases prospectuses have been issued and Table 5 shows the costs in these cases. In nearly all cases of firms raising funds on the Stock Market actual costs are greater than those estimated in the prospectus. The case of Artic Environmental may provide some indication of the costs faced by firms in raising funds. In addition to the placement fees and expenses of £70,000, additional fees of £8000 per annum were payable to the firm arranging the placing, and this firm (Private Placings) also had options over just under 6% of the issued shares at the placement price. In the U.K. the annual charges by funds in the period 1984/85 varied between Stg£2,5000 and Stg£20,000 (Peat Marwick Report, p. 209).

Table 4: Costs for Individual Firms

Name	Amount Raised (£m)	Cost	Cost %
Aerospace Industries (1988)	0.375	0.019	5.1
Artic Environmental	0.350	0.070	19.9
Coastal Shipping	1.000	0.085	8.5
Glotec	0.310	0.044	14.2
Granuaile	2.100	0.190	9.0
Irish Continental Group	2.530	0.230	9.1
Oglesby & Butler*	1.000	0.006	6.0
Strongbow*	0.947	0.114	12.0
Sunday Tribune	0.518	0.068	13.0
Superwood*	1.107	0.128	9.7
Foleys Sawmills	0.500	0.045	9.0
Lissadell	0.900	0.080	8.8

* Actual costs. Other costs shown are estimates shown in the prospectus.

Table 4 shows that the costs of raising funds vary from a low of 5% to a high of 20% with an unweighted average of 10.4 per cent. This average is similar to the unweighted average of all companies obtaining a quotation on the Dublin Stock Exchange (Full, USM and SCM) of 10.2 per cent in the years 1983-90. Hence firms raising finance using a BES appear to face similar costs to firms obtaining a stock market quotation.

An interesting point that has arisen in relation to these direct issues is whether they are indeed "prospectus issues", governed by the Companies Acts in relation to format and contents of the "prospectus" and documents available for inspection. Personal inspection of documents is unusual. In two cases personal inspection proved impossible, due to the requirement to make an appointment (prospectus of Master Pork, p. 17) and the inability to do so; in another case documents stated as being "available for inspection" were not available (Technikat). The documentation in relation to BES issues also does not accord with the requirements of the Companies Acts in relation to a prospectus (Usher, Ch. 12). In particular material contracts are not referred to (or made available for inspection), audited accounts are rare (where a company has already been trading) and information relating to directors is scanty.

Exit

The issue of realisation of investments or the question of exiting always receives some attention from BES funds and individual schemes. For example the second AIIB fund lists a number of ways of realising an investment, for example a private placing, or a merger or a public issue of shares on the Stock Exchange. This is the route most frequently mentioned in documentation relating to funds. As discussed earlier, some BES schemes have involved guarantees that the shares would be repurchased at a price to guarantee an offered return (this arrangement was disallowed by Section 7 (a) of the 1989 Finance Act). In the year to April 1989 such schemes constituted a majority of BES funds raised, with identified schemes accounting for £31.39 million. The largest of these schemes related to the provision of finance for leasing (Shannon International Leasing £23 million), and other schemes have involved the purchase of Hotels (for example Parkes Hotel, Stillorgan, £4.25 million). The only difficulty with such schemes was the problem of exit. In relation to the latter two schemes this problem was solved, by Allied Irish Banks in one case and Bank of Ireland in the other providing guarantees that the shares would be repurchased, by undertaking to provide loan funds to enable the shares to be repurchased. In both cases no dividends will be paid. Thus the BES was used as a low cost way of financing assets. It is possible that the returns to investors will be greater than the gross sums originally invested, but this is not necessary for the schemes to have a high rate of return. Most BES investments for year ending 5th April 1990 had formalised buy-back arrangements (using put and call options) with loans to enable shares to be repurchased guaranteed by a bank. Formalised buy-back arrangements were also a feature of BES schemes for the year ending 5th April 1991, and up to August

1991 but without direct bank guarantees. It is also possible that even without formalised exit arrangements shares may be bought back by BES companies under the 1991 Companies Act.

Repurchase agreements may also raise problems of conflicts of interest where there is inter-firm but intra-group trading in shares. One fund operated by an firm specialising in investments in unquoted companies (DCC, owned jointly by Bank of Ireland and various pension funds), specifically states that the “fund may invest in companies in which DCC is a shareholder”, and that DCC may “negotiate and acquire an interest in Investee Companies for itself” on an arms-length basis.

‘Deferred loan’ type schemes are extremely low risk. The best analogy would be setting up a BES scheme which invested the funds in a Post Office Savings Bond with a guaranteed return of 40 %. If the sum invested was merely returned to the investor, the returns would amount to almost 19 % per annum. The difference between the sum invested and the sum returned (40%) would be the returns to the promoters of the scheme.

Returns to Investors

Returns to investors are a function of the marginal tax rate and the rate of interest if funds are borrowed, or as an indication of the opportunity cost of capital otherwise. The attraction of BES investment has fallen in recent years as a result of falling marginal tax rates and rising interest rates. Marginal tax rates have also been reduced in Ireland and interest rates have risen, thus reducing the attractiveness of BES investments.

Example

£20,000 invested. The marginal tax rate is 56%. Fees are 5% plus Vat (£1230). Funds are borrowed at 16% over five years. Income tax is repaid after six months. Only the initial investment is returned, that is £20,000.

<i>Cash flows in present values</i>	£
Initial investment	20,000.00
5% commission plus Vat	1,230.00
Total amount borrowed	<u>21,230.00</u>
Present value of Income Tax Refunded (£11,200)	10,371.00
Present value of £20,000 paid in five years	9,520.00
Net loss	1339.00

Points

1. The break even or internal rate of return of this project is slightly over 13% – that is if interest rates fell to 13% this project would break even.
2. If guaranteed returns were increased to 114% the project would break even given the assumptions in the example.
3. If interest on borrowed funds was also allowed as a tax deduction, returns would rise to approximately £3,849.
4. If tax rates fell to 52%, the net loss would rise to £1895.

It is not known what proportion of BES investments in Ireland were funded from borrowed funds on which the interest was tax deductible but in those cases BES investments are highly attractive. The above example shows that BES investments are not attractive to private investors if funds must be borrowed and the interest on borrowed funds is not tax deductible. Given the changes in the Finance Act 1990 which no longer allows interest on borrowed funds to be tax deductible, that marginal tax rates have fallen from 56 to 48% and are likely to fall in future years, and that interest rates will remain around current levels, BES schemes are likely to become relatively less attractive. Not surprisingly given falling tax rates and rising interest rates in the U.K., funds raised under the BES have declined in recent years.

An Assessment of the Effectiveness of the BES

Any attempt at assessing the BES faces a major obstacle, in that there is no published information detailing the identities of firms raising finance using the BES. In addition some proponents of BES schemes base their support on issues such as wider share ownership and encouraging 'entrepreneurial behaviour'. Apart from data difficulties such issues are difficult to evaluate either on an achievement basis or a merit basis. The Revenue Commissioners, however, publish data relating to the number of firms receiving BES investment, the amounts received, and their sector of operation, and some of this data is used later.

In this section the focus is on BES firms which were identified by an examination of the business pages of newspapers, and various business magazines. A total of 190 BES firms were identified as receiving BES funds up to March 1991 and subsets of these firms form the basis of the following evaluation. This data is derived from advertisements for BES funds and other sources. In some cases BES funds raised may be overestimated, where funds raised are less than funds sought.

Previous sections have demonstrated that there are considerable costs to both investors and recipient firms in raising funds via the BES. These are not the only costs. There are also considerable costs to the State in terms of tax revenue foregone. In addition if investments turn out to have zero value, the amount invested by individuals (net of tax relief) can be offset against any other capital gains tax due (*Sunday Business Post* 18/3/90). An examination of BES proposals relating to individual firms also shows considerable "tax efficiency". For example several firms declare that no dividends will be paid, rather profits will be reinvested, and hence the shareholder will eventually pay capital gains tax, reduced by indexation relief and personal allowances. The 1988/89 Hill Samuel fund states "The objective of the fund is to seek capital growth and investors should not therefore expect material dividend income from the investments".

Two firms who have paid dividends have been able to benefit from Export sales relief (Superwood) and S. 34 relief relating to exemption from earnings from patents in order to pay tax exempt dividends to shareholders (Oglesby and Butler). This latter aspect is also a feature of other BES projects (Suparule and Optoelectrics).

Of the 190 BES investments identified 55 received grant assistance from the IDA and/or SFADCo. It is also interesting to note that 10 of the 55 BES schemes received grant assistance during or prior to 1980. Nadcorp has purchased share capital in three of the 55 and the IDA in 6. A number of these companies had been in receivership/liquidation (for example, Cavan Crystal, Galway Crystal, Foxford).

It was possible to obtain data relating to employment and funds raised under the BES for 29 firms that were also grant assisted by the IDA/SFADCo. Six of these companies had been grant aided in 1980 or before. Total employment amounted to 1393 in 1990/91 and these companies received approx. £12.1 million in grants. Some companies may also have received Feoga funds so £12.1 million should be regarded as a minimum amount. These 29 firms also raised approx. £17.46 million under the BES.

The IDA (*Annual Report*, 1990, p. 4) shows costs per job "created and sustained throughout the period 1984-90" calculated in 1990 prices and this data is reproduced in Table 5. Table 5 also shows costs per job for 29 BES firms, including both the costs of tax relief and grants.

Table 5: Costs per Job £'000 (1990 prices)*

	IDA DATA	29 BES FIRMS		
		Grants [†]	BES	Total
Small Business/Enterprise Development Programme	8.227			
Irish and Overseas Industry	17.729			
International Services	7.301			
Average	14.271	13.876	6.449	20.325

* This was calculated by converting grants received and BES funds received into 1989 prices using the CPI index. BES funds received in the tax year ending 5th April of each year was attributed to the same calendar year.

† Relates to 29 BES firms. Six of these firms are in liquidation/receivership, and their employees were recorded as zero, except for one firm (Cara Greeting Cards where 25 employees, and Superwood where 45 employees were included).

In terms of grant aid per employee the BES figures compare well with IDA data. For example the average cost per job in 1989 for Irish and overseas industry amounted to £17,729, compared with an average cost in terms of grants for 29 BES firms of £13,876. However, if the cost of tax relief is included average cost per job rises to £20.325. It is also likely that some of the BES funds invested also attracted interest relief on borrowed funds, hence the cost of tax relief is likely to be higher than that shown in the table. It might also be argued that 'cost per job' data should include I.D.A. current

costs. This would have the effect of increasing all 'cost per job' data shown in Table 5.

Data provided by the Revenue Commissioners (Table 6) shows costs per job on an incremental basis, comparing total employment for 50 BES firms for the year 1988 with 1989 – that is total tax foregone due to BES relief (assuming an average tax rate of 53%) divided by the change in employment.

Table 6: Cost Per Incremental Job for 50 BES Firms

Sector	Employees	Increase	Tax Cost
Manufacturing	1072	+208	14,493
Computer Software	41	+10	12,374
Food	42	+36	7,508
Total All Sectors (including tourism & shipping)	1424	+390	15,973

Source: Revenue Commissioners

Care must be taken in interpreting this data because of the matching problem. Employment may increase in anticipation of receiving BES Funds. The initial increase in employment may be financed by bank borrowing, which is subsequently repaid. This problem of associating a given increase in employment with the receipt of BES funds is made more difficult where firms receive BES funds on two or more occasions. A more accurate indication of the effect of BES funds on job creation would require a number of years employment data for BES firms.

Nevertheless the data shown in Table 6 is valuable in confirming that there are considerable costs in terms of tax foregone. If it is assumed that firms in the manufacturing/computer software sector received average IDA grants per employee, then the cost per job approximately doubles for BES firms. It is also important to note that the data in Table 5 and Table 6 are not distorted by cost per job in SIL, or by including Cooley Distillery and related companies.

Because BES relief is restricted to manufacturing companies and companies producing computer software, it is not surprising that most of the BES firms identified also received grant aid. What is perhaps surprising is the extent of the grant aid. The BES rather than acting as a substitute of grant aid appear to be more of a supplement to grant aid. The typical BES firm benefits from a 10 per cent tax rate, grants, and lower finance charges via BES financing.

The minister responsible for introducing the BES legislation in Ireland (Bruton) has stated that the BES scheme is intended as a substitute for State grants. But it is likely that all BES projects (with the exception of tourism projects – 'holiday cottage

schemes', hotels) have received state grants in some form. A common feature of prospectuses or information published relating to individual BES investments is the conjunction of BES tax relief with other forms of tax relief – for example the 10 per cent tax rate for manufacturing firms and shipping firms. Two prospectuses for shipping companies stress the availability of grants as well as a 10% tax rate. Because State agencies have already grant aided firms, which subsequently receive funds using BES tax relief, the BES can not be said to be picking winners. State agencies have already done the selection. Oglesby and Butler is sometimes presented as the most spectacular example of a BES Fund picking a 'winner'. However the Shannon Development Company initially provided a soft loan to this firm. This loan was subsequently replaced with funds from the Hill Samuel BES Fund.

More recent extensions of the BES in Ireland have largely affected non-grant aided firms in particular 'trading houses' Bord Failte approved "holiday cottage schemes" (now restricted) and more recently hotel and leisure complexes. While the latter schemes do not benefit from grant aid, there is some evidence that BES relief has been supplemented by income tax relief on borrowings to invest.⁵ It is also likely that some building developments which use 23 relief also used BES relief. Briefly, 23 relief permits construction costs to be offset against rental income in calculating taxable income. This relief is available until 5th April 1991. Where a group of houses, or in some cases apartments, are designated also as holiday homes, they are also eligible for BES relief. In many cases these "holiday homes" were located in or close to major urban areas (Dublin and Cork).⁶ BES relief has been excluded from developments of this type in certain urban areas.

Conclusion

The bulk of BES investment to date has been in asset backed schemes, which have been structured in the form of a 'deferred loan'. This structure makes exit possible, with high probabilities of given returns. The main risk is whether the scheme qualifies and will continue to qualify for BES tax status. In particular property developments in urban areas enables easy realisation of the investment or exit. These property backed BES projects create little new employment, apart from construction activity, are low-risk, and are an extension of the very favourable tax reliefs already in existence for the housing sector.⁷ Hence it is not surprising that BES relief was withdrawn from such 'housing projects' and also other asset backed schemes.

For the year ending April 5 1990 and 1991 it is likely that most BES funds raised were invested in the hotel sector. Supporters of such schemes would argue that benefits to the economy consist not only of additional construction but also of employment in the hotel/leisure sector. The issues that arise are (a) does the additional employment warrant the costs in terms of tax foregone; (b) Is there a more cost effective way of aiding investment in this sector. A related issue is the quality of employment created (for example is it low skill and seasonal?). It is also likely that some BES hotel investment

involves displacement, that is non-BES hotels are replaced with BES aided hotels.⁸ Some BES tourism projects have also resulted in equity withdrawal, or replacement of other sources of finance such as bank borrowing, rather than expenditure on additional assets. Most BES hotel prospectus's examined state that a varying proportion of funds raised will be used to reduce borrowing. For example, Waterford Castle stated that £1.25 m. of £2.5 m. sought would be used to reduce bank borrowing; and the bulk of £0.910 million raised by Ariel House will be used to reduce bank borrowing.

There is no economic justification for providing BES relief to what are essentially property companies. Similarly there can be little justification for providing BES relief to other asset backed investments, such as leasing firms. Employment generated is likely to be low, and it may also be the case that employment is unskilled. The justification for continued BES relief should hinge on whether viable firms received funds, and hence survive, which would not have received funds in the absence of BES relief - the 'additionality test'. Secondly the cost of the total package of tax relief on BES funds, grants paid, and other tax reliefs should be assessed and compared with State aid to non BES investment. What limited evidence is available suggests that BES relief is seen as a supplement to other forms of State aid rather than a substitute.² In relation to additionality, it is certain that some firms received funds that would not otherwise have done so. However a justification for BES relief must then inquire whether it is desirable that these select firms received tax relief. It is likely that many firms which received BES funds would fail this latter test. Other aspects of the BES also deserve examination - for example, the possibility that there may be a regional bias in the location of firms receiving BES funds. Such biases have been found in the U.K. (Mason and Harrison, 1989) and there is a strong possibility that such biases also exist in Ireland.

The final issue to consider is whether BES relief should be restricted to the manufacturing, computer software and food processing sectors. These sectors are likely to be high risk. Indeed all failures of BES schemes to September 1990 have been in the manufacturing/software sectors (47 of the 53 were in manufacturing). Without recent changes to the BES it is likely that the bulk if not all of BES investment would flow into asset backed projects. The 1991 Finance Act 1991 announced restrictions in asset backed projects which will help BES projects in manufacturing and other areas to raise funds, but because of expected reductions in marginal tax rates, high interest rates, and higher risk of allowable projects, BES finance is unlikely to be a major source of risk capital in future years. There is also some evidence that demand for equity capital is limited. The *Review of Industrial Performance 1990* states (P. 122); "The existence of appreciable numbers of firms reporting a surplus of equity suggests that a shortage of capital is not the major constraint on expansion".

Notes

- 1 For example Chancery PLC in a document advertising for BES funds state: “We believe the question of whether or not to make a BES investment is simpler than last year. Try asking yourself or your clients- “would you be interested in investing in a residential property company with up to 40 % discount ?” The chairman of the British Venture Capital Association is quoted as saying that most of the U.K. BES investment did not go into ‘job-creating enterprises but into the sort of exercise that enabled “misplaced yuppies” to move from Chelsea flats to Kentish oasthouses’, (*The Guardian* 9/3/89.)
- 2 Failure rates are also likely to be partly a function of time . For example 33% of BES firms established in the U.K. in 1983 had failed by 1990, compared with only 7% of firms established in 1984 (*Financial Times* 26/11/90.)
- 3 Some of these schemes had been under investigation by the Department of Finance and resulted in changes to the BES in the 1989 Finance Act. (*Irish Times* 6/3/89.)
- 4 This data may not be totally comparable. The data provided by the Revenue Commissioners relates to the year investments are undertaken, as distinct from the year that funds are raised.
- 5 For example a financial scheme promoted in conjunction with the Business and Trading House investment fund, suggests that by arranging to pay a series of annuity payments in consideration for a lump sum, the annuity payments could be paid net of income tax at the standard rate. The brochure cites s. 433(1) of the Income Tax Act 1967 and s. 5(2) of the Finance Act 1974. A prospectus relating to a property development scheme at Blarney co. Cork, 7 miles from Cork city, cites s. 34 Finance Act 1974 and s. 8 Finance Act 1978. This latter arrangement is no longer possible (S. 7 Finance Act 1990).
- 6 One of the features of the surge in house prices in Dublin in 1988/89 is the associated growth in the value of suitable building sites, in particular in areas where “town houses”, that is s. 23 developments predominate. See *Irish Times Property Supplement*, March 30 1989.
- 7 John Blackwell N.E.S.C. report on housing.
- 8 A report by NCB is quoted (*Sunday Business Post* 1/4/90) as saying that BES funding is “partly responsible for the prospective over-supply of new hotel rooms particularly in Dublin”. Bord Failte has argued that the lack of hotel infrastructure causes a loss of tourism revenue (*Sunday Business Post* 11/11/90) and that BES investments by providing this infrastructure has attracted additional tourists and has created a total of 7000 jobs. This latter job estimate will largely depend on the assumed linkage between BES tourism investments and tourist numbers, and secondly the assumptions relating to the job creating effects of tourist expenditure. It would be possible to justify a large number of ‘tax

expenditures' (for example transport) by assuming appropriate linkages between the economic activity which benefits from the tax expenditure and job gains (or jobs 'saved'), and also by assuming appropriate multipliers between these new ('saved') jobs and other economic activity.

- 9 This contrasts with the original hopes for the BES. The Minister for Industry and Commerce (Mr. J. Bruton) commented when the scheme was first introduced, that the BES "will provide a new source of funds, and hence, I hope, reduce the necessity in new enterprises for State grants in that other sources of investment funds apart from the State and the bank will now be available for entrepreneurs". (O.E.C.D. 1987, p. 58.) A newspaper comment on the investment policy of Equitas states that one company "is so new that it has not yet obtained IDA grants". (*Irish Times*, Oct. 24th 1985.)

References

- Comptroller and Auditor General, *Annual Report of the Comptroller and Auditor General, 1998/9*, Pl. 7233, Government Stationery Office.
- Department of Industry and Commerce, *Review of Industrial Performance, 1990*, Stationery Office, Dublin, Pl. 7423.
- Hills, J. Savings and Fiscal Privilege, *The Institute for Fiscal Studies, Report Series No. 9*, London: Institute for Fiscal Studies, 1984.
- Mason Colin M. and R.T. Harrison, "Small firms policy and the 'north-south' divide in the United Kingdom: the case of the Business Expansion Scheme", *Transactions of the Institute British Geography*, N.S. Vol. 14, 1989, pp. 37-58.
- Mason, C. Harrison J. and Harrison R. *Closing the Equity Gap? An Assessment of the Business Expansion Scheme*, Small Business Research Trust, London, 1988.
- O.E.C.D. *Innovation Policy, Ireland*, Paris, 1987.
- Peat Marwick, *The Peat Marwick Report on the Business Expansion Scheme*, Inland Revenue, U.K. 1986.
- Pinches G.F. , *Essential of Financial Management*, 3rd Ed. Harper & Row, London. 1990.
- Stewart J., 'Financial Aids to Small Business', *The Irish Banking Review*, March 1984, pp. 18-31.
- Usher P., *Company Law in Ireland*, London: Sweet & Maxwell, 1986.