MAZARS

FNABA
FEDERAÇÃO NACIONAL DE ASSOCIAÇÕES DE BUSINESS ANGELS

Study on the impact on the State Fiscal Revenue of tax incentive of 30% granted to Business Angels' investments

November, 2011

Executive Summary

Portugal needs more innovative companies and increased exporting capacity as this is the only way to promote the necessary job creation, to maintain the stability of the current economic and social system and to reverse and balance the external debt of the Country. However, for the creation of jobs the entrepreneurial and business ecosystem must work efficiently, in order for the businesses to have access to the markets and to innovation, to be competitive and to have investment capacity.

A regeneration of the Portuguese business system is strongly needed, replacing dying companies with new dynamic and innovating businesses, with exporting capacity, betting into tradable goods.

At a time when bank financing is insufficient, the formal private equity industry has neither vocation, nor interest in financing *start ups* or *seed companies*, the foreign investment in these companies is almost non-existent and the State does not have the resources available to invest is this type of companies; alternative solutions must be found in Portugal.

It is in this context that the present study has been commissioned by FNABA to Mazars. The study concludes that the tax incentive granted to Business Angels is, beyond any doubt, an important measure to revitalize the Portuguese economy, with clear benefits to the Fiscal Revenue.

Lisbon, November 15th, 2011

Study on the impact on the State Fiscal Revenue of tax incentive of 30% granted to Business Angels' investments

I. Introduction

Currently, the Portugal tax law includes a tax incentive in terms of IRS (Personal Income Tax) that corresponds to the possibility of deduction from the tax bill, up to 15% of its gross value, of an amount corresponding to 20% of the investments made by Business Angels in companies with growth potential, under certain conditions (paragraph 6 and following of the current article 32 of the Tax Benefits Code, future paragraph 5 and following of article 32-A of the Tax Benefits Code).

The present study arises within this context and having as an inspiration the United Kingdom parallel case, considering that it has increased the same tax incentive to Business Angels from 20% to 30% in April this year and, in 2012, it is planned that it will increase the relevant maximum amount for each investor in a given year from £ 500,000 to £ 1,000,000.

The present study shows that the referred tax incentive is not merely a decrease in revenue or increase in tax expense for the State Fiscal Accounts. Rather, it is a recovery engine for the economy with the guarantee of a quick return of the tax incentive granted with tax revenue increase in a few months. It is a risk free investment for the State: the expected rates of return are high, the payback occurs in the first months of activity of the company incorporated with the Business Angel's investment.

Because we are certain that it is an excellent recovery engine for the economy, and because we know that the State is starving for additional Fiscal Revenue, we propose an increase of the tax incentive from 20% to 30%, in order to show the State's intention to stimulate the creation of new businesses and the creation of new jobs that will generate additional Fiscal Revenue.

II. Assumptions

For the purposes of preparation of the present study we have taken into consideration the following assumptions:

- We have considered that 2 percent points of VAT incurred would not be deductible. This is typical in all businesses in Portugal. Other VAT output or input is neutral;
- Bank financing has not been considered (which would improve the Fiscal Revenue with a bigger investment);
- It was considered that the BA would invest half of the money needed (in practice BAs tend to invest less than 50%). If we considered less than 50%, it would improve Fiscal Revenue;
- Capital gains on disposal by the BA have not been considered. If they were considered, it would improve the Fiscal Revenue with 10.75% or 21.5% CGT;
- Indirect impacts, like taxes on profits of suppliers, less unemployment subsidies, etc. were not considered. If considered it would improve the Fiscal Revenue;
- It has been considered that the Tax Break is refunded in June of the year after the investment is made by the Business Angel;
- It has been considered that the BA would be able to deduct the total amount of tax deduction. In case there is a ceiling in terms of amounts (e.g. € 50.000), Fiscal Revenue improves;

- Additional legal emoluments, due to new shareholders, change of Articles, etc. were not considered;
- Fiscal Revenue that could arise from property taxes was not considered;
- A low average effective IRS (Personal Income Tax) rate of 10% was considered;
- An average Social Security charge of only 30% (20% cost of the employer and 10% contribution of the employee) was considered (actual rates applicable are higher: 34,75% employee + employer and 29,6% management + company);
- In case the company stops the activity after one year, it was considered that VAT incurred would not be refunded.

III. Study

For purposes of the present study it was considered that the *start up* would require an investment of € 100.000 and that the company "consumes" the total investment. The study is valid for any other investment amount, since, apart from the fixed costs (that are residual) of incorporation and annual compliance, the remaining costs are directly related to the investments and with the activity of the *start up*. I.e., the investment amount is not going to affect neither the State's payback, nor the "return" of the "investment" to the Fiscal Revenue.

Scenario A

Scenario A is the most pessimistic scenario in which the *start up* "consumes" all the investment in the first year of activity and cannot produce and sell, closing the business in the first year:

SCENARIO A - Business closes after 1 year							
Startup funded with the help of a Business Angel under Tax Break Scheme	**Investment**	**1st year**	**2nd year**	**3rd year**	**4th year**	**5th year**	**Total**
Investment	-100.000						
Revenues		-					
Management Staff Costs		50.000					
Other Staff Costs		30.000					
Other costs		20.000					
EBT		- 100.000	-	-	-	-	- 100.000

Under this scenario and despite the "failure", granting of the tax incentive is beneficial for Fiscal Revenue, given that, in the first year of activity, the *startup up* results in the collection of the following taxes and other charges:

Revenue arising for State from the Startup	**Investment**	**1st year**	**2nd year**	**3rd year**	**4th year**	**5th year**	**Total**
IRS - Personal Income Tax (10%)		6.667	-	-	-	-	6.667
Social Security Contributions (30%)		20.000					20.000
VAT (20%)		4.000	-	-	-	-	4.000
IRC - Corporate Income Tax (25%)				-	-	-	-
Other legal emoluments	500	85	-	-	-	-	585
Total State Revenues	500	30.752	-	-	-	-	31.252

Scenario B

The scenario B is what we can call the expected most common scenario, given that the *start up* "consumes" all the investment but starts producing and after five years is selling € 500.000 per annum (cruise mode).

SCENARIO B - Expected Scenario							
Startup funded with the help of a Business Angel under Tax Break Scheme	**Investment**	**1st year**	**2nd year**	**3rd year**	**4th year**	**5th year**	**Total**
Investment	-100.000						
Revenues		-	100.000	150.000	300.000	500.000	
Management Staff Costs		50.000	50.000	50.000	75.000	75.000	
Other Staff Costs		30.000	30.000	50.000	75.000	125.000	
Other costs		10.000	20.000	25.000	35.000	60.000	
EBT		- 90.000	-	25.000	115.000	240.000	290.000

Under this scenario, the State Revenue will be as follows:

Revenue arising for State from the Startup	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
IRS - Personal Income Tax (10%)		6.667	6.667	8.333	12.500	16.667	50.833
Social Security Contributions (30%)		20.000	20.000	25.000	37.500	50.000	152.500
VAT (2%, not deductible)		200	400	500	700	1.200	3.000
IRC - Corporate Income Tax (26,5%)				1.000	12.250	63.600	76.850
Other legal emoluments	500	85	85	85	85	85	925
Total State Revenues	500	26.952	27.152	34.918	63.035	131.552	284.108

Scenario C

The scenario C is an optimistic scenario that allows us to understand that if the business goes better than expected, Fiscal Revenues boost!

SCENARIO C - Better than expected scenario	

Startup funded with the help of a Business Angel under Tax Break Scheme	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
Investment	-100.000						
Revenues		100.000	300.000	600.000	1.000.000	2.000.000	
Management Staff Costs		50.000	75.000	100.000	150.000	200.000	
Other Staff Costs		30.000	90.000	180.000	300.000	600.000	
Other costs		20.000	60.000	120.000	200.000	500.000	
EBT		-	75.000	200.000	350.000	700.000	1.325.000

Under this scenario, the Fiscal Revenue will be as follows:

Revenue arising for State from the Startup	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
IRS - Personal Income Tax (10%)		6.667	13.750	23.333	37.500	66.667	147.917
Social Security Contributions (30%)		20.000	41.250	70.000	112.500	200.000	443.750
VAT (2%, not deductible)		400	1.200	2.400	4.000	10.000	18.000
IRC - Corporate Income Tax (26,5%)			19.875	53.000	92.750	185.500	351.125
Other legal emoluments	500	85	85	85	85	85	925
Total State Revenues	500	27.152	76.160	148.818	246.835	462.252	961.717

IV. Conclusions

The table below is a summary of the conclusions reached and allows us to understand that the Fiscal payback occurs in the first months of activity of the *start up*, regardless of the scenario considered.

Return for the State in terms of Revenues	Scenario A	Scenario B	Scenario C
Revenue from taxes 1st Year	31.252	27.452	27.652
Revenue from Taxes 5 Years	31.252	284.108	961.717
Taxes deducted if 30%	15.000	15.000	15.000
State Payback if 30% (Years)	-0,02	0,05	0,04
Return for the State in 5 Years, if 30% TB	108%	1794%	6311%
Compound Annual Return for the State if 30% TB	18%	92%	152%

Note that the tax incentive is only granted in the middle of the year following the investment; in practice, the Fiscal Revenues are collected from the *start up* before granting tax relief/refund to the Business Angel. Consequently, in any case, there is no disbursement of funds by the State in granting the incentive.

On the other hand, the expected rate of return for the State is extremely high and even if the *start* up closes in the first year of activity, the State will have a yield greater than 100%, in the scenario of granting a tax incentive of 30%.

From the above, it is evident that this is a tax incentive that promotes the investment and assures, even in the worst case scenario, the return of the granted incentive through the taxes and other charges due by the *start up.*

It could be argued that investments could always occur, even without the tax incentive, particularly if they have high rates of return. However, in the current environment of high uncertainty, volatility and risk aversion, the lack of motivating incentives will hardly encourage Business Angels to take such risk. Combining the financing difficulties, lack of capital for high risk investment and lack of guarantees from the promoters, many projects that could be good initiatives will not get out of the paper.