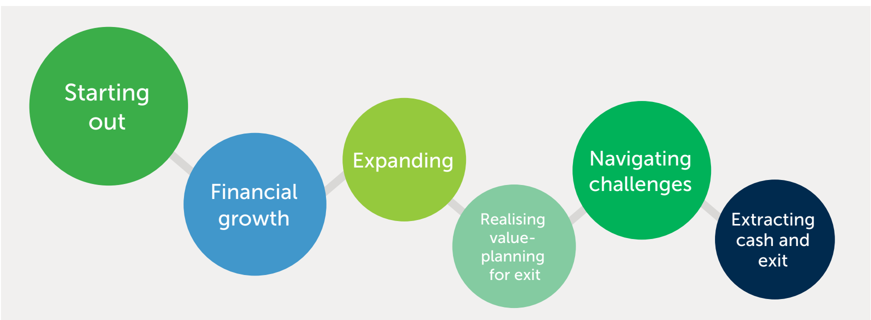
The Entrepreneur Lifecycle – Part II: Financing Growth and Expansion

by Nora Cosgrove and Jonathan Ginnelly

This article is the second in a series of three articles that will examine the entrepreneur lifecycle and the key considerations that entrepreneurs should think through at each stage in the cycle. In this article, we will focus on the expansion and growth phases of the lifecycle and consider issues such as financing, incentives for investors and key employees, as well as structural/governance issues for the company.



Financing growth and plans for expansion of businesses may not be something that is at the forefront of a lot of business owner's minds at the moment given the current public health crisis and the resultant economic impact. A lot of the discussions around the raising of finance at the moment relate to bridging funding gaps until businesses can operate somewhat normally again or refinancing existing borrowings. For many business owners the main objective at the moment is survival. However, with an eye to the future and with the hope that businesses impacted by the Covid-19 crisis can recover and flourish into the future, we will examine some of the mechanisms available to businesses to finance growth, either through borrowings or outside investment.

We will also consider some other aspects such as tax efficient mechanisms to retain key employees and attract new talent, availing of corporate tax incentives, as well as issues around maintaining effective governance in a company with an expanding shareholder base.

Financing mechanisms

While many business owners still approach banks as the primary source of financing for investment and expansion projects it should be noted that there are alternatives. Depending on the needs of the business, the method of obtaining is varied. While some businesses will opt for financing through senior debt from banks, others might opt to explore alternatives such as private equity investment or institutional lenders who provide finance via unitranche or subordinated debt products.

In many cases these alternative sources of financing can offer a greater level of flexibility to business regarding the terms of the financing, how funding is drawn down, quicker turnaround times with regard to approval among other benefits. However, as these alternative sources of finance offer greater flexibility they can require greater levels of asset leverage, as well as higher margins and costs. As such, examining what works best for the business in terms of obtaining financing, the flexibility of such finance, ease of access and approval is important but the costs are also crucial before a business commits to any form of financing.

Employment Investment Incentive Scheme ("EIIS")

An additional mechanism for obtaining business financing is EIIS. This scheme offers income tax relief for the cost of investing in certain companies incorporated in Ireland.

Essentially, companies will issue shares to the investor for the amount invested which must be retained by the investor for at least four years. In order to qualify for the scheme, the investor or their family must not own any capital in the company. They must also not be connected to the company in the two years before the shares are issued and ending four years after they are issued. From 2020 onward the maximum annual investment allowed per individual investor is €250,000. This threshold is increased to €500,000 if the investor commits to the investment for a least seven years.

Given the potential tax benefits associated with such investments, EIIS can be an important source of financing for companies that are positioning themselves for expansion but who may not have sufficient leverage to secure financing through borrowings or be able to attract private equity investment. While there is risk for the investor putting his or her money into a company that might not have a long history of success, the potential overall rewards can be significant.

Employee incentives

A crucial aspect of expansion and growth is recognising and retaining key employees that have had an important role in getting the business to its current level, and who perhaps may have an important role in taking the business to the next level. In addition, in a competitive employee market, having attractive rewards programmes in place can sometimes tip the balance in attracting talent to the company who can bring the business to the next level. One such tax efficient scheme is KEEP.

Key Employee Engagement Programme ("KEEP")

KEEP provides a share option incentive advantageous to employees. The programme helps qualifying companies to retain essential key employees by offering share options which are exempt from income tax, USC and PRSI for both the shareholder and the employer. The company must be a micro company or an SME to qualify and the shares must be issued between 1 January 2018 and 31 December 2023. The shares must be new ordinary fully paid up shares, which carry no present or future preferential right to dividends or a company's asset. Employees are essentially tied into the employer's objectives and are retained, which results in a benefit to both the employer and employee.

Tax incentives to assist expansion

For many businesses, the cornerstone of their expansion will be the successful development of new processes and products. To this end, to incentivise business to develop intellectual property, tax incentives such as the Research & Development credit and the Knowledge Development Box have been introduced.

Research and Development ("R&D") Credit

The R&D credit was introduced to incentivise companies to invest in research, advancing scientific and technological uncertainty. Tax relief on qualifying expenditure is by way of a 25% tax credit against the corporation tax income (30% for small and micro companies from 2019). Any excess credits can be carried forward or back to prior years or availed of in instalments. Additionally, small and micro companies can benefit from the R&D credit before they begin trading. This benefit can prove especially advantageous to entrepreneurs who are transitioning from sole trader to the company structure. The R&D credit can also be claimed for expenditure on buildings used for qualifying activities.

It is not necessary for a company to make a scientific breakthrough or even prove success in their R&D endeavours in order to claim the relief. A company may also surrender its R&D credit to key employees of the company, which may be seen for some as an attractive incentive to retain staff.

Knowledge Development Box ("KDB")

KDB is a follow on from the R&D credit, available to income arising from the intellectual property created as a result of successful research and development. Availing of this relief can reduce corporation tax to an effective rate of 6.25%. The benefit of this relief has been extended to SMEs to include inventions that are 'novel, non-obvious and useful'. These inventions can now qualify for the relief, subject to the company obtaining a KDB Certificate from the Controller of Patents, Designs and Trademarks.

Operating model

As the company scales up with foreign expansion plans, a key decision relates to putting in place an appropriate business model.

This would include evaluating whether it is best to operate overseas via a branch or subsidiary or whether to use third party distributors or other third-party service providers. Where a company choses to expand through their own entities, it is becoming increasingly important that the operating model and related tax considerations are aligned with the commercial objectives of the business and are consistent with the functional profile of the business.

The model adopted should allow for flexibility for future business growth, whether that is organic or by way of acquisition.

With transfer pricing having become such an important element of corporate tax policy over the last number of years, it is vital to have an effective model in place from as early as possible to drive efficiencies and to ensure the company can robustly defend any challenge from tax authorities.

Corporate and shareholder governance

An important consideration in the expansion or growth of a business, particularly where outside investors have come on board is the issue of governance. While there are many benefits to bringing outside investors on-board, such investment may have an impact on the way the company is managed and controlled. As such, in the course of obtaining investment, consideration should be given to whether a shareholders agreement might be put in place. The agreement can deal with any number of issues such as director appointment, voting control, remuneration committees, among others. Depending on the type of investor coming on board they may be happy not to have a seat on the board of directors and prefer to leave those responsibilities to the original shareholders.

Alternatively, where there are a larger number of shareholders, with varying share types the right to director appointments or voting control might be linked to those specific share types. As such, having a clear agreement as to the mechanism for appointment of directors, as well as clarity on issues around voting (among others) is important. It may be that some shares entitle the shareholder to no voting rights or limited voting rights, while others may have full voting rights and rank pari passu with the original shareholders share. Thus, clear governance documentation is essential where there is an ever more diverse group of shareholders.

Conclusion

The expansion/growth phase of the entrepreneur lifecycle can be fraught with danger and challenges. Taking the leap from a small/moderately sized business to the next level is by no means straight forward and involves a great deal of risk.

This risk is primarily borne by the business owner, but also to a degree by other stakeholders such as new investors taking a chance on a company by investing in it. Therefore, effective taxation incentives to encourage investors to come on board, to retain and attract talent, and encourage the development of IP are all crucial factors in taking the business to the next level. Business owners should familiarise themselves with such taxation measures as early as possible so that they can structure their business to maximise their effectiveness and thus help them drive growth and expansion.

Nora Cosgrove
Director in the Corporate and International Tax department in Deloitte.

She advises domestic and international clients on all corporate tax issues affecting them including tax structuring, accessing start-up funding and tax incentives/ reliefs, cross-border transactions, group reorganisations, refinancing, due diligence and associated services in connection with mergers and acquisitions.

Jonathan Ginnelly
Director in the Private Clients Tax department in Deloitte

He advises on personal and domestic corporate taxation issues, including asset structuring with family companies, shareholder issues and succession planning".