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COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

REPORT 2009



Commission on Taxation

Report 2009

BAILE ÁTHA CLIATH
ARNA FHOILSIÚ AG OIFIG AN tSOLATHAIR
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Foreword

We present this Report at a challenging time for Ireland. A time when firm action is needed to strengthen our economy so that it sustains and creates employment and continues to provide resources for those in need. Growth that is sustainable is a key objective – from growth will come jobs and tax revenues – from jobs will come reward and security - and from tax revenues will come the ability to provide services and redistribute resources in our society.

There are many areas of Ireland's tax system that work well. Over the years it has been a key facilitator in redistributing income and a foundation for our ability to attract industry and sustain jobs. So we are starting from a good place. Nonetheless we have found many areas where the system can be restructured and reformed and these are the focus of our recommendations.

In keeping with our Terms of Reference these recommendations have regard to the medium to longer term and, in aggregate, they are compatible with keeping Ireland a low tax economy. We do not advocate an overall increase in the levels of taxation but rather a broader and less volatile base. Indeed one of our overriding concerns is the relatively narrow base of Ireland's current tax system which makes it very susceptible to changes in economic conditions. Even falls in output much less extreme than those experienced in 2009 would, if sustained, generate large budget deficits. Over time these could challenge our ability to provide essential services and, in the extreme, could challenge our fiscal autonomy. A focus on revenue streams that are less likely to collapse during a downturn is necessary and we need such a focus immediately.

Some of our proposals are radical – an annual tax on residential property, domestic water charges, a carbon tax, and removing or limiting most of the tax breaks that are currently available. We believe that it is not possible to keep things as they are. Our recommendations should not be compared with the status quo. Instead we need to ask what are the likely alternatives if they are not adopted. In particular we need to ask where the revenues will come from if not from the new areas of taxation and charges that we recommend.

Our proposals have the general character of making Ireland less vulnerable to economic shocks, encouraging enterprise and innovation, ensuring sustainable water supply and waste treatment, meeting our responsibilities on climate change, supporting the autonomy of local government, encouraging provision for retirement, and improving the fairness of our tax system.

Some recommendations will involve taxing ourselves in ways we have avoided for decades, but they will guarantee greater stability in our tax revenues while having the least negative effect on the ability of our economy to grow and create jobs. They will bring greater certainty to the capacity of the State to support those in need and reduce uncertainty about sudden changes in tax rates and structures.

There will be a natural tendency for all who will be affected – which is almost all of us – to argue that they are a special case and should be exempted. Where such argument is indulged, the inevitable consequence is to increase the burden commensurately on the rest.

It is twenty-five years since Ireland's tax system was last examined in detail. The sixteen month timeframe for completion of our deliberations required us to concentrate on broad reform rather than detailed

design. There will be areas which deserve more detailed examination and analysis sooner rather than later. We therefore recommend examination of Ireland's tax system at more regular intervals in future. This should ensure that we continue to have a system that is responsive to emerging social and economic developments and is always ahead of the curve and never behind the game.

I wish to thank all of the Members of the Commission for their commitment and professionalism since we first met in March 2008. Like any seventeen-person body we have differing views and perspectives. It is to the Members' credit that they were consistently objective in their input and focused only on an outcome that seeks to deliver the optimal taxation system for Ireland.

We could not have completed our work and delivered this Report without the excellent work and sustained dedication of the Commission Secretariat so ably led by Jim Kelly. We are in their debt.

A handwritten signature in black ink, appearing to read 'Frank Daly', written over a horizontal line.

Frank Daly
Chairman

Membership of the Commission

Frank Daly, Chairman

Tom Arnold, CEO, Concern

Julie Burke, Solicitor, JMB Tax Solicitors

Micheál Collins, Department of Economics, Trinity College Dublin

Frank Convery, Heritage Trust Professor of Environmental Policy, University College Dublin

Tom Donohue, Partner, Russell Brennan Keane, Chartered Accountants

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Mark Redmond, CEO, Irish Taxation Institute

Willie Soffe, Chairman, Dublin Transportation Office

Mary Walsh, Chartered Accountant

Deirdre Somers, CEO, Irish Stock Exchange (resigned September 2008)

Secretariat

Jim Kelly, Secretary

John Conlon, Assistant Secretary

Joe Cullen

Ann O'Driscoll

Caroline Cody

Sighle de Barra (from June 2008)

Barry Sullivan (from December 2008)

Fraser Hosford (from January 2009)

Ronan O'Reilly (up to October 2008)

Signatories of the Report

Frank Daly, Chairman

Tom Arnold

Julie Burke

Micheál Collins

Frank Convery

Tom Donohue

Eoin Fahy

Colin Hunt

Sinead Leech

Con Lucey

Danny McCoy

Feargal O'Rourke

Mary O'Sullivan

Mark Redmond

Willie Soffe

Mary Walsh

Brendan Hayes declined to sign the Report for reasons set out by him in his letter to the Chairman which is included at Annex 2.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 1

EXECUTIVE SUMMARY AND LIST OF RECOMMENDATIONS



Part 1:

Executive Summary and list of Recommendations

Introduction [Part 2 of our Report]

Establishment and terms of reference

The Commission was established on 14 February 2008 to review the structure, efficiency and appropriateness of the Irish taxation system and with the intention that our work would help establish the framework within which tax policy would be set for the next decade at least.

Our terms of reference are far-reaching. We were asked to have regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government, in particular the four commitments:

- To keep the overall tax burden low and implement further changes to enhance the rewards of work while increasing the fairness of the tax system
- To ensure that our regulatory framework remains flexible, proportionate, and up to date
- To introduce measures to further lower carbon emissions and to phase in on a revenue neutral basis appropriate fiscal measures including a carbon levy over the lifetime of the Government, and
- The guarantee that the 12.5% corporation tax rate will remain

We were invited, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the taxation system and specifically to:

- Consider how best the tax system can support economic activity and promote increased employment and prosperity while providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term
- Consider how best the tax system can encourage long term savings to meet the needs of retirement
- Examine the balance achieved between taxes collected on income, capital and spending
- Review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds
- Consider options for the future financing of local government, and
- Investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax

In our terms of reference we were requested to report by 30 September 2009. Following discussions during March 2009 between the Minister for Finance and our Chairman, this was subsequently brought forward to 31 July 2009.

When we were established in February 2008, our primary focus was on the medium and long term and on the fitness for purpose of the tax system for a period of 10 to 15 years. Since then there has been a very significant change in Ireland's economic circumstances and, while we are of course mindful of these changes, we consider that our primary focus should remain on the medium to longer term and we have

prepared our Report on this basis. The tax system we are proposing is one that we believe will provide greater equity and assist economic growth and this in turn will provide the resources for public services in the future.

Guiding principles

We set down guiding principles – comprising both general principles of taxation and operational principles – to assist us in fulfilling our mandate.

Equity - Equity that is, taxing persons on their ability to pay.

Flexibility - A flexible tax system is one that is responsive to, and capable of adjusting in line with, changes in society, markets, business practices, technology and economic conditions. Flexibility may also be looked at in the context of budget volatility and the ability to raise one tax to compensate for a shortfall in another.

Tax neutrality - In a general sense, tax neutrality is used to describe a tax system that does not create a bias that could influence a taxpayer to choose one course of action over another. In other words, decisions are made on their economic merits and not for tax reasons.

Simplicity - The simplicity principle requires that the tax rules are known and that liability is clear.

Evidence-based approach - We adopted an evidence-based approach so that, where available, facts and appropriate benchmarks were used to support our analysis and conclusions.

Pragmatism - The tight timeframe we had in which to complete our deliberations, together with our wide terms of reference, suggested that we should mostly focus on tax reform rather than tax design. The obvious exceptions here were carbon tax and property taxation, as these are not features of the current tax system.

Our approach to tax reform

Role of a tax system

The primary role of a tax system is to raise revenue to fund Government expenditure.

The Irish tax system has evolved over time to reflect changing economic and social conditions and will need to be equally responsive to new developments in the future. In general, we consider that many aspects of the tax system work well and do not require reform. Other areas are in clear need of reform and are the main focus of the proposals in our Report.

Broaden the base rather than increase the rates

Some of our proposals involve widening the scope of the charge to tax. We consider that lower tax rates on a broad base are better than higher rates on a narrow base. Having a broad tax base allows tax revenue to be raised from a wider range of sources and enables rates of tax to be kept low. In adopting this base broadening approach, we are positioning the tax system to support economic activity which has the potential to sustain and increase employment, encourage enterprise and thus enhance living standards for all.

Overall levels of taxation

We do not seek to increase overall levels of taxation. Rather, we set out to broaden the tax base so that tax is levied on a wider range of income, gains and assets. It is our general view that the revenues raised through the measures we propose should be used to reduce the tax burden in other areas so that the reform is tax neutral overall.

Balance of taxation between income, capital and spending

In striking the appropriate balance of taxation between income, capital and spending, Government in its approach to revenue raising should:

- Seek to broaden the base within each tax head, and
- Look to property taxes, spending taxes (especially environmental taxes), and income taxes in that order

A stable revenue base

We consider that stability is an important attribute of a tax system. This implies that the tax system should be designed with a view to eliminating as far as possible volatility of tax receipts. A consideration in achieving a stable tax base is to tax those factors that cannot avoid the charge to tax. The most obvious example of this is immovable property. We consider that the taxation of property is one area of Ireland's tax system that is particularly in need of reform. Introducing an annual tax on residential property represents an important step towards providing a stable and non-volatile tax base.

Equity

Equity is a key aspect of a tax system. A tax system has a role in the redistribution of income. This is achieved by taxing those with higher levels of income at a higher rate than those with lower levels of income. The redistribution occurs not only in the tax system but also through the welfare system and both systems should operate in a coordinated way. Equity should be considered in the context of the overall tax system. A lack of progressivity in one area of the system may be compensated for by having a high degree of progressivity in other areas, or by focused direct expenditure - which is financed from tax revenues.

Ireland's taxation system [Part 3 of our Report]

Part 3 gives a broad overview of national taxes, of social insurance and levies and of local authority taxes and charges in operation in Ireland. These are considered in some detail in other Parts of our Report.

Income tax, value-added tax, excise duties and corporation tax together account for over 90% of tax receipts; stamp duties, capital acquisitions tax and capital gains tax make up most of the balance. Social insurance contributions and levies are also important in the Irish taxation context and we outline the key components of these in this Part. Finally, Part 3 also gives an overview of the principal charges imposed by local authorities, thus providing a context for our consideration of the future financing of local government in Part 11 in accordance with our terms of reference.

The Macroeconomic Framework and the Balance of Taxation [Part 4 of our Report]

The Irish economy

The Irish economy has experienced dramatic change since the reports of the previous Commission on Taxation over 25 years ago. In the intervening years Ireland has experienced significant economic growth with living standards converging on, and in some cases surpassing, those of other developed economies. The recent change in the Irish economy has impacted greatly on the country's fiscal position and resulted in a significant increase in unemployment levels. Our approach is that the extra revenue that is raised by our proposals for broadening the base of the tax system should be available to reduce existing tax rates, particularly taxes on labour. In this way our structural reform should allow the taxation system to collect a set amount of revenue with less distortion to the economy and in a more equitable manner. It should also contribute, along with other policies aimed at restoring competitiveness, to the policy goal of moving towards effective full employment in the medium term.

Our terms of reference make it clear that we are to have regard to keeping the overall tax burden low. Furthermore, our remit is to consider the structure of the taxation system for the "medium and longer term" rather than consider broader fiscal policy and the short-term situation.

Balance of taxation between income, capital and spending

We note that in striking the appropriate balance of taxation between income, capital and spending, Government in its approach to revenue raising should seek to broaden the base within each tax head and look to property taxes, spending taxes (especially environmental taxes) and income taxes in that order.

This suggested hierarchy of different taxes is based on their economic impact. Policymakers will need to consider any trade-off with other objectives of tax policy, particularly equity. The basis for this ranking is that a tax on less mobile factors will cause less economic distortion, as confirmed by both international and Irish evidence. Corporation tax is omitted from the ranking because Ireland already has a low corporation tax rate and our terms of reference require us to have regard to "... the guarantee that the 12.5% rate of corporation tax will remain".

This ranking is not a simplistic 'one size fits all' model for tax policy. The particular circumstances of a specific country may give reason to expect deviations from this ranking. In this way different models may be appropriate for different countries. The appropriate ranking may also change at different points in time.

A sustainable fiscal balance

It is our view that, for the longer term, fiscal policy should pursue a counter-cyclical budgetary approach that achieves balance over the economic cycle. Taking into account the position of the economic cycle involves the accumulation of resources in good times so that in less benign times fiscal policy can be expanded in order to support greater economic activity. There is now a greater emphasis on the role of fiscal policy in demand management in Ireland because, as a member of the Eurozone, we no longer have our own exchange-rate policy and monetary policy. With regard to capital spending we advise some flexibility, in particular so that the large costs that can be incurred by a 'start-stop' approach to large capital projects are avoided.

In addition, public spending should be based on a stable revenue base. Unstable sources of tax revenue can include pro-cyclical taxes which intensify the business and economic cycle. Thus we recommend a move away from a transaction-based tax on property such as stamp duty towards introducing more stable revenue sources, including an annual tax on residential property and user charges.

Tax system - structural issues [Part 5 of our Report]

Income tax structural issues

The main purpose of the income tax system is to collect revenue to fund public services. The system has other important roles including the redistribution of resources as well as incentivising a number of desired outcomes such as participation in the labour force. There are now four parallel systems, with four different bases, which collect tax on income: income tax, PRSI, the health contribution levy and the income levy. We consider that there should be a single system that collects tax on income.

Income tax is charged by way of a two-rate structure. For the longer term we consider that a three-rate structure has merit on grounds of equity, greater progressivity and flexibility. Such a structure should reflect the need to keep taxes on labour low and marginal rates competitive.

Unit of taxation and individualisation

We support, as a general principle, the continuation of the position whereby the family is the unit of taxation and that this should be the position for all direct taxes. However, in relation to income tax, a “hybrid” arrangement has been in place since 2000, with regard to the tax band structure and credits that apply to married couples. We consider that this arrangement should remain in place as it represents a balance between, on the one hand, acknowledging the choices families make in caring for children and, on the other, taking account of the need to encourage labour force participation.

Cohabiting couples

As regards the tax treatment of opposite sex and same sex cohabiting couples under the tax code, we hold the view that tax law should follow the general law in this area. To the extent that general law extends to opposite sex and same sex couples the same treatment under the law as that afforded to married couples at present, we envisage that they should be covered by our recommendation as regards the unit of taxation.

Minimum wage and taxation

Policy in relation to lower earners over the past decade was aimed, among other things, at taking low earners out of the income tax net so that people could keep more of what they earn. Our view is that the general aim should be to continue to exempt the minimum wage from taxation.

High earners

A measure to limit the use of certain tax reliefs and exemptions for those on high incomes came into effect in 2007. It provides for more equity by improving progressivity in the income tax system. A balance has to be struck between providing tax incentives to encourage investment in areas of the economy and a measure which restricts the use of those same incentives. We recommend that the measure remains part of our tax code, that it be periodically reviewed and that it should apply to individuals availing of reliefs

and exemptions who earn more than €250,000 rather than the existing limit of €500,000.

PRSI

PRSI has certain characteristics of a tax. It is a complex system that has a wide scope covering both benefits and contributions. It is not easily understood and contains a number of anomalies. We recommend that there should be a separate comprehensive consideration of the PRSI system. We examine the aspects of PRSI that have the characteristics of tax and make a number of recommendations regarding PRSI which include broadening and rationalising the base.

The health contribution levy does not confer any right or entitlement of benefit on the contributor. It is thus in the nature of a tax. We recommend that this levy should be abolished and integrated into the income tax system when fiscal conditions improve sufficiently to allow a transition to the new structure. We also recommend that the national training fund levy should be abolished and a different approach to funding the national training fund should be put in place.

Refundable tax credits

A refundable tax credit is one where, if an income-earner has insufficient income to use all of his or her tax credit, the unused portion is paid to him or her by way of a cash transfer. We do not recommend a move to refundable tax credits at this stage. However, if there is not an appropriate level of uptake of direct expenditure support through measures like Family Income Supplement payments after a period of five years, the question of refundable tax credits should be considered as a policy option to ensure a more equitable distribution of resources.

Integration of the tax and welfare systems

We recommend further integration of the tax and social welfare systems in terms of closer technical and policy integration, greater exchange of information and the further development of administrative co-operation between the Revenue Commissioners and the Department of Social and Family Affairs.

The tax treatment of social welfare payments

Certain social welfare payments are exempt from tax. We conclude that, as a general rule, all social welfare payments should be subject to taxation and that the statutory provisions which exempt from income tax elements of social welfare payments should be discontinued. However, we do not recommend any change in the taxation status of maternity benefit, adoptive benefit and health and safety benefit and we recommend that specific exemptions from income tax should be introduced for the Family Income Supplement, domiciliary care allowance and the respite care grant. We also recommend that arrangements should be put in place as early as practicable to ensure that tax due on social welfare payments is collected at source by the Department of Social and Family Affairs. When in place, the arrangements for this would facilitate the taxation at source of child benefit payments. Section 8 of Part 8 contains our recommendations with regard to child benefit and taxation.

The taxation of capital

In regard to capital gains tax we recommend that capital gains should not be taxed to the extent that they arise from inflation. We also recommend the reintroduction of rollover relief in the case of farm land disposed of under a compulsory purchase order. However, in Part 8 we recommend limiting the reliefs

available on the transfer of business and farm assets within families.

Residence

Residence rules are important as regards equity and protecting Ireland's taxing rights. The present rules – which are based solely on time spent in the country – need to be strengthened. We are recommending that the existing 183/280 days test for determining the tax residence of an individual be supplemented by additional criteria, which should include tests relating to a permanent home and an individual's centre of vital interests.

Remittance basis

The remittance basis is an anachronism that is not compatible, on equity grounds, with a modern tax system and it should be discontinued. However, withdrawal of the remittance basis is a significant change to the tax system and there should be a lead-time of three to five years before any legislation to discontinue it takes effect. We also recommend (in Part 7) a carefully targeted incentive aimed at attracting key skills into Ireland.

Regulatory framework

Equity, efficiency and fairness should underpin the administration of Ireland's tax system. The perception of fairness is vital if a tax authority is to have the confidence of taxpayers. The relationship between the taxpayer and the taxing authority is enhanced where the compliance burden is minimised to the greatest extent possible. Against this background, we make a number of recommendations on the appeals process, interest charges and the regulatory and compliance burden.

Tax avoidance

Tax avoidance offends the principle of equity and can undermine both the tax base and tax compliance. Against this background we consider the current approach to dealing with avoidance and we recommend a review of the effectiveness of the measures now in place.

Taxation of property [Part 6 of our Report]

Restructuring of taxation of property

We consider that all property should be subject to recurrent taxation – either through the local government commercial rates system or a recurrent tax on residential property. We recommend the introduction of an annual property tax on residential property. Such an annual tax should be put in place as soon as is feasible.

A rebalancing of the existing tax system to provide for a more stable tax base is desirable and an annual property tax will help achieve this. The restructured property tax system that we propose will help reduce economic distortion arising from the present emphasis on transaction based property taxes. It is appropriate to move away from an undue reliance on stamp duty – where the tax revenues are contingent on the level and value of property transactions. A property tax would provide a reliable revenue stream that cannot be avoided and can therefore provide stable revenue for the Exchequer and, in due course, local government financing.

Economic aspects of an annual property tax

Our examination of property taxation measures had regard to evidence that annual taxes on land and buildings have a small adverse effect on economic performance and that taxes on capital and financial

transactions are highly distortionary. An over-reliance on transaction taxes – particularly stamp duty on property – has contributed to tax revenues dropping more quickly than (nominal) GNP. An annual property tax would, in our view, create a sounder base from which the property market can develop.

Other taxes on property

When an annual property tax is introduced, stamp duty on a residential housing unit that is a person's principal private residence should be zero-rated. However, stamp duty should continue to apply for investor purchasers of residential housing units. The rate should take account of transaction tax rates (and thresholds) that apply across the EU.

There are two other specific areas where we propose changes to the taxation of property. Firstly, windfall gains arising from increases in land values due to rezoning decisions should be subject to an additional capital gains tax charge. Secondly, a recurrent property tax should be introduced on land zoned for development that is not used for the zoned development.

Design features of an annual property tax

The annual property tax (APT) we recommend should:

- Apply to all residential housing units with the broad exception of local authority and social housing and some limited other exceptions
- Be payable by the owner of the property
- Be calculated by reference to the open market value of the property using valuation bands and be subject to self-assessment
- Apply at a rate which is proportionate
- Have regard to ability to pay with a general waiver provision exempting house-owners under a low income threshold. A deferral option should also be provided where certain criteria are met
- Have transitional rules in the case of a principal private residence of a person who paid stamp duty during the previous seven years, and
- Have a wide range of payment options

The need for an up-to-date valuation base

We recommend the development of an up-to-date valuation base for all residential, business, commercial and industrial property in Ireland.

Implementation

The timing of any change in policy on the taxation of residential property is a sensitive issue. However, it is arguable that such a change is less difficult at a time when the residential property market is at or near the end of a downturn in the economic cycle. Introducing an annual property tax would, in our view, create a sounder base from which the property market can develop when taken with other compensating measures such as the zero-rating of stamp duty on principal private residences.

Property tax rate

Prescribing the rate of an annual property tax is not a matter for us. However, factors that should be taken into account in setting a rate to replace, in a stable property tax system, the somewhat volatile flows from

stamp duty include:

- The revenue flow to be replaced should not reflect the windfall receipts from stamp duty which arose from the rapidly growing property market during the period 2003–2007, and
- The need to finance waivers for those on low incomes

Local government financing

We envisage that the annual property tax will be an important component in the future financing of local government and recommend that before the next local elections in June 2014, Government should give local authorities flexibility regarding setting the rates of tax. We explore other aspects of local government financing in Part 11 of our Report.

Supporting economic activity [Part 7 of our Report]

Context of our work – low effective tax rates

We believe that the best way to achieve low effective tax rates is to broaden the tax base so that tax rates can be kept low. This highlights a trade-off between supporting overall economic activity and supporting specific economic sectors and activities. We believe that primacy should go to supporting overall economic activity and tax rates are centrally important in this regard. We do accept, however, that incentives are needed in limited circumstances and we deal with these in Part 8 of our Report. We also believe that the specifics of the tax code are important; how the Irish tax code compares with other jurisdictions has extra consequences for a small open economy with large levels of mobile investment.

It is generally agreed that corporation tax policy, in particular the introduction of the 12.5% standard rate of corporation tax from 2003 onwards, has been a key factor in Ireland's economic success. A low, stable corporation tax rate is very important in supporting economic activity in the long term.

We stress the importance of a low tax wedge in maintaining competitiveness. A core principle of tax policy into the medium term should be to keep taxes on labour and the labour tax wedge low, in order to reduce the costs of employment, stimulate demand for labour and encourage labour force participation.

Facilitating enterprise

A tax code that facilitates enterprise is a key component in supporting economic activity. We identify specific areas where further improvement is warranted. We recommend measures to help new business and the removal of what we perceive to be barriers to the efficient functioning of existing business. Our key recommendations include abolishing stamp duty on share transactions, reducing the rate of tax on dividends from ordinary shares, relaxing the close company surcharge provisions and easing the preliminary tax payment rules for both large companies and new non-corporate enterprises.

We also propose a change to the treatment of capital expenditure for business purposes. Our recommendation is that accounts depreciation for tax purposes should replace the existing capital allowances regime for capital expenditure on 'tools of the trade' and also on buildings. In the case of buildings we recommend that the new regime should apply to buildings that currently qualify for capital allowances. We also propose that the list of such buildings be extended. This move will contribute significantly to the development of a tax system that is appropriate, flexible and capable of responding to change – key elements of our remit on supporting economic activity.

Supporting sectors and activities

We also focus on the development, through taxation, of the knowledge-based economy, and make recommendations in relation to research and development (R&D) tax credits and the tax treatment of royalty payments from abroad. It is clear that Ireland's ability to regain the productivity per person it experienced in the period 1994-2000 will depend in substantial part on the development of a knowledge and innovation led economy. Tax incentives focused on these areas will assist in making this transition.

Maintaining the corporation tax rate at 12.5% is an important signal that enterprise is important and to be encouraged. The price signals for carbon and for water that we propose in Parts 9 and 11 create a market incentive for innovators. Our proposals as regards R&D tax credits are likewise supportive – we recommend that companies should be given the option of offsetting R&D tax credits against employer PRSI costs. These are significant changes which, we believe, will enhance the overall attraction of Ireland as a location of choice for enterprise.

We also explore the role of taxation in 'upskilling' the labour force as this is a key component of economic development. We propose two new incentives: one aimed at persons who are made unemployed so that they can offset the retraining costs they incur on certified training courses against income for previous years; the other aimed at attracting key skills into Ireland. We recommend a carefully targeted incentive based on specific skills, rather than salary criteria, to allow Ireland compete in world markets for mobile employees who are in demand internationally.

The measures that we recommend to support specific sectors and activities will also of course benefit enterprises outside the target sectors and complement our package of measures to support business generally.

The review of tax expenditures [Part 8 of our Report]

Defining a tax expenditure

There is no generally accepted definition in Ireland of what constitutes a tax expenditure. We therefore adopted the OECD definition of a tax expenditure – as a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure. There are valid reasons why a tax system needs to incorporate relieving measures and exemptions, for example, to help it function equitably and efficiently and to interact with other systems at an international level. Such measures, while they may reduce the tax base, are part of the structure of the tax system or are desirable elements that make the tax system function efficiently. These are part of the benchmark tax system and, in accordance with the OECD definition, are not tax expenditure.

We also recommend that, in general, direct government expenditure should be used instead of tax expenditures.

Tax expenditures can involve a number of undesirable characteristics including a lack of equity as between different taxpayers and a lack of transparency and visibility in the allocation of public resources. They also have the potential to facilitate tax avoidance, have no cost restraints and are generally not reviewed regularly. The potential unequal distribution of public resources, which arises from the use of tax expenditures, was a key consideration for us.

Role for tax expenditures

We consider, however, that tax expenditures, if carefully designed and controlled, have an important role to play in delivering desired behavioural responses.

There are three instances where it would be appropriate to examine the possibility of introducing a tax expenditure. They are:

- To correct market failure
- To attract mobile investment, and
- To offset shortcomings in other areas of public policy

Where a tax expenditure is proposed, or an existing expenditure's timescale is to be extended, we recommend that it be tested against these criteria as well as meeting the principles of efficiency, stability and simplicity. It would also be necessary to justify a departure from the equity principle which a tax expenditure invariably necessitates.

Evaluation of tax expenditures

We recommend that for all future tax expenditures, and reforms of tax expenditures, there should be an *ex ante* evaluation process in advance of decisions to implement or extend any tax expenditure. As part of this process, the costs and benefits of the proposal should be assessed and the alternative of a direct expenditure approach should be considered. Only those which can be justified by reference to that test should be put in place.

We also recommend better measurement and data collection on the costs and benefits associated with the introduction or extension of the tax expenditure and the review of its impact. Data collection on costs and benefits needs to be considered in the design or modification of tax expenditure.

Finally, we recommend the publication of an annual tax expenditures report by the Department of Finance which should be a part of the annual budget process and subject to Oireachtas scrutiny. As a means of exerting control over spending through the tax system, a number of devices should be used including the imposition of thresholds and ceilings (outside of which no tax relief would be available) and reductions in the rate at which tax relief is given or in the quantum of a base figure to which tax relief might apply.

Benchmark tax system and review of current Irish tax expenditures

Our Report first identifies a complete list of all tax relieving measures in the Irish tax system. In total 245 tax relieving measures are identified. Having reviewed these, we concluded that 130 were part of the benchmark tax system and 115 were tax expenditures. We classified these tax expenditures into the following eight categories:

1. Children
2. Housing
3. Health
4. Philanthropy
5. Enterprise, including farming
6. Employment
7. Savings and investment
8. "Other" tax expenditures

Each tax expenditure within these eight categories was analysed in terms of cost, numbers benefiting, the policy objectives underpinning them and how each rated when measured against the principles for a tax expenditure. Based on this examination we made a recommendation as to whether each tax expenditure should be continued, discontinued or modified. These are set out fully in the main body of Part 8 of our Report. We also recommend that transitional arrangements should be put in place, where appropriate, in relation to tax expenditures which are being discontinued.

Tax and the environment [Part 9 of our Report]

Overview

Under the provisions of the EU Energy and Climate Change Package agreed in December 2008, Ireland is legally obliged to reduce its emissions by 20% (from a 2005 base) by 2020 in the following sectors – agriculture, residential, low intensity energy and commerce, transport and waste. There is no price signal facing those operating in those sectors indicating that the capacity to absorb greenhouse gases is now very scarce and should be used sparingly and that reducing such emissions will be rewarded by reduced payments.

Those who emit more are in effect subsidised by those who emit less. A charge that would repair this market failure by rewarding the reduction of emissions and penalising the converse is, therefore, appropriate. In terms of impact on emissions it will be an important policy tool to help Ireland achieve its legally binding EU obligations and make a positive contribution to the climate change agenda.

Imposing a tax on the leading greenhouse gas (carbon dioxide) will incentivise the action needed in ways that leave the response up to the emitter and that reflect the polluter pays principle – in essence those who emit more pay more. We also recommend that specific arrangements be put in place to ensure that those who experience energy poverty will be fully protected from the impacts in terms of price rises.

Carbon tax

The introduction of a carbon tax was specifically mentioned in our terms of reference and in Part 9 of our Report we outline a detailed proposal for a carbon tax. The tax should apply to fossil fuels consumed in Ireland, it should be based on tonnes of carbon dioxide (CO₂) emitted by each fuel and it should be collected upstream, at the earliest point of supply. It should be visible at the point of final consumption, to help ensure that behavioural change aspects are maximized and it is not seen as 'just another tax'. In general, the rate should match the price of carbon available under the EU emissions trading scheme (EU ETS); however, we believe that a floor price is also appropriate, so that the tax will have some effect on behaviour and give certainty. Streamlining with existing excise provisions, exemptions for participants in the EU emissions trading scheme and possible accommodation of businesses with special agreements to reduce their carbon footprint, are other components of our recommendations.

We do not propose that a tax on other greenhouse gases (methane, nitrous oxide, and the three F-gases) should be imposed. Methane and nitrous oxide emissions from agriculture cannot at this time be accurately monitored, reported and verified so our conclusion not to impose a carbon tax is pragmatic. We recommend that research into measures to reduce agricultural emissions should be pursued. Our preferred approach for the F-gases is to conclude voluntary agreements with business and to foster producer initiatives.

Other environmental measures

The targeting of greenhouse gas emissions via a carbon tax is just one application of environmental taxes. We recommend amendments to the VAT Directive to allow lower rates for energy efficient goods and services. We support the accelerated capital allowances scheme for energy efficient equipment, and suggest that the potential for expanding it to incentivise innovation, along the lines of the scheme used by the Netherlands, should be evaluated. We also recommend the gradual phasing out of VRT over a ten-year period and its replacement with taxes on motor usage. A car scrappage scheme, confined to the purchase of electric cars and vehicles with very low carbon emissions, may also be appropriate.

Revenue neutrality and carbon tax

Our terms of reference indicate an intention that environmental measures should be revenue neutral. The overall effects of our proposed carbon tax on vulnerable households should be appraised to ensure that such households (urban and rural) are cushioned from the effects of the tax. We also suggest that the recycling of carbon tax revenues to fund energy efficiency incentives for business and households would be appropriate. The availability of carbon tax revenues to improve competitiveness is also a valuable policy tool.

Green economy

Other aspects of our Report (set out in Part 11) include recommendations in relation to the introduction of domestic water charges and the pricing of waste collection and final disposal charges in accordance with the polluter pays principle. These are directly relevant to our environmental remit. We bring all elements together under a “green economy” umbrella in Part 9. The price signals for carbon and for water that we propose create a market incentive for innovators particularly those in energy efficiency, renewables supply and greenhouse gas abatement.

Tax incentives for retirement savings [Part 10 of our Report]

Introduction

The State provides a State pension through the social welfare system. The pension is intended to provide an adequate basic standard of living in retirement. In many cases this State pension will be supplemented by private pension arrangements, generally through occupational pension schemes and personal pension arrangements, which are regulated by the State and afforded support through the tax system.

The gap in coverage – whereby some individuals do not save for retirement and instead rely on the State pension to meet all of their needs – forms a backdrop to our deliberations. A key consideration in our examination of this issue was our changing demographics. By 2050, Ireland will move from an old-age dependency ratio of six people of working age to every one person aged 65 or over (6:1), to a ratio of 2:1 – in other words, just two people of working age to every one person aged 65 or over. Unless there is more personal saving for retirement in the meantime, there is likely to be a significant gap in coverage.

Tax incentives for retirement provision

The tax system offers incentives to encourage retirement provision, by allowing contributions to occupational pension schemes, personal retirement savings accounts (PRSAs) and retirement annuity contracts (RACs) to be deductible in calculating taxable income. While these incentives are widely used, there remains a

gap in retirement savings coverage, particularly in the case of those with low to middle incomes.

Equity issues

There are a number of equity issues in regard to the tax treatment of retirement savings. Our proposals address some, but not all, of the equity issues involved.

The main issue is the inequity involved in the fact that those liable to tax at the higher rate of income get tax relief at 41% while those liable at the standard rate get tax relief at 20%. This involves the Exchequer giving different levels of support to different taxpayers. Relief should be given at a single rate irrespective of the individual's marginal tax rate.

Giving tax relief for all pension contributions at the higher rate would act as a strong incentive to those on lower levels of income who have not been providing for their retirement to begin to do so. In addition, it would not disincentivise those taxable at the higher rate who have been getting relief at that rate because they would continue to get relief at that rate. However, we had concerns about the costs of this approach, particularly the costs if auto-enrolment, which is another of our proposals, were to apply.

We present a model that could improve equity in the tax treatment of retirement savings and also act as an incentive to those liable to tax at the standard rate to make savings for their retirement. We also believe that coverage could be increased by applying an auto-enrolment approach and giving enhanced relief in the early years of retirement provision.

Package of measures for retirement savings

We are putting forward a model through which the tax system could be used to encourage people to save for their retirement. The main elements are:

Matching contribution - All contributions towards supplementary retirement provision should qualify for a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer. Giving State support to retirement provision in this way would improve equity and incentivise savings by low to middle income earners. Support could be given at a higher rate, of €1 for each €1 contributed by the taxpayer for a limited period for all supplementary pension contributions.

Soft-mandatory approach - Employers would be obliged to offer the PRSA facility and automatically enrol employees in the scheme. The 'soft' aspect is that an employee would be entitled to opt out of the scheme later.

A retirement savings scheme - A retirement savings scheme along the lines of the former special savings incentive accounts (SSIA) scheme, should also be introduced. This would be a simple savings scheme that would allow savings for retirement based on a minimum savings requirement and involving an Exchequer contribution of €1 for each €2 saved. It would also allow limited pre-retirement access to funds.

We recognise that the changed economic climate is not making it easy for individuals to decide to invest in pension products. One aspect of the model we present, that of the matching contribution by the Exchequer where pension contributions are made by individuals, may be appropriate to a more stable economic and retirement savings environment than exists at the time of publication of our Report.

Tax treatment of the lump sum

The tax-free status of the lump sum on retirement facilitates transition from full pay to pension. It may also act as an incentive to individuals to save for their retirement. On the other hand, the payment of a

lump sum defeats to some extent the purpose of a pension which is to provide an income in retirement. We consider that changes should be made to the tax treatment of the lump sum.

Under existing rules a tax-free lump sum of 25% of the fund, or 1.5 times final salary, is allowed. We recommend that

- The first €200,000 of that lump sum should be tax-free
- The excess of that lump sum over €200,000 should be taxable at the standard rate

Future financing of local government [Part 11 of our Report]

Introduction

Our terms of reference asked us to consider options for the future financing of local government. Our recommendations in this Part are also informed by other considerations including the ongoing debate about autonomy and accountability in local government, re-establishing the linkage between responsibility and revenue raising and the polluter or user pays principle in regard to the supply of services.

Our recommendations for the future financing of local government focus on changing the balance between nationally provided and locally collected sources of income. Local authorities source around 55% of their overall current income from their own generated sources such as: commercial rates, housing rents and receipts for goods and services such as waste charges and water charges from the commercial sector. The share of local authority-budgeted income provided directly by the State in 2009 amounts to just over €2 billion – or 45% of total current income. Overall our recommendations will change that balance to a position where, by the end of a five-year period, local authorities would source well over 75% of their income from their own generated sources.

Property taxation and local government financing

Ireland is one of the few countries which does not impose a tax on domestic property to fund local government. In Part 6 of our Report we set out our recommendations for introducing an annual property tax (APT). We also recommend that after an appropriate period all of the revenues from this tax should be used for local government financing

- In the first instance APT revenues should be hypothecated for local government financing once the tax has become established, and
- By no later than the next local elections (June 2014) APT rate setting powers should be devolved to local government

Water charges

Ireland is investing heavily in the development and operation of water supply and waste treatment systems, and must continue to do so, both in order to ensure that water of high quality is available where and when it is needed, and to meet requirements of the EU Drinking Water and Wastewater Directives. With the exception of the contributions of business, these very substantial costs are funded from general taxation. Households do not pay for water, and there is no incentive to conserve, so that consumption per capita is about 30% more in Ireland than in jurisdictions that do charge based on use. Those who use water irresponsibly are in effect subsidised by those who use it sparingly, and there is a constant need to expand the supply of treated water involving major and expensive engineering projects. It is unlikely

that Ireland will be able to maintain this level of expenditure indefinitely from general taxation, and the outcome will be inadequacies in the quantity and quality of supply.

We recommend that domestic water charges should be phased in over a five year period. These charges should be substantially based on use but commence with a flat rate charge and move to volumetric billing once meters are put in place. Early installation of meters should be incentivised. Such charging will not just encourage water conservation but simultaneously generate the funds needed to ensure that water supply, water quality and Ireland's consumption levels per capita are up to international norms. Water wasters will no longer be subsidised by those who conserve. We recommend that waivers be made available to those who are unable to pay water charges.

Commercial rates

We recommend a number of measures to broaden the commercial rates base which should increase financing from this source by at least 10%. The main measures include rating State properties, changing the relief for vacant properties and the part-rating of third-level and professional institutions.

Receipts for own goods and services

The user/polluter pays principle was relevant to our review of the delivery of water and waste services by local authorities. We recommend a number of other measures to increase revenues from the supply of own goods and services by local authorities.

There is a wide gap (estimated at nearly €40 million in 2006) between the cost of running the planning system and the revenue received in planning fees. We recommend that this should be addressed and responsibility for setting planning fees should be devolved from the Minister for the Environment, Heritage and Local Government to local authorities, subject to central guidelines being developed.

There is considerable variation in the rental income per local authority housing unit across local authorities. We recommend that maximum rent levels should be removed to ensure that some tenants and households do not benefit disproportionately. The significant disparity across local authorities between rents collected on an income per housing unit basis should also be addressed urgently. A review of the current differential rents scheme should be carried out to improve the sustainability and effectiveness of the scheme, as previously recommended by National Economic and Social Council (NESC). Finally, there should be no deviation from the policy that housing rents are based on a person's ability to pay.

Encouraging behavioural change so that all consumers manage waste in a more efficient manner, and that waste reduction is achieved in line with the principle of 'reduce, re-use and recycle' should – along with landfill minimisation targets – be a primary focus of waste charge rates.

The Landfill Levy should be further increased to encourage diversion from landfill and meet our obligations under EU law and a similar mechanism should be considered for other forms of final disposal.

The balance of local government financing and the equalisation of funding

The Needs and Resource Model (developed by the Department of the Environment, Heritage and Local Government in 2000) ensures that the difference in the costs bases of local authorities are reflected in relevant decisions by central government on equalisation funding. We recommend that this be periodically reviewed and that a comprehensive review be carried out when our recommendation that the revenues from an annual property tax be used as a source of local government financing is implemented.

Recommendations in our Report are as follows:

For ease of reference each recommendation number commences with the relevant Part number. There are no recommendations in Parts 1 to 3 of our Report.

Part 4: The macroeconomic framework and the balance of taxation

- 4.1 The base-broadening measures in our Report should be introduced on a revenue neutral basis. In this context priority should be given to lowering the tax burden on labour.

Part 5: Tax system — structural issues

Income tax

- 5.1 There should be a single system which collects tax on income.
- 5.2 A three-rate income tax structure has merit but should have regard to the need to keep taxation on labour low and marginal rates competitive.
- 5.3 As a general principle, the family should continue to be the unit of taxation for all direct taxes.
- 5.4 The present arrangements with regard to band structure and credits which apply to married one-earner and married two-earner couples should remain in place.
- 5.5 If taxation is applied to child benefit, a child tax credit should be introduced to offset the additional tax payable in respect of child benefit for those in the lower half of the income scale.
- 5.6 The general aim should be to continue to exempt the minimum wage from income tax.
- 5.7 An earned income credit at a modest level should be phased in over time for proprietary directors and the self-employed.
- 5.8 A measure to limit the use of specified tax reliefs and exemptions by high earners should remain part of our tax code.
- The required effective rate should apply to those earning over €250,000. It should apply on a graduated basis to those earning between €200,000 and €250,000.
 - This measure should be periodically reviewed, including when economic growth returns to a more stable trend, to determine whether the level of the required effective rate should be increased.

The interface between the tax and the social welfare systems

- 5.9 In view of the burden on the Exchequer, the PRSI base should be broadened.
- 5.10 There should be a separate comprehensive consideration of the PRSI system.
- 5.11 A similar PRSI base should apply to employees and the self-employed and there should be a single rate of charge which should apply to both.
- 5.12 The employer PRSI ceiling should not be reinstated.
- 5.13 The employee PRSI ceiling should be abolished and this should be done on a phased basis.
- 5.14 Employees should be subject to PRSI on unearned income such as investment income and rental income.

- 5.15 Share-based remuneration, including share options, should be subject to PRSI.
- 5.16 Relief from PRSI should apply in respect of pension contributions made by self-employed contributors, subject to payment of a minimum PRSI contribution to secure future entitlement to benefits.
- 5.17 Trading losses should be deductible for PRSI purposes subject to the payment of a minimum annual PRSI contribution.
- 5.18 The step effect in PRSI and the health contribution levy should be eliminated.
- 5.19 The health contribution levy should be integrated into the income tax system.
- 5.20 The national training fund levy should be abolished and a different approach to funding the national training fund should be put in place.
- 5.21 There should be further integration of the tax and social welfare systems.
- 5.22 On balance, we do not recommend a move to refundable tax credits at this stage. If there is not an appropriate level of uptake of direct expenditure support through measures like Family Income Supplement payments within a five-year period, the question of refundable tax credits should be considered as a policy option to ensure a more equitable distribution of resources.
- 5.23 As a general rule, all social welfare payments should be subject to taxation.
 - The statutory provisions which exempt from income tax elements of social welfare payments which are otherwise taxable should be discontinued.
 - There should be no change in the taxation status of maternity benefit, adoptive benefit and health and safety benefit.
 - Specific exemptions from income tax should be introduced for Family Income Supplement, the Domiciliary Care Allowance and the Respite Care Grant.
- 5.24 Arrangements should be put in place as early as practicable to ensure that tax due on social welfare payments is collected at source by the Department of Social and Family Affairs.

The taxation of capital

- 5.25 Gains attributable to inflation should be excluded from the charge to capital gains tax.
- 5.26 Capital gains tax rollover relief should apply to the gains on disposal of farm land pursuant to a compulsory purchase order where the proceeds are re-invested in farm land.

Consumption taxes

- 5.27 The policy approach to determining the level of excise duty applicable to alcohol and tobacco products should take account of factors such as health outcome, public order issues, cross-border trade and other societal issues.
- 5.28 A deferral system should be applied in place of the daily payment system that currently applies to excises on mineral oils. However, any change should ensure that there is no cash-flow cost to the Exchequer.
- 5.29 Stamp duty on ATM, credit and debit cards should be phased out in the interest of promoting the move towards a cash-free society.

International issues

- 5.30 The 183/280 days test for determining the tax residence of an Irish citizen should be supplemented

by additional criteria, which should include a permanent home test and a test based on an individual's centre of vital interests.

- 5.31 The rule that allows an individual, who makes a gift of property to Ireland, to be regarded as neither resident nor ordinarily resident in Ireland, notwithstanding being present in Ireland for significant periods, should be discontinued.
- 5.32 The remittance basis of taxation for income tax and capital gains tax should be discontinued.

Regulatory framework

- 5.33 The relationship between the State and the taxpayer should be informed by reasonableness and proportionality through the provision of safeguards to ensure equitable treatment. To the extent that it is practicable, safeguards should be provided on a statutory basis.
- 5.34 The State's interaction with the taxpayer so as to ensure tax compliance should be proportionate.
 - Access to determinations of the Appeal Commissioners should be simultaneously available to taxpayers and the Revenue Commissioners.
 - A cost-effective route of appeal should be available to all taxpayers.
 - Other recommendations made in the Reports of the Law Reform Commission and the Revenue Powers Group in relation to the reform, jurisdiction and operation of the appeal system should be implemented.
- 5.35 The interest rate applicable to overdue tax payments should be reviewed each year having regard to the prevailing market rates and the rate should be sufficiently high to discourage taxpayers from deferring tax payments.
- 5.36 The Revenue Commissioners should adopt general criteria towards reducing the regulatory burden as outlined in section 7.2.2 of Part 5.
- 5.37 Dividend withholding tax exemption claims by foreign parent companies should not require third party certification.
- 5.38 Self-assessment should apply to interest and royalty withholding tax exemptions and reductions that are available in tax treaties.
- 5.39 The relevant contracts tax rate should be reviewed to ensure that it does not lead to a taxpayer paying tax in excess of final liability.
- 5.40 Flexibility should be given to the Revenue Commissioners to vary the strict application of interest and penalty provisions in *bona fide* situations where relevant contracts tax was not applied but at no loss to the Exchequer.
- 5.41 A system should be put in place to permit payments for professional services to be made without deduction of professional services withholding tax to compliant taxpayers with an appropriate certificate from the Revenue Commissioners.
- 5.42 Where detailed data is required to allow the appropriate evaluation and cost-benefit analysis of tax expenditures, the taxpayers and businesses availing of the tax expenditures should be required to e-file their tax returns.

Tax avoidance

- 5.43 Where tax avoidance is identified and demonstrates a weakness in the law, a specific provision in the tax code should be enacted to prevent the avoidance in question.

- 5.44 Twenty years after the introduction of the general anti-avoidance provision, it is now opportune to review its effectiveness as a tool to tackle tax avoidance. This should include consideration of a time limit within which the Revenue Commissioners would be required to make a decision on the point at issue.

Part 6: Taxation of property

- 6.1 The provision of an up-to-date valuation base for all property and land in Ireland should be addressed as a priority issue.
- 6.2 Provide for an annual property tax on all residential housing units with the broad exceptions of local authority and social housing units and some other limited exceptions set out in section 4.2 of Part 6.
- 6.3 Stamp duty for purchasers of principal private residences should be zero-rated.
- 6.4 Stamp duty should continue to apply to investor purchasers of residential housing units. The rate should be competitive having regard to the transaction tax rates and thresholds that apply across the EU.
- 6.5 The windfall gains from increases in land values due to rezoning decisions should be subject to an additional capital gains tax charge.
- 6.6 A recurrent property tax on land zoned for development should be introduced.

Part 7: Supporting economic activity

Corporation tax

- 7.1 A low stable corporation tax rate should remain a core aspect of Irish tax policy to support economic activity in the long term.

Taxes on labour

- 7.2 A core principle of taxation policy into the medium term should be to keep taxes on labour income, and the labour tax wedge, low in order to reduce the cost of employment and to sustain and stimulate demand for labour.
- 7.3 Taxes on labour should be kept low to support economic activity.
- 7.4 The degree of progressivity of taxes on labour should take into account the potential economic effects, particularly on job creation and entrepreneurship, as well as equity considerations.
- 7.5 Policymakers should take into account the fact that the economic impact of labour taxes is not uniform across the income distribution range and by reference to other demographics.

Supporting business

- 7.6 The 'corporation tax holiday' for new business should be extended to companies starting out in 2010 or 2011, and a similar scheme should be introduced for the non-corporate sector (see Recommendation 8.65).
- 7.7 An optional arrangement should be made available to new non-corporate businesses to allow them to spread their tax payments over the first three years.
- 7.8 Stamp duty on all share transactions should be reduced to zero.
- 7.9 The tax rate on dividends received by Irish residents should be reduced to the rate applying to

deposit interest.

- The measure should apply to ordinary shares.
- Safeguards should be included to ensure that the provision operates as intended.

7.10 Corporation tax payable on gains on disposal of assets used for trading purposes should be at the rate applicable to trading profits.

7.11 All companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax.

7.12 The recommendation that all companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax should be implemented having regard to the cash-flow costs involved in such a move. In this regard, options might include:

- Gradually increasing the small company threshold over a number of years, until all companies are covered.
- Allowing large companies the option of using a fixed multiple – say 105% – of the previous year's figure.

7.13 The close company surcharge on professional service companies should be removed.

7.14 The close company surcharge on investment and estate income of companies should be retained. However, the *de minimis* amount before the provisions come into play should be substantially increased in order to ease the regulatory burden for companies in such cases.

7.15 The Revenue Commissioners should closely monitor the new regime to ensure that it operates as intended.

7.16 The remaining close company surcharge provisions should be examined by the Department of Finance and the Revenue Commissioners to ensure their effectiveness.

7.17 A review should be undertaken by Government to assess the effects of the air travel tax on business in general and tourism in particular. This review should be set in the context of the pending inclusion of air travel in the EU Emissions Trading Scheme (EU ETS) from 2012.

7.18 Taxable income should be computed for business income (Schedule D, Case I and II) based on the accounting profits of a business, with normal statutory disallowances. In particular, we propose that accounts depreciation for tax purposes should replace the capital allowances regime used in business.

- In the case of buildings, the new provision should only apply where the buildings qualify for capital allowances under the existing rules (but see Recommendation 7.19).
- Businesses should be permitted to change to the new regime at any time in a five-year transitional period.
- Existing special regimes should continue.

7.19 The list of buildings that qualify for deductibility for tax purposes should be extended.

Supporting sectors and activities

7.20 Companies should, at their option, be permitted to offset their R&D tax credit against their employer PRSI costs.

7.21 Unilateral credit relief for foreign withholding tax on royalty payments should be extended to all trading companies.

- 7.22 An overall foreign pooling system for foreign withholding tax on royalty payments should be introduced.
- 7.23 Persons who are made unemployed should be entitled to offset the retraining costs they incur on certified training courses against income for the previous six years.
- 7.24 The partial reintroduction of the remittance basis in the Finance (No. 2) Act 2008 should be discontinued.
- 7.25 A carefully targeted tax incentive, along the lines indicated in Box 7.13, should be introduced to attract skilled persons into Ireland to meet short-term skills gaps.

Part 8: The review of tax expenditures

General

- 8.1 The OECD definition of a tax expenditure – as a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure – should be adopted.
- 8.2 Measures that are part of the benchmark tax system should not be considered as tax expenditures.
- 8.3 In general, direct Exchequer expenditure should be used instead of tax expenditures.
- 8.4 There are three instances where it would be appropriate to examine the possibility of introducing a tax expenditure. These are:
- To correct market failure
 - To attract mobile investment
 - To offset shortcomings in other areas of public policy

Where a tax expenditure is proposed, or an existing expenditure's timescale extended, the following questions should be asked, in sequence:

- Does the expenditure fall within one or more of the three instances outlined above?
- If so, does the proposal adhere to each of the following principles:
 - Efficiency
 - Stability, and
 - Simplicity
- If so, can a departure from the equity principle, which the tax expenditure invariably necessitates, be justified?

A tax expenditure should only be introduced, or extended, if it answers affirmatively to each of these questions.

- 8.5 For all future tax expenditures, and reforms of tax expenditures, there should be:
- An *ex ante* evaluation process in advance of decisions to implement or extend any tax expenditure, including an assessment of the costs and benefits of proposals and consideration of the alternative of a direct expenditure approach.
 - Better measurement and data collection on the costs and benefits associated with the introduction or extension of the tax expenditure and the review of its impact.
 - Publication of an annual tax expenditures report by the Department of Finance as part

of the annual budget process and subject to Oireachtas scrutiny.

- Spending through the tax system should be controlled by, for example, the imposition of thresholds and ceilings and reductions in the rate at which tax relief is given or in the quantum of a base figure to which tax relief might apply.

8.6 Transitional arrangements should be put in place where appropriate in relation to tax expenditures which are being discontinued.

Relating to children

8.7 Child benefit should be taxable income.

- The taxing of child benefit should be benchmarked against alternatives, including means testing, to ascertain the most effective method of achieving the aims and objectives of the child benefit programme.
- If taxation is applied, we recommend the introduction of a child tax credit to offset the additional tax payable in respect of child benefit for those in the lower half of the income scale.

8.8 The exemption of foster care payments from income tax should continue.

8.9 The one-parent family tax credit should continue and the credit should be allocated to the principal carer only and in a similar way to the current arrangements for child benefit.

8.10 The home carer tax credit should continue.

8.11 The widowed parent tax credit should continue.

8.12 The capital allowances for childcare facilities should be discontinued.

8.13 The income tax exemption for childcare service providers should be discontinued.

8.14 The exemption of employer-provided childcare from the benefit-in-kind charge should be discontinued.

Relating to housing

8.15 Mortgage interest relief should be continued in the case of firsttime buyers and discontinued for those who are outside this category. The current step down arrangements for firsttime buyers regarding the rate at which relief is given should continue to apply.

8.16 Income tax relief for rent paid for private rented accommodation should be discontinued.

8.17 The capital gains tax exemption on the disposal of a principal private residence should be continued.

8.18 Income tax relief for service charges should be discontinued.

8.19 The rent-a-room relief should be discontinued.

8.20 The capital gains tax and stamp duty exemptions on the disposal of site to a child should be discontinued.

Relating to health

8.21 Medical insurance relief should be continued on a more limited basis.

8.22 Relief for health expenses should continue at the standard rate.

8.23 Once the Fair Deal system for nursing home care has been implemented, removal of the tax relief for nursing home expenses should be considered.

8.24 The range of treatments contained within the scope of the relief for health expenses should be

subject to regular review.

- 8.25 Tax relief for contributions paid to permanent health benefit schemes should continue.
- 8.26 Tax relief for long-term care policies should be discontinued.
- 8.27 When direct expenditure support at the appropriate level is in place, the incapacitated child tax credit should be discontinued.
- 8.28 The allowance for employing a carer for an incapacitated individual should continue. However, the rate of relief should be the same as that available under health expenses relief.
- 8.29 The dependent relative tax credit should be discontinued.
 - The entitlement to mortgage interest relief that is derived from entitlement to the credit in relation to a principal private residence occupied by a dependent relative should continue. A person should be able to avail of firsttime buyer levels of relief once in respect of himself or herself and once in respect of a dependent relative who has not claimed for himself or herself.
 - The separate entitlement to CGT relief on the disposal of a principal private residence occupied by a dependent relative should be discontinued.
- 8.30 When direct expenditure support at the appropriate level is in place, the blind person's tax credit should be discontinued.
- 8.31 The arrangements for the scheme of accelerated capital allowances for palliative care units should be modified by the introduction of a termination date for the scheme.
- 8.32 The Disabled Drivers and Disabled Passengers Scheme should be modified in accordance with the recommendations of the 2002 Interdepartmental Review Group.

Relating to philanthropy

- 8.33 The scheme for payment of tax by means of donation of heritage items should be retained but should be modified so that the tax relief is limited to 50% of the value of the item donated.
- 8.34 The scheme for payment of tax by means of donation of heritage property should be retained but should be modified so that the tax relief is limited to 50% of the value of the property donated.
- 8.35 The capital gains tax exemption on works of art loaned for public display should be retained but the exemption should only apply to the gain accruing in the period for which the work of art has been so loaned.
- 8.36 Income tax relief for expenditure on heritage buildings and gardens should be discontinued.
- 8.37 The benefit-in-kind exemption on employer-provided art objects in a heritage building or garden should be discontinued.
- 8.38 The CAT exemption of heritage property and heritage property of companies should be retained.
- 8.39 The threshold on the eligibility of individual donations to charities and approved bodies to attract tax relief should be reduced from €250 to €100.
- 8.40 The relief for individuals under Recommendation 8.39 should be at the standard rate in all cases.
- 8.41 An upper limit of €500,000 per person on the annual value of donations which may attract tax relief is recommended. This limit should be enforced using the principles of self-assessment and audit.
- 8.42 The self-employed should be treated in the same way as PAYE earners under the scheme with the tax relief being paid to the charity or approved body.
- 8.43 In relation to donations from companies, the amount that would attract tax relief should be the same

as for individuals, i.e. a maximum of €500,000 per annum. The rate of tax relief on corporate donations should be the corporate tax rate and, as with donations from individuals, the tax relief should be paid to the charity or approved body.

- 8.44 The tax relief scheme available on donations to sports bodies should be modified. The tax relief regime that is recommended in respect of donations to charities and other approved bodies should also apply in relation to relief for donations to sports bodies and aggregate limits should apply to both reliefs.
- 8.45 Relief for gifts made to the Minister for Finance should continue.
- 8.46 The tax-exempt status of philanthropic and sports bodies should continue. However, the capital gains tax exemption should be discontinued where development land is disposed of.

Relating to enterprise (including farming)

- 8.47 The restriction of balancing charges on a building to the relevant holding period for that building should be discontinued for future acquisitions.
- 8.48 Grants to meet revenue expenditure should be taken into account in calculating taxable trading income and capital allowances should be available on expenditure net of capital grants. However, in the case of employment related grants, there may be a case for postponing the approach we suggest until more favourable labour market conditions apply.
- 8.49 The tax credit for research and development should continue.
- 8.50 Tax exemption for patent royalties should be discontinued.
- 8.51 The tax deduction for capital expenditure on scientific research should continue.
- 8.52 Film relief should be continued but should be subject to regular review in accordance with our principles as set out in Section 5 of this Part.
- 8.53
- The Business Expansion and Seed Capital schemes should remain in place up to their 2013 deadline.
 - The schemes should be reviewed to evaluate their effectiveness and the extent to which market failure exists in advance of any further extension beyond 2013.
 - The administrative burden placed on companies seeking to benefit from the schemes is onerous and should be reviewed.
- 8.54 Stock relief for farming businesses should be discontinued.
- 8.55 Income tax relief for farm land leasing income should be continued. However, the measure should be reviewed in 2012 in accordance with our principles as set out in Section 5 of this Part.
- 8.56 The accelerated allowance for capital expenditure on farm buildings for pollution control should not be continued when it expires in 2010. For subsequent years, normal capital allowances should apply.
- 8.57 The tax relief for the purchase of milk quota should be discontinued.
- 8.58 The restructuring aid for sugar beet growers should continue.
- 8.59 The tax exemption for payments to National Co-operative Farm Relief Services Ltd. and payments made to its members should be discontinued.
- 8.60 The accelerated capital allowances for energy efficient equipment should continue.
- 8.61 Relief for investment in renewable energy generation should continue. Any extension should adhere

to our general principles as set out in Section 5 of this Part.

- 8.62 The Mid-Shannon corridor scheme should not be continued beyond its current expiry date.
- 8.63 The investment allowance for machinery and plant and for exploration expenditure should be discontinued.
- 8.64 The tax treatment of the decommissioning of fishing vessels should continue.
- 8.65 The relief from tax for start-up companies should be continued. However, the scheme should be modified so that companies who begin trading in 2010 or 2011 would benefit from the exemption for two-years or one-year, respectively, within the existing three-year timeframe for the relief. In addition, the exclusion which applies to service companies should be removed.
 - A new scheme for unincorporated businesses should be established which would have its own three-year time cycle in line with the approach we recommend for the existing scheme.
 - Both the existing scheme and the proposed new one for unincorporated business should be subject to review in accordance with our general principles as set out in Section 5 of this Part after a reasonable period of time.
- 8.66 The tax treatment of venture fund managers should be modified such that in the case of an individual who is a venture capital fund manager:
 - Where the investment return on a carried interest represents income, it should be taxed at the appropriate marginal rate, and
 - Where the investment return on a carried interest is a capital gain, it should be subject to capital gains tax at the normal rate (25%).
- 8.67 The tonnage tax regime should be continued.
- 8.68 The capital gains tax relief for family transfers should be continued but limited so that it applies to asset values up to €3 million. Where the value of the asset transferred exceeds €3 million, only the part of the gain that is attributable to the excess over €3 million should be charged to tax.
- 8.69 Capital gains tax relief for disposal of a business or a farm on retirement should continue.
- 8.70 For business relief for CAT, a reduction of no more than 75% of the value of the business should be allowed before tax is calculated. The reduction should be subject to an overall monetary limit of €3 million.
- 8.71 For agricultural relief for CAT, a reduction of no more than 75% of the value of the property should be allowed before tax is calculated. The reduction should be subject to an overall monetary limit of €3 million. A condition of the relief should be that a farm asset is owned and operated as a farm for a period of six years after the transfer.
- 8.72 Business relief and agricultural relief should be amalgamated into a single relief.
- 8.73 Stamp duty relief for transfers of land to young trained farmers should continue.
- 8.74 The stamp duty exemption relating to the sale or transfer of EU Single Farm Payment Entitlements should be continued.
- 8.75 The tax incentives relating to forestry should be continued.

Relating to employment

- 8.76 Income tax relief for trade union subscriptions should be discontinued.
- 8.77 The relief for benefit-in-kind for employer-provided personal security assets and services should continue to apply where arrangements are made for all employees at risk.

- 8.78 The relief for benefit-in-kind and PRSI exemption for employer-provided public transport travel passes should continue.
- 8.79 The relief for benefit-in-kind and PRSI exemption on employer-provided bicycles and related safety equipment should continue.
- 8.80 The income tax exemption for scholarships should continue.
- 8.81 The income tax relief for fees paid for third-level education should continue.
- 8.82 Income tax relief for fees paid for training courses should continue.
- 8.83 The exemption from income tax of statutory redundancy payments should continue.
- 8.84 Income tax relief for *ex-gratia* termination payments should continue but the quantum of the exempt payment should be limited to €200,000 and the reliefs for Standard Capital Superannuation Benefit and top-slicing relief should be simplified.
- 8.85 *Ex-gratia* termination payments related to death or disability should be subject to a limit in relation to the tax-free amount permissible.
- 8.86 Income tax relief for termination payments where an employment involves foreign service should continue. However, it should be subject to an overall monetary cap of €200,000 in line with our recommendation for termination payments in excess of the statutory redundancy amount.
- 8.87 The exemption from income tax for retraining on redundancy should continue.
- 8.88 There are grounds for discontinuing the systematic short-time relief for equity reasons. However, discontinuation should not be implemented until more favourable labour market conditions apply.
- 8.89 Income tax relief for long-term unemployed and double deduction in respect of payroll costs should continue.
- 8.90 Income tax relief for employees on payments related to compensation for loss of future earnings should continue.
- 8.91 The PRSI exemption for employee (unapproved) share options should be discontinued.
- 8.92 Continue the income tax exemption for approved profit-sharing schemes (APSSs) and remove the PRSI, health contribution levy and income levy exemptions.
- 8.93 The tax treatment which applies to employee share ownership trusts (ESOTs) should continue.
- 8.94
 - The income tax exemption for approved share option schemes (APSOs) should be discontinued.
 - The taxable value of option gains should also be liable to both employer and employee PRSI and to the health contribution levy and the income levy.
- 8.95 Continue the income tax exemption for the save as you earn (SAYE) schemes and remove the PRSI, health contribution levy and income levy exemptions.
- 8.96 Extend the SAYE rules to permit a broader range of employee stock purchase plans (offered to all employees on similar terms and subject to an overall share purchase limit) to be eligible for income tax relief.
- 8.97 The income tax exemption for new shares purchased on issue by employees should be discontinued.
- 8.98 The artist's exemption should be discontinued; consideration should be given to introducing income averaging in the taxation of income from creative work.
- 8.99 The sportsperson's relief should continue.
 - The total repayment of tax for any 10-year period should be capped at €350,000 as

adjusted for inflation.

- The sportsperson can only select a block of 10 consecutive years for which to claim the relief as opposed to the best 10 non-continuous years.
- The relief should be subject to review after five years of operation under these new arrangements.

8.100 The seafarer's allowance should be discontinued.

8.101 The expenses of members of the Oireachtas should be treated in the same way under the tax code as expenses paid to employees and office holders generally.

- A monetary limit should be put in place on the dual abode allowance and the flat rate element of the relief which applies in relation to hotel and guesthouse accommodation should be discontinued.

8.102 The income tax exemption for payments under Scéim na bhFoghlaimeoirí Gaeilge should be discontinued.

Relating to savings and investments

8.103 Tax exemption for the income of credit unions should be continued.

8.104 The annual exemptions for interest and dividends on special term accounts and special term share accounts should be continued.

Relating to other expenditures

8.105 The age tax credit should continue.

8.106 The age exemption and marginal relief should continue.

8.107 The tax relief for income under dispositions for short periods (deeds of covenant) should continue.

8.108 The tax relief available to Veterans of the War of Independence should continue.

8.109 The relief from income tax of military and other pensions, gratuities and allowances should continue.

In future, the tax treatment of military service gratuities should be consistent with the tax treatment of lump sum payments in other public service employments.

8.110 The exemption from income tax of profits from lotteries should continue.

8.111 Consanguinity relief within the stamp duty code should continue.

Part 9: Tax and the environment

Taxing carbon dioxide emissions

9.1 A carbon tax on fossil fuels should be introduced.

9.1.1 The carbon tax should be based on a standardised measure of CO₂ content of the energy product. Measurement factors used should accord with international norms.

9.1.2 The carbon tax should apply to energy products released for consumption in Ireland.

- The tax rate should approximate the ETS price of carbon.
- The price should be established annually, on a recognised market place for trading carbon credits.
- A floor price for carbon should be set.

- 9.1.4 Any phasing in of the tax rate should depend on the scale of the price.
- 9.1.5
- The carbon tax should be collected at the earliest practical point of supply and linked into the existing mineral oils tax system where appropriate.
 - The carbon tax should be clearly visible at the point of final consumption to ensure it is not seen as 'just another tax'.
 - Working capital problems caused to small distributors/suppliers with slow stock turnover by the imposition of a tax at the earliest point of supply should be accommodated where practicable.
- 9.1.6
- In general, there should not be preferential rates of carbon tax.
 - Binding action-based and/or target-based monitored agreements to reduce emissions should be accommodated under the carbon tax design.
- 9.1.7
- Carbon tax should not apply to ETS participants.
 - Tax should not be imposed at this time on ETS participants in order to capture the gains they made from the free allocation of permits; the issue should be monitored and taxation may be appropriate in the future.
- 9.1.8 Administrative rules for the carbon tax should fit in with existing tax provisions where practicable.

Tax on other greenhouse gases

- 9.2 Research into measures to reduce agricultural emissions – such as alternative technologies and feeding systems – should continue and be intensified.
- 9.3 If methane and nitrous oxide emissions from agriculture become capable of being monitored, reported and verified with sufficient accuracy, their exclusion from the carbon tax should be reconsidered.

Product taxes

- 9.4 Environmental product taxes should be considered where voluntary initiatives are unsuccessful. If such taxes are to be considered, the criteria developed by us (see Box 9.8) should be met.

Energy efficiency

- 9.5 Continue the Accelerated Capital Allowance for energy-efficient equipment scheme for its current term; evaluate the potential for expanding the scheme to incentivise innovation (based, for example, on the Dutch model).
- 9.6 Ireland should support amendments to the EU VAT Directive that would allow the implementation of lower VAT rates for energy-efficient goods and services.
- 9.7 Businesses that are not in the emissions trading scheme should be given a rebate on their carbon tax payments if they participate in an approved mandatory energy reduction programme.

Transport

- 9.8 The VRT system should be replaced by a system based on car usage, in the longer term. Such a system should be introduced over a 10 year period in order to minimise adverse impacts (in relation, for example, to the existing fleet of tax-paid vehicles).
- 9.9 A focussed scrappage scheme, targeted at encouraging a switch to the purchase of electric and very low carbon emitting vehicles, should be considered.

Part 10: Tax incentives for Retirement Savings

- 10.1 The regime for non-funded pensions should be examined to identify the implicit tax cost to the Exchequer in the context of an equitable distribution of the tax expenditure on pensions.
- 10.2 The current tax relief for personal retirement provision should in the medium to long-term be replaced by a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer.
- 10.3 The matching contribution approach should be accompanied by a kick-start provision involving a contribution of €1 for each €1 contributed by the taxpayer in the first, say, five years of pension provision by an individual.
- 10.4 The matching contribution should apply where an individual has relevant earnings including where, because of the level of his or her earnings, the individual is not liable to tax.
- 10.5 A soft-mandatory approach could make a significant contribution to increasing pension coverage and should be considered.
- 10.6 An employee's payslip should show the amounts contributed by the Exchequer to the employee's retirement savings.
- 10.7 A retirement savings scheme along the lines of the former SSIA scheme, that is easily understood and which involves an Exchequer contribution, should be introduced – the scheme is outlined in Box 10.16 of Part 10.
- 10.8
 - As the annual earnings limit does not apply to employer contributions, there is a need to retain the standard fund threshold.
 - There should be a correlation between the annual earnings limit and the standard fund threshold, and the reduction in the annual earnings limit suggests that there should be a corresponding reduction in the standard fund threshold.
- 10.9 A lump sum taken on retirement should be liable to tax as follows:
 - An amount of up to €200,000 should be tax free.
 - The balance of the lump sum should be subject to tax at the standard rate of income tax.
- 10.10 The current tax relief rules should be reviewed to ensure that contributions and remuneration levels cannot be manipulated close to retirement to allow individuals to take advantage of unintended and inappropriate benefits.
- 10.11 Age-related limits on the amount of an individual's relevant earnings should continue.
- 10.12 The flexibility of an ARF should be extended to defined contribution occupational pension schemes.
- 10.13 Anomalies in the treatment of different retirement arrangements should be eliminated as far as possible.
- 10.14 The various ages specified in the legislation governing the time at which benefits may commence should be reviewed and conformed.

Part 11: Future financing of local government

Local commercial property taxation measures

- 11.1 The revaluation initiative should be expedited to ensure that a transparent nationwide valuation system, including a cost-effective route of appeal, is in place as soon as possible. Regular revaluations should be carried out thereafter, in order to ensure that the valuation base remains up-

to-date. This should be done as provided for in legislation, at intervals of not more than 10 years.

11.2 The vacancy relief provisions should be amended to provide for the granting of vacancy relief by local authorities, in accordance with the following principles:

- Vacancy relief should only be granted where the following conditions are satisfied:
 - An owner/leaseholder is *bona fide* unable to obtain a suitable tenant, or
 - A property is vacant due to repairs or alterations being carried out on it, and
 - That the relief, where granted, is time-limited so as not to encourage the owners of a premises to allow it to become dilapidated, and
 - The rate of the relief to be granted by a local authority to be within the range 50-100% for the time-limited period
- Vacancy relief should be applied *pro-rata* according to the period of vacancy in any year.

11.3 The provision which states that a property must be vacant at the time of the striking of the rate by a local authority should be removed.

11.4 Permanent offshore structures should be made subject to commercial rates.

11.5 Bed and breakfast accommodation and guesthouses should be brought within the commercial rates base where there are four or more bedrooms in a dwelling house provided on an ongoing basis for overnight guest accommodation. Self-catering apartments and holiday homes provided by tourism operators should also be brought within the rates base.

11.6 Third-level and professional institutions should be part-rated to reflect the fact that they generate significant funds from their own resources and conduct commercial activity on their campuses.

11.7 Community halls should be part-rated where significant commercial activity takes place in such facilities.

11.8 Agricultural farm buildings which are owned by a body corporate should be subject to commercial rates.

11.9 All buildings or land occupied by the State should be brought fully within the commercial rates base.

Annual property tax as a source of local government funding

11.10 After an appropriate period all of the revenues from an annual property tax should be used for local government financing.

11.11 The proposed annual property tax system should be established and operated as a national property tax system for a short initial period:

- Its revenues should then be hypothecated for local government financing as soon as is feasible – once the tax has become established, and
- By no later than the next local elections (June 2014), rate-setting powers should be devolved to local government subject to the considerations set out at section 5.3 of Part 11.

11.12 A new method of equalisation of funding, using a needs and resources model, should be developed in conjunction with the devolution of rate-setting powers to local government to reflect the changed funding base for local government.

Water charges

11.13 Measures should be put in place immediately to ensure that the costs of water services provided are fully recovered from the non-domestic sector.

- 11.14 Domestic water charges should be introduced, as a sustainable approach to realising an acceptable conservation culture.
- 11.15 There should be some level of incentivisation to ensure that consumers are encouraged to install meters.
- 11.16 Charges should be phased in over a period of time.
- 11.17 The charging should commence with a flat rate charge and change to volumetric billing for consumers once meters are put in place.
- 11.18 A waiver scheme should be provided for low-income householders.
- 11.19 Water meters should be installed in all new housing units.
- 11.20 A public information campaign should clearly outline the rationale for water charges and the way in which they will be implemented.
- 11.21 Water pricing should be introduced for all water consumers by local authorities based on a consistent methodology and applying the principle of full cost recovery.

Waste charges

- 11.22 The polluter pays principle should continue to underpin waste charges to ensure that all consumers pay for their own waste.
- 11.23 The landfill levy should be increased to encourage behaviour to divert waste away from landfill and meet our obligations under EU law and a similar mechanism should be considered for other forms of final disposal.
- 11.24 Waivers should be available from all service providers in all local authority areas to all clients who lack an ability to pay.
- 11.25 We do not support the establishment of a national waiver scheme. The pricing of waste and water services should be designed to fund the cost of providing services to consumers who qualify for a waiver.
- 11.26 Tax relief on service charges should be abolished.

Other means of financing local government

- 11.27 Following an efficiency review:
 - The Department of the Environment, Heritage and Local Government should develop a charging system in conjunction with local authorities to ensure a higher proportion of planning costs are recouped from planning applicants
 - Consideration should be given to devolving responsibility for setting planning fees from the Minister to local authorities subject to central guidelines being developed
- 11.28 There should be no deviation from the policy that housing rents are based on a person's ability to pay. Maximum rent levels should be removed to ensure that some tenants and households do not benefit disproportionately.
- 11.29 A review of the current differential rents scheme should be carried out to improve the sustainability and effectiveness of the scheme, as previously recommended by NESC.
- 11.30 The significant disparity across local authorities between rents collected on an income per housing unit basis should be addressed without delay with a view to elimination.

- 11.31 The Needs and Resource Model should be periodically reviewed and evaluated to ensure that the difference in the costs bases of local authorities are reflected in relevant decisions by central government on equalisation funding. The reviews should be undertaken in partnership with local authorities.
- 11.32 The initiatives being undertaken to improve efficiencies in local authority expenditure programmes should continue to receive a priority focus at local authority level and from central government. That priority will be assisted by the new standardised costing system which provides for greater benchmarking of local authority performance.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 2

INTRODUCTION



Part 2: Introduction

Section 1: Establishment and Terms of Reference.

Section 2: Approach adopted.

Section 3: Principles in the reform or design of the tax system.

Section 4: International obligations and the tax system.

Section 5: Our approach to tax reform.

Part 2: Introduction

Section 1: Establishment and terms of reference

The Commission on Taxation was established on 14 February 2008 to review the structure, efficiency and appropriateness of the Irish taxation system. In setting up the Commission, the Taoiseach (then Tánaiste and Minister for Finance), Brian Cowen, T.D., indicated that its work would help establish the framework within which tax policy would be set for the next decade at least, and that it was important that it took a strategic, considered and balanced perspective that recognised the evolving challenges ahead.

The terms of reference for the Commission were far-reaching. We were asked to have regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government, in particular the four commitments:

- To keep the overall tax burden low and implement further changes to enhance the rewards of work while increasing the fairness of the tax system
- To ensure that our regulatory framework remains flexible, proportionate, and up-to-date
- To introduce measures to further lower carbon emissions and to phase in on a revenue neutral basis appropriate fiscal measures including a carbon levy over the lifetime of the Government, and
- The guarantee that the 12.5% corporation tax rate will remain

We were invited, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the taxation system and specifically to:

- Consider how best the tax system can support economic activity and promote increased employment and prosperity while providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term
- Consider how best the tax system can encourage long term savings to meet the needs of retirement
- Examine the balance achieved between taxes collected on income, capital and spending
- Review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds
- Consider options for the future financing of local government, and
- Investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax

In our terms of reference, we were requested to report by 30 September 2009. Following on from discussions between our Chairman and the Minister for Finance, Brian Lenihan, T.D., in March 2009 we agreed to bring forward our reporting date to 31 July 2009.

Section 2: Approach adopted

2.1 Meetings, subgroups, plenary sessions

We held our inaugural meeting on 5 March 2008 and 32 plenary meetings were held between April 2008 and July 2009. Having regard to the broad terms of reference, the short timescale and the size and composition of the Commission, we agreed at the first meeting that the most effective way of organising the work would be to establish a manageable number of subgroups to focus on specific aspects of our terms of reference. Plenary meetings considered the more general issues as well as the reports from the subgroups on the work allocated to them.

Accordingly, seven subgroups were established to consider certain specific topics mentioned in the terms of reference as follows:

- How best the tax system could encourage long term savings to meet the needs of retirement
- Options for the future financing of local government
- Fiscal measures to protect and enhance the environment including the introduction of a carbon tax
- Review of all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds
- How best the tax system can support economic activity and promote increased employment and prosperity
- The issues around maintaining an equitable incidence of taxation
- The balance between taxes collected on income, capital and spending and providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term

The subgroups met a wide range of interested parties in the course of preparing their reports. In total the subgroups held over 100 meetings.

2.2 Submissions

We decided at the outset that written submissions received by us would be an important source of views for us in fulfilling our mandate. They would also provide interested parties with an opportunity to make proposals on one or more of the topics covered in the terms of reference. There had been considerable interest in the work of the Commission, as this was the first substantial review of the tax system in over 25 years.

Advertisements inviting submissions were placed in the national press and some 175 replies were received. A list of those who made submissions is provided in Annex 3 of our Report.

2.3 Oral hearings

We invited 12 organisations which made submissions to attend oral hearings in support of their written proposals where we considered the issues covered in their submissions could be usefully

explored further and were necessary for our deliberations. The oral hearings took place from 23 February to 25 February 2009. A list of those who attended oral hearings is in Annex 4.

2.4 Other consultations

We consulted widely with a large number of interested parties, in both the private and public sectors, to help us in our deliberations. Details are in Annex 4.

Section 3:

Principles in the reform and design of the tax system

3.1 Introduction

We established a set of guiding principles – comprising both general principles of taxation (such as equity) and operational principles to help us in our work (such as adopting an evidence-based approach) that would guide us in fulfilling our mandate. The principles, which were developed having regard to our terms of reference, are as follows.

3.2 Principles of taxation

3.2.1 Equity

Equity is a key aspect of a tax system. Equity means taxing persons on their ability to pay. Our terms of reference invited us to consider the structure of the tax system in the context of *maintaining an equitable incidence of taxation*. We are also asked to have regard to the commitment contained in the Programme for Government to increase *the fairness of the tax system*. One of the difficulties with equity is that it means different things to different people.

Equity is generally broken down into two components, horizontal equity and vertical equity.

- **Horizontal equity:** The concept of horizontal equity suggests that two persons with the same income should pay the same amount of tax. However, if they are not in equal positions because say, one person is a lone parent, the equity principle may also suggest that the tax burden of the single parent should be reduced. This raises questions as to the appropriate amount of the reduction and the documentation required by the tax authorities to justify eligibility for a reduction, and illustrates a core dilemma in the design of a tax system: equity and simplicity may be in conflict with each other¹.
- **Vertical equity:** The concept of vertical equity suggests that the tax burden should be distributed fairly across persons with different abilities to pay. Persons with higher income should pay more in taxes than persons with lower income. A progressive tax takes a higher percentage of income as income rises, so that high earners pay a higher proportion of their incomes than low earners.

Taxes that are not progressive may be either proportional (sometimes called “flat”) or regressive. A flat or proportional tax, which takes the same percentage of income from each taxpayer, does

¹ Horizontal equity is also relevant in an EU context, where the principle that resident and non-resident taxpayers in similar situations carrying out similar transactions should be subject to similar taxation treatment, is well established.

not, in general achieve vertical equity. It may, on the other hand, be highly efficient to implement. A regressive tax takes a smaller percentage of income as income rises — poor people pay a larger fraction of their incomes in taxes than rich people. This does not achieve vertical equity.

Equity is relevant not only to income disparities but also to the treatment of sectors of society with particular needs and to life consumption and savings patterns. The tax system (and fiscal policy through direct expenditure) to some extent addresses variations in life consumption patterns through, for example, the provision of mortgage interest relief for first-time buyers and enhanced tax relief for pension provision for individuals as they get older. We have, however, noted provisions in the tax code that unreasonably favour particular categories of taxpayer and we deal with these in our Report. Such provisions are not consistent with equity.

Equity must, however, be considered in the context of the overall tax system. A lack of progressivity in one area of the system may be compensated for by having a high degree of progressivity in other areas, or by focused direct expenditure – which, of course, is financed from tax revenues.

Rates of tax are also relevant to equity in that they enhance the progressivity of the tax system. While the introduction of a third rate of income tax could increase progressivity, there is a need to strike the appropriate balance between progressivity on the one hand and the impact on the incentive to work and enterprise on the other. It is of course also arguable that, looked at solely from the point of view of encouraging economic growth, a flatter system would be preferable. These are tensions that we have encountered during our discussions.

3.2.2 Flexibility

All societies change over time. So do markets, business practices, technology and economic conditions. A flexible tax system is one that is responsive to and capable of changing in line with these factors. For example, electronic commerce transformed the global economy from the late 1990s onwards, and tax systems worldwide had to adapt to the new types of transactions that emerged.

Flexibility may also be looked at in the context of budget volatility and the ability to raise one tax to compensate for a shortfall in another tax. This raises the question of over reliance on particular areas to provide a revenue stream versus having a broader base, and was something that we consider in the context of the balance of taxes topic in Part 4 of our Report.

The interaction between flexibility and the stability that is required for business was also looked at by us – a tax that has too much flexibility may create uncertainty for businesses and individuals.

We were asked in our terms of reference to have regard to the commitment in the Programme for Government that the regulatory framework should remain flexible, proportionate and up to date. We considered this aspect of flexibility also.

3.2.3 Tax neutrality

In a general sense, tax neutrality is used to describe a tax system that does not create a bias that could influence a taxpayer to choose one course of action over another. In other words, decisions are made on their merits and not for tax reasons.

As specific measures can be incorporated into the tax system to provide for, or to depart from, tax

neutrality in order to achieve a particular policy goal such as encouraging economic activity, we considered that the adoption of tax neutrality as a general principle without qualification would unduly hinder our consideration of options. Instead, ways that the tax system approximated to or departed from tax neutrality were examined in the course of our deliberations, as this allowed us to focus on the efficacy of different measures.

3.2.4 Simplicity

The simplicity principle requires that the tax rules are known and that liability is clear. It implies that the tax system is comprehensible and rational: in other words, one where the tax base is certain and where the tax rules are clear and easily understood, so that the taxpayer can anticipate in advance the tax consequences of a transaction.

The regulatory burden caused by taxation requirements covers the time and cost of the administration associated with compliance – such as making returns or keeping records that would not otherwise be required by the company or the individual concerned. It also includes the work needed in becoming compliant with a tax rule – such as putting appropriate technology, practices and procedures in place.

In adopting simplicity as a core principle, we considered the regulatory burdens of any new taxes, or changes to existing taxes, that we proposed. The terms of reference asked us to consider how best the tax system could support economic activity, and we considered that having logical, intelligible tax rules should be part of these considerations.

In a business context, the regulatory burden falls disproportionately on small and medium-sized enterprises (SMEs). Proposals to reduce the regulatory burden are addressed in Part 5.

3.3 Operational principles

3.3.1. Evidence-based approach

Our adoption of an evidence-based approach meant that, wherever available, facts and appropriate benchmarks were used to support our analysis and our conclusions.

3.3.2. Pragmatism

We have had 16 months in which to complete our deliberations. This tight timeframe and the nature of our terms of reference, suggested that we should for the most part focus on reviewing the current tax system rather than designing a new one. The obvious exceptions here were carbon tax, property tax and domestic water charges as these are not currently features of the Irish tax system. Other areas of the tax system were evaluated in the context of the existing structures and range of taxes. A more extensive analysis of the Irish tax system might, for example, examine whether progressivity in direct taxation is best provided mainly through the income tax system, whether taxing total income rather than consumption expenditure is appropriate and whether Ireland's tax system is optimal by reference to norms in other countries. Other tax system models are possible but our consideration of these was necessarily constrained by our reporting timeframe.

Adopting a pragmatic approach also meant that proposals considered by us were tested for viability. Tax policy in Ireland operates within an EU and international framework, and we

considered the impact of this framework and its implicit constraints at the outset – further detail is provided in Section 4 of this Part.

The need to take a strategic, considered and balanced perspective required our proposals to be grounded in reality and to be implementable with a quantifiable impact on Exchequer revenue.

3.4 Interaction between principles and other yardsticks

The guiding principles listed above – equity, flexibility, neutrality, simplicity, an evidence-based approach and pragmatism – interact with each other in complex ways. While dealing with the conflicting demands imposed by the principles proved to be a challenging task, we felt that these principles best provided the guidelines needed in undertaking the tasks specified in our terms of reference.

We also considered other criteria in the course of our deliberations. For example, the ability of the tax system to raise enough money to pay for a given level of public expenditure is central to the terms of reference, and raised issues such as the stability and predictability of the tax base and its overall magnitude. In addition, the polluter pays principle – where the polluting party pays for the damage done to the environment – featured in the discussions on the environmental taxes (see Part 9) and local government financing (see Part 11).

Section 4: International obligations and the tax system

4.1 Introduction

There are overriding principles in the EC Treaty that prohibit discrimination and restrictions on the so-called fundamental freedoms – i.e. the prohibition of discrimination based on nationality and the ability of goods, services, capital and labour to move freely within the internal market. There are also European Union (EU) directives – on direct, indirect and capital taxes – that apply in Ireland. While direct tax falls within the competence of Member States, that competence must be exercised in accordance with EU law. Ireland must also meet its obligations under double taxation treaties and other international agreements. Any proposals for change contained in our Report must be implemented in a manner that is consistent with those obligations.

4.2 EC Treaty basic principles

The principle of free movement of goods is set out in Title I of the Treaty. The principles of free movement of persons, services and capital are set out in Title III.

Free movement of goods (Articles 23 – 31): The free movement of goods is one of the cornerstones of the internal market. Articles 28 to 30 prohibit Member States from imposing or maintaining quantitative restrictions on imports, exports and goods in transit and all measures having equivalent effect (i.e. intra-Community trade barriers), except in special circumstances.

Free movement of persons (Articles 39 – 42): Discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment is prohibited. A number of directives and regulations have been developed (since 1968) to promote this principle – for example, co-ordination of agreements on social

security, and on visas, residence and work permits across Europe.

Freedom of establishment (Articles 43 – 48): Restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State, or on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State, are prohibited. Freedom of establishment includes the right to take up and to pursue activities as a self-employed person and to set up and manage companies in any of the Member States. Companies formed under the law of a Member State and with their registered office, central administration or principal place of business in the EU are treated the same way as individuals who are nationals of Member States.

Freedom to provide services (Articles 49 – 55): Restrictions on the freedom to provide services in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended are prohibited.

Free movement of capital and payments (Articles 56 – 60): Article 56 provides that all restrictions on the movement of capital between Member States and between Member States and third countries are prohibited. Restrictions on payments between Member States and between Member States and third countries are also prohibited. Article 58 provides for some limitations on Article 56 and allows Member States to distinguish between taxpayers who are not in the same situation with regard to residence or place where capital is invested. It also allows Member States to take measures to prevent infringements of national laws or to take measures which are justified on public policy or security grounds. However, while Article 58 allows different tax treatment of residents and non-residents and of domestic and foreign-sourced capital, the European Court of Justice (ECJ) has tended to interpret the provision narrowly.

If a conflict arises between Community law and a law of a Member State, then Community law prevails – in this regard, the role of the ECJ in striking down provisions of EU Member States' tax systems that are incompatible with the EC Treaty has become more evident in recent years.

4.3 Compatibility with state aid rules

Tax measures must not only conform to the principle of non-discrimination and the fundamental Treaty freedoms, but also need to be in line with Community state aid rules. Article 87(1) of the EC Treaty provides that "...any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market". There are, however, a number of exceptions to this. For example, aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment may be considered to be compatible with the common market.

4.4 Other international obligations

In Ireland, international treaties take precedence over domestic law. Ireland has concluded a significant number – 46 in force and a further five signed – of double taxation treaties with other countries, primarily drafted by reference to the OECD Model Tax Convention with respect to taxes on Income and on Capital. The purpose of double taxation treaties is to allocate taxing rights

between the contracting States in order to avoid double taxation and to prevent fiscal evasion.

Other international law which is relevant to Irish tax includes the European Convention on Human Rights² and Kyoto Protocol to the UN Convention on Climate Change.

Section 5: Our approach to tax reform

5.1 Role of a tax system

The primary role of a tax system is to raise revenue to fund government expenditure - for day-to-day spending and capital projects. Where expenditure is met through borrowing, tax revenue will be needed to meet the financing costs of such borrowing as well as its repayment. Other roles of a tax system are redistributing income and wealth, deterring certain activities and promoting enterprise and employment.

The Irish tax system has evolved over time to reflect changing economic and social conditions and will need to be equally responsive to new developments in the future. It will, for example, play a role in dealing with Ireland's changing demography, a different environmental context and globalisation of markets. Some of these feature in our Report. In general, we consider that many aspects of the tax system work well and do not require reform. Other areas are in clear need of reform and are the main focus of the proposals in our Report.

5.2 Broaden the base rather than increase the rates

We do not seek to increase the overall levels of taxation. Rather, we set out to broaden the tax base. Having multiple tax sources allows tax revenue to be raised from a wider range of sources and having a broad tax base enables rates of tax to be kept as low as possible, minimising the economic efficiency cost of taxation³. Thus it is our view that lower tax rates on a broad base are better than higher rates on a narrow base. A new tax on property offers the opportunity to reduce the burden of taxation on labour and on economic activity and a new carbon tax has environmental benefits.

Ireland is a small open economy. This means that the economic factors of production are likely to be more mobile and thus they will be more responsive to changes in taxation. Therefore the imperative to broaden the tax base so as to achieve lower tax rates is heightened. Broadening the base includes both extending the base of existing taxes and introducing new taxes on different bases.

Increasing rates of tax on the other hand would be likely to result in behavioural change with a negative impact – for example increased income taxes could be a disincentive to work and a barrier to business growth and job creation. Increased indirect taxes would lead to further adverse effects on cost competitiveness. Higher tax rates are also likely to result in an increase in tax evasion and avoidance.

Of central importance to our approach is positioning the tax system to support economic activity because increased economic activity has the potential to increase employment and thus enhance living standards for all.

² Enacted in Irish Law as the European Convention on Human Rights Act 2003

³ On the importance of lower tax rates, which can achieve the same level of tax revenue with a broader tax base, see 'Taxation and Economic Efficiency', A.J. Auerbach and J. Hines Jr., in 'Handbook of Public Economics, volume 3', A. J. Auerbach and M. Feldstein (ed.), 2002, and 'The Challenge of Tax Reform and Expanding the Tax Base', J. Poterba, The 2009 ESRI Geary Lecture, May 2009.

5.3 Provide a stable revenue base

We consider an important attribute of a tax system is its ability to provide a stable base for tax revenue. This implies that the tax system should be designed with a view to minimising the volatility of tax receipts so that resources required for public services can be provided in a stable way. This implies that tax should be levied in a variety of ways, not all of which need necessarily be correlated with the economic cycle.

5.4 Transitional arrangements

The package of measures that we propose in our Report constitutes structural changes to the taxation system to make it more efficient and equitable in the medium term. The timing of the implementation of these measures is a matter for Government. However, we believe it is important that not all the policy changes would occur at the same time. The phased implementation of these recommendations will need to take account of their interrelated nature and their differing tax administration requirements.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 3

IRELAND'S TAXATION SYSTEM



Part 3

Ireland's Taxation System

Section 1 is an introduction.

Section 2 gives a broad outline of all the taxes and duties that operate at a national level in Ireland.

Section 3 briefly considers social insurance, the health levy and the national training fund levy.

Section 4 outlines the taxes and charges that operate at local authority level.

Appendices 1 and **2** contain supplementary information.

Section 1:

Introduction

1.1 National taxes

The Irish taxation system encompasses the taxation of income, consumption and capital. At the national level:

- Income is subject to income tax in the case of individuals and corporation tax in the case of companies
- Spending or consumption taxes include value-added tax and excise duties
- Capital is subject to tax in a number of ways. Gifts and inheritances are subject to capital acquisitions tax and gains on the disposal of assets are subject to capital gains tax. Capital taxes also include stamp duty which is charged on transactions, including the purchase of property and shares

1.2 Income levy

A surcharge on income (income levy) was introduced in the Finance (No. 2) Act 2008. This came into effect on 1 January 2009. The full year estimate for the income levy is approximately €2 billion. The levy applies on gross income above an exemption threshold, as follows:

Table 3.1: Income levy thresholds

Income	Rate
Below €15,028	Exempt
€15,028 to €75,036	2%
€75,037 to €174,980	4%
Over €174,980	6%

Source: *The Revenue Commissioners*

National taxes raised some €41 billion in 2008 for the Irish Exchequer (down from €47.5 billion in 2007). The estimated receipts for 2009 – including the income levy – are approximately €34.4 billion.

Table 3.2: Net tax receipts, Ireland 2007 - 2009

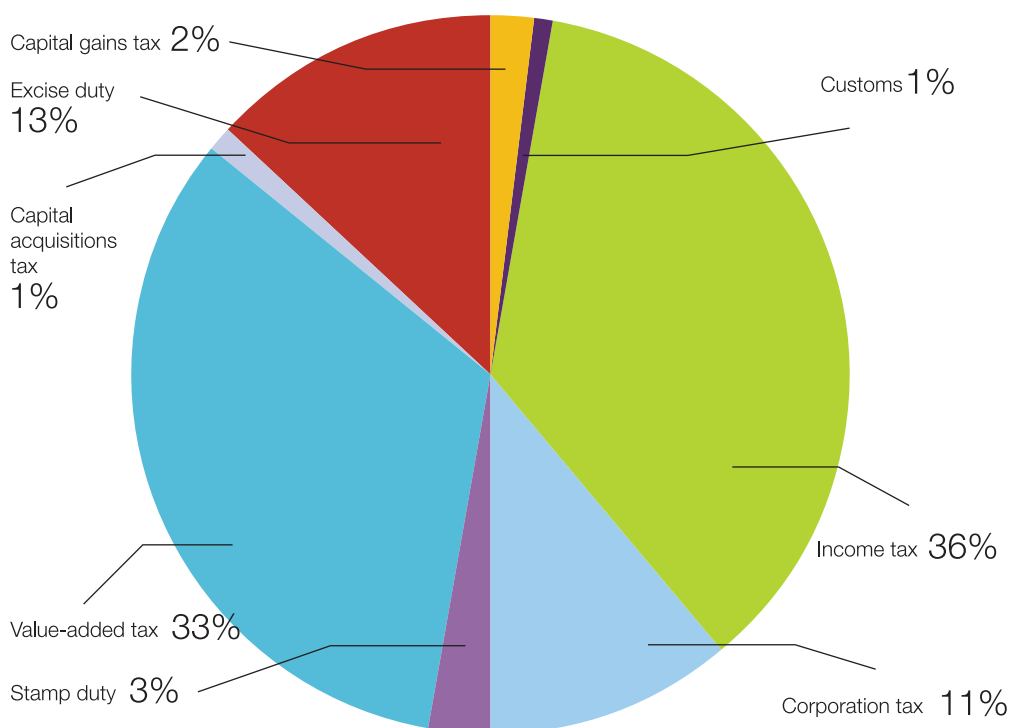
	Net Receipts 2007		Net Receipts 2008		Net Receipts 2009 (estimated)	
	€billion	%	€billion	%	€billion	%
Income tax	13.6	29%	13.20	32%	12.47	36%
Corporation tax	6.4	13%	5.07	12%	3.74	11%
Value-added tax	14.5	30%	13.43	33%	11.42	33%
Stamp duties	3.2	7%	1.76	4%	0.98	3%
Excise duties	6.0	13%	5.60	14%	4.63	13%
Capital gains tax	3.1	6%	1.42	3%	0.63	2%
Capital acquisitions tax	0.4	1%	0.34	1%	0.30	1%
Other (customs duty, misc.)	0.3	1%	0.25	1%	0.23	1%
Total	47.5	100%	41.07	100%	34.4	100%

Source: The Department of Finance and the Revenue Commissioners

Note: Net tax receipts are derived by subtracting repayments and refunds from the total amount collected ("gross receipts").

Figure 3.1 shows the breakdown of net receipts by tax for 2009 – it can be seen that income tax (including the income levy) accounts for some 36% of total estimated receipts.

Fig 3.1: Net tax receipts by tax head – Estimates for 2009, Ireland



Source: The Department of Finance and the Revenue Commissioners

An overview of the above taxes is given in Section 2, where we also present summary information on the distribution of taxpayers by income level in Ireland.

1.3 Social insurance

Social insurance contributions, health levy contributions and a national training fund levy are also significant contributors to Ireland's resources. They yielded approximately €9.75 billion in 2008 (up from €9.43 billion in 2007) and are estimated at €9.78 billion for 2009. The information is shown in Table 3.3. Social insurance, health and training levies are considered in Section 3.

Table 3.3: Social Insurance, health and training levies, 2007 – 2009

	2007		2008		2009 (estimated)	
	€billion	%	€billion	%	€billion	%
Social insurance	7.72	81.9%	7.98	81.85%	7.50	76.7%
Health levy contributions	1.30	13.8%	1.33	13.64%	1.89	19.3%
National training fund levy	0.41	4.3%	0.44	4.51%	0.39	4.0%
Totals	9.43	100%	9.75	100%	9.78	100%

Source: The Department of Finance

1.4 Local government

Taxes and charges also arise at the level of local government. These include rates on commercial property, a levy on private residences (other than main homes) and charges for the provision by local authorities of services such as refuse collection. In 2007, these accounted for 55% of the income needed to fund the current expenditure of the country's local authorities. The balance of local authorities' current expenditure comes from two sources:

- Government grants and subsidies, and
- The Local Government Fund (a central fund financed by the proceeds of motor tax and an Exchequer contribution)¹

Revenues from local government sources yielded approximately €2.75 billion in 2008 (€2.7 billion in 2007) and are estimated at €2.83 billion in 2009. Local government charges and levies are considered in Section 4.

1.5 Summary picture

Taking national taxes, social insurance contributions, levies and local authority revenue sources together, it can be seen that national taxes predominate in terms of total receipts, with, for example, the local authority component accounting for just 6% of the total receipts in 2009. This is low by European standards².

¹ There is also an Environmental Fund, which is used to support waste management and other environmental initiatives by central Government and local authorities. The income of the fund comes from two main sources – an environmental landfill levy (collected by local authorities) and a plastic bag levy (collected by the Revenue Commissioners).

² Direct comparisons between Member States are difficult as the base on which estimates are made varies considerably between countries.

The breakdowns are shown in Table 3.4 and Figure 3.2. These three components of Exchequer receipts are considered in some detail in our Report. An overview is given in Sections 2, 3, and 4 in summary form. Full details on all the taxes are available from the relevant Government websites:

www.revenue.ie (for national taxes)

www.welfare.ie (for social insurance and levies)

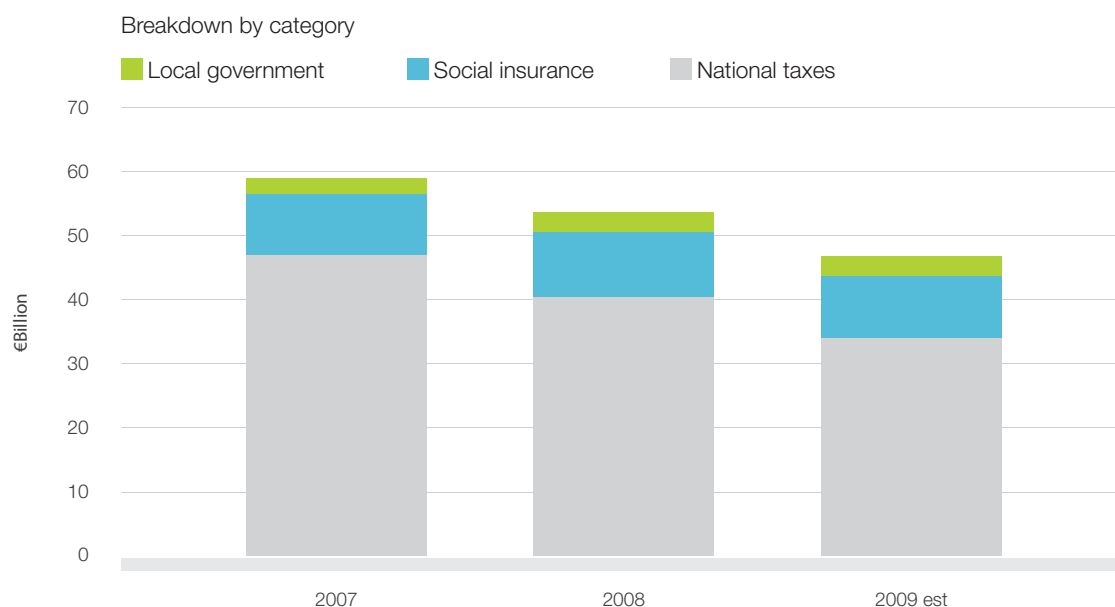
www.enviro.ie (for local government finance)

Table 3.4: Taxes, social insurance, local authority receipts, 2007 – 2009

	2007		2008		2009 (estimated)	
	€billion	%	€billion	%	€billion	%
National taxes (see Section 2)	47.5	79.66%	41.07	76.67%	34.4	73.18%
Social insurance (see Section 3)	9.43	15.81%	9.75	18.20%	9.78	20.80%
Local Government (see Section 4)	2.70	4.53%	2.75	5.13%	2.83	6.02%
Totals	59.63	100%	53.57	100%	47.01	100%

Sources: The Revenue Commissioners, Department of Finance, Department of the Environment, Heritage and Local Government.

Figure 3.2: Breakdown of categories of receipts considered in our Report



Source: Derived from figures in Table 3.4.

Section 2:

National taxes

2.1 Introduction

We present a broad overview of Ireland's principal taxes and duties in this Section. We outline, in turn: income tax (section 2.2), corporation tax (section 2.3), capital gains tax (section 2.4), capital acquisitions tax (section 2.5), stamp duties (section 2.6), value-added tax (section 2.7), and excise duties (section 2.8). We conclude in section 2.9 with an overview of the taxation regime for savings and investments; we also give an outline of the main withholding taxes operating in Ireland.

2.2 Income tax

2.2.1 Income tax system

Income tax is charged annually for each calendar year. An individual's liability to Irish income tax is determined by concepts of 'residence', 'ordinary residence' and 'domicile'. These concepts are explained in Appendix 1. Broadly, individuals resident in Ireland are liable to Irish income tax on their worldwide income, wherever it arises. Individuals who are "ordinarily resident" (but are not resident) are also taxed on worldwide income, other than income from trades, professions or employments which are not carried out in Ireland; other "foreign" income up to €3,810 per annum is also exempt from Irish tax. Individuals who are non-resident in Ireland are liable to Irish income tax on income arising in Ireland. Appendix 2 gives a broad overview of double taxation relief.

Most individuals pay income tax through the Pay As You Earn (PAYE) system. The PAYE system is a method of tax deduction under which an employer calculates the tax due and deducts it each time a payment (such as wages) is made to an employee or director³. The employer must pay the tax deducted to the Revenue Commissioners.

Income tax operates on a self-assessment basis for self-employed and other individuals who receive income from sources which are not subject to the PAYE system. Under self-assessment, the individual must:

- Pay preliminary tax by end-October
- File a tax return, with the balance of tax due, by end-October of the following year

To compute income tax liability:

- A person's income for tax purposes is established
- Some reliefs and deductions are made in computing the amount of taxable income
- This taxable income is charged to tax by reference to the rates of income tax in force for the tax year, and
- Relief is then given for any tax credits to which the person is entitled

Ireland operates a "schedular system", under which income is grouped into four Schedules – C, D, E and F – for tax assessment purposes. These are summarised in Table 3.5. Special rules apply for calculating taxable income under each schedule and for determining the timing of the charge to tax.

Table 3.5: The schedular system

Schedule*	
C	Mainly applies to financial institutions - covers interest (taxed at source) on Government and other securities
D	Annual profits or gains, divided into five Cases, as follows: • Case I, income from trades • Case II, income from vocations and professions • Case III, investment income and foreign income that is not taxed at source; includes foreign trading income • Case IV, income taxed at source; profits or gains not within any other Case of Schedule D or any other Schedule • Case V, rents from Irish property.
E	Income from employments, directorships and pensions arising in Ireland
F	Dividends and other distributions received by individuals

* Schedules A and B (which were concerned, respectively, with taxing **the ownership** of land and buildings and **the occupation** of lands, farmhouses and farm buildings) were abolished in 1969.

Allowances, rate bands and tax credits depend on the personal circumstances of the taxpayer. For 2009 the rates of income tax are 20% (the standard rate) and 41% (the higher rate). Levies and social insurance also apply.

Income tax is charged at graduated rates in the case of individuals. The graduated rate bands that apply for 2009 are as follows.

Table 3.6: Income tax rate bands, Ireland 2009

Category	Band
Single person	First €36,400 at 20%; balance at 41%
Married one-earner couple	First €45,400 at 20%; balance at 41%
Married two-earner couple	First €45,400 at 20% with up to a further €27,400 also at 20%; any amount above that chargeable at 20% is taxed at 41%
Lone or widowed parent	First €40,400 at 20%; balance at 41%

To arrive at net tax, credits are deducted from the gross tax figure. Employees get the basic personal tax credit and (excluding proprietary directors) the employee tax credit (ETC). Those who are self-employed are also entitled to the basic personal tax credit, but not to the ETC. Additional personal credits - for example, one-parent family and widowed parent credits - may apply depending on the personal circumstances of the income earner.

We consider a number of structural issues in relation to income tax in Part 5 of our Report. Part 8, which deals with tax expenditures, also covers income tax reliefs available under the Irish tax code.

2.2.2 The distribution of taxable income

Distribution statistics on personal incomes, prepared by the Revenue Commissioners in the course of the administration of income tax for 2006, are summarised in Table 3.7. The Table relates to income assessed in respect of the tax year 2006 by reference to tax returns which were processed up to mid August 2008. While the distribution may have changed subsequently, 2006 is the latest year for which figures are available.

Table 3.7: Distributions of number of taxable incomes, taxable income and tax, 2006

Taxable income	Cases		Income		Tax	
	Number	%	€million	%	€million	%
up to €10,000	442,504	20.04	2,135.00	2.79	3.47	0.03
€10,000 to €12,000	85,336	3.86	938.84	1.23	3.39	0.03
€12,000 to €15,000	125,751	5.69	1,699.30	2.22	8.09	0.07
€15,000 to €17,000	92,590	4.19	1,482.01	1.94	11.93	0.10
€17,000 to €20,000	141,939	6.43	2,626.81	3.43	60.44	0.50
€20,000 to €25,000	221,049	10.01	4,966.25	6.49	215.32	1.80
€25,000 to €27,000	81,871	3.71	2,128.39	2.78	125.58	1.05
€27,000 to €30,000	112,010	5.07	3,190.04	4.17	217.17	1.81
€30,000 to €35,000	165,119	7.48	5,354.84	7.00	446.50	3.73
€35,000 to €40,000	135,282	6.13	5,061.37	6.62	549.72	4.59
€40,000 to €50,000	191,040	8.65	8,523.18	11.14	1,172.35	9.79
€50,000 to €60,000	124,473	5.64	6,806.65	8.90	1,109.55	9.26
€60,000 to €75,000	117,861	5.34	7,859.82	10.27	1,448.58	12.10
€75,000 to €100,000	88,557	4.01	7,572.63	9.90	1,685.75	14.08
€100,000 to €150,000	52,693	2.39	6,248.96	8.17	1,689.99	14.11
€150,000 to €200,000	13,856	0.63	2,366.49	3.09	740.86	6.19
€200,000 to €275,000	7,673	0.35	1,773.20	2.32	595.01	4.97
Over €275,000	8,496	0.38	5,761.16	7.53	1,892.65	15.80
Totals	2,208,100	100.00	76,494.94	100.00	11,976.35	100.00

Source: Derived from Table IDS16; Income Tax Distribution Statistics 2006, Revenue Commissioners Statistical Report 2008, p.26

2.3 Corporation tax

Corporation tax is charged on profits (income and gains) of a company. Companies that are resident in Ireland are taxed on their worldwide profits. Non-resident companies that trade in Ireland through a branch or agency are charged on the profits of that branch or agency.

The standard rate of corporation tax is 12.5%. It applies to trading income under Case I and Case II of Schedule D (see Table 3.5 above on the schedular system of taxation). Other rates may also apply:

- A rate of 25% applies to non-trading income (for example, interest, rents, royalties) and income from what are known as "excepted trades" (activities which consist of working minerals, petroleum activities and also dealing in or developing land, other than construction operations)
- An effective rate of 10% for manufacturing activities, which is in the process of being phased out but remains in existence for some companies until end-2010
- A rate of 25% for company capital gains. (However, gains from disposals of development land are chargeable to capital gains tax at 25% and are not included in the profits chargeable to corporation tax.)
- Effective rates of 30%, 35% and 40% for companies in the petroleum exploration business where profits exceed applicable thresholds

Corporation tax is charged on profits arising in an accounting period, which is a period of not more than 12 months and is usually the period for which the company makes up its annual accounts. The self-assessment system applies, under which the company must:

- Compute and pay its preliminary tax in two instalments (six months and one month) before the end of the accounting period
- Pay the balance of tax and file its return nine months after the end of the accounting period

Companies defined as small (that is, with a corporation tax liability less than €200,000 in the previous year) pay a single instalment of preliminary tax one month before the end of the accounting period.

Corporation tax is charged on income that is calculated under the same Schedules and Cases that apply for income tax. Taxable trading income is based on profits according to financial statements but subject to specific tax rules. The general rule is that revenue expenditure that is wholly and exclusively incurred for the purpose of a trade can be offset in calculating trading income. Deductions are not allowed for business entertainment expenditure or for capital expenditure.

Depreciation of capital assets as computed for accounts purposes is not an allowable expense in calculating a company's income for the purposes of corporation tax. However, capital allowances in respect of capital expenditure on plant, machinery and buildings may be allowable. The Finance Act 2009 introduced a provision to allow deductibility for expenditure on intellectual property.

A company that makes a trading loss in an accounting period can offset the amount of the loss against profits for the same or the previous accounting period in order to reduce its corporation tax liability. Any trading loss not set off can be carried forward for offset against future trading income

of the trade concerned. Losses can also be surrendered between companies in a group under 75% common corporate control in the EU, Iceland or Norway.

Issues relating to corporation tax rules are dealt with in Parts 5, 7, 8 and 9 of our Report.

2.4 Capital gains tax

Capital gains tax (CGT) is chargeable on gains made on the disposal of assets. A disposal means the transfer of ownership of the asset. Persons are chargeable to CGT for a year depending on their residence and domicile. Broadly, individuals who are resident or ordinarily resident in Ireland are liable to pay CGT on their worldwide gains. Individuals who are neither resident nor ordinarily resident are chargeable to CGT on gains made on the disposal of 'specified assets', such as land and minerals in Ireland, and businesses carried on in Ireland. Individuals who are not domiciled in Ireland are liable to CGT on gains arising in Ireland and on other gains to the extent that they are remitted to Ireland.

The first €1,270 of an individual's net gains for a year (that is, gains minus current year losses and losses brought forward from earlier years) is exempt from CGT.

The rate of CGT is generally 25%. The self-assessment system applies to the payment of the tax and the filing of returns. For individuals, CGT is payable

- By 15 December in respect of gains arising from January to November of that year, and
- By 31 January in the case of gains arising in the previous December

Generally, the gain is the difference between the market value of the asset at the time of the disposal less the cost of the asset. Where an asset was acquired before 6 April 1974 (the date of introduction of CGT), its cost is taken to be the market value of the asset at that date. Up to 2003, the cost or deemed cost (value) of the asset was adjusted to take account of inflation – a system known as indexation. Indexation was abolished for expenditure incurred after 2002.

Death is not an occasion of charge for capital gains tax purposes. Assets received by a person by reason of death are regarded as acquired by that person at their market value at the date of death.

We examine issues in relation to capital gains tax in Parts 5, 6, 7 and 8 of our Report.

2.5 Capital acquisitions tax

2.5.1 Inheritance and gift tax

Inheritance tax and gift tax are part of the capital acquisitions tax (CAT) code and operate under similar rules. The person receiving the inheritance (successor or beneficiary) or gift (donee) is liable to pay the tax. The tax is charged on the 'taxable value' of the inheritance or gift. The taxable value is normally the market value of the property comprised in the gift or inheritance, less any costs or expenses incurred by the donee or successor, including any consideration paid.

The amount of gift tax or inheritance tax that is payable depends on whether the tax-free thresholds (known as 'group thresholds') have been exceeded. CAT at 25% is charged on an amount in excess of the group threshold. There are three different group thresholds. These depend on the

relationship between the person receiving the gift or inheritance and the person who provided the gift or inheritance (the disponent), as follows:

Table 3.8: Thresholds for gift tax and inheritance tax, 2009

Group	Relationship to disponent	Group threshold
A	Son/daughter, including step children; foster children and grandchildren under the age of 18 in certain circumstances	€434,000
B	Parent*/brother/sister/niece/nephew/grandchild	€43,400 (i.e. 10% of A)
C	Relationship other than A or B	€21,700 (i.e. 5% of A)

**A parent taking an inheritance (as opposed to a gift) from a child may qualify for the Group A threshold.*

The threshold can be reached either by a single inheritance or gift or by aggregating previous inheritances or gifts within the same group threshold. Self-assessment applies for these taxes.

2.5.2 Discretionary trust tax

Discretionary trust tax also comes under the capital acquisitions tax category. A discretionary trust is a trust that gives the trustee discretion to pay the beneficiary as much of the trust income or assets as the trustee considers appropriate. There is a once-off charge to tax, at a rate of 6%, on property in a discretionary trust and an annual 1% tax.

The initial once-off charge applies to the trust fund at a rate of 6%, on the latest of:

- The date on which the property becomes subject to the discretionary trust the date of death of the disponent (settlor), and
- The date the youngest principal object of the trust (as defined) reaches the age of 21

The tax is payable within four months of the due date. There is a refund of half the initial tax if the trust is wound up within five years.

The annual charge applies to the trust fund at a rate of 1%. It is charged on 31 December and payable (under self-assessment) within four months of that date. However, the 1% charge is not payable until the following year if the initial charge arose in that year.

We examine issues in relation to capital acquisitions tax in Parts 5 and 8 of our Report.

2.6 Stamp duties

Stamp duty is a tax on instruments (written documents) such as deeds of transfer, leases, insurance policies, share certificates, mortgages, covenants, bills of exchange, credit cards and cheques. The rates generally range from 1% to 9%, depending on the nature and value of the property concerned. In some cases, the duty is not based on the value of the transaction, but is a fixed amount (for example, stamp duty on credit cards).

The person accountable for the tax depends on the instrument. For example:

- In a sale, the accountable person is the purchaser
- In a lease, the accountable person is the lessee, and

- In a document that operates as a gift, both the donor and the donee are accountable for the tax

Generally, stamps are impressed on or affixed to the instruments, but it is also possible to have a stamp duty charge when there is no instrument that can be physically stamped. This is the case under the CREST system, which allows for the electronic transfer of shares.

Rates of stamp duty on residential, and on non-residential, property are summarised in Table 3.9.

Table 3.9: Stamp duty rates on residential and non-residential property, 2009

	Property value	Rate
Residential	First €125,000	Nil
	Next €875,000	7%
	Balance	9%
Non-Residential	Up to €10,000	0%
	€10,001 to €20,000	1%
	€20,001 to €30,000	2%
	€30,001 to €40,000	3%
	€40,001 to €70,000	4%
	€70,001 to €80,000	5%
	Over €80,000	6%

Source: The Revenue Commissioners

The stamp duty on cheques, credit cards, and similar products ranges from 50 cent (cheques) to €30 (charge card and credit card accounts). A 3% stamp duty is charged on most non-life insurance premiums while life assurance policies and the conveyance or transfer on sale of any stocks or marketable securities attract a stamp duty of 1%.

We consider a number of stamp duty issues in our Report. These include the stamp duty on cheques and cards (Part 5), on real property (Part 6), and on share transfers (Part 7). We also examine stamp duty reliefs in Part 8.

2.7 Value-added tax

Value-added tax (VAT) is a tax on the supply of goods and services and is charged as a percentage of the price of a good or service supplied. It is collected by VAT-registered traders on their supplies to their customers and paid to the Revenue Commissioners. The structure and scope under which Member States can apply VAT to goods and services are determined by EU law.

The main rates of VAT that apply in Ireland are:

- Zero-rate, which generally applies to most food, children's clothes and shoes

- Reduced rate of 13.5%, which applies mainly to domestic fuels, labour intensive services and repairs and maintenance, certain property transactions and most construction and building related services
- Standard rate of 21.5%, which applies to the remainder of goods and services (examples include cars, electrical goods and confectionery)

In addition, a rate of 4.8% applies to supplies of livestock sold by registered farmers. Under a separate system, called the "flat rate system", farmers who do not register for VAT are entitled to add an amount (the "flat-rate addition", 5.2% in 2009) to the price of the goods they sell to VAT-registered persons. The purpose of this is to compensate such farmers for the VAT they incur on their purchases. The registered person reclaims the flat-rate addition in his or her VAT return.

In general, services provided by charities, non-profit organisations and certain financial and professional services are exempt from VAT, while Government departments and local authorities are outside the scope of the tax⁴. Exempt suppliers do not charge VAT on the goods and services they provide and cannot reclaim VAT incurred on the goods and services that they purchase. The rules for supplies of goods and services between Member States, as well as supplies into and out of the EU, are complex. However, with effect from 1 January 2010, a new Directive comes into effect, which will simplify and clarify the rules for the place of supply of services. This Directive introduces two general rules, depending on whether the customer is a business or a consumer:

- For intra-Community supplies of Business to Business (B2B) services, the new general rule provides that the place of taxation is the place where the customer is established (reverse charge), thus aligning the tax more closely with the place of actual consumption
- For intra-Community supplies of Business to Consumer (B2C) services, the general rule provides that the place of taxation is where the supplier is located

Issues in relation to VAT are dealt with in Part 5 of our Report.

2.8 Excise duties

2.8.1 Introduction

Excise duties are indirect taxes on the consumption or use of certain products or in connection with certain activities. Three broad categories of excise duty apply in Ireland – EU excises, which are subject to the harmonised provisions of EU law, vehicle registration tax (VRT), and other national excise duties.

2.8.2 EU excises

Excise duties on alcohol, tobacco and energy products (such as motor and heating fuels, electricity and natural gas) are covered by EU legislation. All EU Member States are obliged to apply excise duties to these product categories. Rates of excise are a matter for the Member State concerned, subject to compliance with minimum amounts specified in EU Directives.

EU legislation in the area of excise duties on these products can be divided into three main categories

⁴ Ireland's treatment of State and local authorities as taxable persons only where a specific order to that effect has been made by the Minister for Finance has been the subject of a very recent (16 July 2009) ruling of the European Court of Justice (ECJ) – Case C-554/07. The ECJ found that this treatment is contrary to Articles 2, 9 and 13 of Directive 2006/112/EC; it ruled inter alia, that Ireland contravened the Directive in failing to require public authorities to be subject to VAT where they are engaged otherwise than in their capacity as a public authority.

- **The structure of the tax** covering issues such as the definition of the product categories, the way in which the excise duty is calculated (for example, per hectolitre, per degree of alcohol, or per 1,000 cigarettes), and the scope of possible exemptions
- **The minimum rates of duty** that Member States have to apply for each type of product
- **General provisions that apply** across the product categories, such as rules on the production, storage and movement between Member States of excise products

Excise rates in Ireland relative to other Member States are set out in the following Table:

Table 3.10: Excise rates in Ireland compared with EU averages - selected products

Product	EU Rates		Ireland
	Minimum	Average	Rate
Wine - still (per hectolitre)	€0.00	€54.14	€328.09
Wine - sparkling (per hectolitre)	€0.00	€95.35	€656.18
Beer (per hectolitre per degree alcohol)	€1.87	€6.12	€19.87
Spirits (per hectolitre of pure alcohol)	€550.00	€1,527.42	€3,925
Cigarettes (per 20)	*	€2.07	€4.99
Petrol per hectolitre	€359.00	€488.95	€508.79
Diesel per hectolitre	€302.00	€373.34	€368.05

Source: EU Commission. Based on 1 January 2009 data

* Excise duties levied on cigarettes must fulfil a number of conditions, including the following: they must account for at least 57% of retail selling price and be at least €64 per 1,000 cigarettes for cigarettes in the most popular price category.

2.8.3 Vehicle registration tax

Vehicle registration tax (VRT) is chargeable on the registration of a motor vehicle designed and constructed for road use in Ireland. All such vehicles, other than those brought in temporarily by visitors, must be registered with the Revenue Commissioners. A vehicle must be registered before it can be licensed for road tax purposes.

There are three classifications of vehicle for VRT purposes – category A (passenger cars), category B (small vans, crew cabs and other small commercial vehicles), and category C (large commercial vehicles, lorries and buses).⁵ The ‘rebalancing’ of vehicle registration tax in favour of environmentally friendlier passenger cars (category A) came into effect from 1 July 2008, under which:

- The VRT rate applicable to new and used imported cars registered on or after 1 July 2008 is determined by the CO₂ emission rating of the car. (This replaced a system where the tax was based on engine size)
- A seven band CO₂ emissions system – A to G – applies. It is underpinned by a CO₂ Emissions Labelling System for cars (similar to the energy efficiency labels for white goods)
- Seven VRT rates, ranging from 14% to 36%, depending on the car’s CO₂ emission level,

5

There is also a VRT category D, which includes ambulances, fire engines and vehicles used in the transportation of road construction machinery. There is no VRT payable on a category D vehicle.

apply to the Open Market Selling Price (OMSP) of the car

Category B vehicles are charged VRT at 13.3% of the OMSP, while Category C vehicles are charged at a flat rate of €50.00.

2.8.4 National excises

The 'national excises' is a loose term to cover a range of excise duties (other than VRT) that are not subject to harmonised EU law. These duties cover such items as betting duty, bookmaking premises duty, bookmakers' licence duty, air travel tax and the duty on permits and licences required for gaming and amusement machines and by auctioneers.

Issues in relation to excise duties are dealt with in Parts 5 (mineral oils), 7 (air travel tax) and 9 (VRT and fuel taxes) of our Report.

2.9 Miscellaneous other taxes

2.9.1 Returns from savings and investments

Irish residents are subject to tax on returns from their savings and investments in a number of ways:

- Interest on most deposits is subject to deposit interest retention tax (DIRT) at 25%. This is a final liability tax
- Returns from domestic collective investment funds, and from domestic life assurance policies, are subject to a 'gross roll-up' regime, with exit tax rates of 25% or 28% on payments. A similar regime applies to EU funds and policies, under self-assessment
- Dividends from shares in Irish or foreign companies are taxed at the individual's marginal rate of income tax. In the case of dividends from Irish companies, the company withholds tax at the standard rate of income tax and pays it to the Revenue Commissioners
- Rental income from property is taxed at the individual's marginal rate of tax

2.9.2 Withholding taxes

Withholding taxes are collection mechanisms which enable tax to be deducted at source. There are a number of specific withholding taxes provided for in the Irish tax code. Examples include dividend withholding tax, withholding tax on interest payments by companies and to non-residents and exit taxes on returns from investment funds. In addition, Deposit Interest Retention Tax (DIRT) operates in respect of interest received on deposit accounts in Irish financial institutions.

Two withholding taxes apply in relation to the provision of services: These are Relevant Contracts Tax (RCT) and Professional Services Withholding Tax (PSWT).

2.9.3 Professional Services Withholding Tax (PSWT)

PSWT provides for the deduction of tax at source from payments for "professional services" (which are widely defined) made by accountable persons – such persons cover Government departments and offices, local authorities, the Health Service Executive, commercial and non-commercial State bodies and their subsidiaries. The public body deducts the tax (at the standard rate of income tax) from the payment made to the professional service provider.

2.9.4 Relevant Contracts Tax (RCT)

RCT is a scheme of tax deduction from payments to sub-contractors in the construction, forestry and meat processing industries. The principal contractor deducts tax at the rate of 35% from payments made to sub-contractors, unless the sub-contractor can provide a certificate of authorisation and the Revenue Commissioners allow payment to be made without deduction of tax. There is a refund facility where the tax deduction exceeds the sub-contractor's expected liability.

Issues in relation to these taxes are dealt with in Part 5 of our Report.

Section 3: Social insurance and levies

3.1 Introduction

The social insurance system in Ireland comprises two key features, namely a social solidarity component and a contributory principle. The social solidarity component means that the costs of social benefits and programmes are shared collectively as a society. The contributory principle means that individual's build up entitlement to benefits for both themselves and their families if and when a particular contingency arises. The social insurance system provides cover for a large range of social welfare payments to workers and their dependants.

Pay-related social insurance (PRSI) contributions, payable by persons in insurable employment, are collected mainly through the income tax system. There is a range of different classes of PRSI and the total PRSI contribution for an employee is determined by both the pay and the PRSI contribution class that applies to that employee and the benefits for which he or she is insured. Contribution classes are determined by the nature of the employment.

PRSI is made up of three different components –

- **Social insurance** (payable by employees, employers and the self employed)
- **Health contribution levy** (payable by certain employees, and
- **National training fund levy** (paid by employers)

3.2 Social insurance

Social insurance contributions by employees, employers and the self-employed go into the Social Insurance Fund, which is used to fund social insurance payments, including social welfare pensions. Social insurance is administered by the Department of Social and Family Affairs.

Generally, the PRSI rules apply a full rate of 4% on employees on reckonable earnings (which means gross pay less superannuation and approved permanent health insurance), a rate of 3% on the self-employed on reckonable income and a charge on employers at a rate of 10.75% of the reckonable earnings of their employees. Both the employer contribution and the self-employed contribution apply without a ceiling; a contribution ceiling of €75,036 applies in the case of employees.

3.3 Health contribution levy

Collection of the health contribution levy is undertaken by the Revenue Commissioners in the context of collecting income tax and PRSI. The health contribution levy applies at a rate of 4% on income up to €75,036 and at 5% thereafter – there is no upper limit. Recipients of certain social welfare payments and medical card holders are exempt from payment of the health contribution levy; persons earning less than €26,000 per annum are also exempt. The levy does not confer any entitlement to benefit on the contributor. It does not form part of the Social Insurance Fund. The contribution goes to the Department of Health and Children to help fund health services.

3.4 National training fund levy

The national training fund levy is collected by the Revenue Commissioners as part of PRSI contributions by employers. The national training fund is administered by the Department of Enterprise, Trade and Employment to support a broad range of employment training initiatives.

The levy is applied at a rate of 0.7% of reckonable earnings of employees in Class A and Class H employments (approximately 76% of all insured employees).

Issues in relation to PRSI are dealt with in Part 5 of our Report.

Section 4: Local authority taxes and charges

4.1 Principal charges imposed by local authorities

4.1.1 Commercial rates

This is a local tax assessed on the net annual letting value of commercial and industrial properties which is used to fund local authorities. It is the only recurrent tax on property in Ireland and yielded €1.344 billion for local authorities in 2008.

Rates are levied annually by county, city, borough and certain town councils. Each of these authorities has exclusive rating jurisdiction within its own area. As a general rule, rates are levied on the occupiers of commercial property. The valuation of such property for rating purposes is carried out by the Valuation Office. Each year the level of the rate (known as the Annual Rate on Valuation or ARV) is determined by the elected council as part of the budgetary process. The annual rates bill for a commercial premises is calculated by applying this ARV to the valuation of the property concerned.

4.1.2 Development contributions

Contributions are struck at a rate or level which the elected representatives of the local authority determine. These contributions are payable by persons developing property on foot of planning permissions, to ensure an appropriate contribution towards the cost of public infrastructure and facilities. Under the Planning and Development Act 2000, a planning authority can, when granting a planning permission, include conditions requiring the payment of the development contribution.

4.1.3 Waste charges

Many local authorities impose charges for the provision of domestic refuse collection or disposal. Under the Waste Management Act 1996 all local authorities in Ireland are obliged to collect or arrange for the collection of the domestic waste in their functional areas. They must also provide or arrange for the provision of facilities for the disposal and recovery of household waste.

The local authority can operate a refuse collection itself, or can permit a private company to collect the waste in its region. Domestic waste charges are levied on almost all households that use an organised refuse collection service. Where waste charges are paid to a local authority, the revenue raised goes towards:

- Funding the collection service
- The operation of waste disposal facilities such as landfill sites, and
- The provision of recycling facilities

Income tax relief is available for individuals who pay service charges to local authorities and to independent contractors for domestic refuse collection or disposal.

4.1.4 Water charges

Local authorities impose charges on most non-domestic users for water supply. In general, water charges are not imposed on most domestic users for water supply, though many rural group-water schemes are financed from contributions from domestic users.

4.1.5 Levy on second homes

A flat rate charge of €200 per annum was introduced from 2009 on non-principal private residences. The levy is collected by each local authority and revenues are retained by the local authority to fund services.

4.2 The environmental levy

The environmental levy is Ireland's 'plastic bag tax', the purpose of which is to reduce the consumption of plastic shopping bags. The levy is not imposed by local authorities. It is collected by retailers (through the value-added tax system) and paid over to the Revenue Commissioners. The money generated from the levy goes into the Environmental Fund which is used to support waste management, litter and other environmental initiatives.

The future financing of local government is dealt with in Part 11 of our Report. Property tax is dealt with in Part 6.

Appendix 1

Residence, ordinary residence and domicile

Residence

Ireland's tax residence tests are based on time spent in Ireland, with a 'look back' to the previous year. An individual is resident in Ireland for a tax year if he or she

- Is present in Ireland for 183 days or more in that tax year, or
- Is present in Ireland for 280 days or more in aggregate in that tax year and the preceding tax year (the 'two-year test')

Any day in which an individual is present is counted for tax residence purposes; presence in Ireland for periods of 30 days or less in any tax year is not taken into account in applying the two-year test.

Ordinary residence

Ordinary residence for tax purposes in Ireland is established after three consecutive years of residence in Ireland. An individual ceases to be ordinarily resident when he or she has been non-resident for three continuous years.

Domicile

Domicile is a legal concept which is based on an individual's 'permanent home', regardless of residency status at any particular time, and depending on the facts of each case. Generally, persons are domiciled in the country of which they are nationals and in which they spend their lives. Under Irish law, every individual is regarded as acquiring a domicile of origin at birth - this is the domicile of the father or mother, depending on circumstances. An individual may acquire a domicile of choice by showing (by means of arrangements made regarding his or her personal and economic affairs) that the intention is to acquire and retain a new domicile.

Issues in relation to residence are dealt with in Part 5 of our Report.

Appendix 2

Double taxation overview

International context

A person resident in Ireland for tax purposes is normally liable to Irish tax in respect of his or her worldwide income. Where the person's income includes foreign sourced income, the country in which the income arises will normally tax that income. Where this happens, the foreign sourced income will be taxed on the double. A similar situation can arise where a person who is not resident in Ireland for tax purposes has Irish sourced income. The extent to which such double taxation may arise will depend on the domestic tax laws of the countries concerned.

Double taxation agreements

The differing taxation scenarios can give rise to incidences of double taxation (where the same income or gains may be subjected to taxation in more than one country) or no taxation (where income or gains escape taxation in any country). Countries deal with these issues by entering into double taxation treaties. These treaties cover direct taxes on income and capital, which in Ireland's case are income tax, corporation tax and capital gains tax. Ireland has comprehensive double taxation treaties with 46 countries.

Relief from double taxation

Double taxation can be relieved in a number of ways. Where a double taxation treaty applies, it may provide that one of the countries would refrain from taxing the particular income (the exemption system) or that the residence country would reduce tax on the doubly taxed income by tax paid on that income in the source country (the credit system). Ireland normally relieves double taxation by the credit system.

Where a tax treaty does not apply, the residence country may allow relief from the double taxation on a unilateral basis. Ireland has a number of measures providing unilateral relief from double taxation.

Other forms of double taxation agreements

A double taxation agreement between Ireland and the United States is also in place covering Irish inheritance tax and US federal estate tax. There is also an agreement with the United Kingdom covering Irish gift and inheritance tax and UK inheritance tax.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 4

THE MACROECONOMIC FRAMEWORK AND THE BALANCE OF TAXATION



Part 4:

The Macroeconomic Framework and the Balance of Taxation

Section 1 is an introduction.

Section 2 deals with the Irish economy.

Section 3 deals with the balance of taxation on income, capital and spending.

Section 4 deals with issues of fiscal sustainability.

Appendices 1 and 2 contain supplementary information.

Our recommendation in this Part is as follows:

- 4.1** The base-broadening measures in our Report should be introduced on a revenue neutral basis. In this context priority should be given to lowering the tax burden on labour.

Section 1: Introduction

Our terms of reference invited us to consider how best the tax system can support economic activity and promote increased employment and prosperity while providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term.

We were also asked, in the context of maintaining an equitable incidence of taxation and a strong economy, and having regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government¹ to “*examine the balance achieved between taxes collected on income, capital and spending*”.

To address these issues, we examined the following elements:

- The balance between tax on income, capital and spending
- Issues of fiscal sustainability

In considering this macroeconomic perspective on taxation, this Part of our Report provides a brief overview of the Irish economy (Section 2). It then examines the balance between taxes on income, capital and spending (Section 3) and suggests an approach to determining that balance in the future in a manner that will best serve long-term economic growth, in the context of wider social objectives. Section 4 examines issues of sustainability of the fiscal balance into the medium and longer term.

Under our terms of reference, our focus is primarily concerned with the medium and longer term. While the fiscal difficulties that exist at the time of writing are likely to persist for some time, the main and intended focus of our Report is strategic as is consistent with our terms of reference.

Section 2: The Irish economy

2.1 Economic background

The Irish economy has experienced dramatic change since the reports of the previous Commission on Taxation more than 25 years ago. In the intervening years Ireland has experienced significant economic growth with living standards converging on, and in some cases surpassing, those of other developed economies.

Average economic growth of over 6% was achieved from 1987 to 2007.² The economic and social impact of this is perhaps best seen in the labour market: the number of people in employment almost doubled from 1.1 million in 1987 to 2.1 million in 2007; and unemployment correspondingly decreased from 17% to 4.5% over the same time period. The sources of economic growth varied over this time period, with domestic components becoming more prominent in recent years.

¹ The commitments in question are listed in Section 1 of Part 2 of our Report.

² This figure is for real growth in Gross Domestic Product (GDP); for Gross National Product (GNP) the real growth rate was 5.5%. Economic growth is valuable as both a policy objective and an indicator because typically it is highly correlated with employment and income. Policy on taxation, however, affects the interrelated areas of economic, social and environmental performance and thus the Commission is concerned with economic growth that is sustainable.

The economic environment changed quite suddenly in 2008 with Ireland entering into recession. Both domestic and international reasons lie behind this change in the economy. Domestic drivers of economic growth contracted and the world economy experienced its biggest downturn since the 1930s. This has led to a sharp increase in unemployment. The future environment remains uncertain as policy responses to the economic, financial and property market situations, both domestic and international, continue to develop.

Despite the current difficulties, research by the ESRI estimates that Ireland's 'potential' output growth rate is still around 3% a year. The International Monetary Fund (IMF) makes a more conservative estimate that potential output growth for Ireland is in the range of 2%, in the medium term³. Ireland's underlying strengths which will underpin this future growth include a young and highly educated workforce, a flexible labour market, the quality of our public servants, high levels of investment in modern infrastructure, access to the EU's internal market of almost 500 million people, a stable currency in the euro, an established presence in key business sectors, relatively low government debt entering the current downturn, an environment that supports enterprise, strong democratic and social institutions and a commitment to social cohesion and equity.

2.2 The current environment

The ESRI lists four major challenges for the Irish economy in 2009: the restoration of order to the banking system, the structural re-balancing of the Government accounts, the correction of the serious loss of competitiveness, and the economic and social consequences of the increase in unemployment. A similar analysis is offered by NESC who suggest that in this current environment Ireland faces five interrelated challenges: banking, fiscal, economic, social and reputational.⁴

Any recovery in the Irish economy will not be brought about by taxation policy alone but rather, as the ESRI notes, "is likely to occur initially through a recovery in world demand, increasing the demand for Irish exports".⁵ Thus while our long-term structural proposals will make a contribution to the short-term challenges facing this country, they will primarily address the fiscal situation and not the overall economic downturn. Nevertheless, in the medium to longer term, the structure of the taxation system will play a significant role in enabling Ireland to achieve its economic and social policy objectives.

2.3 Fiscal policy

Our intention since we commenced our work in early 2008 has been to propose a new structure for the tax system that could be adopted in a revenue neutral manner. Our terms of reference make it clear that we are to have regard to keeping the overall tax burden low. Under this approach the extra revenue that is raised by our proposals for new taxes and reforming existing taxes and tax expenditures should be available to reduce the existing tax burden, particularly the tax burden on labour. In this way our structural reform should allow the taxation system to collect a set amount of revenue with less distortion to the economy and in a more equitable manner.

Despite the fact that events have overtaken our work and the downturn in the Irish economy has had adverse consequences for the Government's fiscal position, our emphasis remains on a new

3 'Ireland: 2009 Article IV Consultation', International Monetary Fund, June 2009. For a similar estimate see also 'Potential Output in Ireland', K. Whelan, TCD-DEW conference, 20 May 2009.

4 'Ireland's Five-Part Crisis: An Integrated National Response', NESC, No. 118, March 2009.

5 'Recovery Scenarios for Ireland' ESRI, May 2009.

tax structure which can be delivered in a revenue neutral manner. Our terms of reference are to consider the structure of the taxation system for the “medium and longer term”. Our remit is not about broader fiscal policy and the short-term pressures facing Government. A well-structured tax system will raise a given amount of tax revenue in a way that both causes least harm to the economy and is equitable; deciding on the exact quantum of tax revenue to be raised involves wider fiscal and macroeconomic issues and is a matter for Government.

We believe that the extra revenue our proposals raise should primarily be used to lower labour taxes. In particular, the extra revenue that is raised from reforming the various tax expenditures discussed in Part 8 of our Report should be re-used within the labour tax system to maintain Ireland’s competitive labour tax wedge. Keeping labour costs competitive, including the direct tax costs as measured by the labour tax wedge, supports demand for labour and employment levels; this important fiscal objective is explored in Part 7 of our Report. This use of the revenue - raised on the basis of our tax expenditure reform proposals - would mean that in the longer term the percentage of tax revenue that comes from labour will remain the same but, by coming from a broader labour tax base, will have less distorting impact on the economy. In addition, the broadening of the overall tax base by introducing an annual property tax, a carbon tax and water charges facilitates the reduction of the tax burden on labour.

We are conscious of the impact that the new base-broadening measures could have on individuals and households. We believe that each new individual measure is justified on its own merits, as outlined in the respective Parts of our Report. The desired overall impact of our proposals is optimised when the burden of labour taxes is reduced. As well as maintaining the low tax wedge, a reduction in the labour tax burden would lessen the cumulative impact of these measures on the disposable income of individuals and households and also sustain labour force participation. This focus on labour-force participation is important because of the impact the waivers and exemptions in our proposed property tax, carbon tax and water charges, in particular, will have on the rewards of work and incentive to seek employment.

The additional revenue raised by the broadening of the tax base could reduce the overall labour tax burden on individuals in a number of ways: reducing the standard or higher rate of income tax, reducing the income levies, increasing the main credits or widening the standard rate bands. For example, each extra €1 billion in revenue raised as a consequence of our recommendations would finance one of the following options: the standard rate could be reduced by two percentage points, the higher rate could be reduced by five percentage points, the income levy rates could be reduced by 50%, the personal and the employee tax credits could be increased by €300 each or the standard rate band could be widened by approximately €7,000. There is of course a variety of possible combinations of these options, and we recognise that these are choices for Government to make in the context of future budgetary policy.

If further tax revenue is to be raised, we believe that raising extra revenue by broadening the tax base, both within particular tax heads and across the taxation system, will impact less negatively on economic growth than simply increasing tax rates. Our macro perspective on the balance between different tax categories, presented in the next section, includes a ranking of different taxes according to their impact on economic growth.

2.4 Conclusion

The Commission's intention since we commenced our work in early 2008 has been to propose a new structure for the tax system that could be adopted in a revenue-neutral manner. The recent change in the economic environment has impacted greatly on the country's fiscal position. We recognise that the timing of the proposed compensatory measures is challenged by the current fiscal situation. However, it is still our approach that by broadening the base of the tax system, revenue is made available to reduce the existing tax burden on labour.

Recommendation 4.1

The base-broadening measures in our Report should be introduced on a revenue neutral basis. In this context priority should be given to lowering the tax burden on labour.

Section 3

Balance of taxation on income, capital and spending

3.1 Definitional issues

We have interpreted the terms 'income', 'capital' and 'spending' in the terms of reference as meaning the following:

- **Taxes and levies on income:** This relates to all taxes and levies on income and includes both income tax and corporation tax⁶ as well as employer and employee PRSI
- **Taxes on capital:** This covers taxes on capital assets, including property, whether on gains on the disposal of such assets or on the acquisition or holding of such assets. It includes stamp duty, capital acquisitions tax and local authority rates
- **Taxes on spending:** This covers VAT and excises (and would include a carbon tax if one were in place)

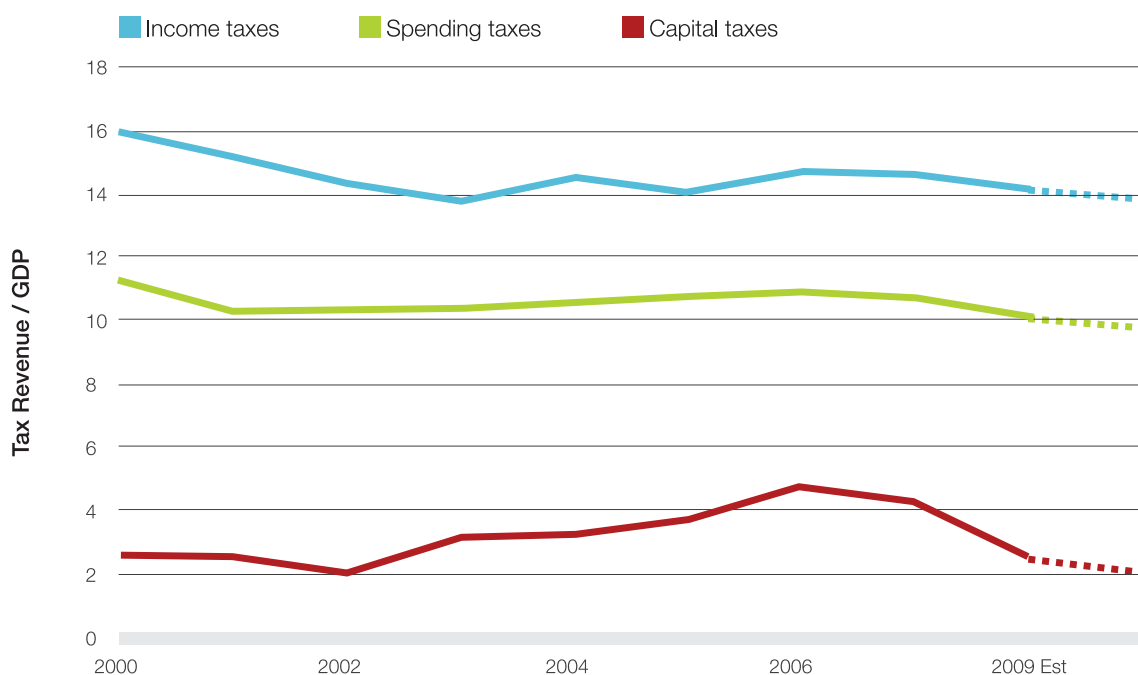
3.2 Analysis of historical tax revenue data

Historical tax revenue data, with taxes grouped in accordance with the above definitions, are presented graphically in Figure 4.1 with tax revenue expressed relative to GDP. The data show a trend of increased reliance on taxes on capital with a reduced reliance on taxes on income and spending. This trend then reversed after 2006 as the yield from capital taxes declined. Within capital taxes, property related taxes grew in importance: in 2006 the proportion of total taxes accounted for by stamp duty was over twice that in 2000. Data from the Revenue Commissioners indicate that in the years 2005 and 2006, stamp duty on property accounted for about 75% and 82%, respectively, of all stamp duty receipts for those years.

6

In general, companies pay corporation tax on capital gains and it has not been possible to identify tax on capital gains of companies separately from tax on corporate income.

Figure 4.1: Irish balance of taxation 2000-2009



Source: Figures prepared by the Commission Secretariat based on Exchequer data obtained from the Department of Finance. Data for 2009 are estimates.

3.3 Analysis using Eurostat data

We examine Ireland's situation in an international context in Table 4.1 which shows Ireland's position in 2007, the latest year for which data are available, against the EU average in that year using the Eurostat classification of taxes under the headings of capital, labour and consumption. The Table also shows Ireland's average position over the period 2000 to 2007 compared with the average position in the European Union over the same period.

Table 4.1: Taxes on capital, labour and spending, as a % of total taxation

Eurostat Definitions				
	2007		Average 2000 to 2007	
	Ireland	EU 27	Ireland	EU 27
Capital	30.0	21.3	28.3	19.7
Labour	34.2	45.2	34.7	46.7
Consumption	35.8	33.6	37.1	33.8

Source: 'Taxation Trends in the European Union', Eurostat, 2009 Edition.

Commission Definitions as set out in section 3.1		
	2007	Average 2000 to 2007
	Ireland	Ireland
Capital	14.1	11.1
Income	49.2	51.4
Spending	36.6	37.5
Source: Data prepared by the Commission Secretariat based on Exchequer data obtained from the Department of Finance. Data for EU 27 using definitions as set out in section 3.1 are not readily available.		

The Eurostat classification of taxes provides for different groupings from our classification as outlined in section 3.1 above. One key difference relates to the treatment of corporation tax and of income tax from self-employed persons. These taxes are treated as taxes on capital rather than taxes on labour. Appendix 1 provides further details of the Eurostat classification. For illustrative purposes, we include, in the lower part of Table 4.1, the relevant Irish data under our classification as set out in section 3.1.

Using the Eurostat data, it would appear that, for Ireland, the proportion of total taxes accounted for by labour is significantly below the EU average for 2007, as well as on average over the period 2000 to 2007. One important reason for this is the lower amount of social security contributions in Ireland as compared with many other Member States.

Analysing the data for each individual Member State indicates that there is no normative balance which ought to be put in place (see Appendix 2). Each Member State has followed its own policy with the result that a wide range of approaches is adopted across the European Union.

3.4 The balance of taxation and economic growth

In seeking to determine what the appropriate balance should be, a range of policy objectives is relevant including economic growth, international competitiveness, equity and environmental issues. Focusing on the first policy objective of economic growth suggests a hierarchy of different taxes in terms of their economic impact. This economic growth 'ranking' of taxes suggests that increases in corporate taxes are most harmful for growth, followed by increases in personal income taxes and then spending taxes. Annual taxes on immovable property appear to have the least impact.

There are three related grounds for this ranking. First, the more mobile a factor is, the more responsive it will be to a change in taxation. Thus a tax on less mobile factors will cause less economic distortion. Second, this ranking accords with current international evidence in this area, as presented in a recent OECD review.⁷ This paper suggests that a revenue neutral growth-oriented tax reform would be to shift part of the revenue base from taxes on personal and corporate income to less distortionary taxes such as annual taxes on immovable property or on spending. Third, our ranking is also in agreement with recent Irish research by the ESRI which predicts the impact different tax increases would have on the economy, using the country's main macroeconomic model.⁸

⁷ 'Tax and Economic Growth', OECD Economics Department Working Paper No. 620, 11 July 2008. The document refers to economic growth as being growth in GDP per capita. A later OECD document 'Going for Growth 2009' presents the key findings of this and other working papers in a less academic fashion. In May 2009, we also consulted with Professor Chris Heady, a co-author of this research.

⁸ 'The Behaviour of the Irish Economy: Insights from the HERMES macro-economic model', A Bergin et. al., ESRI Working Paper No. 287, April 2009.

It is important to note that this ranking cannot be converted into a simplistic 'one size fits all' model for tax policy. The particular circumstances of a specific country may give reason to expect deviations from this ranking.⁹ Examples of this could include countries with different levels of mobility or different cultural attitudes to taxation and its contribution to society. In this way different models may be appropriate for different countries. The appropriate ranking may also change at different points in time. The ranking proposed here is for incremental changes from the existing balance of taxation.¹⁰

Ireland is a small open economy with some particular characteristics related to mobility. Our history of emigration and geographical proximity to the UK, in particular, have resulted in Ireland having a very open labour market; and the structure of Irish industry shows the important contribution of mobile foreign direct investment (FDI). These issues affect both corporate taxes and labour-related taxes and are dealt with in more detail in Part 7 of our Report. However, it should be noted that Ireland already has a low and stable rate of corporation tax.

Using this ranking to guide the economic efficiency dimension of tax policy is in accordance with our base broadening approach to tax reform outlined in Part 2 of our Report. A well-balanced tax structure is one part of having a broad tax base and it enables lower tax rates. Broadening the base by introducing an annual property tax and a carbon tax is generally better for Irish economic growth than increasing rates of income tax. Reflections on applying this growth ranking to individual taxes in Ireland are presented briefly below.

The second aspect of base-broadening is to reform each individual tax by broadening its base and reducing tax rates. This policy of improving the design of individual taxes is a complement to changing the balance between different tax sources.

Both methods of base-broadening and rate reduction are likely to contribute to long-run economic growth. However, policymakers need to consider any trade-off between these growth-enhancing proposals and other objectives of tax policy, particularly equity.

3.5 Taxes on capital, specifically immovable property

The ranking outlined above indicates that annual taxes on immovable property are least damaging to economic growth. While taxes on capital increased as a proportion of total revenues in Ireland up to 2006, the growth was based to a large extent on transaction taxes on property at prices and levels which were cyclically-based and not sustainable. There is, therefore, a need to address this structural weakness in the capital tax base. An annual tax on residential property would help to achieve this.¹¹ In Section 4 we address the issue of long-term sustainability of tax revenue and fiscal balance.

3.6 Taxes on spending

Another implication of the ranking of taxes in section 3.4 is that a positive outcome for economic

⁹ The OECD paper notes that empirical results based on cross-country macroeconomic data only yield results that are true on average.

¹⁰ This ranking is based on empirical evidence, both Irish and international, relating to the existing balance of taxation, and thus strictly only holds for incremental changes from the existing balance. On a technical note, the marginal economic cost of raising revenue should be equated across each tax head in order to achieve an economically efficient balance across different categories of taxation. In general, the marginal cost of raising revenue from a tax head will increase as the tax rate increases. Therefore if there was a very large change in the tax rate pertaining to a particular tax head, the associated marginal cost would rise substantially, and thus the tax and growth ranking could change.

¹¹ Businesses are already subject to an annual tax on property in the form of local authority commercial rates.

growth could be achieved through a shift to spending taxes, although such a move would reduce progressivity. This view is echoed by the European Commission document *Public Finances in EMU-2008* where, in the context of a discussion on alternatives to taxes on labour, it indicates that the shift from labour taxation or social security contributions to VAT may produce positive, but limited, employment and growth effects.

The main changes which could be looked at are base-broadening and rate changes. There would seem to be merit in keeping the option of base-broadening open as a possibility for the longer term although there may be equity considerations associated with this topic which would have to be addressed. As indicated, questions of progressivity can arise. For example, if the VAT base was broadened and the standard rate of VAT (currently 21.5%) was reduced on a cost-neutral basis, this would imply a significant increase in the price of items which are currently zero-rated. In addition, the cost of luxury items would reduce in such an event. Having regard to this consideration, we are not recommending immediate action in relation to VAT.

Additional spending taxes may have a role to play as part of a broader based tax system. In this regard, our recommendations to introduce a carbon tax and water charges, for example, will lead to an increase in taxes on spending.

3.7 Taxes on personal income

The evidence underlying the growth ranking of taxes outlined in section 3.4 suggests that income taxes should be kept as low as possible with base-broadening and rate reduction being favoured where possible. With regard to the issue of base-broadening, our review of tax expenditures has brought forward a wide range of proposals which will assist in achieving such a purpose. There is some evidence that a flatter structure (i.e. a less progressive personal income tax system) may be better for growth. However, there is a potential cost in terms of equity and we therefore do not recommend such an approach. In practice, there will always be a need to balance the aim of economic growth against the principle of equity in the personal income tax system.

3.8 Corporation tax

There is a body of opinion that low and stable statutory corporate tax rates can lead to particularly large productivity gains in firms that are dynamic and profitable, and we are conscious of the positive employment consequences arising from this. In addition, low rates are one of the factors that encourage inward investment. Ireland already has a low corporate tax rate and our terms of reference require us to have "regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government, in particular, the guarantee that the 12.5% rate of corporation tax will remain". The current rate of 12.5% is a strong brand for Ireland's domestic economic activity and inward investment and, as a rate, is appropriately low. We are supportive of Government commentary that there is no intention to move it either upwards or downwards. The stability of the rate over the last decade (following on from the existence of the 10% manufacturing rate for almost 30 years) is a significant reinforcement to the actual rate itself.

We thus omit corporation tax and suggest that the hierarchy for raising revenue is property taxes, spending taxes (especially environmental taxes), and income taxes in that order.

3.9 Conclusion

In striking the appropriate balance of taxation between income, capital and spending, Government in its approach to revenue raising should

- Seek to broaden the base within each tax head, and
- Look to property taxes, spending taxes (especially environmental taxes), and income taxes in that order

Section 4: Issues of fiscal sustainability

4.1 EU Stability and Growth Pact (SGP)

Under Economic and Monetary Union (EMU), the Stability and Growth Pact sets out the framework in which Ireland's fiscal policy must operate. The sustainability required of member countries focuses on two criteria:

- **Annual government deficit**
The ratio of the Government deficit to GDP must not exceed 3%. EU rules provide "for an exception if an excess over the reference value is only exceptional and temporary and if the ratio remains close to the reference value"
- **Government debt**
The ratio of gross government debt to GDP must not exceed 60%

In addition to avoiding a deficit of more than 3% of GDP, the SGP requires member countries to adhere to a medium term budgetary objective of keeping their budget balance close to balance or in surplus. In March 2005, the European Council decided to allow greater flexibility in the rules. For example, where a deficit in excess of 3% arises, a member country may avoid an Excessive Deficit Procedure¹² if negative growth or a protracted period of low growth relative to potential growth is experienced; previously a fall in GDP of 2% was required to avoid a fine. The periods in which corrective action must be taken were also extended to account for circumstances where "unexpected adverse economic events with major unfavourable budgetary effects occur during the excessive deficit procedure".¹³ In addition, to allow for investment, the scope for greater budgetary flexibility over the medium term was put in place for member countries with low debt and high potential growth.

4.2 A counter-cyclical fiscal balance

It is our view that, for the longer term, fiscal policy should pursue a cyclically adjusted budgetary approach. This approach would take into account that the budget balance is influenced by the position of the economic cycle.¹⁴ When the economy grows rapidly, incomes, consumer spending, and company profits will all increase, leading to growing tax revenues. Conversely, as the economy slows, tax revenues may decrease while at the same time government spending

¹² This is essentially an enforcement process exercised by the European Commission on behalf of the European Union.

¹³ Presidency Conclusions (P37) European Council Brussels, 22 and 23 March 2005, Ref. 7619/1/05 REV 1.

¹⁴ The term economic cycle refers to economy-wide fluctuations in production or economic activity over several months or years, around a long-term growth trend. It typically involves shifts over time between periods of relatively rapid economic growth (expansion or boom), and periods of relative stagnation or decline (contraction or recession).

increases to meet expanding social welfare commitments. This means that in the high growth years, a surplus might actually be a deficit in cyclically-adjusted terms, and thus fiscal policy might need to be tightened through decreased current spending or increased taxation. This way, when economic conditions are less benign, public spending may be increased and/or taxes lowered in order to support greater economic activity. In such a scenario the budget deficit may be cyclical and so consistent with a balanced budget over the course of the economic cycle.

The rationale for counter-cyclical fiscal policy in Ireland is now stronger because as a member of the euro we do not have our own currency and thus no longer have access to two national economic policy tools: exchange-rate policy and monetary policy. This places greater emphasis on the role of fiscal policy in demand management.

The structural deficit or surplus (the fiscal balance adjusted for the cyclical element) should be a prime focus of the budgetary process and should, for example, be given as much prominence in the written and oral presentation of the budget as the 'ordinary' fiscal balance. The projected pre-Budget cyclically-adjusted deficit or surplus should be published. While acknowledging the difficulty in measuring the structural balance, we believe that an independent body, for example the ESRI, might be requested to determine the beginning of the cycle and the point in the cycle in the form of a pre-Budget report. Our concern is for a counter-cyclical budgetary approach that achieves balance over the economic cycle. With regard to capital spending, we advise some flexibility, in particular so that the large costs that can be incurred by a 'start-stop' approach to large capital projects are avoided and best value for money is achieved.

4.3 Longer term sustainability

The long-term sustainability of the public finances is an important component of overall economic stability which is in turn critical to economic growth and increased employment. As indicated by Lane,¹⁵ "a non-sustainable fiscal position is destabilising for the economy. Taxpayers and investors find it difficult to make commitments if there is excessive uncertainty about the future level of taxation."

In our view the general approach to fiscal policy in the longer term should be consistent with the following principles outlined by NESCI:

*"Public finances must be managed on a sustainable basis. Sustainability requires that the public finances are in a position to absorb the normal budgetary pressures that arise. From a longer term perspective, sustainability requires that the public finances are managed on a basis such that the longer term costs associated with the ageing of the population can be met."*¹⁶

In this regard, Part 10 of our Report discusses how the tax system can encourage long-term savings to meet the needs of retirement. That Part constitutes an input into the much larger question of pension provision within Ireland in the context of the changing demographics of the population. Taxation policy on its own cannot resolve the increasingly onerous pension issues that will confront our society over the coming decades.

A further element that is important in achieving a sustainable fiscal balance is that public spending

¹⁵ 'A New Fiscal Strategy for Ireland', P. R. Lane, The Economic and Social Review, Summer 2009.

¹⁶ 'NESCI Strategy 2006: People, Productivity and Purpose', No. 114, December 2005.

should be based on a stable revenue base. Unstable sources of tax revenue can be pro-cyclical taxes which can intensify the business cycle and, as we have seen, fiscal policy is now more important in demand management post-EMU. This suggests, for example, a move away from a transaction-based tax on property (for example stamp duty), and towards introducing more stable revenue sources such as an annual tax on property, user charges and other local service charges.

Another sustainability issue for countries within EMU is that, in the absence of a monetary policy lever at national level, fiscal policy instruments may be needed as a policy tool to help avoid asset price bubbles. Research into this area is still developing but it can be expected to mature in the next couple of years after the present economic crisis, with its roots in the financial markets, is thoroughly researched. Policymakers should follow this work as it progresses and as more definite conclusions become available.

4.4 Conclusion

Our preference is for a counter-cyclical budgetary approach that achieves balance over the economic cycle. We advise some flexibility with regard to capital spending. In addition, public spending should be based on as stable a revenue base as possible.

Appendix 1

Definitions used by Eurostat/European Commission in their publication 'Taxation Trends in the European Union' for the taxes on consumption, labour and capital

Definition of taxes on consumption

Taxes on consumption are defined as taxes levied on transactions between final consumers and producers and on the final consumption goods. These can be identified as the following categories:

- Value-added type taxes
- Taxes and duties on imports excluding VAT
- Taxes on products except VAT and import duties, which include excise duties except stamp taxes, and taxes on financial and capital transactions have also been recorded as capital taxes
- Other taxes on production, including taxes on international transactions, taxes on pollution and the under-compensation of VAT (flat-rate system)
- Other current taxes such as poll taxes, expenditure taxes, and payments by households for licences

Definition of taxes on labour

Taxes on labour fall into two categories – taxes on employed labour income and taxes on non-employed labour income.

- **Taxes on employed labour income**
Taxes on employed labour comprise all taxes, directly linked to wages and mostly withheld at source, paid by employers and employees, including compulsory social contributions. They include compulsory actual employers' social contributions and payroll taxes, compulsory social contributions paid by employees and the part of personal income tax that is related to earned income

- **Taxes on non-employed labour income**

Taxes on non-employed labour comprise all taxes and compulsory social contributions raised on transfer income of non-employed persons, where these can be identified. This transfer income includes social transfers that are paid by the State, for example, unemployment, invalidity and health care benefits and benefits from old-age pension schemes (both State and occupational pension schemes)

Definition of taxes on capital

The term 'capital' is defined broadly, including physical capital, intangibles and financial investment and savings. Capital taxes include taxes on business income in a broad sense; not only taxes on profits but also taxes and levies that could be regarded as a prerequisite for earning profit, such as property tax or motor vehicle tax paid by enterprises. Taxes on capital include capital and business income taxes and taxes on stocks (wealth) as follows:

- **Capital and business income taxes**

These include taxes that economic agents earn or receive from domestic resources or from abroad. They include taxes on income or profits of corporations, taxes on income and social contributions of the self-employed, plus personal income tax raised on the capital income of households (rents, dividends and other property income). In practice, this is mainly the personal income tax paid on dividends, interest and entrepreneurial activity and corporate income tax as well as other taxes on holding gains

- **Taxes on capital stock**

These include wealth tax, capital taxes including inheritance tax, property tax or taxes on the use of fixed assets, professional and business licences and some taxes on products

Appendix 2

Taxes on consumption, labour and capital, as a % of total taxation, 2007

Sorted in descending order by reference to Member States' taxes on labour

	Labour %	Consumption %	Capital %
Sweden	59	26	15
Austria	55	28	17
Germany	55	27	18
Belgium	52	25	23
Finland	52	30	18
France	52	25	23
Slovenia	51	35	14
Denmark	51	33	16
Estonia	51	41	8
Netherlands	50	31	18
Hungary	50	37	13
Italy	49	24	27
Lithuania	49	38	13
Czech Republic	48	29	23
Latvia	48	39	13
Spain	46	26	30
Portugal	43	36	21
Greece	42	36	23
Luxembourg	42	27	31
Romania	41	40	19
Slovakia	39	38	22
United Kingdom	39	30	32
Poland	39	37	25
Ireland	34	36	30
Bulgaria	32	54	16
Malta	27	40	33
Cyprus	26	39	34
EU-27 arithmetic average	45	34	21

Source: 'Taxation trends in the European Union: Data for EU Member States and Norway', Eurostat / EU Commission, 2009 Edition. Data are rounded to the nearest 1%.



COMMISSION ON TAXATION
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PART 5

TAX SYSTEM – STRUCTURAL ISSUES



Part 5: Tax System – Structural Issues

Section 1 is an introduction.

Section 2 considers income tax.

Section 3 considers the interface between the tax and social welfare systems.

Section 4 considers the taxation of capital.

Section 5 considers consumption taxes.

Section 6 considers international issues.

Section 7 considers the regulatory framework.

Section 8 considers tax avoidance.

Appendix 1 contains supplementary information.

Our recommendations in this Part are as follows:**Income tax**

5.1	There should be a single system which collects tax on income.
5.2	A three-rate income tax structure has merit but should have regard to the need to keep taxation on labour low and marginal rates competitive.
5.3	As a general principle, the family should continue to be the unit of taxation for all direct taxes.
5.4	The present arrangements with regard to band structure and credits which apply to married one-earner and married two-earner couples should remain in place.
5.5	If taxation is applied to child benefit, a child tax credit should be introduced to offset the additional tax payable in respect of child benefit for those in the lower half of the income scale.
5.6	The general aim should be to continue to exempt the minimum wage from income tax.
5.7	An earned income credit at a modest level should be phased in over time for proprietary directors and the self-employed.
5.8	A measure to limit the use of specified tax reliefs and exemptions by high earners should remain part of our tax code. • The required effective rate should apply to those earning over €250,000. It should apply on a graduated basis to those earning between €200,000 and €250,000. • This measure should be periodically reviewed, including when economic growth returns to a more stable trend, to determine whether the level of the required effective rate should be increased.

The interface between the tax and social welfare systems

5.9	In view of the burden on the Exchequer, the PRSI base should be broadened.
5.10	There should be a separate comprehensive consideration of the PRSI system.
5.11	A similar PRSI base should apply to employees and the self-employed and there should be a single rate of charge which should apply to both.
5.12	The employer PRSI ceiling should not be reinstated.
5.13	The employee PRSI ceiling should be abolished and this should be done on a phased basis.
5.14	Employees should be subject to PRSI on unearned income such as investment income and rental income.
5.15	Share-based remuneration, including share options, should be subject to PRSI.
5.16	Relief from PRSI should apply in respect of pension contributions made by self-employed contributors, subject to payment of a minimum PRSI contribution to secure future entitlement to benefits.
5.17	Trading losses should be deductible for PRSI purposes subject to the payment of a minimum annual PRSI contribution.

5.18	The step effect in PRSI and the health contribution levy should be eliminated.
5.19	The health contribution levy should be integrated into the income tax system.
5.20	The National Training Fund Levy should be abolished and a different approach to funding the National Training Fund should be put in place.
5.21	There should be further integration of the tax and social welfare systems.
5.22	On balance, we do not recommend a move to refundable tax credits at this stage. If there is not an appropriate level of uptake of direct expenditure support through measures like Family Income Supplement payments within a five-year period, the question of refundable tax credits should be considered as a policy option to ensure a more equitable distribution of resources.
5.23	As a general rule, all social welfare payments should be subject to taxation. • The statutory provisions which exempt from income tax elements of social welfare payments which are otherwise taxable should be discontinued. • There should be no change in the taxation status of maternity benefit, adoptive benefit and health and safety benefit. • Specific exemptions from income tax should be introduced for Family Income supplement, the domiciliary care allowance and the respite care grant.
5.24	Arrangements should be put in place as early as practicable to ensure that tax due on social welfare payments is collected at source by the Department of Social and Family Affairs.

The taxation of capital

5.25	Gains attributable to inflation should be excluded from the charge to capital gains tax.
5.26	Capital gains tax rollover relief should apply to the gains on disposal of farm land pursuant to a compulsory purchase order where the proceeds are re-invested in farm land.

Consumption taxes

5.27	The policy approach to determining the level of excise duty applicable to alcohol and tobacco products should take account of factors such as health outcome, public order issues, cross-border trade and other societal issues.
5.28	A deferral system should be applied in place of the daily payment system that currently applies to excises on mineral oils. However, any change should ensure that there is no cash-flow cost to the Exchequer.
5.29	Stamp duty on ATM, credit and debit cards should be phased out in the interest of promoting the move towards a cash-free society.

International issues

5.30	The 183/280 days test for determining the tax residence of an Irish citizen should be supplemented by additional criteria, which should include a permanent home test and a test based on an individual's centre of vital interests.
5.31	The rule that allows an individual, who makes a gift of property to Ireland, to be regarded as neither resident nor ordinarily resident in Ireland, notwithstanding being present in Ireland for significant periods, should be discontinued.
5.32	The remittance basis of taxation for income tax and capital gains tax should be discontinued.

Regulatory framework

5.33	The relationship between the State and the taxpayer should be informed by reasonableness and proportionality through the provision of safeguards to ensure equitable treatment. To the extent that it is practicable, safeguards should be provided on a statutory basis.
5.34	The State's interaction with the taxpayer so as to ensure tax compliance should be proportionate. • Access to determinations of the Appeal Commissioners should be simultaneously available to taxpayers and the Revenue Commissioners. • A cost-effective route of appeal should be available to all taxpayers. • Other recommendations made in the Reports of the Law Reform Commission and the Revenue Powers Group in relation to the reform, jurisdiction and operation of the appeal system should be implemented.
5.35	The interest rate applicable to overdue tax payments should be reviewed each year having regard to the prevailing market rates and the rate should be sufficiently high to discourage taxpayers from deferring tax payments.
5.36	The Revenue Commissioners should adopt general criteria towards reducing the regulatory burden as outlined in section 7.2.2 of Part 5.
5.37	Dividend withholding tax exemption claims by foreign parent companies should not require third party certification.
5.38	Self-assessment should apply to interest and royalty withholding tax exemptions and reductions that are available in tax treaties.
5.39	The relevant contracts tax rate should be reviewed to ensure that it does not lead to a taxpayer paying tax in excess of final liability.
5.40	Flexibility should be given to the Revenue Commissioners to vary the strict application of interest and penalty provisions in <i>bona fide</i> situations where relevant contracts tax was not applied but at no loss to the Exchequer.
5.41	A system should be put in place to permit payments for professional services to be made without deduction of professional services withholding tax to compliant taxpayers with an appropriate certificate from the Revenue Commissioners.
5.42	Where detailed data is required to allow the appropriate evaluation and cost-benefit analysis of tax expenditures, the taxpayers and businesses availing of the tax expenditures should be required to e-file their tax returns.

Tax avoidance

5.43	Where tax avoidance is identified and demonstrates a weakness in the law, a specific provision in the tax code should be enacted to prevent the avoidance in question.
5.44	Twenty years after the introduction of the general anti-avoidance provision, it is now opportune to review its effectiveness as a tool to tackle tax avoidance. This should include consideration of a time limit within which the Revenue Commissioners would be required to make a decision on the point at issue.

Section 1:

Introduction

In this Part we consider aspects of the structure of the tax system that do not fall under the specific questions addressed to us in our terms of reference.

Our terms of reference invite us to consider the structure of the taxation system in a contextual framework of maintaining an equitable incidence of taxation and a strong economy and having regard to a number of factors, including commitments in the Programme for Government:

- To enhance the rewards of work while increasing the fairness of the tax system, and
- To ensure that the regulatory framework remains flexible, proportionate and up to date

Section 2:

Income tax

2.1 Introduction

Our terms of reference invite us *“in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the taxation system.....”*. In this Section, we examine issues related to the structure of the income tax system and present our recommendations as to the appropriate general structure for the longer term.

There is evidence to suggest that, if economic growth is the main policy aim to be pursued, then a flatter income tax structure is a more appropriate instrument than one that leans towards greater progressivity, as the latter is likely to act as a disincentive to further effort. This evidence is presented in an OECD working paper – *Tax and Economic Growth* and an OECD report – *Going for Growth*¹. According to the OECD working paper, a flatter income tax structure is described as one with few allowances and tax credits:

“A flat tax system with few allowances and tax credits is generally simpler to administer and probably gives rise to fewer tax-induced distortions than other systems, but it puts less emphasis on redistribution. By contrast, a highly progressive income tax system normally reduces incentives to work and to invest in human capital, although ‘in-work benefits’ can improve work incentives for low wage workers while increasing progressivity. High progressivity may also increase the incentives for tax avoidance and tax evasion and contribute to a growing shadow economy that reduces measured GDP, although it is arguable that the tax level is more important than its progressivity in this regard. This may reduce tax revenues and undermine the fairness of the system. There is also a possibility that high top marginal rates will increase the average tax rates paid by high-skilled and high-income earners so much that they will migrate to countries with lower rates resulting in a ‘brain drain’ which may lower innovative activity and productivity.

¹ *Tax and Economic Growth* OECD Economics Department Working Paper No. 620, July, 2008. OECD Economic Policy Reforms: *Going for Growth* 2009, Structural Policy Indicators, Priorities and Analysis

The notion is accepted in all countries that progressive income taxes play a role in achieving a more equal distribution of income and consumption. However, it is also widely acknowledged that progressivity has the undesirable effect of distorting individual decisions to supply labour and invest in human capital.

There are a number of ways of defining progressivity. In this study, a progressive tax system is defined as one in which the average tax rate increases with income or, equivalently, in which the marginal tax rate is higher than the average tax rate at any income level."

However, a balance must be struck between flatness and progressivity or, put another way, between growth and fairness. The OECD working paper refers to 'a non-trivial trade-off' between tax policies that enhance GDP per capita and distributional objectives. This balance between growth and fairness is one which we have sought to achieve in our recommendations.

2.2 Income tax rate structure

2.2.1 Introduction

The main purpose of the income tax system is to collect revenue to fund public services but the system has other important roles including the redistribution of resources as well as incentivising desired outcomes such as participation in the labour force.

The present income tax system is graduated by means of various personal tax credits, allowances and reliefs as well as by the level of tax rates and the width of the tax bands to which the rates are applied. Changes to the values of tax credits, allowances, reliefs, tax rates or tax bands impact on the net tax position of earners. Increases in tax credits and standard-rated allowances and reliefs confer the same cash value benefit on all earners with sufficient income to avail of them while band widening only benefits those whose incomes are above the existing band ceilings or whose incomes would be subject to a higher rate of tax as a result of increases in wages were it not for the widening. Non-standard-rated allowances and reliefs are deducted from gross income before tax rates are applied. As such, within the present two-rate band structure, they confer a greater benefit on earners liable for the higher rate of tax.

As regards rate changes, and within the present two-rate band structure, a change in the standard rate (decrease or increase) will impact on all taxpayers and, in the case of an increase (without any corresponding change to tax credits), may also result in those who are marginally under the threshold to tax being brought into taxation. A change in the higher rate of tax impacts only on those earners whose taxable incomes are at a level where the higher rate applies. However, it will also affect the value of allowances and reliefs which are provided at the marginal rate. Outside of structural impact, it can also have a headline effect.

We consider that, for the longer term, there is a continuing role for each of these elements - credits, allowances and reliefs (standard-rated and at marginal rate), tax rates and tax bands in the income tax system. In relation to the allowances and reliefs which we have described as tax expenditures in our Report, they should, of course, be subject to regular review in accordance with our principles as set out in Section 5 of Part 8 of our Report.

There are now four parallel systems which collect tax on income. These are:

- i) Income tax
- ii) PRSI
- iii) Health contribution levy
- iv) Income levy (introduced in Finance (No. 2) Act 2008)

Each has a different base from the others. The bases for the health contribution levy and the income levy are wider than the income tax base. In addition, the income levy may be seen as a mechanism devised as a temporary measure to operate with a minimum amount of graduation (in terms of providing for exemptions, allowances) to ensure that correct payroll deductions are made when the rate is changed.

A single system for taxing income

Our strong view is that there should be a single system which collects tax on income. In this regard, we examined the option of bringing together the income tax system and the two levies into such a single system. We also looked at the option of integrating the health contribution levy on its own into the income tax system. The results of this examination suggest that, in current circumstances, where the key imperative is to restore fiscal balance, there are likely to be significant consequences from such a move in terms of potentially increasing marginal rates of tax and imposing taxation or a greater amount of tax on those on low incomes while significantly increasing the tax liability of those on higher incomes.

Integrating the four systems into a single system for taxing income would inevitably give rise to an increase in the standard rate of income tax if the main personal credits remain at their 2009 levels. This would give rise to a reduction in the relative value of the personal credits, thus bringing low earners into the tax net or causing them to pay more tax. The Table at Appendix 1 gives an indication of the scale of marginal tax rates that would be likely to arise in the event of integration as compared with those which apply at present.

The likely effects on low earners and on marginal rates of tax could impact on growth potential by adversely influencing the incentive to work or to do more work. Taking into account the ‘temporary’ nature of the income levy, our recommendation as set out in section 3.1 of this Part is that the health contribution levy only should be integrated into the income tax system but that the transition in this regard should not begin until fiscal conditions improve sufficiently to allow a new structure operate in a way which minimises disincentives to work.

2.2.2 Income tax rate structure

The present two-rate structure has been in place for over 17 years having been implemented in the tax year 1992/93. Before that, a three-rate structure applied and prior to that (1983/84), a six-rate structure was in place.

Conceptually, a third rate of tax could involve an upward or downward adjustment of the levels of the existing two rates with the third rate included in the structure either above, below or between the adjusted rates. If revenue raising is the primary aim, a two-rate structure is essentially as efficient as the three-rate structure in producing a given revenue yield. This is because most of the tax collected is yielded from the rate that applies to most taxpayers. The main reasons for introducing a third

rate are equity, increased progressivity and flexibility. A third rate of income tax is consistent with an equitable incidence of income taxation.

A three-rate band structure should reflect the need to keep taxes on labour low and marginal rates competitive as discussed in Part 7.

For the longer term we consider that such a three-rate structure has merit on grounds of equity, greater progressivity and flexibility. An appropriate lead-in period would be required to permit payroll system development. The Revenue Commissioners have also advised us that a third rate of tax is feasible subject to an appropriate lead-in period being provided.

Recommendation 5.1

There should be a single system which collects tax on income.

Recommendation 5.2

A three-rate income tax structure has merit but should have regard to the need to keep taxation on labour low and marginal rates competitive.

2.3 Unit of taxation

2.3.1 Introduction

As part of our examination, we reviewed the unit of personal taxation. The key question is – what is the appropriate unit on which personal tax should be assessed and charged? The choice is between the individual on the one hand and the family on the other. Many of the issues involved in this area are social rather than economic in nature. Internationally, there is no standard approach to the choice of the appropriate unit of taxation. The main argument in support of the proposition that the individual should be considered as the appropriate unit for taxation purposes is one of support for labour market participation. From a labour market perspective, having the individual as the unit of taxation could incentivise second earners in married couples to re-enter the workforce by reducing their marginal tax rate.

Under the system in existence in 2009, the unit of taxation can be said to be the family based on marriage where both spouses live together. However, with the partial individualisation of the standard rate band and the individualised employee tax credit, a hybrid system is in place in Ireland. This hybrid system is neither a fully aggregated system nor a fully individualised system. The current tax treatment of couples is set out at Annex 6.

2.3.2 Arguments which support an individualised unit of taxation

At a general level, systems that take the family (or household) instead of the individual as the basic unit of taxation tend to impose high marginal taxes on second earners and provide tax subsidies to households where only one spouse works outside the home². There is evidence to suggest that a reform of the tax treatment of couples, by making their taxes more independent (and thereby reducing marginal tax rates on second earners), would produce a positive but small effect on married women's participation in the labour force³.

² (1999) Women's Employment in Europe: Trends and Prospects, Jill Rubery, Mark Smith, Colette Fagan.

³ (2009) Tax Structure and Female Labour Supply: Evidence from Ireland, Tim Callan, Arthur van Soest, J.R. Walsh.

Where the individual is the unit of taxation, each individual earner has his or her own tax credits and standard band and there is no transferability of unused bands or credits. In addition, the preferential standard rate band that applies in the case of married one-earner couples as compared with single earners would cease to apply⁴. Also, the current beneficial arrangements which apply to spouses under the capital gains tax, stamp duty and capital acquisitions tax codes would fall to be reconsidered.

These include, for example, tax free transfers of assets between spouses and the ability to offset capital losses made by one spouse against capital gains made by the other spouse. Annex 6 has further details. A fully individualised tax system, if it were mirrored by a similar approach in the social welfare code, would offer a possible solution to the inconsistency in the treatment of cohabiting couples under the two systems (paragraph 2.3.5 below refers).

2.3.3 Arguments which support a family-based unit of taxation

The arguments which support the view that the family is the appropriate unit of taxation include the following:

- Consideration of the laws, traditions and social conditions which exist in the country in which the system of taxation operates. In Ireland, the Constitution (Articles 41 and 42) defines the family as the basic unit of society and lays down principles for its protection
- It may be considered more equitable to assess tax on a family basis
- Members of a family generally share their resources on the basis of relative need rather than according to how incomes happen to be divided between them, and
- As soon as a marriage is contracted, it is the continued income and financial position of the family that is ordinarily of primary concern, not the income and financial position of the individual members.

Thus, the married couple itself adopts the economic concept of the family as the income unit from the outset

The previous Commission on Taxation formed the view that *“two identical families enjoying the same total income ought not ...to be taxed any differently just because, in the case of one family, the income accrues initially to one member and, in the other, it is acquired by two or more”*. Full acceptance of such a view, which is founded in the principle of equity, would mean, in effect, support for a reversal of the policy of band individualisation. This would, however, fail to take account of the impacts on the labour market and there is, therefore, a balance to be struck between equity on the one hand and supporting economic development on the other.

2.3.4 Conclusions

The broad question to be considered is whether a continuation of the existing approach in which the family is the key unit for taxation purposes is to be endorsed for the medium to long term or whether instead there should be a change to a system where the individual is the basic unit for tax purposes. Having regard to the arguments, in principle we support the continuation of the position whereby the family is the unit of taxation and that this should be the position for all direct taxes. The question of individualisation of income tax is considered in more detail in section 2.4.

⁴ The question of the continuation of the home carer tax credit would also fall to be considered in such circumstances.

Recommendation 5.3

As a general principle, the family should continue to be the unit of taxation for all direct taxes.

2.3.5 Treatment of other relationships – cohabiting and same-sex couples

If the general position is that the family is to be the unit of taxation, the question then arises as to how cohabiting couples and same-sex couples are to be regarded under the terms of such an arrangement.

There have been a number of studies in recent years in the general area of family including:

- The Tenth Progress Report of the Oireachtas All-Party Committee on the Constitution entitled 'The Family' which was published in early 2006
- The Options Paper presented to the Minister for Justice, Equality and Law Reform in November 2006 by the Working Group on Domestic Partnership, and
- The Report of the Law Reform Commission on the rights and duties of cohabitants which was published in December 2006

We are aware of legislative proposals in the form of a Scheme of a Bill⁵ being brought forward at the time of our Report by the Minister for Justice, Equality and Law Reform which are intended to establish civil partnership registration (for same-sex couples only) which will confer a broad range of rights and responsibilities on couples who choose to register. These rights and responsibilities will, we understand, be broadly analogous to those conferred on spouses on marriage.

The proposed legislation will afford registered civil partners essentially the same treatment under the law as that afforded to married couples at present. The proposed legislation does not deal directly or explicitly with tax and social welfare issues.

2.3.6 Inconsistency of treatment

The apparent inconsistency in the treatment of cohabiting couples⁶ under the tax and social welfare codes was highlighted by the Ombudsman in October 2008 in the context of the publication of a digest of complaints⁷.

The point at issue is that, while the State treats cohabiting couples in the same way as married couples for social welfare purposes, it does not follow the same approach under the tax system. The argument is made that the approach is inconsistent and unfair and that, overall, the State is simply suiting itself in the treatment of cohabiting couples.

In 1999, the Working Group Examining the Treatment of Married, Cohabiting and One-Parent Families under the Tax and Social Welfare Codes acknowledged that, to the extent that the tax and social welfare codes approach and recognise co-habitation, it is to avoid a situation where co-habiting couples receive better treatment than married couples and this approach is derived from the constitutional requirement to protect the institution of marriage as clarified and articulated to date by a number of Supreme Court judgments⁸.

5 Scheme of Civil Partnership Bill.

6 The issue here relates to opposite sex cohabiting couples.

7 See the Office of the Ombudsman website (www.ombudsman.gov.ie) for further details.

8 *Murphy v. Attorney General* (1980) and *Hyland v the Minister for Social Welfare and the Attorney General* (1989)

There is no simple answer to this matter. The issue was examined in detail as part of the studies outlined above. As noted in paragraph 2.3.2, fully individualised tax and welfare systems might overcome the apparent inconsistency of treatment but we are not recommending an individualised approach for the tax system.

The Law Reform Commission suggested⁹ that cohabiting couples may be grouped into three categories: those who may eventually marry, those opposed to marriage and those unable to marry. That Commission expressed the view that if the State by its laws were to recognise and improve the position of a cohabitant who is already married to someone else, those laws would undermine the institution of marriage. The Irish Human Rights Commission Report commented in this regard that, *“It is certainly fair to conclude that the recognition of an extramarital union, and an attempt to equate it with an existing marital union, may undermine the position of marriage in an unconstitutional manner”*.

The Working Group on Domestic Partnerships expressed the view that, while persons in extra-marital partnerships may be vulnerable, they cannot have legal status for their second relationship while they remain married to someone else. In relation to cohabiting couples who do not wish to marry, the Working Group observed that *“some people may be reluctant to commit to another permanent relationship because of the emotional scars they carry from the break-up of an earlier marriage. Equally, they may be in straitened financial circumstances due to the cost of separation and/or divorce and the continuing commitments to the first family. In such a scenario, the risk of the partner in the second relationship being particularly vulnerable in the event of break-up would be high”*. It concluded, however, that *“in the absence of conclusive research on the motivation, duration and structure of conjugal cohabitation, it is difficult to identify what institutional innovations would be appropriate to the needs of cohabitants”*.

2.3.7 Conclusions

A key issue in looking at the issue of cohabiting couples is the special position of marriage under the Constitution. It does not seem advisable to seek to address the issue through tax policy changes alone. In relation to the treatment of opposite sex and same sex cohabiting couples under the tax code, our view is that tax law should follow the general law in this area. To the extent that general law extends to opposite sex and same sex couples the same treatment under the law as that afforded to married couples at present, we envisage that they should be covered by our Recommendation as regards the unit of taxation.

⁹ Law Reform Commission Consultation Paper on the Rights and Duties of Cohabitees, LRC, Dublin, 2004, para. 2.12.

2.4 Individualisation

2.4.1 Introduction - two-rate structure

The two-rate structure that applies in 2009 has been in place since 1992¹⁰. The standard rate bands are the ranges of income within which the standard rate of income tax applies for the various categories of income earner i.e. single earners, married one-earner couples and married two-earner couples¹¹.

For 2009, the tax bands have the following values:

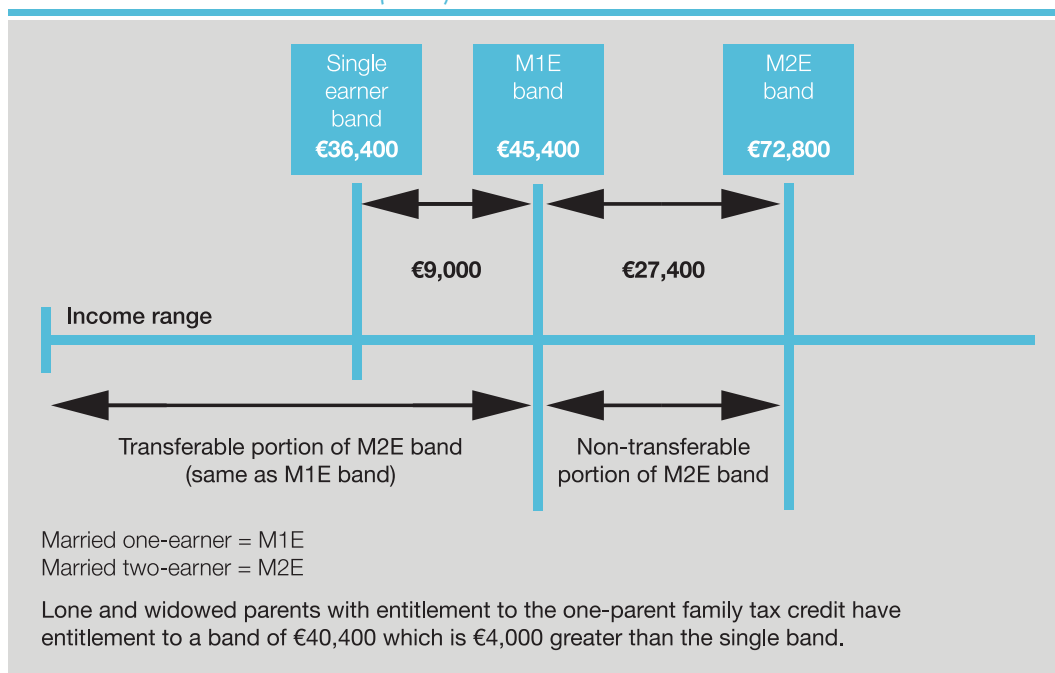
Single	€36,400
Married one-earner	€45,400
Married two-earner	€72,800 maximum*

*€45,400 of this is at the standard rate with the possibility that a further €27,400 may also be at the standard rate depending on the income of the lower earning spouse.

Income up to the values shown is liable to tax at the standard rate of tax. Income in excess of the above values is liable to tax at the higher rate of 41%. The single band is €9,000 less than the married one-earner band. This has been the position since the 2002 tax year. The maximum married two-earner band is twice the value of the single band¹².

The following table shows the band structure that applies in 2009.

Table 5.1: The standard rate bands (2009)



10 In the 1992/93 tax year, the rates of tax applying to the bands were 27% and 48% for the standard and higher rates respectively. At that time, married couples, whether one-earner or two-earner, had a standard rate which was double the value of the single band.

11 Lone and widowed parents with entitlement to the one-parent family tax credit also have entitlement to a standard rate which is €4,000 greater in value than that which applies to the single earner.

12 This has been the position for a long number of years following the case of *Murphy v Attorney General* 1980. In that case, it was held, among other things, that "the consequent imposition in certain circumstances, of tax on the married couple at a rate higher than would be imposed on two single persons enjoying identical incomes did constitute a breach by the State of its undertaking, by s. 3 of Article 41 (of the Constitution), to guard with special care the institution of marriage and protect it from attack".

Where standard bands are increased through the Budget and Finance Bill process, those whose incomes exceed the existing band ceilings benefit through a reduction in net tax; those whose incomes are under the ceilings receive no benefit. Thus, if the 2009 band for a single person of €36,400 were to be increased by €1,000, single earners with income at or over €37,400 would gain €210¹³ per annum and those with income between €36,400 and €37,400 would gain proportionately¹⁴. To this extent, increases in the standard bands favour those higher up the income scale.

2.4.2 Meaning of the term ‘individualisation’

The term *individualisation*, refers in particular to the process of individualising the tax bands which began in 2000¹⁵. This is the sense in which we use the term in this Part. The effect of individualisation, if completed, would be to give each individual earner, whether single or married, a standard rate band of the same value¹⁶.

The most likely¹⁷ way to complete individualisation would be to bring the value of the single band up to the value of the married one-earner band, with a married two-earner couple having a maximum band of twice the value of the single band but with no transferability between the spouses. This would give revised standard rate bands as follows:

	If individualisation completed	2009 tax bands
Single	€45,400	€36,400
Married one-earner	€45,400	€45,400
Married two-earner	€90,800	€72,800

For income levels above €45,400 in the 2009 tax year, the move towards band individualisation would result in married one-earner couples paying more tax than married two-earner couples on the same income – see Examples 1 and 2 at Annex 7.

In 2009, the maximum potential difference in tax liability due to band structure and differing entitlement to credits between a married two-earner couple and a married one-earner couple with a carer in the home is €6,684 per annum – see Examples 3 and 4 in Annex 7. This is equivalent to about €128.50 per week. The differential between the married one-earner band and the upper limit of the married two-earner band only impacts on incomes above €45,400. Married one-earner couples on average earnings are not affected by the different standard rate bands.

13 $€37,400 - €36,400 = €1,000 \times 21\%$ (i.e. the difference between the higher rate and the standard rate) = €210.

14 A single person earning under €35,400 would gain no benefit but may have done so if the bands had been increased previously.

15 Budget 2000 and Finance Act 2000 refer. It has also been argued in relation to the personal income tax system that individualisation encompasses the employee tax credit which has applied on an individual earner basis since its introduction as the Employee (PAYE) Allowance in 1980.

16 Lone and widowed parents would also have the same band as other earners in these circumstances and the question of what further entitlement, if any, they might receive above that applying to a single earner might need to be considered.

17 This assumes that bands would not be reduced in value.

2.4.3 Examination of options for the future

We examined the following options in relation to the future disposition of the bands:

1. Completion of individualisation
2. Reversal of individualisation (restore the position which existed prior to Budget 2000 where married one-earner couples had the same standard band as married two-earner couples at double the value of the band available to single earners)
3. Continue the 'hybrid' approach

Our analysis is summarised in the following paragraphs.

Option 1 - Completion of individualisation

This move, if completed at the level of the current married one-earner band, would mean that each earner would have his or her own standard rate band at the same level as the current married one-earner band.

The main advantage of completing individualisation is that it would support the labour market and the economy by further incentivising second earners in married couples to remain in or re-enter the workforce by reducing their marginal tax rate¹⁸. Marginal tax rates are important because they influence individual decisions to work or to work more. Completion of individualisation would also make it easier to introduce more than two rates of income tax if desired, which could further increase progressivity.

On the other hand, completing individualisation would further disadvantage married one-earner couples relative either to married two-earner couples or to single people in terms of the amount of income which is liable to tax at the standard rate. For example, if individualisation was completed at the current level of the married one-earner band (€45,400), it would mean that a married two-earner couple could potentially earn €45,400 more per annum at the standard rate than a married one-earner couple on the same income. When account is taken of existing tax credits, the maximum potential difference due to band structure and differing entitlement to credits between a married two-earner couple and a married one-earner couple with a carer in the home would be €10,464 per annum or about €200 per week. This would arise at an income level of €90,800 or more – see Example 5 at Annex 7.

The move would also most likely give rise to the need to further support, through the tax code or direct expenditure, the choices which married one-earner families make in relation to care arrangements for their children.

There would, of course, be significant Exchequer cost implications arising from this option (or indeed the option of reversing individualisation). However, this cost aspect, while relevant, is subsidiary to the issue of the correct approach in principle.

Option 2 - Reversal of individualisation

This approach, if completed at the level of the maximum of the married two-earner band, i.e. €72,800, would mean that married one-earner couples would have the same band as married two-earner couples and that all married couples would have double the value of the band available

¹⁸ A move to individualised taxation to increase labour force participation was recommended by the OECD in its two economic reviews of Ireland in 2006 and 2008. The National Competitiveness Council suggested that the marginal tax rate on second earners should continue to be reduced.

to single persons. The transferability restriction which applies to the spouses in two-earner couples would no longer be relevant. The measure would remove significant numbers of married one-earner couples from liability for the higher rate of tax.

This approach would acknowledge the different choices that families make in caring for their children. It would improve the position of married one-earner couples relative to single earners and married two-earner couples. In addition, it would address the issue as it applies to elderly one-earner couples. The argument has been made by such couples that, under current arrangements, they pay more tax than two-earner couples on the same income but that the issue of labour force participation has much less relevance for them.

The additional annual value to married one-earner families of having a band at the level of the married two-earner band would be up to €5,754 per annum¹⁹, equivalent to about €110 per week. The reversal of individualisation would also offer the opportunity to consider whether the home carer tax credit²⁰ should continue. As with the move to complete individualisation, this measure would also make it easier to introduce more than two rates of income tax.

A reversal of individualisation would act as a disincentive to second earners to enter the workforce and would signal a marked policy shift away from that of encouraging increased labour force participation which in turn promotes economic growth.

Compared with the current position of the bands or a scenario where individualisation was completed, this approach would involve relatively greater on-going costs in widening tax bands. This is because all married couples would get double the benefit of any band increase given to single earners and no transferability restriction would apply in the case of married two-earner couples.

Option 3 - Continue the current 'hybrid' approach

This approach strikes a balance between the objectives of supporting labour market participation and growth on the one hand and recognising choices families make in raising their children on the other. Compared with the alternatives of completing individualisation or reversing it, it offers a greater degree of flexibility in terms of costs in deciding the extent to which bands may be widened in any year.

While this approach seeks to be as neutral as possible in relation to individualisation, it is not possible to widen the bands in a fully 'neutral' way. While one might seek to retain the €9,000 differential in nominal terms between the single band and the married one-earner band, the gap between the potential earnings at the standard rate of married one-earner and married two-earner couples actually widens.

For example, in the 2005 tax year a married one-earner couple could earn €38,400 at the standard rate while a married two-earner couple could potentially earn €58,800. The difference in the bands was €20,400 or, potentially, €4,488 per annum²¹ less of a tax bill for married two-earner couples.

19 $€72,800 - €45,400 = €27,400 \times 21\% = €5,754$.

20 This credit, currently valued at €900 per annum, is available to married one-earner families with a carer in the home. It was introduced as a €3,000 tax allowance at the standard rate in Finance Bill 2000 following the public reaction to band individualisation in Budget 2000. Following the move to tax credits, it remained at a value of €770 until Budget 2008 when it was increased to €900.

21 $€20,400 \times 22\% = €4,488$ (the higher rate was 42% in 2005).

After Budget 2009, a married one-earner couple may earn €45,400 at the standard rate while a married two-earner couple may potentially earn €72,800. The difference in the bands is now €27,400 or potentially €5,754 per annum less of a tax bill for married two-earner couples. Even allowing for CPI inflation in the intervening period, the gap has widened.

2.4.4 Conclusions

If the sole criterion for assessing this question is one of supporting economic activity, then there are strong arguments in favour of completing band individualisation. It would reduce barriers to employment and encourage second earners to participate in the labour force.

However, we recognise that there are wider societal and equity issues, which also need to be considered when examining this question. This is particularly the case for families with dependent children and other caring responsibilities. If the guiding policy principle is one which acknowledges the different choices which families make in caring for their children, then there are also strong grounds for considering a reversal of band individualisation.

Overall, we take the view that the present arrangements with regard to band structure and credits which apply to married one-earner and married two-earner couples should remain in place. They represent a balance between, on the one hand, acknowledging the choices families make in caring for children and, on the other, taking account of the need to encourage labour force participation.

Recommendation 5.4

The present arrangements with regard to band structure and credits which apply to married one-earner and married two-earner couples should remain in place.

2.5 Tax treatment of families with dependent children

In Section 8 of Part 8 of our Report, we are recommending the withdrawal of a number of childcare reliefs, as well as the removal of the tax exemption for child benefit. These recommendations are being made for equity and efficiency reasons. In relation to child benefit, we suggest that, to give effect to an actual redistributive effect, those lower down the income scale should not lose, and should be seen to not lose, in actual terms from the move to taxation. We examined whether this should be through a direct payment or through the tax system and concluded that, in the shorter term at least, the tax credit route would be preferable on grounds of better visibility – in general, families would see the increased tax arising from the taxation of child benefit but would also see the offsetting credit. In the longer term, of course, our proposal that the Department of Social and Family Affairs should operate a taxation at source system would mean the recipients of child benefit would receive a payment net of tax. In that event, the best way to deliver the redistributive payment may need to be reviewed.

- 2.5.1** Our proposal is that, if taxation is applied to child benefit, a child tax credit should be introduced which would be designed to offset the additional tax payable on child benefit for those on lower income. At the current level of child benefit, an annual tax credit in the region of €400 in respect of each child would seem to be necessary to offset tax at the standard rate arising on a child benefit payment. There would also be administrative issues to be resolved between the

Department of Social and Family Affairs and the Revenue Commissioners in ensuring that families received the credit. At present, the Revenue Commissioners do not have information about children as part of their data on tax cases. Elsewhere we make recommendations about greater operational integration of the tax and welfare systems which, if implemented, would help to address this.

Recommendation 5.5

If taxation is applied to child benefit, a child tax credit should be introduced to offset the additional tax payable in respect of child benefit for those in the lower half of the income scale.

2.6 The minimum wage and taxation

2.6.1 Introduction

This section deals with the tax treatment of the minimum wage. We also discuss the minimum wage in Part 7 (Appendix 2). The statutory minimum wage (in 2009) is €8.65 per hour which is equivalent to €17,542 on an annualised basis²². It came into effect in April 2000 and, since then, it has increased six times. It was last increased in July 2007. In nominal terms, the wage has increased in value by almost 55% since its introduction.

Until the supplementary Budget in 2009, the consistent policy in relation to lower earners over the previous 10 years or so was aimed, among other things, at taking low earners out of the income tax net so that people could keep more of what they earn. This approach sought to incentivise employment participation. Currently, a single person earning the minimum wage in its annualised form in Ireland pays no income tax or PRSI on that wage. However, since 1 May 2009 those earning the minimum wage pay 2% of their income in the form of the income levy²³.

The entry point to income tax for a single employee aged under 65 is €18,300 which is €758 above the annualised figure for the minimum wage of €17,542. In addition, the employee weekly threshold for liability to PRSI is €352 (€18,304 on an annualised basis)²⁴.

2.6.2 The tax treatment of the minimum wage

Differing views exist on the tax treatment of the minimum wage. One view is that everybody should make a tax contribution, no matter how small, including those earning at or below the minimum wage in its annualised form. Excluding people earning at or below the minimum wage from income tax could allow part-time employees who may be earning above the minimum wage to be outside the tax system. In addition, the manner in which the wage has been exempted i.e. through increases in the main personal tax credits, has given rise to a situation where, for example, married one-earners with children or lone parents pay no income tax at all on incomes very significantly in excess of the minimum wage (see Annex 7 which sets out the 2009 thresholds to income tax).

Another view is that there is a case for keeping the lowest earners out of the income tax system in the interest of fairness. If the State has decided that employees should have an entitlement to a minimum level of pay, this view argues that that minimum should not then be reduced by taxation.

22 €8.65 x 39 x 52.

23 With effect from 1 May 2009 the income levy applies to income in excess of €15,028 (€289 per week) at a rate of 2% (for those aged under 65). The 2% applies on income up to €75,036. Beyond that it applies at 4% on income up to and including €174,980 and at 6% on income thereafter.

24 Liability for the health contribution levy does not arise until a person's income exceeds €500 per week or €26,000 per year.

2.6.3 Conclusion

Looking towards the long term, the fact that the minimum wage is exempt from taxation creates a headline effect and sends a clear message to prospective employees about the competitive employment environment in Ireland. Our view is that the general aim should be to continue to exempt the minimum wage from income tax. However, this is not to suggest that the wage must be kept out of the tax net at all times. Further, based on the argument outlined above, we consider that the minimum wage should, as a general aim, continue to be exempt from PRSI also.

Recommendation 5.6

The general aim should be to continue to exempt the minimum wage from income tax.

2.7 The employee tax credit

2.7.1 Introduction

The employee tax credit (ETC), also known as the PAYE tax credit, may be claimed by an individual who is in receipt of emoluments chargeable to income tax under Schedule E. The value of the credit is €1,830 per annum. It is provided on an individualised basis and this has been the case since it was first introduced as an allowance. It is not applicable to emoluments paid by a company to proprietary directors²⁵ or their spouses or to those who are self-employed.

2.7.2 Background

The employee tax credit was introduced in Budget 1980 following deep unrest regarding the basis of assessment applied to earners on PAYE and that applied to other taxpayers such as the self-employed.

The latter, at that stage, as a general rule, paid tax based on profits of the accounting period ending in the preceding income tax year. In that Budget, a special Schedule E employee allowance of £400 (€508)²⁶ was provided for each PAYE taxpayer *“in order to improve the tax progression for these taxpayers and also to take account of the fact that the self-employed generally have at present the advantage of paying tax on a previous year basis”*.

The Minister for Finance explained the exclusion of proprietary directors (and their spouses) – *“I intend to exclude from this provision those Schedule E taxpayers in a position to control their own remuneration or that of their spouses, for example, directors of proprietary companies”*.

2.7.3 Extension of the credit to the self-employed

We considered whether it was consistent with the equity principle to allow the credit to one category of worker and to deny it to another.

25 The credit may be claimed by children of proprietary directors and the self-employed who are full-time employees in the business of their parents and where certain conditions are fulfilled. These are:

(a) PAYE must be operated in respect of the employment, and
(b) The individual's income from the employment must be at least €4,571.

A 'proprietary director' means a director of a company who is either the beneficial owner of, or able, directly or through the medium of other companies or by any other means, to control more than 15% of the ordinary share capital of the company.

26 The allowance of €508 was marginally rated and was then worth a maximum of €305 (i.e. £400 x 60% = £240 (€305)).

Timing of payment of tax

The main argument for extending the ETC to the self-employed is that they no longer pay income tax on the previous year basis. They are now required to pay preliminary tax for a year of assessment before the end of that year. In addition, the self-employed sector is likely to have higher compliance costs than the majority of the PAYE sector.

While the self-employed now must pay their tax in the current year, some timing benefits remain because the preliminary tax does not have to be paid until 10 months into the tax year. In contrast, a PAYE taxpayer earns income and pays tax at the same time throughout the tax year. In addition, a self-employed taxpayer is allowed to base the preliminary tax payment on the liability of the previous tax year. This confers an advantage where there is an increase in profitability from one year to the next. Where there is a reduction in taxable profits, the preliminary tax can be based on the profits of the current year.

On the other hand, the self-employed taxpayer may face tax liabilities by 1 November, two months before the end of the tax year, on profits that have not yet been earned. A further argument is that, as accounts of a taxpayer are prepared on an accruals basis, much of the profit on which preliminary tax must be paid will not have been converted into cash at the time the preliminary tax is required to be paid.

Timing and level of income

Over the years, it has been suggested that self-employed taxpayers can legitimately manage the timing and level of their income so as to maximise Government supports available in other areas.

The self-employed are required to return income earned in each year and there is not great scope for manipulation of this. However, there may be scope in the timing of expenditures and write-offs in calculating income. In addition, there remain differences in the criteria applied to determine the deductibility of expenses. Expenses must be incurred *“wholly and exclusively for the purposes of the trade”* in the case of the self-employed but *“wholly, exclusively and necessarily in the performance of the duties”* in the case of employees.

The extent to which it might be possible to further reduce differences in timing arrangements for payment of tax between the self-employed and employees, as well as the extent to which the treatment of employees' expenses might be equalised with those of the self-employed, would add to the rationale for reducing the less advantageous treatment of the self-employed.

Position of proprietary directors

We have mixed views on the position of proprietary directors. One view is that such individuals, being owners of their companies, have considerable scope to manage the timing and level of their income. Another view is that salaries taken by proprietary directors are subject to taxation in accordance with the PAYE system and that, as such, the individuals should not be treated differently from others paying tax under that system.

An alternative approach – earned and unearned income

The nominal value of the ETC has increased significantly in recent years. This was a relatively

more economical way of keeping the minimum wage out of the tax net²⁷. We accept that some differences remain that warrant the ETC but the value of the credit is disproportionate to these. Consequently, there is a case for reducing the difference. At the same time, we acknowledge the significant Exchequer implications of such a change.

Rather than differentiating between income from employment and other income, the differentiation in future could be between earned and un-earned income and a tax credit given to those taxpayers, in receipt of earned income. This would recognise the fact that income from both employment and self-employment is earned and would reward effort. It would also compensate for the fact that much passive investment income is taxed at lower levels of tax.

An 'earned income credit' would primarily recognise the incremental costs of working by comparison with a taxpayer with unearned (investment) income. It would also recognise the fact that since the early 1980s there has been a significant change in employment patterns in Ireland. The notion of a person remaining with one employer – 'job for life' – or even remaining in one career has changed fundamentally. An increasing number of individuals may now move between periods of self-employment and employment, a pattern that is likely to increase over time. In short, we consider that the earned income credit reflects the cost to most taxpayers of being in employment, whether with an employer or self-employed.

2.7.4 Costings

The cost to the Exchequer of extending the ETC to the self-employed and proprietary directors and their spouses is estimated at €658 million in a full year. This is made up of €190 million for proprietary directors and €460 million for self-employed individuals.

The numbers of income earners who are self-employed or proprietary directors are estimated at about 219,300 and 126,300, respectively, for 2009.

2.7.5 Conclusion

There is no easy or immediate solution to the equity issue arising from not applying the ETC to a substantial cohort of taxpayers. In addition, we acknowledge the significant cost implications which would be likely to arise in practice in making a rapid adjustment to address the equity issue. However, we are satisfied that this matter should be addressed over time. We consider that an earned income credit at a modest level should be phased in over time for proprietary directors and the self-employed.

Recommendation 5.7

An earned income credit at a modest level should be phased in over time for proprietary directors and the self-employed.

27

As compared with an approach where the basic personal credit alone was increased in value or where the employee and personal credit were each increased to take the minimum wage out of the tax net.

2.8 High earners

2.8.1 Introduction

A measure²⁸ to limit the use of specified tax reliefs and exemptions for those on high incomes came into effect in the tax year 2007. This measure provides for a more equitable incidence of taxation by improving progressivity in the income tax system. The restriction works by limiting the total amount of 'specified reliefs' that a high-income individual can use to reduce his or her tax liability in any tax year²⁹. It requires in effect that those earning €500,000 or more per annum must pay an effective rate of tax of not less than 20%. The required effective rate applies on a graduated basis to those earning between €250,000 and €500,000 per annum. No such requirement applies for those earning less than €250,000.

The restrictions only apply where three conditions are met:

- The person's income is €250,000 or more before use of tax shelters or exemptions
- The person uses the tax shelters or exemptions subject to the restriction to shelter income from tax, and
- The amount of the tax shelters or exemptions so used is greater than 50% of the person's income before use of tax shelters

If our recommendations on tax expenditures in Part 8 of our Report are accepted and implemented – in addition to the current phasing out of many property tax incentives – the number of incentives available to high income earners to reduce their effective tax rate to less than 20% should diminish considerably. However, we believe that a measure to limit the use of tax reliefs and exemptions by high-income individuals should remain part of our tax code and that it should be periodically reviewed. As long as any tax incentives remain part of the tax code individuals will be likely, by the cumulative use of such incentives in the absence of a control, to reduce their tax liability.

2.8.2 Limitation measure is working

In cases where the full restriction applies (i.e. cases with income over €500,000), the measure is having the intended effect and, as indicated in a Report published by the Department of Finance (2009)³⁰ the individuals concerned have an average effective rate of tax on income sheltered by incentives or exemptions of around 20%. The Report also indicates that a number of individuals, whose main source of income was previously treated as exempt income – patent income and artists' income – and who were not previously in the tax net, have now been brought into the tax net by the measure. This increase in effective tax rates is consistent with the principle of vertical equity: that the tax burden should be distributed fairly across persons with different abilities to pay and that high earners should make an appropriate contribution to the overall tax take.

In cases where the restriction applies on a graduated basis (those earning from €250,000 to €500,000) the measure is having the intended effect. In these cases also a number of individuals,

28 Section 17 of the Finance Act 2006.

29 Broadly, the reliefs that are restricted include:

- The various sectoral and area-based property tax incentives.
- Certain exemptions relating to artists' income, patent royalties etc.
- Certain investment incentive reliefs such as BES relief and film relief.
- Relief for interest paid on loans used to acquire an interest in a company or in a partnership.

30 Analysis of High Income Individuals' Restriction 2007

whose main source of income was previously treated as exempt income and who were not previously in the tax net, are also now in the tax net.

2.8.3 The effective rate of 20%

We considered whether having an effective rate of 20% has the potential to create a target rate for high earning individuals. In so doing, we also had regard to the role the tax system can play in making wealth productive. We consider that a balance has to be struck between the provision of tax incentives to encourage investment in particular areas of the economy and a provision in the tax system which restricts the use of those same incentives. Our recommendations on tax expenditures will, if adopted, result in a more efficient suite of incentives which will support economic activity in Ireland in the future. It is appropriate that such incentives, provided they are consistent with the principles we have set out in Part 8 of our Report, can be accessed by people willing to invest in productive areas of the economy. Given the necessity to return to stronger economic growth in the short and medium term, we do not recommend any change to the existing effective rate of 20%. We do, however, suggest that this rate be reviewed when economic growth returns to a more stable trend.

2.8.4 The graduated application of the relief to those earning between €250,000 and €500,000

We considered whether the graduated application of the measure to those earning between €250,000 and €500,000 should be changed. In our view, all individuals who earn over €250,000 in a year should pay an effective rate of tax of at least 20% and there should be no graduated provision for those earning between €250,000 and €500,000. This would provide for a more equitable incidence of taxation for people with earnings in excess of €250,000 and who have the ability to use tax reliefs and exemptions to reduce their effective rate of tax to less than 20%.

We accept, however, that there is a need for a graduated application of the rules in order to avoid a step effect at €250,000. We consider that the graduation should apply to income in the band €200,000 to €250,000.

2.8.5 Conclusion

A balance has to be struck between the provision of tax incentives to encourage investment in particular areas of the economy and a provision in the tax system which restricts the use of those same incentives. Application of the principles which we outline in Part 8 of our Report should result in a more efficient suite of incentives to support economic activity, including jobs growth, in the future and it is appropriate that these should be accessed by those willing to invest in them.

Recommendation 5.8

A measure to limit the use of specified tax reliefs and exemptions by high earners should remain part of our tax code.

- The required effective rate should apply to those earning over €250,000. It should apply on a graduated basis to those earning between €200,000 and €250,000.
- This measure should be periodically reviewed, including when economic growth returns to a more stable trend, to determine whether the level of the required effective rate should be increased.

Section 3:

The interface between the tax and social welfare systems

3.1 The pay related social insurance (PRSI) system

3.1.1 Introduction

Our terms of reference asked us *“to consider the structure of the taxation system”* and to examine and review a number of specific questions. In this connection, the interface with the social welfare system is an important structural issue which needs to be considered.

We carried out our examination of this area under the following headings.

- The PRSI system
- Integration of the tax and social welfare systems
- Refundable tax credits
- The tax treatment of social welfare payments

The treatment of cohabiting couples under the tax and social welfare systems is addressed separately in section 2.3 which deals with the unit of taxation.

3.1.2 Description of the PRSI system

The social insurance system in Ireland comprises two key features, namely a social solidarity component and a contributory principle. The social solidarity component means that the costs of social benefits and programmes are shared collectively by society. The contributory principle means that individuals build up entitlement to benefits for both themselves and their families if and when a particular contingency arises. The social insurance system provides cover for a large range of social welfare payments to workers and their dependants.

PRSI contributions, which are collected mainly through the income tax system, provide the main source of funding for the system. There are 11 different classes of PRSI, and over 30 subclasses within these, and the class applicable determines eligibility for various benefits.

PRSI is made up of a number of different components:

- Social insurance, payable by employees, employers and the self-employed, is administered by the Department of Social and Family Affairs which provides a range of social welfare benefits and pensions
- The health contribution levy, payable by employees, goes to the Department of Health and Children to help fund health services
- The national training fund levy, payable by employers of Class A and H contributors, goes to the Department of Enterprise, Trade and Employment to support a broad range of employment training initiatives

3.1.3 Social insurance fund

Social insurance contributions by employees, employers and the self-employed form the Social Insurance Fund which is used to fund social insurance payments, including social welfare pensions.

An actuarial review of the social insurance fund was carried out for the Minister for Social and Family Affairs in 2005. The main conclusion of the review was that, while total income to the Social Insurance Fund is projected to equal or exceed benefit outgoings in the period to 2010, thereafter the net cash flow position is projected to decline rapidly.

Ireland has yet to face increased future pensions liabilities as a consequence of population ageing. The fund's finances are critically affected by the structure of the population and the labour force. The population projection carried out for the purposes of the Actuarial Review in 2005 indicates that the number of people of working age for each person aged 65 years or over is projected to fall from a ratio of almost 6:1 in 2006 to almost 2:1 in 2061. As a consequence of this, the Social Insurance Fund will require ongoing Exchequer subvention to meet increased pension liabilities. This could mean that consideration will have to be given in the medium term to the adequacy of Ireland's PRSI levels and whether they should be increased towards levels pertaining elsewhere across Europe. Increases in rates of PRSI, in particular employer PRSI, would likely have a negative impact on employment. The difficulties in this area suggest that the base for PRSI should be broadened where possible.

Recommendation 5.9

In view of the burden on the Exchequer, the PRSI base should be broadened.

3.1.4 PRSI – social insurance or a tax?

The question of whether PRSI is a social insurance or a tax has been considered on a number of occasions.

The previous Commission on Taxation concluded that social insurance is a form of taxation and that social insurance contributions should be replaced with a social security tax assessed and collected on the same basis as income tax. The Commission on Social Welfare (1986) took issue with the categorisation of social insurance as a tax and regarded the system of social insurance contributions as having a significant insurance dimension, which is not outweighed by the absence of an actuarial link between benefits and contributions.

We consider that, on one hand, PRSI can be regarded as an insurance arrangement. The purpose of any social insurance system is to fund a range of social welfare benefits to workers and their dependants. A social assistance system is also operated to assist people without adequate insurance entitlement. By making PRSI contributions, workers obtain entitlements to benefits. While it is a fact that the benefits will not vary by reference to the quantum of contributions made, the system is designed as an insurance-type scheme that provides benefits to those who make contributions.

On the other hand, the fact that there is no direct correlation between contributions made and entitlement to benefits under the system suggests that it does not have all the hallmarks of an insurance scheme. Those who pay higher contributions do not have an entitlement to correspondingly higher benefits. While it may be appropriate that those on higher incomes should make higher contributions in the context of fairness, it could be argued this may be more a feature of a tax system than an insurance arrangement. Our general conclusion was that PRSI has some characteristics of a tax and therefore that the contribution side should be examined by us.

We therefore examined PRSI to the extent that it has an impact on our terms of reference. We note the complexity of the PRSI system and its wide scope covering both benefits and contributions. Our consideration of PRSI is not intended to be comprehensive and such a consideration is, in any event, outside our terms of reference. We confined our examination to the contributions side of PRSI and to examining anomalies within various categories of contributors. This is the aspect of PRSI that is in the nature of a tax. It became very clear, however, during our examination that the overall PRSI system is complex, unwieldy and contains significant anomalies. We consider that there should be a separate comprehensive consideration of the PRSI system.

Recommendation 5.10

There should be a separate comprehensive consideration of the PRSI system.

3.1.5 PRSI measured against our principles

Because PRSI interacts with the tax system and impacts on the tax wedge it is a part of the costs of employment. Employee PRSI is similar to income tax as regards the tax wedge.

We measured PRSI against our principles of simplicity and equity and also against efficiency. We concluded that PRSI is regressive by its nature, fails the simplicity and efficiency tests and challenges the equity principle. Other considerations may be relevant to measure its appropriateness as a social insurance. This, however, is not a matter for us.

Simplicity

PRSI fails on simplicity. There is no doubt that the system is complex. There are 11 classes of contributions and insurability and over 30 subclasses within these.

The complexity of the system imposes a considerable burden on employers and also on contributors due to different contribution rates payable that are dependent on the nature of employment income. There is also complexity for contributors as similar income is subject to different rates depending on whether the contributor is an employee or is self-employed.

Equity

PRSI may conflict with the equity principle. The application of a ceiling on employee contributions means that PRSI is regressive in that those earning more than the ceiling pay a lower proportion of their income in PRSI than those earning less than the ceiling. This conflicts with vertical equity. PRSI does not apply to all income and this conflicts with horizontal equity. It is difficult to come to an overall conclusion on whether the system is fair without taking account of the rules as regards both contributions and benefits. Deficiencies in equity on the contributions side might be explained by the fact that the system is a social insurance system and that, in attempting to determine whether it is equitable on an overall basis, account needs to be taken of benefits as well as contributions.

Efficiency

A tax system should facilitate the optimal use of resources. It should not have measures that are likely to discourage the efficient use of resources. PRSI, while a social insurance system intended to provide benefits to individuals in return for contributions, imposes a cost on labour. Depending on the state of the labour market, employees will tend to focus on take home pay and, to the extent that

they do so, employee PRSI may be a cost of employment falling on employers. Similarly, employer PRSI may not impact directly on the take home pay of employees. Thus, PRSI (both employee and employer contributions) may be a labour cost borne by employers and may act as a disincentive to employment. To that extent, PRSI can be seen as failing the efficiency test.

3.1.6 The PRSI structure

In the two most common PRSI contribution classes (A1 and S1)³¹, PRSI applies at a rate of 4% on reckonable earnings of employees, 3% on reckonable income of the self-employed and there is a charge on employers at a rate of 10.75% of their employees' reckonable earnings. The base for the self-employed is wider than that for employees but the rates applying are different. We consider that a similar base should apply to employees and the self-employed and a single rate of charge should apply.

Employer PRSI should be regarded as a payment to cover employment-related benefits, such as jobseeker's benefit, illness benefit, occupational injuries benefit and health and safety benefit which are available only to employees³², while other benefits³³, which are available to all workers, should be linked to the employee and self-employed PRSI.

Recommendation 5.11

A similar PRSI base should apply to employees and the self-employed and there should be a single rate of charge which should apply to both.

3.1.7 PRSI as part of the tax wedge

The impact of PRSI as a part of the tax wedge is similar to the impact of income tax on employment costs and therefore is relevant to competitiveness. The tax wedge is defined by the OECD as "the gap between the labour costs the employer pays and the corresponding net take home pay the employee receives". It includes income taxes and social security contributions. A high tax wedge increases the costs of employment. A low tax wedge indicates a reduced cost of employment and incentivises employers to take on employees. The level and structure of taxes are major influences on the functioning of labour markets. With workers and companies becoming increasingly mobile, it is important that the tax burden on labour is minimised.

3.1.8 Employer PRSI contribution

It has been argued that the rate of the employer PRSI contribution, generally 10.75%, can be seen as a disincentive to employment given that it applies without a ceiling³⁴ and that the removal of the ceiling had a disproportionate impact on industries and business that one would wish to attract to Ireland. It has also been claimed in submissions that a reduction in employer PRSI would incentivise employers to retain and increase staff numbers, thus having a multiplier effect on the economy and increasing Ireland's competitiveness. To reinstate the ceiling would reduce employment costs and aid competitiveness and could stimulate employment. However, it would not

31 For convenience, we refer to persons in these two classes as employees and self-employed respectively. We recognise that the S1 class applies to some employments.

32 Employed contributors also have entitlement to treatment benefit, carers benefit, invalidity pension and State pension (transition).

33 Both self-employed contributors and employed contributors have entitlement to the following benefits: State pension (contributory), widow or widower's pension (contributory), guardian's payment (contributory), maternity benefit, adoptive benefit and bereavement grant.

34 There was an employer PRSI ceiling up until 2001.

be appropriate to reinstate the employer PRSI ceiling given international comparisons. The rates at which social insurance contributions are paid are low by international comparison (although it is acknowledged that the corresponding benefits vary considerably) and the cost of reinstating a ceiling would exacerbate the projected deficit of the Social Insurance Fund in meeting its liabilities.

Recommendation 5.12

The employer PRSI ceiling should not be reinstated.

3.1.9 Employee PRSI contribution

An annual contribution ceiling of €75,036 applies in the case of employees and there is no ceiling in respect of the self-employed. Once an individual's earnings exceed this cut-off point, no further employee PRSI is payable. It seems inequitable that individuals on high income do not pay PRSI on all their income. However, additional contributions paid do not result in higher benefits. Abolishing the ceiling would increase the tax wedge and could have implications for employment costs. It could also affect Ireland's competitive position. Abolishing the ceiling would address the equity issue and could give an additional yield to the Social Insurance Fund. It would also improve social solidarity where costs of social benefits are shared collectively by society.

On balance, we believe that the employee PRSI ceiling should be abolished. However, in order to mitigate the impact on the employees concerned and on employment costs, and noting the current marginal rates since introduction of the income levy, we consider that the abolition should be on a phased basis.

The estimated additional yield to the Exchequer would be about €150 million in a full year.

Recommendation 5.13

The employee PRSI ceiling should be abolished and this should be done on a phased basis.

3.1.10 Incorporating PRSI into general taxation

We considered incorporating employee PRSI into the general taxation system. In effect, this would separate benefits and contributions. The cost of benefits would simply be an item of Exchequer expenditure to be met out of general taxation. The overall taxation burden would remain unchanged, but the amount of tax collected under the income tax heading would rise and that collected via employee PRSI would cease. There would be a substantial increase in the headline rates of income tax with possible negative perceptions. For example, abolition would require an increase of about three percentage points in the standard rate or a seven percentage point increase in the higher rate of income tax. In the absence of counterbalancing measures, the increase in the standard rate would mean that lower earners would be brought into the tax net. The link between financing the social support system and its costs and benefits would be less apparent. Replacing social insurance with a tax could also have implications for existing and accruing entitlements. We do not recommend this course.

3.1.11 Comparison of the bases

We considered the possibility of having a common base for income tax, PRSI and, if they are

retained, the health contribution levy and the national training fund levy. The base on which PRSI is charged differs substantially from the base for income tax purposes. A comparison of the bases, including the bases on which the health contribution levy, income levy and the national training levy are applied, is set out in Annex 8. Liability to PRSI is calculated on an individual basis and takes no account of marital status or dependants, as is the case with income tax. This is because it is an insurance payment from which an individual may derive benefits. Unlike income tax, there is no liability to PRSI when an individual reaches 66 years of age³⁵. Apart from the employee PRSI ceiling, the other significant differences relate to income tax exemption limits for individuals over 65 years and deductions and allowances which are an intrinsic feature of the income tax system and the more extensive tax expenditures in the income tax system.

Moving to a common base would considerably simplify the system. However, there are several difficulties that would have to be addressed in any move to a common base:

- Different methods of categorising income
- Inconsistency in allowable deductions
- Different exemption limits, thresholds and ceilings applicable
- Different age-related exemptions under PRSI and income tax
- Exemptions for particular classes of individuals in the case of employee PRSI
- The fact that income tax takes account of marital status and dependants, and
- The complexity of the PRSI system and different benefit entitlements

Approaches to getting a common base might be either to apply the income tax base for PRSI purposes or to apply the PRSI base for income tax purposes, or perhaps a hybrid of some sort. The difficulty in trying to fully conform the base is that PRSI and income tax have very different roles.

PRSI is designed to build up entitlement to benefits while income tax is designed to charge a tax on the income of a person to finance government expenditure.

While having a common base is desirable for simplicity reasons, achieving it fully may not be feasible.

3.1.12 Anomalies within the PRSI system

Investment income

Self-employed contributors pay PRSI on income, including income such as investment and rental income. In the case of employees, investment income and rental income are not subject to PRSI unless the individual is also chargeable to PRSI as a self-employed person. We recommend that employees should be subject to PRSI on unearned income. This would broaden the base and improve equity. From an operational point of view, consideration could be given to withholding contributions at source in the case of income on deposits and other savings products.

It is not possible to provide an accurate estimate of the potential yield.

Recommendation 5.14

Employees should be subject to PRSI on unearned income such as investment income and rental income.

35 PRSI Class K applies to individuals in receipt of an occupational pension, certain office holders (for example, judges and State solicitors), and individuals over 66 years of age, previously on Class S. A PRSI contribution is not payable and there are no benefits accruing. Only the health contribution levy is payable. Class M is for individuals with no contribution liability such as employees under 16 years of age or individuals within Class K with a nil health contribution levy liability (for example, medical card holders). Class J normally applies to people with reckonable pay of less than €38 per week. However, it also applies to some individuals aged over 66 years or over or people in subsidiary employment. Only the health contribution levy is payable by the employee. An employer PRSI contribution of 0.5% is payable.

Share-based remuneration

PRSI is not charged on share option gains or remuneration in the form of shares because these do not constitute 'reckonable earnings', 'reckonable emoluments' or 'reckonable income' for the purposes of the Social Welfare Consolidation Acts. In the case of share options this is contrary to the treatment in most OECD countries where social insurance contributions are payable on share option gains. Share-based remuneration is a form of income and charging PRSI would remove the bias in the PRSI system in favour of share-based remuneration rather than cash remuneration. The PRSI treatment of share-based remuneration should mirror the PRSI treatment of other employment income. We acknowledge that there are likely to be significant administrative issues associated with the implementation of this recommendation.

It is estimated that the additional yield from this measure is about €29 million.

Recommendation 5.15

Share-based remuneration, including share options, should be subject to PRSI.

Pension contributions by self-employed contributors

Employees can claim exemption from PRSI for contributions in respect of occupational pension contributions. Self-employed contributors who are subject to the PAYE system (proprietary directors) may avail of PRSI relief on payments to occupational pension schemes. In the case of self-employed contributors outside the PAYE system, there is no exemption from PRSI where contributions are made towards pension provision. This is not consistent with the principle of horizontal equity. The Department of Social and Family Affairs does not consider that a question of inequity arises when the wider issue of the treatment of the self-employed is considered in the general context of social insurance coverage. We consider that, to achieve equity between contributors, relief from PRSI should apply in respect of pension contributions made by self-employed contributors, subject to paying a minimum PRSI contribution to secure future entitlement to benefits. However, in Part 10, we recommend a matching Exchequer contribution as the best way to give tax relief for pension contributions. If the latter recommendation is adopted, PRSI relief will not arise and the question raised here is not relevant. This recommendation therefore will not be necessary.

It is estimated that the additional cost of this will be about €34 million in a full year.

Recommendation 5.16

Relief from PRSI should apply in respect of pension contributions made by self-employed contributors, subject to payment of a minimum PRSI contribution to secure future entitlement to benefits.

Losses

Losses incurred in a trade or profession are not deductible for PRSI purposes. It is difficult to see the rationale for the exclusion of a deduction for actual losses incurred in a trade from income for PRSI purposes except for a situation whereby offsetting losses could reduce income subject to PRSI to zero, so that the individual would not be building an entitlement to future benefits. We recommend that trading losses be deductible for PRSI purposes subject to the payment of a minimum annual PRSI contribution.

We estimate the additional cost of this will be about €9 million in a full year.

Recommendation 5.17

Trading losses should be deductible for PRSI purposes subject to the payment of a minimum annual PRSI contribution.

Step effect

Inconsistencies arise because of the manner of application of exemption limits in PRSI. Unlike income tax which applies on a graduated basis, liability to PRSI (and health contribution levy) applies on all income where the exemption limit is exceeded, thereby creating a 'step effect'. An employee is exempt from PRSI where annual earnings are less than €18,304. However a liability of €468 in respect of employee PRSI arises where income increases from €18,304 to €18,305. Similarly, PRSI is not payable by a self-employed contributor where the income is less than €3,174. However, where income exceeds this limit, PRSI is payable on all income at the rate of 3% or €253 whichever is greater. Accordingly, an individual with self employment income of €3,175 will have a PRSI liability of €253.

We considered a number of options to resolve this issue. A common base or the adoption of a graduated system where income is marginally in excess of the exemption limits would go some way to address these inequities. However, this would involve significant Exchequer costs and could impact adversely on low income earners. We recommend the elimination of the PRSI step effect which impacts on employees through the removal of the weekly PRSI exemption limit (€352) and the weekly PRSI free allowance (€127) and their replacement with a reducing non-refundable equivalent PRSI credit of €14.08 per week (€352 x 4%). The credit would be due in full where earnings do not exceed €352 per week, ensuring that all earners with a liability below €352 per week will continue to have no liability to PRSI. For earnings above €352 per week, the amount of the credit could be gradually reduced. This would eliminate the step effect from the system while maintaining the benefits of the existing exemption and PRSI free weekly allowances.

Table 5.2 illustrates how this might operate:

Table 5.2: PRSI proposed credit system

Weekly Income €	Existing liability €	Proposed liability €
352	0	0
362	9.4	1.4
372	9.8	2.8
382	10.2	4.2
392	10.6	5.6
402	11	7
412	11.4	8.4
422	11.8	9.8
432	12.2	11.2
440	12.52	12.32
442	12.6	12.6
443	12.64	12.64

A similar step effect occurs with the health contribution levy. Where income is less than €26,000 there is no liability to the health contribution levy. However, a liability of €1,040 (4%) arises where the income increases to €26,001. We consider that this is inappropriate and that moves should be made to eliminate the step effect. The issue could be resolved in a similar way to that proposed in relation to the employee PRSI step effect.

Our recommendation below in relation to the health contribution levy is that it should be integrated into the income tax system but that this move should not begin until fiscal conditions improve. In the meantime, consideration might be given to eliminating the impact of the health contribution levy step effect through an approach of the type outlined above.

The estimated cost of eliminating the PRSI and health contribution step effects as outlined above is about €180 million in a full year.

Recommendation 5.18

The step effect in PRSI and the health contribution levy should be eliminated.

3.1.13 Health contribution levy and the national training levy

Health contribution levy

Collection of the health contribution levy is undertaken by the Revenue Commissioners in the context of collecting income tax and PRSI (including the national training fund levy). Unlike social insurance, the health contribution levy does not confer any entitlement to benefit on the contributor. It does not form part of the social insurance fund. We consider it to possess many of the hallmarks of a tax.

The previous Commission on Taxation considered whether the health contribution levy and other 'special levies' should be brought within the general tax system. In general, that Commission was opposed to the concept of earmarked taxes or special levies and recommended that they should be integrated into general taxation. The Commission on Social Welfare (1986) and the Expert Working Group on the Integration of Tax and Social Welfare (TWIG 1996) also concluded that the health contribution levy was a form of taxation.

The health contribution levy is paid to the Department of Health and Children to help fund health services. The contribution and its application to the benefit of the Department of Health and Children has established a clear and discrete source of finance for the health services. It may also create a link in the public mind between the provision of health services and the need to finance them and this linkage may make payment of the contribution more acceptable than the payment of other taxes into the general Exchequer.

Abolishing the health contribution levy would remove a form of taxation from within a social insurance system and would simplify the PRSI system.

It would greatly rationalise PRSI classes³⁶ through the removal of one PRSI class and 15 subclasses which exist solely for the purposes of the health contribution levy and administrative procedures would be simplified because two systems are being amalgamated.

36 According to the Department of Social and Family Affairs, there are currently 11 classes and 34 subclasses in the PRSI system. One class (K1) and eight subclasses exist solely for the purposes of the health contribution levy exemption limit. A further seven subclasses exist solely for the category of individuals who are specifically exempt from payment of the health contribution levy (medical card holders, individuals getting a social welfare widow/widower's pension, a one-parent family payment or a deserted wives benefit or allowance). Abolition of the health contribution levy would result in the removal of these subclasses and significantly reduce the complexity of the PRSI system. The administrative burden for employers, the Revenue Commissioners and the Department of Social and Family Affairs would also be reduced.

The base³⁷ for income tax purposes differs from the base for the health contribution levy and pursuing this option will lead to winners and losers. Abolishing the levy and integrating it into the general taxation system would address the anomaly where recipients of particular social welfare payments and medical card holders are completely exempt from payment of the health contribution levy regardless of the level or source of their income. Such individuals (and those with earnings of less than €26,000, who are also exempt from the health contribution levy) would face an increased liability. Those who might gain from such a move include those who avail of deductions which are available against income tax but not against the health contribution levy. These issues would have to be taken into account in any move to a new system.

We recommend that this should not take place until fiscal conditions improve sufficiently to allow an orderly transition to a new structure. However, we consider that the health contribution levy should be abolished and integrated into the general taxation system.

Recommendation 5.19

The health contribution levy should be integrated into the income tax system.

National training fund levy

The national training fund levy is collected as part of PRSI contributions by employers. The fund is administered by the Department of Enterprise, Trade and Employment to support a broad range of employment training initiatives. The fund is resourced by a levy on employers of 0.7% of reckonable earnings in respect of employees in Class A and Class H employments (approximately 76% of all insured employees) and is incorporated into the employer's share of PRSI. Unlike the health contribution levy, it is not a liability of the employees. Like the health contribution levy, the training levy does not confer any entitlement to benefits on the contributor. Contributions to the fund amounted to about €440 million in 2008.

We consider that (similar to the health contribution levy) the national training fund levy should be more appropriately regarded as a tax. It should be abolished in the longer term but employer PRSI should be retained at its current rate. The main benefit of this is that it would help to simplify the PRSI system by removing elements i.e. the training fund levy and the health contribution levy, which are essentially taxation measures. Alternative approaches to funding the national training fund will be required.

Recommendation 5.20

The National Training Fund Levy should be abolished and a different approach to funding the National Training Fund should be put in place.

3.2 Integration of tax and social welfare systems

3.2.1 Introduction

The current Government Programme, *An Agreed Programme for Government*, contains the following commitment:

"The Government will ... integrate the tax and social welfare systems fully to allow for more efficient data and money transfer mechanisms and provide for a fully integrated PPS number".

³⁷ Annex 8 outlines the different bases for income tax, income levy, PRSI, the health contribution levy and the national training levy.

3.2.2 Integration of the tax and welfare systems

A number of the submissions which we received also raised this issue. A key issue here is to define what ‘integration’ of the tax and welfare systems means. We consulted with the Departments of Social and Family Affairs and Finance in this regard. They hold the view that it relates to issues of a technical and operational nature and does not imply a policy shift to a fully integrated tax and benefit system of the type examined by the Tax and Welfare Integration Group (TWIG)³⁸ in the mid-1990s.

In examining this question, we were also assisted by the work done by the TWIG. The Group made the following observation which we found to be useful in helping our understanding:

“It must be recognised at the outset that ‘integration of tax and social welfare’ can mean different things to different people: those who advocate ‘integration’ do not always define what they mean by the word. We did not see integration as having a single meaning – rather there is a continuum of forms of integration. This ranges from, at one extreme, total integration of the tax and welfare systems involving the merging of the tax system, social insurance system and social assistance system into a single unified tax and transfer system, to, at the other extreme, retention of the existing system but with better co-ordination between them; such co-ordination could be at either policy level or a practical level or both.”

We understand ‘integration’ to mean closer technical and policy integration between the Revenue Commissioners and the Department of Social and Family Affairs and greater exchange of information between the two organisations with any barriers to this, including legal ones, being systematically addressed and, where possible, removed.

We strongly support integration of the tax and welfare systems in these terms and we endorse the further development of the administrative co-operation that exists between the two organisations which is underpinned by various memoranda of understanding. Such co-operation is essential so that Government can effectively plan and implement economic and social policy interventions.

Recommendation 5.21

There should be further integration of the tax and social welfare systems.

3.3 Refundable tax credits

3.3.1 Introduction

We examined refundable tax credits by reference to the contribution they might make to increasing the equity of the income tax system and to supporting economic activity.

A refundable tax credit is one where, if an income-earner has insufficient income to use all of his or her tax credit, the unused portion of the credit is paid to him or her by means of a cash transfer³⁹. Refundable tax credits are also referred to as non-wastable tax credits and negative income tax.

38 Expert working group established “to study in consultation with the social partners the integration of the tax and social welfare codes”. The Group’s terms of reference were “To identify the problems arising from the interaction of the tax and welfare systems and to identify the steps necessary to achieve greater co-ordination/integration of the two systems, with particular attention to the impact on people’s incomes and to the tax code, social welfare system, budgetary and administrative implications”.

39 This is the OECD definition of a refundable tax credit.

Internationally, a number of countries provide refundable tax credits. These include, for example, Canada and the United States⁴⁰.

3.3.2 Reasons for considering refundable tax credits

Tax credits, as they currently apply in the Irish tax system, are generally only of value when the taxpayer has sufficient income on which he or she has enough of a gross tax liability to use them; there are some exceptions such as mortgage interest relief and tax relief for health insurance premiums which are provided at source and are available regardless of income or whether tax is paid. The present arrangements for these latter reliefs arose from a move to simplify the delivery of the reliefs.

A number of the submissions which we received supported the introduction of refundable tax credits.

Generally, the tax system does not provide income support. Differing views exist on the role that refundable tax credits might play in the area of equitable income distribution. Existing tax repayments represent no more than a repayment of tax already paid that exceeded the person's net tax liability. A move from tax credits to refundable tax credits would extend the role of the tax system into the area of income support. It would also have implications for the social welfare system.

3.3.3 Types of refundable tax credit systems

Refundable tax credit systems may be configured in a number of ways. One example is a system of universal application where everyone (of employable age) would qualify for refundable credits⁴¹ regardless of whether they are within the tax system. Such a system would be conceptually very similar to a system of basic income⁴². Another is a narrower system limited to those at work or with a work record and, generally, discussion tends to be concerned with this system.

Arguments in favour of refundable tax credits

Resources available for distribution at budget time should be distributed fairly to every adult person whether they are paying tax or not. Refundable tax credits could help to achieve this objective.

A refundable tax credit targeted at those in work could have the potential to increase overall income derived from being in paid employment, including self-employment. The annual Budget uses available resources to provide benefits both to those who pay income tax through tax reductions and to those in receipt of income support through the social welfare system. Refundable tax credits offer the opportunity to assist those at relatively low incomes who are in between these two categories and who would otherwise receive no benefit i.e. those who do not pay income tax or receive any social welfare payment.

40 Canada operates the Working Income Tax Benefit (WITB) which was introduced in 2007. This is a refundable tax credit intended to provide tax relief for eligible low income individuals and families who are already in the workforce and to encourage others to enter the workforce. Canada also operates Goods and Services Tax/Harmonised Sales Tax credit (GST/HST) which is refundable and is intended to help individuals and families on low and modest incomes offset all or part of the GST/HST they pay. The credit is not applied automatically and persons must apply annually to benefit. In the United States, the federal Earned Income Tax Credit (EITC) is a refundable tax credit paid through the tax system which is intended primarily to support low income families with children but is also available on a more modest basis for persons and couples without children. The credit is intended to support and encourage labour force participation and is available only to those who participate in the paid labour force.

41 In such a scenario, it would be a matter for the State to decide at the outset the scope and value of credits to be made refundable. However, it is very likely that each individual in the PAYE sector would have to receive the current combined value of the single basic personal credit and the employee credit as less than that would be unlikely to be acceptable. As there would be no distinction between those at work or not in work, it is also likely that credits of the same value would have to be given to every individual, whether in work or not and whether an employee or self-employed, and the distinction between the basic personal credit and the employee credit would no longer be relevant.

42 A basic income is an income unconditionally granted to all on an individual basis, without involving a means test or a requirement to work. It is a form of minimum income guarantee.

Arguments against refundable tax credits

While the tax system has a role to play in the broader issue of equitable income distribution, it is not the primary mechanism for the distribution of income to low-income households – the social welfare system is the main instrument for this. The fundamental role of taxation is to raise revenue to fund the provision of services by the State. In providing those services, the State fulfils its various policy objectives, including tackling disadvantage. In this regard, those on low incomes and who are disadvantaged receive support through the direct expenditure mechanisms of the State. Support for low income households may be better targeted through the social welfare system and the introduction of a refundable tax credit system, which would be complex to administer in a cumulative tax system such as exists in Ireland, may not be an appropriate response. In addition, a refundable tax credit system could give rise to a disincentive effect to work.

The issue of costs may also arise in the case against refundable tax credits.

3.3.4 Conclusion

Refundable tax credits have the potential to increase equity in the tax system. They would assist those low paid workers who are below the threshold to taxation and are not in receipt of income support payments. A significant disadvantage is that they can be a disincentive to participation, including increased participation, in the labour force. This can have a negative impact on economic growth. Economic growth can facilitate employment creation and maintenance and this can increase the welfare of all.

However, if there is not an appropriate level of uptake of direct expenditure support through measures like family income supplement payments within a five-year period, the question of refundable tax credits should be considered as a policy option to ensure a more equitable distribution of resources.

Recommendation 5.22

On balance, we do not recommend a move to refundable tax credits at this stage. If there is not an appropriate level of uptake of direct expenditure support through measures like Family Income Supplement payments within a five-year period, the question of refundable tax credits should be considered as a policy option to ensure a more equitable distribution of resources.

3.4 Taxation of social welfare payments

3.4.1 Introduction

A list of the main social welfare payments is set out in Annex 9. This also provides a brief description of each payment and indicates whether each is subject to taxation or not. Most social welfare payments are made on a weekly basis. The payments can include extra amounts for a spouse or partner and a child – known as qualified adult and qualified child payments.

3.4.2 Current tax treatment

While social welfare payments may be broadly categorised into three types as indicated in Box 5.1 below, the tax treatment of a payment is not related to such categorisation. Instead, the general position is that it is related to the intrinsic nature of the payment or whether it falls

within the charge to tax under the income tax code. However, this is not universally the case. There are payments which, based on their nature, could be subject to taxation but are not taxed. These include jobseeker's allowance, disability allowance, farm assist, the supplementary welfare allowance and the domiciliary care allowance⁴³. The non means-tested respite care grant, which could also be subject to taxation because of its nature, is made to carers who are in receipt of means-tested payments, or social welfare payments of about the same level, so that, in most instances, tax would be unlikely to arise.

In addition, some payments have been exempted statutorily from taxation. Examples here include child benefit payments and jobseeker's benefit paid to systematic short-time workers. Further, elements of some payments have been made tax exempt, for example, the first 36 days (6 weeks) of illness and injury benefit are exempt from taxation.

Box 5.1: Types of social welfare payments

- Contributory payments based on a person's PRSI record; qualification for a payment depends on having a minimum number of PRSI contributions
- Non-contributory payments which require a person to satisfy a means test and be habitually resident in Ireland
- Other payments and benefits, such as child benefit and the respite care grant which do not depend on PRSI contributions or means

Broadly speaking, long-term⁴⁴ social welfare payments are taxable. These include, for example, the state and widows pensions (contributory and non-contributory), invalidity pension and disablement benefit. Short-term⁴⁵ payments such as maternity benefit and adoptive benefit are not taxable. Since the 1990s, a number of short-term payments have been made taxable through the enactment of legislation. These are illness benefit (formerly disability benefit), jobseeker's benefit (formerly unemployment benefit) and injury benefit.

3.4.3 Consideration by the previous Commission on Taxation

When the previous Commission on Taxation examined the tax treatment of social welfare payments, it was advised by the Revenue Commissioners that, in the absence of specific charging provisions providing for a charge to tax in respect of short-term benefits, they could not treat such benefits as income since they were not annual payments. The benefits in question⁴⁶ included unemployment benefit (jobseeker's benefit), disability benefit (illness benefit), maternity allowance, invalidity pension and death grant. That Commission expressed the belief that the exemption of short-term social welfare benefits from income tax was contrary to equity principles which dictate that the amount of the income rather than its source should determine the amount of tax that is payable. It recommended that all social welfare benefits should be charged to income tax.

43 Technically these payments are liable to income tax if they continue for more than 12 months. However, as means are taken into account in deciding entitlement to them, it is likely that the recipients will be not be liable to pay tax because their tax credits would exceed any liability arising on the amounts received. In the case of the Domiciliary Care Allowance, this payment was means tested on the means of the child prior to April 2009. Since April 2009, when responsibility for the Domiciliary Care Scheme was transferred to the Department of Social and Family Affairs from the Health Service Executive, it is not contingent on the means of the child or the carer.

44 Over 12 months duration.

45 Up to 12 months duration.

46 The Commission also specifically mentioned some others which do not exist today including intermittent (wettime) insurance and deserted wife's benefit.

3.4.4 Our consideration

In looking at this issue, we asked the following questions:

- As a general principle, should all social welfare payments be subject to taxation?
- If so, should there be any exemptions?
- How could tax due on social welfare payments be collected efficiently in practice?

Should all social welfare benefits be taxable?

The two main considerations here are equity and labour market incentivisation:

- The equity argument is that all income should be taxed equally, regardless of source
- The incentive argument is that the non-taxation of social welfare benefits contributes to particular disincentives to work

In relation to equity, the exemption of short-term social welfare payments is contrary to the principle that the amount of income rather than its source should determine the amount of tax that is payable. The issue of the disincentive effect is discussed briefly below.

Labour market incentivisation issues

The reports of the previous Commission on Taxation and the Commission on Social Welfare in the 1980s, drew attention to the disincentive effects of non-taxation of benefits. It was pointed out in particular that, at certain times of the year, the combination of disability benefit and tax rebates could mean that a person was financially better off by taking a period of sick leave or by not returning to work after a period of illness. These issues remain relevant today notwithstanding the increases in in-work incomes due to, for example, tax reductions and the introduction of the minimum wage.

Illness benefit is tax free for the first six weeks in any year. The effect of this treatment is that there is a net gain to such employees for the first six weeks in any year in which they claim illness benefit. The personal rate of illness benefit is €204.30 per week. For those paying tax at 41%, the gain is about €83 per week and for those paying tax at 20% the gain is about €40 per week. For those who claim an increase in their illness benefit in respect of a qualified adult (€135.60), these gains rise to about €139 and €67 respectively. In the case of a married person paying tax at 41%, the potential gain over a six week period is €836. This would appear to be an entirely unintended impact of the operation of the exemption, is inequitable and could operate as a serious incentive to take sick leave.

Injury benefit is also tax free for the first six weeks in any tax year as is the first €13 per week of jobseeker's benefit. These exemptions arose out of social partnership negotiations and were intended to improve the position of those adversely affected by extension of taxation to the payments in the early 1990s. Notwithstanding the considerations which lead to the above exemptions, the equity and incentivisation arguments made already in relation to the taxation of social welfare payments generally are equally relevant in the case of these payments.

Our conclusion, based on considerations of equity and labour market incentivisation, is that, as a general rule, all social welfare payments, both of a long-term and short-term nature, should be subject to taxation. In addition, the statutory provisions which exempt from income tax elements of social welfare payments which are otherwise taxable should be discontinued.

Should there be any exemptions?

Maternity Benefit

Maternity benefit is outside the charge to income tax. We were advised by the Revenue Commissioners that the basis for this is that there is no specific charging provision in the Taxes Consolidation Act 1997 relating to the payment and that it is a short-term payment (payable for a maximum of 26 weeks) and therefore does not come within the category 'annuity or annual payment' required for income taxation. They also added that maternity benefit would not be regarded either as a pension or a 'stipend' i.e. a fixed regular allowance or salary.

Adoptive benefit and health and safety benefit are similarly outside the charge to income tax.

We were advised by the Department of Social and Family Affairs that the rates of payment for maternity benefit are earnings-related but are set at a level to reflect post tax income. The payment is intended to allow mothers to remain outside the workforce for a period to nurture their newborn children and there is a positive social dimension to the payment. Having regard to these aspects, we do not recommend any change in the taxation status of maternity benefit. Similarly, no change to the tax status of adoptive benefit and health and safety benefit is recommended.

Family income supplement

Family income supplement (FIS) provides income support for employees on low earnings with families. The purpose of the scheme is to incentivise employment participation particularly in circumstances where the employee might only be marginally better off than if he or she were claiming other social welfare payments. It is calculated on the basis of 60% of the difference between the income limit for the family size (see Annex 9) and net income after tax. In 1998, the basis of assessment was changed from gross income to net income to improve the effectiveness of the scheme. It would make no sense to tax the payment. We consider that a specific exemption from income tax should be provided for FIS.

Domiciliary care allowance and respite care grant

The domiciliary care allowance and respite care grant play an important role in supporting carers. The amount of the income arising from the payments, even when combined with other social welfare income, is likely to be below the income tax thresholds so that, in practice, no tax would arise in most cases. We consider that specific exemptions from income tax should be introduced for these payments.

Recommendation 5.23

As a general rule, all social welfare payments should be subject to taxation.

- The statutory provisions which exempt from income tax elements of social welfare payments which are otherwise taxable should be discontinued.
- There should be no change in the taxation status of maternity benefit, adoptive benefit and health and safety benefit.
- Specific exemptions from income tax should be introduced for family income supplement, the domiciliary care allowance and the respite care grant.

How could tax due on social welfare payments be collected?

While many social welfare payments are already subject to taxation, and the tax should properly be collected under the PAYE system, in practice the system does not apply in a straightforward manner. Currently, the Department of Social and Family Affairs does not operate as an employer under the PAYE system. The arrangements between that Department and the Revenue Commissioners include provision for the electronic transfer of data relating to beneficiaries of social welfare payments.

Where a person in receipt of a social welfare payment, or the person's spouse, is in employment, the tax due may be collected by the employer through the PAYE system that applies to the employment. The Revenue Commissioners take into account the payment by adjusting the tax credits or bands of the recipient or his or her spouse. The tax collection arrangements may also involve, for example, restricting tax refunds to unemployed persons, adjusting tax credits or bands on resumption of employment, or reviewing the person's tax affairs at the end of the tax year.

While the mechanisms described above may result in the correct amount of tax being collected, an individual in receipt of social welfare benefits should be in a position to know that any payments received are fully available to meet his or her needs and that they will not be exposed to an unquantified tax liability in the future. This matter has been the source of difficulties over a long period of time and ought to be tackled primarily in the interests of the individuals concerned but also in the interests of more efficient administration. In our view, the mechanism for collection of tax due on social welfare payments is currently unsatisfactory and needs to be addressed. While appreciating that there are significant practical issues, it seems to us that, for the longer term, the optimal approach is one which would see the Department of Social and Family Affairs operate taxation at source in relation to social welfare payments to the extent that such payments are taxable.

Recommendation 5.24

Arrangements should be put in place as early as practicable to ensure that tax due on social welfare payments is collected at source by the Department of Social and Family Affairs.

Section 4: The taxation of capital

4.1 Introduction

The term 'capital', as used in this Section, may be taken to mean the net value of all property owned by a person. It could also be regarded as wealth (and we use both terms interchangeably). Capital taxation can take various forms. It may apply at regular or irregular intervals. Recurrent capital taxes are imposed by reference to values at a particular date and are usually charged on an annual basis. In contrast, some taxes on capital are imposed by reference to a particular event – for example, capital gains tax on the realisation of a gain on the disposal of an asset and capital acquisitions tax on the acquisition of a gift or inheritance.

4.2 The case for the taxation of capital

Capital taxation is designed to impose a tax on the capital or wealth, as distinct from the income, of a person. The case for the taxation of capital rests mainly on considerations of equity but particular forms of taxes applied to capital may find their appropriate justification in other factors, including encouraging the use of wealth for productive purposes.

The taxation system must be seen to be fair if it is to be acceptable to the community at large. Among the tests of equity is that taxpayers should contribute as nearly as possible in proportion to their respective abilities to pay. It is generally recognised that income alone is rarely a complete test of ability to pay. Wealth confers advantages on its owner even when no income is derived from it. It also gives security. While wage or salary income dies with the earner, capital and the income from capital endure and may be passed on to future generations. Additional advantages attaching to the ownership of wealth – which are not quantifiable in income terms – include social status, prestige and influence.

Capital taxes, in our view, should be seen as complements to income tax. An income tax itself does not tax wealth, it only taxes accretions to wealth.

4.3 Previous measures to tax wealth

4.3.1 Estate duty (up to 1975)

Estate duty was the predecessor of capital acquisitions tax and applied until its abolition in Finance Act 1975. Estate duty was a duty imposed at progressive rates on the estate of a deceased person, that is, on the properties passing or deemed to pass on the person's death. It was based on the entire value of property which was beneficially owned by the deceased. The essence of estate duty was that it was chargeable on all property which changed hands on a death.

4.3.2 Wealth tax (1975 – 1978)

An annual wealth tax applied for three years from April 1975. The Wealth Tax Act 1975 provided for tax to be charged annually at a rate of 1% on the net market value of the taxable wealth of individuals, discretionary trusts and private non-trading companies. The taxable wealth of individuals domiciled and ordinarily resident in Ireland on the valuation date (5th April) comprised all the property, wherever situated, to which the individual was beneficially entitled in possession on that date. Property excluded from the scope of the charge included the principal residence, land attached to that residence up to an acre, furniture and household effects. The tax was abolished with effect from April 1978.

4.3.3 Probate tax (1993 – 2000)

This was introduced in Finance Act 1993 as the 'Taxation of Assets Passing on Inheritance (Probate Tax)'. The tax was imposed at a rate of 2% on the estates of persons who died after 17 June 1993. A charge to probate tax arose if the deceased was domiciled in Ireland at the date of death. All assets (wherever situated) passing under a will or intestacy were liable to the tax. Where the deceased was not domiciled in Ireland, only assets situated in Ireland were liable. Assets passing otherwise than under the will or intestacy were excluded. Liabilities of the deceased at the time of

death were deductible in arriving at the taxable base. There were various other exclusions such as the value of the dwelling house if inherited by a qualified dependent child, 30% of the value of agricultural land and buildings as well as the value of property given for charitable purposes. The tax on property passing absolutely to a spouse was abated to nil. Estates having a taxable value under an index-linked threshold were entirely exempt. This threshold in 2000 was £40,000 (€50,790). Probate tax was abolished in Finance Act 2001.

4.3.4 Shortcomings in previous measures

The three types of taxes described suffered from various shortcomings. They were, to a greater or lesser extent, inequitable, arbitrary, lacking in logic, frequently complex and, in the case of the latter two, generated only marginal tax revenue. None of the three taxes in question is appropriate for consideration in the context of the taxation of wealth in Ireland.

4.4 Issues considered

The absence of an annual wealth tax is not, of course, to suggest that wealth is not taxed in Ireland. Wealth (or capital) is impacted – in either its accumulation or its transfer - by various elements of the tax code, in particular income tax, stamp duty, capital gains tax and capital acquisitions tax. The net wealth of a person is made up of assets received by way of a gift or inheritance or purchased by the person out of income or capital gains. Inheritances and gifts may be subject to capital acquisitions tax and income or capital gains may be taxed when they arise.

In looking at the taxation of wealth for the future, we focused our consideration on the following:

- Capital gains tax
- An annual tax on real property
- Capital acquisitions tax
- Discretionary trust tax, and
- A new wealth tax

4.5 Capital gains tax

Wealth may be generated by capital gains and wealth in turn may give rise to capital gains. Such gains are liable to capital gains tax. We examined the reliefs and exemptions that apply in relation to this tax (which, in effect, reduce the tax on wealth). Our examination of tax expenditures is addressed in Part 8. In that part we make a number of recommendations that would, if adopted, reduce tax reliefs relating to taxation of capital gains.

4.5.1 Progressivity in capital gains tax

Capital gains tax is currently applied at a single rate. The rates for this tax had, in the past, been levied by reference to the period of ownership of the asset - the shorter the period of ownership, the higher the rate(s) charged. From 1992 a single rate⁴⁷ of 40% was introduced, this was reduced to 20% from December 1997 and increased to generally 25% from 8 April 2009.

We considered whether there should be more than a single rate of capital gains tax.

Unlike income, the taxation of which features more than a single rate, and which arises on a yearly

⁴⁷ A number of special rates also applied to gains from disposals of development land. Gains arising on the disposal of certain offshore funds are charged at 40%.

basis, capital gains tend to arise on an occasional basis although they generally accrue over the period of years in which an asset is owned. As income tax is charged on an annual basis it can easily be subjected to a progressive system. A similar treatment would not be so easy to apply equitably in the case of capital gains.

If capital gains were to be treated as income and taxed accordingly, this could give unfair results in a progressive income tax system. A capital gain would tend to push a taxpayer into higher rate(s) of income tax for the year in which the gain is realised than would be the case if the gain were to be taxed in the years over which it accrued. One way to deal with this would be to tax gains as income as they accrue and without waiting for them to be realised. While this might give a fairer result in terms of progressivity, it would result in tax being payable before the gains are realised and without regard to ability to pay. Under current rules, capital gains are taxed when they are realised.

Another approach could be to allocate any capital gains, once realised, to the years over which they accrued and to subject them to income tax rates on that basis. This, however, would be difficult administratively, particularly where assets were held for long periods.

A further approach considered was whether capital gains tax might mirror average effective rates of income tax at particular income levels. This offered no solution as such an arrangement could prove to be inequitable as between taxpayers and result in a very complicated taxation regime.

While our discussions noted the merits of progressivity in capital gains tax rates from the point of view of equity, we concluded that it would, in fact, be extremely difficult to implement in practice. Furthermore a progressive rate structure could be frustrated by the timing of disposals as an individual can determine when a gain is realised by timing the disposal of an asset. If a higher rate of capital gains tax was applied as part of a move to progressivity, it is likely that the higher rate would be avoided by the timing of disposals. If progressivity were to involve a rate lower than the current rate of capital gains tax, it is likely that most gains would end up being taxed at that lower rate. This would be inequitable and would have adverse Exchequer implications.

We concluded that we would not recommend progressive rates of capital gains tax.

4.5.2 Indexation

Capital gains tax applies to gains on the disposal of assets. Special rules apply to calculate the chargeable gain arising. Deductions are allowed in calculating a chargeable gain for the cost of the asset, the costs of enhancing the asset and the costs of acquiring and disposing of the asset. Where a chargeable gain arises over a period of time, a part of the gain will be attributable to increases in the nominal value of the asset arising from inflation. If tax is to apply to real gains only, increases in nominal value which are due to inflation need to be excluded. One way of excluding the part of a gain that is attributable to inflation is to increase the deductible costs of the asset by an indexation factor related to the consumer price index. When capital gains tax was introduced in 1975, the legislation did not provide for indexation but provision was subsequently introduced. Indexation was abolished following a reduction in the capital gains tax rate from 40% to 20% in 1998 and to take account of a lower level of inflation than existed when indexation was introduced. Indexation was not then a feature of most other countries and the abolition brought

Ireland into line with international norms. The change was made in accordance with the overall taxation policy of widening the tax base in order to keep direct taxes low. Indexation is now available only in respect of periods of ownership up to the end of 2002.

We examined the case for indexation. We noted that capital gains tax now applies at a much lower rate than when the relief was previously introduced and also that many countries no longer feature indexation relief in their arrangements for taxing capital gains. As against that, indexation prevents gains being taxed at an effective rate that is higher than the statutory rate and may help taxpayers predict their future tax liabilities more accurately.

Our view is that a capital gains tax charge should only be applied to real gains; that is, that gains attributable to inflation should be excluded. This could be achieved either by means of indexation (using the Consumer Price Index), or by way of a scheme of tapering relief which would relate the capital gains tax charge to the period of ownership of the asset from which the gain arises – the longer the period, the smaller the charge.

There is no estimate of the cost of the reintroduction of indexation.

Reintroducing indexation and achieving a revenue neutral outcome could involve an increase in the rate of capital gains tax.

Recommendation 5.25

Gains attributable to inflation should be excluded from the charge to capital gains tax.

4.5.3 Rollover Relief – Compulsory Purchase Orders and farm land

Prior to 2003 a person engaged in a trade, business, profession or employment could defer gains realised on the disposal of business assets where the proceeds of the disposal were reinvested in replacement assets for use exclusively in the trade, business, profession or employment. In effect, the chargeable gain arising at the time of the disposal of the asset was deferred until the replacement asset ceased to be used. A similar relief was available to a person who made a disposal of property under a compulsory purchase order and used the proceeds to invest in comparable assets. The Finance Act 2003 removed the facility to defer capital gains tax in respect of any disposals after December 2002.

We consider that there is a case for reinstating rollover relief in the case of farm land that is disposed of under a compulsory purchase order where the proceeds are used to invest in further farm land. Where land is acquired from a farmer under a compulsory purchase order, a proportion of the income-earning asset is lost unless the farmer uses the proceeds to acquire replacement farm land. However, a farmer who wishes to replace the land compulsorily acquired would, where capital gains tax is payable, have reduced funds with which to purchase replacement farm land.

We consider that rollover relief should be made available in respect of the chargeable gain arising from the sale of farm land that is compulsorily acquired under a compulsory purchase order where the proceeds from the sale are re-invested in farm land within a period beginning twelve months before the disposal of the farm land and ending three years after the date of the disposal of the farm land.

We note that the governing legislation provides that the compensation is at market value and compensation provides an amount to restore the landowner to his or her pre-compulsory purchase order position.

Recommendation 5.26

Capital gains tax rollover relief should apply to the gains on disposal of farm land pursuant to a compulsory purchase order where the proceeds are re-invested in farm land.

4.6 Tax on real property

Property is a key component of wealth. Our analysis and recommendations in regard to the taxation of property are set out in Part 6 of our Report where we recommend an annual property tax, increased capital gains tax on windfall gains arising from increases in land values due to rezoning decisions and an annual tax on property zoned for development.

4.7 Capital acquisitions tax (CAT)

The Capital Acquisitions Tax Act 1976 introduced a gift tax on taxable gifts taken on or after 28 February 1974 and an inheritance tax in respect of taxable inheritances taken on or after 1 April 1975. CAT replaced estate duty which had applied previously. The crucial difference between these methods of taxing property transferring on death is that, whereas estate duty was charged on the estate of the deceased, CAT, in contrast, is focused on the beneficiaries and the benefits taken by them. The tax is determined for each beneficiary by his or her relationship to the deceased and the value of the property received on the death of the deceased and the amount of benefits previously received from people in the same relationship group.

The replacement of estate duty by a system based on inheritance represented a fundamental reshaping of the approach to the problem of taxing wealth passing on death. It was considered that it resulted in a fairer system and had regard to the prior claims of relatives as against others who benefit on a death. It was also seen as promoting a wider distribution of wealth and was regarded as working more effectively than the former regime to prevent undue accumulations of wealth.

In Part 8 of our Report we make a number of recommendations which may reduce the tax expenditures available under the current CAT rules.

4.7.1 Progressivity in CAT

CAT is charged on the taxable value of a gift or inheritance. The taxable value is the net value of the property comprised in the gift or inheritance less any consideration paid by the beneficiary. Once the taxable value has been determined, the amount of tax payable will depend on whether any of the appropriate tax-free threshold has been used due to receiving previous benefits and whether the benefit exceeds the remaining balance of the relationship group threshold. These group threshold amounts vary depending on the relationship between the donor and the beneficiary.

Thresholds

Three group thresholds (based on the relationship to the donor) have applied since 1999. Examples of relationships in each group are:

- Group A - Son or daughter
- Group B - Parent, brother, sister, niece, nephew, grandchild
- Group C - Relationships other than Group A or B

The Group B threshold is set at 10% of the Group A amount while the Group C figure is one-half

of that of the Group B level. For gifts or inheritances taken on or after 8 April 2009, the Group A threshold is €434,000, the Group B threshold is €43,400 and the Group C figure is €21,700.

Higher exemption thresholds based on consanguinity (family relationships) are a common feature of wealth transfer taxes (as are exemption thresholds for transfers to charities and to the State). The underlying rationale for exemption thresholds is that only concentrations of wealth in excess of the exemption threshold should be taxed.

Instead of applying just the one rate to taxable value that exceeds the relevant relationship group threshold as happens at present, we considered the application of a number of rates to successive slices of that excess. A multiple rate structure applied prior to the introduction of the current arrangement in December 1999.

The acquisition of an asset by way of a gift or inheritance has the same impact on wealth as realising a capital gain. Capital gains are charged to capital gains tax while acquisitions of assets are subject to capital acquisitions tax. In both cases a rate of 25% applies and in our view it is appropriate that the benefit arising to an individual should be taxed at a similar rate. The application of exemption thresholds for CAT means that there is already some progressivity in CAT. Small gifts or inheritances are not subject to the tax while larger gifts and inheritances that exceed the threshold are subject to tax. Introducing additional rates would make the tax complex and difficult to administer and we do not recommend progressive rates for CAT.

4.7.2 Discretionary trust tax (DTT)

Discretionary trust tax is an element of the CAT regime which was introduced in 1984. A discretionary trust may be defined as a trust in which property, put into trust by the person who provides the property, is held on trust by trustees for a class of beneficiaries (called the objects of the trust), but in which the trustees have discretion as to when, how and to which of the objects of the trust they may appoint the capital or the income of the trust property.

The distinguishing feature of a discretionary trust compared to another settlement is that, neither any one of the objects of the trust in whose favour the discretion may be exercised, nor the class of beneficiaries as a whole, is entitled, as of right, to any capital or income of the trust. Each object of the trust has merely a hope or expectation that the trustees may exercise their discretion in his or her favour.

DTT is made up of two elements. There is:

- A **once-off 6%** charge which applies to any property which becomes subject to a discretionary trust. The 6% once-off charge is reduced to 3% if the entire trust property is transferred out of the trust within five years of the 6% charge arising
- An **annual charge** at the rate of 1% also arises on 31 December each year on the value of the property or assets of the trust

Having briefly reviewed the operation of this tax, we are not recommending any changes.

4.8 A new wealth tax

A wealth tax, as that term is often understood, is an annual tax levied usually by reference to a valuation of the taxpayer's total assets less liabilities. It is often charged at a level that makes it capable of being paid entirely out of income – for example, a 1% rate applied under the 1975 scheme.

Justification for a wealth tax includes the following:

- Equity, in that income by itself is not a sufficient indicator of ability to pay and merely taxing income does not take account of the influence and benefits from holding wealth over and above the income derived from it
- A wealth tax can reduce inequalities and provide for a redistribution of income from the well-off to the less well-off
- A wealth tax can yield worthwhile administrative information about a taxpayer to the tax authorities to cross check with other information available to them

Difficulties posed by a wealth tax include the following:

- Defining the taxable unit and whether the tax should apply to individuals or the family
- Whether only Irish residents should be taxed or whether non-residents should be liable on assets situated in Ireland
- What assets should be included in the charge as not all wealth can readily be taxed (e.g. human capital, pension rights) and so a wealth tax is an imperfect mechanism
- Regular valuations would be needed implying heavy compliance costs for the taxpayer and significant administrative costs for the Revenue Commissioners

Wealth taxes can have a negative influence on entrepreneurship by affecting the pool of capital available for start-up businesses and reducing the net return to successful entrepreneurs. They can cause productive capital to leave a country and also discourage foreign investment. Their existence may prompt a perception that the creation of wealth is viewed negatively.

A wealth tax, apart from being costly to administer, may yield little revenue for the Exchequer. This proved to be the case in Ireland where the yield from wealth tax in the three-year period 1975 to 1977 totalled £16 million. There is the further consideration that a wealth tax may be less likely to operate satisfactorily in the modern environment where capital is highly mobile. This is a factor which doubtless prompted many developed countries to abolish wealth taxes⁴⁸.

We do not recommend the introduction of a wealth tax.

Section 5: Consumption taxes

5.1 Introduction

Our consideration of some of the issues in relation to taxes such as VAT, excise duty, VRT and stamp duty is outlined in this Section. Our consideration of other aspects of these taxes is set out in other sections of our Report. Part 8 examines tax expenditures. Part 9 considers tax in the context of the environment and stamp duty issues are addressed in Parts 6 and 7.

Yield

Table 5.3 shows the yield from these taxes for the years 2006 to 2009, and the relevant percentages in terms of the total yield from all revenue to the Exchequer.

48 We noted that a paper entitled "Taxation of Wealth and Wealth Transfers" – prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, chaired by Sir James Mirrlees in the UK, reached similar conclusions in regard to wealth tax.

Table 5.3: Yield from consumption taxes 2006-2009⁴⁹

Year	VAT €m	Excise €m	VRT €m	Stamp duty €m
2009 est.	11,420 (33%)	4,235 (12%)	400 (1%)	980 (3%)
2008	13,430 (33%)	4,479 (11%)	1,121 (3%)	1,763 (4%)
2007	14,497 (30%)	4,598 (10%)	1,406 (3%)	3,244 (7%)
2006	13,451 (30%)	4,409 (10%)	1,287 (3%)	3,632 (8%)

5.2 VAT

5.2.1 Overview

Ireland operates three rates of VAT⁵⁰:

- **Zero rate** which generally applies to most food, children's clothes and shoes and oral medicines. While it is possible to retain the zero rating for goods and services that were in place on 1 January 1991, no new zero VAT rates can be introduced
- **Reduced rate** of 13.5% which applies mainly to domestic fuels, labour intensive services, general repairs and maintenance, restaurants, gas, electricity, certain buildings and construction-related services. Some of these items are "parked" items⁵¹
- **Standard rate**⁵² of 21.5% which applies to the remainder of goods and services including cars, electrical equipment and CD/DVDs, tobacco, alcohol, petrol and auto-diesel, telecommunications, furniture, cosmetics, adult clothing, footwear and rental income from certain buildings

Certain goods and services are exempt from VAT. Examples include financial, medical and educational activities as well as services provided by charities and non-profit organisations. Exemption from VAT means that the persons engaged in the exempt activities are exempt from charging VAT on the goods and services they provide and cannot claim VAT deductions on the goods and services they purchase.

EU comparison

In 2009, Ireland has the third highest⁵³ standard rate (21.5%) in the EU whereas the UK has the lowest (15%⁵⁴). Because of the complexity of the VAT system, it is difficult to make a meaningful comparison between the VAT system in Ireland and the other countries in the EU. While Ireland currently has the third highest standard rate and the highest reduced rate (13.5%) amongst Member States, a wide range of goods and services sold and traded are zero rated. The application of the non-standard rates is varied and, in some Member States, is imposed on a narrow range of

49 In this Section, consumption taxes include spending taxes as outlined in Part 4 and stamp duty.

50 Ireland also applies a VAT rate of 4.8% but this is limited to livestock sold by registered farmers. Unregistered farmers are also allowed to apply an addition (not rate) of 5.2% to the sales price of all produce.

51 Parked items: certain countries are permitted under EU law to retain a reduced rate of not less than 12% for certain items, provided a reduced rate applied to them on 1 January 1991.

52 The standard VAT rate is widely referred to in the media as the rate applicable to luxury goods or services. The design of the VAT system has to be seen in the context of developing an open internal market within the EU. As negotiated the 'standard' VAT rate is intended to apply to the majority of goods and services in all Member States with the exception of those listed in Annex III of the EU VAT Directive.

53 Denmark (25%), Sweden (25%), Finland (22%) and Poland (22%).

54 Prior to the UK's temporary reduction in the standard rate from 17.5% to 15% in 2008, both Cyprus and Luxembourg had the lowest standard rate at 15%.

goods or services, or on goods having a limited share in the final consumption of households. The reliance on transaction taxes in the context of yield to the Exchequer and whether the yield is sustainable is noted in Part 4 of our Report.

5.2.2 Regressivity in VAT

It is sometimes suggested that VAT is a regressive tax system. The Combat Poverty Agency study “The Distributional Impact of Ireland’s Indirect Tax System” concluded that *“The indirect tax system appears to be regressive in the sense that households in the lowest deciles...pay a higher proportion of their income in indirect taxes relative to households in the higher deciles”* (21% as opposed to 9.6% respectively). While we accept this point, we note that the VAT system includes elements of progressivity. For example, low rates of VAT apply to fuel for heating and zero tax rates apply to most food, children’s clothes and footwear. The questions of equity and progressivity need to be looked at in the context of the overall tax system rather than simply having regard to each part of it on its own. In addition, some elements of VAT are relevant to other policy areas of public policy. For example, lowering taxes on drink and tobacco could have negative health effects.

5.2.3 Scope for changing the VAT structure

Constraints under EU law

The scope for changes in the VAT regime is limited because it is governed by EU law with which Irish law must comply. The VAT rates that apply to particular goods or services are determined by the nature of the good or service and not by the status of the customer.

Move to a single rate of VAT?

We considered the option of a move to a single rate of VAT. Such a change would simplify the VAT system and could be done on a tax neutral basis. However, it would have a negative impact on those on low incomes, giving rise to increases in food, fuel and housing whereas it would lower the VAT rate on luxury goods. The consumer group who would bear most of the cost would be those in the lower income deciles. It would raise the rate of inflation and would make Ireland less competitive in comparison with other EU Member States.

Apply the reduced VAT rate to all items in Annex III of the Directive?⁵⁵

Ireland already applies the reduced VAT rate to the majority of goods and services listed in Annex III of the EU VAT Directive while others are subject to VAT at the standard rate. If the items that are currently at the standard rate but listed in Annex III were reduced from 21.5% to 13.5%, an Exchequer cost of over €155 million in a full year would arise. These goods are generally regarded as non-essential items and include goods such as confectionery, bottled water and soft drinks, pet food, non-oral medicines and periodicals. Any rate reduction would benefit all consumers, not just low income households. It is likely that higher income groups would be the main beneficiaries from a rate reduction.

Apply a higher VAT rate to goods currently at the zero rate?

It would be possible to move goods currently subject to VAT at the zero rate to the reduced VAT rate or standard VAT rate. The goods in question are books, most food, medical aids, oral medicine and children’s clothing and footwear. This would broaden the VAT base. This move would be irreversible as it would not be possible under EU law to re-apply a zero rate to such goods and

55 Annex 10 sets out Annex III of the VAT Directive.

services. It would have a negative impact on households with low incomes and it would drive up inflation which would make Ireland less competitive.

Introduce a second reduced VAT rate?

Ireland, along with most other Member States (18), operates only one reduced rate of VAT. In Ireland the reduced VAT rate is 13.5%. The EU average is approximately 8%. A second reduced rate could be set no lower than 5%. Arguments put forward for the introduction of a second reduced VAT rate include:

- Reducing the regressive nature of VAT for those on low incomes
- Giving the Government more scope in relation to the application of VAT to particular goods or services, and
- Making Ireland more competitive

The reduced rate also applies to parked items. Table 5.4 below shows what goods and services are subject to the reduced VAT rate and what proportions of these are 'parked'.

Table 5.4: Goods and services subject to VAT at the reduced rate (2009)

Rate	Percentage of VAT Base	Good or Service (Percentage of the VAT Base)	Full year cost of 1% reduction in the rate (€m)
Reduced	22.67%	Housing (12.59%)	88.88
		Accommodation (3.45%),	24.35
		Meals away from home (3.41%)	24.05
		Biscuits (0.86%), newspapers, (0.65%)	10.64
		The remainder accounts for (1.71%)	12.13
Parked	16.05%	Fuel used for heat or light (4.45%)	31.37
		Other building - non-housing (8.99%)	63.45
		Labour intensive services (1.48%)	10.45
		Work on immovables (0.38%)	2.66
		Short-term car and boat hire (0.27%)	1.92
		The remainder (0.49%)	3.47
Total	38.72%		273.37

Reducing the VAT rate applicable to goods and services listed above would make the VAT system less regressive. In this regard, it would be possible to apply a reduced rate of 5% to housing, accommodation, meals away from home, biscuits and newspapers. The difficulty with such an approach is that the reduction would be of benefit to all, regardless of income – assuming of course, that the reduction is passed on to the consumer. In addition, the introduction of a further rate would make the system more complex and would also significantly reduce Exchequer receipts.

EU law offers considerably less scope to Member States to apply lower VAT rates to 'parked' items. The VAT rate applying to such items can only be reduced to 12%. The cost of fuel used for heat or light would be reduced which would be of assistance to those on lower incomes. The change allowed, however, would in reality make very little difference to households with lower income because the reduction would only be from 13.5% to 12%. The change would also be of benefit

to all, regardless of income. The welfare system already provides fuel allowances which are given by reference to units used and not by price.

5.2.4 Conclusions

- The scope afforded to the Government for the introduction of a second reduced VAT rate is limited because of EU law
- It is difficult to make changes without undesirable consequences, many of which would be regressive
- Lowering the reduced or “parked” rate would not improve Ireland’s competitive position
- Applying VAT at a high rate on goods and services that are zero-rated would have an adverse impact on low income households and on Ireland’s competitiveness
- The introduction of a second reduced rate would represent a fundamental change to the Irish VAT system, make it more complex and significantly reduce Exchequer receipts

5.3 Excise

5.3.1 Overview

Excise duties are indirect taxes on the consumption or use of various products. Alcoholic beverages, manufactured tobacco products, energy products such as motor and heating fuels, electricity and natural gas are subject to harmonised provisions of EU law. All EU Member States are obliged to apply excise duties to these product categories. Rates of excise are a matter for the Member State concerned, subject to compliance with minimum amounts specified in EU Directives. Alcohol, tobacco and energy products accounted for about 80% of the total Exchequer return from excise duties in 2008. The other 20% came from what may be loosely termed the ‘national excises’ – these are not subject to harmonised EU law and cover such items as betting duty, bookmakers’ licence duty and the duty on permits and licences required for gaming and amusement machines and by auctioneers. An excise duty – called air travel tax – is payable by airlines in respect of passenger departures on their aircraft from most Irish airports.

5.3.2 EU - comparison of excise rates

Excise in Ireland is significantly higher than other EU Member States on alcohol and tobacco products. In the case of excise duty on alcohol, Ireland has the highest excise rate on wine and the second highest excise rate on beer and spirits in the EU. A number of countries have a zero rate on wine (mainly wine producing countries) and a significantly lower rate on beer and spirits. In the case of cigarettes, Ireland has the highest excise rate. In the case of excise on mineral oil, petrol and diesel, Ireland’s position in terms of ranking is closer to the EU average.

5.3.3 Alcohol and tobacco rates

We received submissions raising questions about the level of indirect taxes. It was suggested that they have a negative impact on the tourism sector and on the domestic cost environment, particularly for those on low incomes. It was also suggested that increases in excise rates would be likely to result in increased cross-border trade and a decline in tax revenue.

It was argued that high levels of excise duties have been a contributory factor to the significant increase in illegal and counterfeit trade in tobacco. It was suggested that while revenue from excise on tobacco has been reducing since 2007 and industry tobacco shipments data show a downward trend, overall consumption of tobacco products has remained stable, indicating an increase in illicit trade in tobacco products.

We acknowledge that the rates of excise applied to alcohol and tobacco products (cigarettes in particular) have a role in tackling the health consequences of alcohol and tobacco consumption. In relation to alcohol, there are also public order issues. However, we also note that increases in illegal sales add to the difficulties in tackling the health consequences of consumption of tobacco products. All in all, we consider that the policy approach to determining the level of excise duty applicable to such products should involve careful calibration to ensure that illegal sales of tobacco are minimised and to protect the Exchequer base.

Recommendation 5.27

The policy approach to determining the level of excise duty applicable to alcohol and tobacco products should take account of factors such as health outcome, public order issues, cross-border trade and other societal issues.

5.3.4 Excise on mineral oil products

We note that Ireland's excise rates on oil products are generally close to the EU average and we make no general recommendations in this area. However we note with regard to oil products that excise duty on such products is payable by operators before the tax is collected from the customer. It was put to us during the consultation process that the existing system could be replaced with a system where one monthly payment from each company is made on an automated deferred basis, with a catch up provision at the year-end; it was suggested that this would save administrative costs both for the industry and for the Revenue Commissioners.

The excise collection method for mineral oils provides for daily payments⁵⁶ of mineral oil tax to be made and lodged into a local Revenue Commissioners account on the same day the oil leaves the bonded warehouse. This is not consistent with the deferral treatment for alcohol products, VRT and tobacco products.

We consider that this is an anomaly that should be addressed. The absence of a deferral period imposes an unfair burden on the industry and is contrary to the mechanism in some other EU Member States and to the collection mechanism for excises on other receipts such as alcohol and tobacco. However, if the requested scheme were to be introduced, there would be a cash flow cost to the Exchequer in the year of change because less than 12 months payments would be made in that year. Allowing deferral would not be feasible unless a once-off advance payment was to be made in the year of change to ensure that such a cash-flow loss does not arise to the Exchequer.

The cost of this measure is estimated at €6 million (in terms of interest).

56 For administrative convenience, instead of assessing the precise liability for each day in advance of delivery, daily deposits are paid on the basis of estimates of deliveries and are reconciled at the end of the month. Any overpayment or underpayment resulting from the estimates is corrected at that stage.

Recommendation 5.28

A deferral system should be applied in place of the daily payment system that currently applies to excises on mineral oils. However, any change should ensure that there is no cash-flow cost to the Exchequer.

5.4 Vehicle registration tax (VRT)

VRT was introduced in 1993 to replace the excise duty which had previously been payable on vehicles as that duty was no longer compatible with European law. VRT is accounted for as an excise duty and is chargeable on the first registration of a motor vehicle designed and constructed for road use in Ireland. All such vehicles brought into Ireland, other than those brought in temporarily by visitors, must be registered with the Revenue Commissioners. A vehicle must be registered before it can be licensed for road tax purposes.

With specified exceptions, vehicles must generally be registered and the VRT paid by the end of the next working day following the arrival of the vehicle in Ireland⁵⁷. In the case of authorised traders, new and second hand imported vehicles are not registered until they are sold.

From July 2008, significant changes were made to the system of applying VRT to vehicles. The aim was to rebalance the VRT system to incentivise consumers to move to more environmentally sustainable vehicles by applying lower rates of VRT to lower CO₂ emission vehicles.

Issues in relation to VRT are addressed in Part 9 of our Report.

5.5 Stamp Duty

5.5.1 Overview of stamp duty

Stamp duty chargeable in Ireland falls into two main categories.

- The first comprises the duties payable on a wide range of legal and commercial documents, including conveyances of property, leases of property, share transfer forms and agreements. The duties in this category are denoted by means of stamps affixed to or impressed on the document affected and, depending on the nature of the document, may be either ad valorem (based on the value of the property) or of fixed amount. Stamp duty on property is normally collected from the buyer by his or her solicitor, who in turn pays the stamp duty relating to the transaction to the Revenue Commissioners.⁵⁸
- The second category comprises duties and levies payable by reference to financial cards and statements of interest. These duties and levies mainly affect banks and insurance companies and include a duty in respect of financial cards (e.g. credit, ATM, debit and charge cards) and levies on insurance premiums and statements of interest.

Stamp duty on real property is addressed in Part 6 of our Report and stamp duty on share transfers is addressed in Part 7.

⁵⁷ By way of administrative practice, in the case of 'unauthorised persons' (for example, private individuals and other non-registered persons), the Revenue Commissioners permit the payment of VRT within seven days of arrival of the vehicle in Ireland.

⁵⁸ From December 2009, the Revenue Commissioners will introduce a new system for stamping instruments and for paying stamp duty. The new system, called e-Stamping, will accept stamp duty returns on-line or in paper format.

5.5.2 Stamp duty on money cards

Stamp duty on cheques, bills of exchange and promissory notes has existed for many years and, when electronic means of money transfer, such as credit cards, ATM cards and debit cards were subsequently introduced, stamp duty was gradually extended to those products to ensure that the stamp duty receipts from cheques and the like were not eroded. The stamp duty on charge cards and credit cards was reduced from €40 to €30 in Finance Act 2008. The Supplementary Budget 2009 reduced the rates payable in respect of ATM cards, debit cards and combined ATM and debit cards. The rate on bills of exchange, including cheques, was increased in order to fund this measure. The total yield in 2008 from these charges amounted to €176 million.

The Government is committed to greater use of electronic means of payment for commercial, financial and retail transactions. While there have been significant improvements in availability of and access to electronic payment instruments in recent years, Ireland still lags significantly behind other EU Member States in the use of electronic payments. The further development of electronic payments in the economy has the potential to yield significant benefits for consumers, for Ireland's competitiveness and in terms of access to financial services. In Budget 2009, the Minister for Finance announced that the Government would build on progress to date by establishing a high-level group comprising representatives of the main stakeholders to direct the preparation and implementation of a national payments implementation plan over the next two years.

We note also that there is little evidence of tax or stamp duty on such instruments in other jurisdictions. In the interest of promoting the move towards a cash-free society (the security, cost and other benefits of which are well documented), we consider that stamp duty on charge cards, ATM cards, debit cards and combined cards should be phased out.

Recommendation 5.29

Stamp duty on ATM, credit and debit cards should be phased out in the interest of promoting the move towards a cash-free society.

The cost of this measure is estimated at €70 million.

Section 6:

International issues

6.1 Residence

6.1.1 Introduction

An individual's residence for tax purposes is a fundamental factor in determining liability to Irish tax.

	Resident	Non-resident
Capital acquisitions tax	Where either the donor or the beneficiary is resident or ordinarily resident ⁵⁹ , the charge to capital acquisitions tax applies to the all the assets transferred wherever they are situated.	Where both the donor and the beneficiary are non-resident, the charge applies to property situated in Ireland.
Capital gains tax	An individual who is resident or ordinarily resident is liable on chargeable gains on the disposal of all assets wherever situated ⁶⁰ .	An individual who is neither resident nor ordinarily resident is liable only on chargeable gains on the disposal of: • Land or buildings in Ireland • minerals in Ireland • Exploration or exploitation rights in the continental shelf • Unquoted shares deriving their value from the above • Assets of a business carried on in Ireland through a branch or agency
Income tax	Liable on all income, wherever it arises ⁶¹ .	Liable only on Irish sourced income or from any trade, profession or employment exercised in Ireland.

For tax years prior to 1994-95, there were no statutory rules for establishing if an individual was resident or ordinarily resident in Ireland for a tax year. Until that time, Irish residence rules were based on case law and long standing administrative practice. Legislation was introduced in 1994 which gave residence rules a statutory footing. As a result, there are now two residence tests and these are based solely on time spent in Ireland with a 'look back' extending only as far as the previous year. An individual will be resident for tax purposes in Ireland if:

The tests are that an individual will be resident for tax purposes in Ireland if:

- 183 days are spent in Ireland in a tax year, or
- 280 days, in aggregate, are spent in Ireland in a tax year and the preceding tax year – this is known as the 'two-year test'. Presence in Ireland for periods of 30 days or less in any year is not taken into account in applying the 'two-year test'. Consequently, short visits for holidays or other reasons will not result in a person being Irish resident for tax purposes

⁵⁹ An individual who is not domiciled in Ireland is not treated as being resident or ordinarily resident in Ireland on a date unless he or she had been resident in Ireland for the five previous years of assessment and is either resident or ordinarily resident in Ireland on that date.

⁶⁰ The remittance basis for capital gains tax is considered at section 6.1.6 below.

⁶¹ The remittance basis for income tax is described and considered at section 6.1.6 below.

Given the importance of the issue for the equity of the tax system, we considered residence for tax purposes in some detail.

We note and welcome the change made⁶² in 2008 to the tax residence rules so that, in determining whether an individual is tax resident in Ireland for a year, account is to be taken of any part of a day in which the individual is present in Ireland.

6.1.2 Residence rules

We consider that residence rules for tax purposes should contain a number of features.

They should be:

- Equitable in that they allow for the application of taxation fairly to taxpayers in a variety of circumstances
- Easily understood
- Based on objective and clearly defined criteria so as to provide certainty and avoid manipulation
- Framed so as to protect Ireland's taxing rights

Specifying a presence on a particular number of days in a tax year as the basis of determining residence is a test that is commonly used in other jurisdictions. It satisfies the requirements to be easily understood and based on clear criteria. However, we consider that it does not fully resolve the questions of equity and the protection of Ireland's taxing rights.

6.1.3 Difficulties with present rules

A prescribed number of days, while clear, is a criterion that can be 'managed' by taxpayers. It enables an individual, who has a home in Ireland and significant business interests here, to avoid exposure to Irish tax, in particular to income tax and capital gains tax but also, potentially, to capital acquisitions tax. This is inequitable, particularly in the case of individuals who are Irish citizens. Some persons arrange their affairs so that they are not liable to Irish tax because they are present in Ireland:

- For less than 183 days per annum, and
- For less than 280 days, in aggregate, in a tax year and the preceding tax year

In addition to being inequitable, we are of the view that this damages the integrity of the tax system.

The present situation is therefore unsatisfactory and needs to be changed. Irish citizens with significant interests in Ireland should be contributing through the tax system. We concluded that the 183 day (and 280 day) rule to determine tax residence in Ireland should not be changed. If the number of days were to be reduced and no other changes were made, it would still be possible for individuals to manage their affairs so as not to be resident in Ireland for tax purposes.

A 183 day criterion is commonly used to determine residence in OECD countries. However, in many countries, residence is not determined solely or primarily on the basis of a 183 day test. Annex 11 sets out the criteria used to determine tax residence in a number of other countries. We consider that, as in many other countries, other factors should be part of the criteria to establish whether or not an individual is resident in Ireland for tax purposes. These include tests such as

62 In Finance (No. 2) Act 2008

permanent home (which is a common criterion internationally), centre of economic interests, centre of personal interests and citizenship. In many instances, a combination of criteria are applied.

Different countries use different approaches to determine the residence of an individual for tax purposes. As a result, situations can arise where an individual can be regarded as tax resident in more than one country. To deal with such situations, tax treaties (generally based on the OECD Model Tax Convention on Income and on Capital) contain 'tie-breaker' rules for determining the country of residence so that the individual will only be regarded as resident in one country for tax treaty purposes. Where there is no tax treaty, an individual who is resident in more than one country may suffer double taxation.

6.1.4 Conclusions

We concluded that the 183 and 280 days tests should be supplemented by additional criteria to tighten the existing arrangements for determining residence for Irish citizens. The criteria for determining residence are a matter for Irish domestic law and can include the tests mentioned above, which might be used either alone or in combination. Having regard to the position in other countries, this would strongly suggest a permanent home test coupled with a test based on an individual's centre of vital interests⁶³ as offering the best prospect of dealing with the present unsatisfactory situation.

Any changes should ensure equity in the tax system and, while providing certainty to those affected, should avoid the possibility of manipulation of the rules. It is particularly important that any new permanent home test is framed in a manner that minimises uncertainty.

Recommendation 5.30

The 183/280 days test for determining the tax residence of an Irish citizen should be supplemented by additional criteria, which should include a permanent home test and a test based on an individual's centre of vital interests.

6.1.5 Modified residence rules

The criteria for determining whether an individual is resident or ordinarily resident for tax purposes are modified in the case of an individual who is resident outside of Ireland and who makes a gift of property to the State. For the year in which the individual leaves Ireland to become resident elsewhere, he or she is not regarded as ordinarily resident in Ireland. As regards subsequent years, visits to Ireland, of in aggregate up to 182 days, by the individual for the purposes of advising on the management of the gifted property are ignored in determining whether the individual is resident or ordinarily resident in Ireland. A similar treatment applies to the individual's spouse where they accompany the individual on such visits. The individual must be chargeable to tax without limitation in the country in which he or she has become resident.

The treatment allows up to 182 days presence in Ireland, that are connected with advising on the management of the property, to be ignored. This applies before the application of the 183-day rule as mentioned above. This could facilitate avoidance of the general rule on Irish tax residence. In addition, there is an equity issue where such a rule is likely to apply only to a small number of individuals.

63 Described in the OECD Model Tax Convention on Income and on Capital as the state with which the place where the individual's personal and economic relations are closest.

We recommend that this provision should be discontinued in respect of gifts made in the future.

Recommendation 5.31

The rule that allows an individual, who makes a gift of property to Ireland, to be regarded as neither resident nor ordinarily resident in Ireland, notwithstanding being present in Ireland for significant periods, should be discontinued.

6.2 Remittance basis of taxation

6.2.1 Description

The remittance basis applies to foreign sourced income and capital gains of:

- Individuals who are resident, but not domiciled in Ireland, and
- Citizens of Ireland who are not ordinarily resident in Ireland

The general scheme is that, where the remittance basis applies, income and capital gains arising outside Ireland are charged to tax only to the extent that they are remitted to Ireland.

There are four aspects to the remittance basis. Three of these are discussed below. The fourth (Foreign employments covered by the Finance (No 2) Act 2008) is addressed in Section 5 of Part 7.

(1) Treatment of income and capital gains from foreign investments in the case of individuals who are resident, but not domiciled, in Ireland: Individuals who are resident in Ireland are normally taxed on all of their income and capital gains, wherever it arises. Under the remittance basis, an individual who is resident, but not domiciled, in Ireland is only taxed on income and capital gains from foreign investments to the extent that they are remitted to Ireland. Income and capital gains that are not remitted are not taxed in Ireland, although they may be subject to tax in the source country depending on the rules that apply there and the provisions of the relevant tax treaty.

(2) Treatment of income from foreign investments in the case of individuals who are Irish citizens but who are not ordinarily resident, in Ireland: An individual is regarded as ordinarily resident in Ireland from the commencement of a tax year if he or she has been resident for each of the previous three tax years. Consequently, an Irish citizen who has not been resident in Ireland but who becomes resident will not be ordinarily resident for the first three years after his or her return to Ireland. This means that he or she will be able to benefit from the remittance basis for the first three years after returning to Ireland.

(3) Foreign employments of individuals who are entitled to the remittance basis: Any individual entitled to the remittance basis can also avail of it in the case of employment exercised outside Ireland. This means that income from such employments is only taxable in Ireland to the extent that it is remitted to Ireland.

Where an individual is entitled to the remittance basis in respect of foreign employment income there is also an exemption⁶⁴ from the charge to tax in respect of a gain arising from the exercise of share options granted to the individual by reason of the employment. If that exemption did not apply, a gain (calculated as the difference between the price paid for the shares and the value of the shares on acquisition) would be charged to income tax.

64 Section 128 Taxes Consolidation Act 1997 (TCA)

6.2.2 Conclusion

The remittance basis is a historical anachronism and is incompatible, on equity grounds, with a modern tax system as it is inappropriate to distinguish between taxpayers on grounds of domicile.

Equity requires that taxpayers who are in a comparable situation should be afforded the same treatment for tax purposes. Making a distinction between individuals based on their domicile results in a situation where taxpayers who are otherwise in a comparable situation are treated for tax purposes in different ways. This is inequitable. Thus, for example, an individual who, although domiciled outside of Ireland, is a permanent resident should be treated the same as any other resident taxpayer. The special treatment afforded to individuals who are resident, but not domiciled, in Ireland whereby they are only taxable in Ireland on foreign source income and capital gains to the extent that the income and gains are remitted to Ireland is inequitable and should be discontinued.

The withdrawal of the remittance basis of assessment is a significant change in the tax system. When the legislation is amended we believe there should be a lead time of three to five years before change takes effect.

Recommendation 5.32

The remittance basis of taxation for income tax and capital gains tax should be discontinued.

Section 7: Regulatory Framework

7.1 Tax administration

We consider that equity, efficiency and fairness should underpin the administration of Ireland's tax system. Tax compliance depends primarily on voluntary compliance. A high level of voluntary compliance allows a tax authority to focus more resources on those who are not tax compliant. If compliance is not achieved, social cohesion is challenged and Government will have difficulty in providing services to support the community and those unable to make provision for themselves.

It is therefore necessary, in our view, to secure equity between persons through the provision of a tax base that provides measures which are uniform, comprehensive and capable of consistent application to all individuals.

7.1.1 Relationships between tax authorities and taxpayers

The perception of fairness – that everybody is seen to pay their fair share – is paramount if a tax authority is to have the confidence of taxpayers. We consider that a sound, business-like relationship between the taxpayer and the tax authority (which in the main comprises the Revenue Commissioners but can also include public bodies like the local authorities) is facilitated if policy makers and legislators ensure that the tax code is as fair and as easily understood as is possible. Any tax authority will have difficulty in administering a tax system, or tax measures, if they are perceived to be unfair or not easily understood.

Furthermore, the relationship between the taxpayer and the tax authority is enhanced where the compliance burden is minimised to the greatest extent possible. We consider that this puts an onus on the tax authority, and policy makers, to work to keep the compliance burden as low as possible. The delivery of a sound and robust compliance system can be helped through regular interaction with taxpayers. This can be achieved by interaction with groups of taxpayers, business and employer representative bodies and the professional bodies whose members act on behalf of some taxpayers.

7.1.2 Conclusion

The perception of fairness, necessary to a well-functioning tax system, can be assisted by an appropriate balance between the requirement on the tax authority to counter tax evasion and aggressive tax avoidance and the rights of taxpayers to a tax system that is easily administered, has an appropriate compliance burden and has safeguards, including an accessible, effective, affordable and independent appeal structure.

Recommendation 5.33

The relationship between the State and the taxpayer should be informed by reasonableness and proportionality through the provision of safeguards to ensure equitable treatment. To the extent that it is practicable, safeguards should be provided on a statutory basis.

7.1.3 The appeal process

A number of submissions raised concerns about the appeal process. The structure of the appeal process and access to previous decisions of the Appeal Commissioners were particular points of concern raised with us. In relation to the latter point we note that only a very small number (34) of appeal decisions have been published by the Appeal Commissioners. Determinations of the Appeal Commissioners are made available to the Revenue Commissioners but are not, as a matter of course, available to taxpayers. We consider that this does not provide for a transparent form of decision-making which is appropriate to any well functioning administrative appeal process. In our view, it is appropriate that the Appeal Commissioners publish all their determinations in a timely manner. This would provide equivalent access to appeal decisions to taxpayers and the Revenue Commissioners and is consistent with the recommendations on access to appeal determinations already made by the Law Reform Commission and the Revenue Powers Group – see Annex 12.

A number of the recommendations in our Report would, if adopted, result in taxpayers being liable to new taxes, such as an annual property tax, under self-assessment. Many of these taxpayers have, up to now, had no experience of self-assessment and may have legitimate grounds for disputing the manner in which the tax is applied to them. Equally, the past 10 years have seen a significant increase in the range of civil penalties that can be sought from taxpayers in the self-assessment system. It is appropriate that all taxpayers should have access to a low-cost and timely appeals mechanism to deal with such items – the Office of the Appeal Commissioners could be supplemented to deliver an appropriate procedural appeals process.

Recommendation 5.34

The State's interaction with the taxpayer so as to ensure tax compliance should be proportionate.

- Access to determinations of the Appeal Commissioners should be simultaneously available to taxpayers and the Revenue Commissioners.
- A cost-effective route of appeal should be available to all taxpayers.
- Other recommendations made in the Reports of the Law Reform Commission and the Revenue Powers Group in relation to the reform, jurisdiction and operation of the appeal system should be implemented.

7.1.4 Interest on underpaid and overpaid tax

The statutory rate of interest applied to delayed payments of taxation and underpayments by taxpayers engaged in business activities comprises a daily rate of 0.0219% for most taxes and 0.0274% for fiduciary taxes. The annualised equivalents are 8% and 10% approximately. No appeal is available against these charges.

When measured against prevailing interest rates there are clearly punitive elements to these daily charges. In contrast, the interest rate payable on excess preliminary tax eligible for interest is 0.011% per day (approx 4% *per annum*). The differences between these rates are considerable. In addition, interest is imposed on tax underpaid from the due date for payment whereas interest is rarely awarded for tax overpaid as the compensatory period only begins a number of months after the return is filed and not from the date of overpayment.

Previous reviews of this issue⁶⁵ have suggested that the rates are not compatible with the principle of proportionality. We consider that the rates of interest to be charged on overdue taxes should be regularly reviewed having regard to prevailing interest rates. We acknowledge that the interest rate to be charged on overdue taxes should be sufficiently high to discourage taxpayers from deferring tax payments.

Recommendation 5.35

The interest rate applicable to overdue tax payments should be reviewed each year having regard to the prevailing market rates and the rate should be sufficiently high to discourage taxpayers from deferring tax payments.

7.2 Regulatory burden

7.2.1 Introduction

The desirability of low regulatory burdens in a taxation context is well documented and a long standing concept. Certainty, convenience and efficiency are relevant to the regulatory burden topic.

The ESRI Business Regulation Survey of March 2007 describes the burden caused by regulatory (including taxation) requirements in terms of:

- **The administrative burden**, which is the "time and cost of the administration associated with compliance – such as preparing reports and making returns to Government or the

65 The Law Reform Commission and the Revenue Powers Group both examined this issue and concluded that a regular review mechanism of the interest rate chargeable should be provided for.

regulator where such record keeping and reporting would not otherwise be undertaken by the business”, and

- **The compliance burden**, which is “the time and cost in becoming compliant with a regulation, for example putting in place the technology, practices and procedures required by Health and Safety Regulation, and includes administrative burdens”

The Report of the Business Regulation Forum (April 2007) describes *the administrative burden of regulation* in terms of:

- The cost of dealing with ‘red tape’
- Causing businesses to adjust their production processes in ways that add to costs, and
- Having an adverse effect on innovation, entrepreneurship, productivity and competition (when inappropriately designed)

The Report of the Small Business Forum (May 2006) defines compliance costs (of regulatory burdens on small business) in two ways:

- **Substantive compliance costs** which are costs that businesses incur in order to comply with their obligations – for example the cost of installing facilities to comply with working conditions regulations, and
- **Administrative compliance costs**, which are costs that businesses incur in complying with the information obligations in a regulation

We use the term ‘regulatory burden’ to cover all costs borne by the taxpayer as indicated above.

We make a number of general recommendations about reducing regulatory burdens. We frame these in terms of broad criteria or principles. The practical application of these criteria is reflected in our recommendations throughout our Report.

7.2.2 General principles on reducing regulatory burden

We acknowledge the considerable advances in this area in recent years and the continuing commitment of the Revenue Commissioners to reducing regulatory burden.

Reducing regulatory burden is part of creating an environment attractive to business and investment, because it allows businesses to spend more time on business and less time on complying with regulatory requirements. We strongly believe that simplicity of administration is a key element of a tax system structure that best supports economic activity.

There is a broad consensus that in a business context, regulatory burdens fall disproportionately on small and medium-sized enterprises because the costs of setting up systems to meet tax obligations may be disproportionate.

Our view is that, no matter what size a business is, it should not be faced with onerous burdens in complying with taxation issues. In this regard, we welcome the ongoing developments undertaken by the Revenue Commissioners in relation to the electronic filing and payment of taxes. Revenue’s On-line Services (ROS), which facilitate inter alia taxpayers to file tax returns, pay tax liabilities and access their tax details online, contributes substantially to easing regulatory burden on business. A systematic approach to the measurement and codification of data on the regulatory burden would be of assistance in this area.

The following general criteria are applicable in relation to reducing regulatory burden:

- Minimise circular payments – if a system involves a taxpayer paying tax which is refunded at a later date, consider ways to facilitate payment of the net amount in the first instance instead
- Streamline taxpayers' obligations, particularly applications for clearance certificates – keep rules and procedures under regular review
- Take administration and systems development costs into account when amending tax rules and procedures
- Extend self-assessment and provide that entitlement to exemption should be on a self-assessment basis without third party certification

Recommendation 5.36

The Revenue Commissioners should adopt general criteria towards reducing the regulatory burden as outlined in section 7.2.2 of Part 5.

7.2.3 Specific areas where action is recommended on regulatory burden

Withholding taxes

We considered the role played by third parties in the tax payment process.

In the first instance, we concluded that the withholding tax rules imposed on companies making payments of dividends, interest or royalties to persons outside Ireland required amendment, in order to ease the regulatory burden on the payer. We recommend the extension of self-assessment procedures in some circumstances.

- In the case of dividends, our recommendation is that self-assessment should be extended to dividend withholding tax exemption claims and that third party certification should not be required. This means that the dividend paying company would be allowed to pay the dividend free of tax, provided that it was in a position to demonstrate that the conditions were met in the event of an audit
- In the case of interest and royalties, our recommendation is that self-assessment should be acceptable for exemptions and reductions that are available in tax treaties

Outbound payments of dividends

Dividends paid by an Irish-resident company to a non-resident shareholder may be exempt from tax in Ireland. Dividend withholding tax (at the standard rate of income tax) is deducted at source by the company unless the shareholder is entitled to exemption. Claiming the exemption requires (in most cases) that the shareholder files a declaration with the company paying the dividend. The declaration must be accompanied by third party supporting documentation – either a tax residency certificate from another tax authority or a declaration from an auditor where the shareholder is a company.

We consider that the compliance burden imposed on parent companies of Irish subsidiaries to establish entitlement to exemption is disproportionate. We propose that the rule should be relaxed and that the exemption should be determined on a self-assessment basis without third-party certification. This means that the dividend paying company would be allowed to pay the

dividend free of tax without receiving the third party certification, provided that it was in a position to demonstrate that the conditions were met in the event of an audit.

Outbound payment of interest and royalties and prior approval for withholding tax exemption

An Irish paying company must obtain prior approval from the Revenue Commissioners to implement a reduction or elimination of withholding tax on interest or royalties (in accordance with the terms of a double taxation agreement between Ireland and the recipient country). The exemptions under the EU Interest and Royalties Directive are done without prior approval, on a self-assessment basis. We consider that self-assessment should also be acceptable for exemptions and reductions available under tax treaties.

Relevant contracts tax (RCT) and professional services withholding tax (PSWT)

- RCT is a scheme of tax deduction from payments to sub-contractors in the construction, forestry and meat processing industries. The principal contractor deducts tax at source (at the rate of 35%) from payments made to sub-contractors, unless the sub-contractor can provide a certificate of authorisation and the Revenue Commissioners allow payment to be made without deduction of tax. There is a refund application facility where the tax deduction exceeds the subcontractor's expected liability
- PSWT provides for the deduction of tax at source from payments for 'professional services' (which are widely defined) made by government departments and offices, local authorities, the Health Service Executive, commercial and non-commercial State bodies and their subsidiaries. The public body deducts tax at source (at the standard rate of income tax) from payments made to the professional service provider. There is no provision for allowing payments to be made gross but interim refunds may be available

We recommend two specific changes to the rules for these taxes, in order to reduce regulatory burden. In the case of RCT, we note that the provision was introduced in 1970 and that at that time the withholding tax rate of 35% was the same as the standard rate of income tax. The standard rate has dropped considerably since then. The RCT rate has stayed the same. We are of the view that the RCT rate should not be set at a level which results in significant overpayments of tax. We suggest that reducing the rate of RCT should not compromise its effectiveness as a measure which brings sub-contractors within the income tax system.

More generally, we consider that imposing a withholding tax at a rate which can be expected in most cases to result in the withholding of tax significantly in excess of final liability and payment of a subsequent refund is not consistent with the principle of equity. Consequently, the RCT rate, in particular, should be reviewed to ensure that such outcomes are minimised.

In the case of PSWT, we consider that an authorisation process, perhaps similar to the tax clearance system for RCT, should be put in place to allow payments for professional services to be made without deduction of tax to compliant taxpayers who hold an appropriate certificate.

We also suggest that flexibility be given to the Revenue Commissioners, with appropriate safeguards, to vary the strict application of interest and penalty provisions in *bona fide* situations where RCT was not applied but at no loss to the Exchequer.

Tax expenditures and data gathering via tax returns

We also considered the conflict that may arise between drives towards rationalisation and streamlining and the need for information.

Our review of tax expenditures is set out at Part 8 of our Report. In our view, tax expenditures should be the subject of ongoing evaluation and appropriate and timely cost-benefit analysis to ensure that they are both economically efficient and that parliamentary oversight can be well informed. This means that appropriate data via tax returns will be required. We acknowledge that such a requirement adds both complexity and volume to standard tax return forms and increases compliance costs. However, we consider that where taxpayers are availing of tax expenditures, it is reasonable and proportionate that they should supply the appropriate information to the Revenue Commissioners. This will permit the ongoing monitoring and evaluation that is required to ensure that tax expenditures remain fit for the purpose for which they were designed and continue to be economically efficient.

We recommend that, where detailed data gathering is required relating to some tax incentives, taxpayers availing of the schemes should be required to e-file their tax returns to permit early and appropriate monitoring and evaluation.

Recommendation 5.37

Dividend withholding tax exemption claims by foreign parent companies should not require third party certification.

Recommendation 5.38

Self-assessment should apply to interest and royalty withholding tax exemptions and reductions that are available in tax treaties.

Recommendation 5.39

The relevant contracts tax rate should be reviewed to ensure that it does not lead to a taxpayer paying tax in excess of final liability.

Recommendation 5.40

Flexibility should be given to the Revenue Commissioners to vary the strict application of interest and penalty provisions in *bona fide* situations where relevant contracts tax was not applied but at no loss to the Exchequer.

Recommendation 5.41

A system should be put in place to permit payments for professional services to be made without deduction of professional services withholding tax to compliant taxpayers with an appropriate certificate from the Revenue Commissioners.

Recommendation 5.42

Where detailed data is required to allow the appropriate evaluation and cost-benefit analysis of tax expenditures, the taxpayers and businesses availing of the tax expenditures should be required to e-file their tax returns.

Section 8:

Tax avoidance

8.1 Defining tax avoidance

Tax avoidance is not easily defined. Every taxpayer has the right to organise his or her tax affairs in a way that minimises tax liability. At one end of the spectrum, many taxpayers quite legitimately reduce their tax liability by claiming, for example, relief for retirement provision, relief for medical expenses, and so on. In addition, taxpayers may legitimately minimise the tax payable by them under various provisions of tax law. This can involve the intended use of incentives such as the Business Expansion Scheme, property incentives, film relief and similar measures. At the other end of the spectrum, taxpayers (and their advisers) may devise schemes that are essentially artificial in nature. These may involve a transaction, or a series of transactions, designed to use legislation in a way that was not intended by the Oireachtas with a view to avoiding a charge to tax or getting a tax allowance. There is a greater risk of these transactions in periods when high marginal tax rates apply.

The dividing point between tax planning and tax avoidance can be seen from the previous Commission on Taxation's definition of tax avoidance as the minimisation of tax liability through taking advantage of some provision or lack of provision in the law in circumstances other than that perceived to be intended by the legislature. Since tax avoidance is taking advantage of opportunities provided by the law, it excludes fraud, concealment and other illegal measures.

Tax avoidance offends the principle of equity. It can undermine the tax base. It can also undermine tax compliance if the generality of taxpayers are of the view that those taxpayers that have the resources to develop tax avoidance schemes can reduce their tax liability in an unintended way while most taxpayers have no opportunity of doing so.

8.2 Approaches to deal with tax avoidance

Where the Revenue Commissioners identify tax avoidance, they may challenge the taxpayer concerned. In some cases, this may involve a challenge to the taxpayer's interpretation of the law. In the absence of agreement, the correct interpretation may have to be determined by the Courts. In other cases, the challenge may not be to the interpretation adopted by the taxpayer but to the effective implementation of the scheme.

There are a number of broad approaches which can help minimise tax avoidance:

- Poor (or rushed) drafting of tax law can open up new loopholes or extend the law to situations that were not meant to be included. As a general rule, tax law that is simple and easily understood should be easy to comply with and less likely to facilitate avoidance. The more complex tax rules are, the more likely it is that they will be subject to avoidance attempts. On the other hand, there are instances where tax avoidance has involved the unintended use of relatively simple measures. In addition, tax law may need to be complex because it is dealing with issues that are complex
- Tax avoidance schemes should be challenged so that an appropriate signal is sent out both to those who may seek to avoid tax and the generality of taxpayers
- Identified tax avoidance schemes should be countered by specific measures in tax law to

counteract them (specific anti-avoidance rules)

- The use of general anti-avoidance rules by the tax authorities to challenge schemes that seek to avoid tax

8.3 General anti-avoidance rules

In Ireland, when interpreting tax legislation, the Courts look at the meaning of the specific words in the legislation. The Supreme Court⁶⁶ pointed out that other jurisdictions had general anti-avoidance provisions but that, in the absence of such a provision in Ireland, there were no grounds for departing from the plain meaning of the statute in question.

Ireland introduced a general anti-avoidance rule in 1989. General anti-avoidance rules are used in many jurisdictions. They give the tax authority a discretionary role in dealing with tax avoidance. Ireland's general anti-avoidance rule⁶⁷ is a measure that is intended to defeat the effects of transactions that are intended primarily to avoid or reduce a tax charge or to artificially create a tax deduction or tax refund and were not undertaken for commercial purposes. The measure allows the Revenue Commissioners to form an opinion, to give notice to the taxpayer concerned and to challenge a transaction on the basis that it is a tax avoidance transaction. The Commissioners must have regard to the substance of the transaction, and to related transactions, so as to get behind the mere form of the transaction. The intention of the relevant tax statute is also to be taken into account. Seven notices were issued by Revenue during 2008.

The general anti-avoidance measure allows the Revenue Commissioners to form a view that a transaction is an avoidance transaction. A transaction is not an avoidance transaction for the purposes of the section until the Commissioners form that view. The possibility that the Commissioners may form the view that a transaction is a tax avoidance transaction, or that a series of transactions are tax avoidance transactions, means that some level of uncertainty inevitably arises in the case of business transactions.

Protective notification

Under legislation introduced in 2006, where a determination by the Revenue Commissioners that a transaction is an avoidance transaction becomes final, interest and a surcharge of 10% of the tax that the taxpayer unsuccessfully attempted to avoid must be paid. However, the legislation also provides that, by making a protective notification to the Revenue Commissioners within 90 days of implementing a transaction, the taxpayer can, on a non-prejudicial basis, obtain protection from the possibility of such interest or surcharge. According to the Revenue Commissioners, 71 protective notifications were received since the enactment of the provision in 2006. In the interests of certainty for business, where a protective notification has been filed on a correct basis, consideration should be given to a time limit within which the Revenue Commissioners would be required to make a decision on the point at issue.

8.4 Conclusion

Tax avoidance undermines the tax base. It can undermine tax compliance if the generality of taxpayers are of the view that some taxpayers that have the resources to have tax avoidance schemes developed that can reduce their tax liability in an unintended way while most taxpayers

⁶⁶ *McGrath v McDermott* [1988] 1 IR.

⁶⁷ Section 811 of the TCA

have no opportunity of doing so.

Taxpayers who engage in aggressive tax avoidance undermine fairness in the tax system.

Recommendation 5.43

Where tax avoidance is identified and demonstrates a weakness in the law, a specific provision in the tax code should be enacted to prevent the avoidance in question.

Recommendation 5.44

Twenty years after the introduction of the general anti-avoidance provision, it is now opportune to review its effectiveness as a tool to tackle tax avoidance. This should include consideration of a time limit within which the Revenue Commissioners would be required to make a decision on the point at issue.

Appendix 1

Marginal tax rates – indicative illustration

The marginal tax rates shown include income tax, the health contribution and income levies and employees PRSI where appropriate.

Employee Rate of tax on the next euro earned.

		€9,150	€18,300	€34,000	€36,400	€50,000	€60,000	€75,036	€100,000	€150,000	€174,980	€250,000
Existing band structure	Marginal tax rate 2008 (actual)	0.0%	20.0%	26.0%	47.0%	47.0%	43.0%	43.0%	43.0%	43.5%	43.5%	43.5%
	Marginal tax rate 2009* (actual)	0.0%	22.0%	30.0%	51.0%	51.0%	51.0%	50.0%	50.0%	50.0%	52.0%	52.0%
	Health contribution levy integrated** (indicative)	0.0%	26.0%	30.0%	50.5%	50.5%	50.5%	52.5%	52.5%	52.5%	54.5%	54.5%
	Income and health contribution levies integrated** (indicative)	0.0%	25.5%	29.5%	54.0%	54.0%	54.0%	54.0%	54.0%	54.0%	54.0%	54.0%

Self-Employed Rate of tax on the next euro earned.

		€9,150	€18,300	€34,000	€36,400	€50,000	€60,000	€75,036	€100,000	€150,000	€174,980	€250,000
Existing band structure	Marginal tax rate 2008 (actual)	20.0%	20.0%	26.0%	47.0%	47.0%	43.0%	43.0%	43.0%	43.5%	43.5%	43.5%
	Marginal tax rate 2009* (actual)	23.0%	25.0%	29.0%	50.0%	50.0%	50.0%	53.0%	53.0%	53.0%	55.0%	55.0%
	Health contribution levy integrated*** (indicative)	27.0%	29.0%	29.0%	49.5%	49.5%	49.5%	51.5%	51.5%	51.5%	53.5%	53.5%
	Income and health contribution levies integrated*** (indicative)	28.5%	28.5%	28.5%	53.0%	53.0%	53.0%	53.0%	53.0%	53.0%	53.0%	53.0%

* Full year impact post 1 May 2009

**The above chart assumes that our recommendation that the ceiling for employee PRSI be removed is fully implemented.

***Figures assume that the PRSI rate for the self-employed is 3% for illustrative purposes.

Indicative rates post-integration assume that the value of the main personal tax credits is unchanged.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 6

TAXATION OF PROPERTY



Part 6: Taxation of Property

Section 1 is an introduction.

Section 2 outlines how the taxation of property should be restructured.

Section 3 contains the elements of our proposals for a restructured system of property taxation.

Section 4 outlines the main design features of the proposed annual property tax on residential housing.

Section 5 outlines our consideration of stamp duty on commercial property.

Section 6 outlines our consideration of a land or site value tax.

Our recommendations in this Part are as follows:

- | | |
|-----|---|
| 6.1 | The provision of an up-to-date valuation base for all property and land in Ireland should be addressed as a priority issue. |
| 6.2 | Provide for an annual property tax on all residential housing units with the broad exceptions of local authority and social housing units and some other limited exceptions set out in section 4.2 of Part 6. |
| 6.3 | Stamp duty for purchasers of principal private residences should be zero-rated. |
| 6.4 | Stamp duty should continue to apply to investor purchasers of residential housing units. The rate should be competitive having regard to the transaction tax rates and thresholds that apply across the EU. |
| 6.5 | The windfall gains from increases in land values due to rezoning decisions should be subject to an additional capital gains tax charge. |
| 6.6 | A recurrent property tax on land zoned for development should be introduced. |

Section 1:

Introduction

1.1 Description of the tax system pertaining to property

This Section deals with the taxation of property in Ireland. It gives an overview of the existing tax treatment of property, and then sets out our assessment of how the system should be restructured. Tax expenditures relating to the ownership and use of property are dealt with in Part 8 of our Report. Some of these expenditures are referred to in the following overview.

1.2 The tax treatment of property

Capital gains tax (CGT) is payable on chargeable gains on the disposal of assets including property. The rate is 25%¹. A higher rate of CGT on gains arising from the sale of development land applied from 1982 to 1999. A significant exemption from capital gains tax is the gain accruing from the disposal of a principal private residence.

Capital acquisitions tax (CAT) applies to property received as a gift or inheritance. Gifts and inheritances of a value over a threshold, determined by reference to the relationship of the beneficiary to the donor or the deceased, are charged at a rate of 25%. The threshold for a son or daughter is currently €434,000 with lower thresholds for siblings, nephews and nieces, parents and grandchildren (€43,400) and others (€21,700). Significant reliefs apply where the donee or successor receives agricultural land and in such cases the market value of the property is reduced by 90%. A similar relief applies to business property acquired by gift or inheritance.

Stamp duty – This has been a primary source of Exchequer revenue from property in Ireland. It is an *ad valorem* duty where a property, or a lease on a property, is conveyed from one owner or leaseholder to another. It can be classified as a transaction tax and can be a buoyant, but volatile, source of revenue. Different rates of stamp duty apply to the residential and non-residential sectors. The duty is not applied uniformly to all residential housing. Firsttime buyers of new and second-hand houses for owner-occupation are exempt as are most buyers of new houses.

Income tax – Mortgage interest relief for principal private residences is provided at source for owner-occupiers subject to annual limits on the interest amounts – the rate is 15% for non-first time buyers, with firsttime buyers subject to a limit of 25% in years one and two, 22.5% in years three, four and five and 20% in years six and seven. The relief is available for the first seven tax years of a mortgage.

Profits or gains arising from rent received in respect of property located in Ireland are charged to income tax under Schedule D Case V². The interest deductible in calculating income from rented residential properties is, since 7 April 2009, restricted to 75% of the interest accrued. No restriction applies to interest on loans for commercial property.

VAT – VAT is chargeable at 13.5% on the sale of property in the course of business (for a maximum period of five years after completion of the building). Sales of properties are otherwise exempt unless the vendor chooses to make the sale subject to VAT. VAT is not chargeable by a private individual who sells a house in which he or she has lived. The letting of property is exempt

¹ Having been increased from 20% to 22% in Budget 2009 and to 25% in Supplementary Budget 2009.

² Rental income from property in overseas locations is taxed under Schedule D Case III.

from VAT. However, in most cases (excluding the rental of residential properties), the landlord can “opt to tax” the rent in which case VAT is chargeable at the 21.5% VAT rate.

Commercial rates – This is a local tax assessed on the net annual letting value of commercial and industrial properties and is used to fund local authorities. It is paid directly to local authorities. It is the only recurrent tax on property in Ireland and yielded €1.344 billion for local authorities in 2008. See Part 11 of our Report for a fuller discussion of commercial rates.

Development contribution schemes – These are another source of funding for local authorities. Contributions are struck at a rate or level which the local authority determines (and this is a reserved function of the elected representatives). These contributions are payable by persons carrying out development on foot of planning permissions and are intended to provide an appropriate contribution towards the capital cost of public infrastructure and facilities.

The charge on non-principal private residences – The Local Government (Charges) Act 2009 introduced an annual charge of €200 on non-principal private residences. Liability for the charge arises mainly in respect of rental, holiday and vacant properties with the revenue stream going to local authorities.

1.3 Previous residential property taxation systems

A number of forms of domestic property tax applied to residential housing in the past, notably imputed rental income tax, domestic rates, residential property tax and farm tax.

Imputed rental income tax

Prior to 1969/70, income from the ownership of buildings was charged to tax on a notional basis under Schedule A of the Income Tax Act. This tax was effectively an ‘imputed rental income tax’. Schedule A of the Income Tax Act 1967 provided that income from the ownership of buildings was calculated on a notional basis and charged to tax – either on five-fourths of the rateable valuation under the Valuation Acts or the valuation itself, less, in certain circumstances, a small fraction for repairs. This provision covered two types of income: income derived from the letting of property and income imputed to the owner-occupier of a property. This provision was abolished in 1969.

Domestic rates

The domestic rates system was a local property tax on residential housing and was used to fund local government. The tax was based on the valuation of the house. The valuation basis dated back to the mid-19th century and used the net annual valuation of the property. The amount of the tax was contingent on the ‘rate in the pound’ struck by the local authority which was in turn based on the amount of revenue required by the local authority for its annual budget. The system was much criticised for two reasons: firstly, it was based on an antiquated valuation system that was inequitable; secondly, the burden of taxation increased rapidly, with rates in most areas increasing more rapidly than incomes or inflation. The domestic rates system was abolished in 1978.

Residential property tax (RPT)

This was an annual tax introduced with effect from 5 April 1983³ and provided that all relevant residential property owned by an assessable person was charged to tax at a rate of 1.5% where the market value of the property exceeded a limit (which was increased annually in accordance with the

New House Price Index) and the income of the assessable person exceeded a limit. The tax was never a source of significant revenue for the Exchequer and generated only €17 million in revenues in 1996, the last year it operated. It was abolished with effect from 5 April 1997.

RPT was a national tax that applied to all residential properties. However, the number of assessments raised in any year was never more than just over 20,000 (except for 1994 when a flat rate was introduced) because of the income and house valuation threshold exemptions that applied. In 1996, the last year that the tax applied, the total number of households in the country was 1,123,200⁴. The total number of RPT assessments that year was 21,499, representing just less than 2% of all households.

Farm tax

A farm tax was introduced with effect from 1986 and was based on a concept of 'adjusted acreage'. It contained an amalgam of income tax and property tax elements. It was abolished the following year. The proceeds of the tax were intended to form part of the income of local authorities.

Section 2: How the taxation of property should be restructured

2.1 Overview of our proposals

An annual property tax

We recommend that there should be a new configuration of taxation of property in Ireland, including an annual property tax that provides recurrent and sustainable revenue for the Exchequer and, in due course, for local government financing.

Annual or recurrent taxes on immoveable property are a common feature of tax systems in most industrialised and developed countries.

We consider that as a matter of general principle all property should be subject to recurrent taxation – either through the local government commercial rates system or an annual tax on residential property, which we are proposing. Such an annual property tax should form a key part of broadening the overall tax base. We consider that an annual property tax (APT) should be implemented at the earliest possible date, taking account of the very significant administrative challenge for the Revenue Commissioners who will have to develop an assessment, collection and accounting system.

In this context it is appropriate to move away from an undue reliance on stamp duty – where the tax revenues are contingent on the level and value of property transactions. There are significant benefits to moving to a more stable tax base, which provides for a reliable revenue stream and a sustainable source of Exchequer funding.

In developing an annual property tax structure we consider that having a very wide tax base is vital. An important lesson to be learned from the residential property tax system that operated between 1983 and 1997 is that an overly narrow tax base led to an insignificant revenue flow for the Exchequer, high administrative costs and a perception of inequity.

Tax on windfall gains

We are recommending that the windfall gains that arise from increases in land values due to rezoning should be subject to an additional capital gains tax charge. We consider that the 'betterment' which arises to land-owners from decisions made for the common good, such as land rezoning or the provision of physical infrastructure, should be subject to an increased level of taxation.

Recurrent tax on zoned development land

We are proposing a recurrent tax on zoned development land where such land is not being developed. This will be a useful policy tool to address the hoarding of land-banks and help to ensure that land is utilised in accordance with its planning categorisation.

Land or site value tax

We are not recommending a land or site value tax at this time. A land or site value tax is a recurring tax on the land value of a property. No tax is levied on the buildings or improvements that are on the land. We consider that there is a strong economic rationale for land value taxation. However, we believe that it is not a pragmatic approach to the restructuring of our property taxation system right now. There are very difficult hurdles to be crossed in moving to the valuation system that would be required to implement a land or site value tax system. There would also be significant difficulties in communicating to home-owners and land-holders the nature of the taxation charge that is involved and the benefits that would accrue from that change. Our proposed recurrent tax on zoned development land is consistent with many of the principles of a land or site value tax.

2.2 Rationale for an annual property tax on residential property

The rate of economic growth – and associated tax revenue flows – over the next decade is expected to be lower than in the period to 2007. An over-reliance on expenditure and transaction taxes has resulted in tax revenue dropping more quickly than (nominal) GNP. As we outline in Part 4 of our Report we consider that a rebalancing of the existing tax system to provide for a more stable tax base is desirable. An annual property tax will help achieve this. Such a change is required to meet the challenges presented both by the current economic landscape and by the demographic pressures that will arise over the coming decades. In addition, the restructured property tax system that we propose will reduce economic distortion arising from the present emphasis on transaction-based property taxes.

Table 6.1 The yield from stamp duty from residential housing since 2000

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
€m	€m	€m	€m	€m	€m	€m	€m	€m	€m
282	265	349	528	752	945	1,311	1,018	445	85*

**to end June*

We also consider that, in a small open economy such as Ireland, less mobile factors of production, such as property, are particularly appropriate to include in a tax base in the context of increasing globalisation.

The submission we received from the Department of Finance pointed out that:

“... rewarding of work and enterprise are proven elements in Ireland’s successful economic convergence. Taxes on property and capital are relatively low.... These treatments reflect a series of policy decisions taken in the past on foot of conclusions reached on the economic and social consequences of such treatment. A fresh look at these issues is appropriate”.

The National Economic and Social Council (NESC) in its June 2008 strategy report⁵, stated that:

“Current pressures on revenue, and several long-term economic and social considerations, suggest that thought be given to reforms of the tax system that would make it more supportive of Ireland’s goals. In particular, the Commission on Taxation should examine the possibility of replacing stamp duties with a more sustainable and equitable form of property tax. It may be possible to design a system of property tax which yields a less volatile revenue stream than stamp duties, which better supports an active housing market and high-quality physical planning and which is more consistent with Ireland’s goal of relying on creation of high-value goods and services in a high-participation society”.

2.3 Timing

The timing of any change in policy direction on the taxation of residential property is a very sensitive issue. However, it is arguable that such a change is less difficult at a time when the residential property market is at or near the end of a downturn in the economic cycle. Over the period 2003 to 2007 tax revenues from property-related transactions were buoyant due to price inflation and much increased activity in the commercial and residential property sectors.

The current tax base from residential property is now relatively limited because it depends on stamp duty revenues from investors and from the sales of second-hand houses to non-first time buyers. Developing an annual property tax that helps restructure property taxation would, in our view, create a sounder base from which the property market can develop, particularly when taken with other compensating measures such as the zero-rating of stamp duty on owner-occupied properties.

2.4 The rate of annual property tax

The rate of a property tax is a matter for Government. However, we consider that there are two factors that should be taken into account in setting a rate to replace, in a stable property-tax system, the volatile flows from stamp duty. These are:

- The tax revenue flow that should be replaced should not reflect the windfall receipts from stamp duty which arose from the rapidly growing property market during the period 2003 – 2007
- The need to finance waivers for those on low incomes

2.5 The impact of property tax proposals on economic activity

Our examination of property taxation measures had regard to the following:

- Annual taxes on land and buildings have a small adverse effect on economic performance:
 - The tax does not directly affect the decision to supply or demand labour
 - The tax base is stable and tax revenue from this source is predictable, and
 - The tax base is immobile, and is therefore less likely to distort economic behaviour

⁵ The Irish Economy in the Early 21st Century, NESC, No 117, June 2008.

than labour or capital taxes

- A transaction tax, such as stamp duty, discourages people from buying and selling houses and so may discourage them from moving to areas where labour is in greater demand. The tax works against the efficient use of the housing stock
- The behavioural effect of imposing an annual tax on property is difficult to assess. The property tax may encourage investors to acquire property abroad although we consider this unlikely given current economic conditions, the changing approach by lending institutions to lending for property investment and the fact that any property abroad is likely to be subject to a local property tax. Alternatively, an annual property tax may encourage investors to redirect their capital to more productive sectors of the economy – which would be a desirable consequence
- Taxes on property could contribute to the more efficient use of under-developed land through, for example, higher recurrent taxes on vacant property and on under-developed zoned land
- An annual property tax will help the State to share in the increased value of residential housing that arises from its provision of public infrastructure in some areas – for example, the increased house price values that arise from the provision of suburban rail facilities

2.6 The need for an up-to-date and consistent valuation database

Options for the future taxation of property in Ireland are constrained by the absence of an up-to-date valuation database on which an annual property tax (or indeed a land value tax) could be based. This is a policy failure that deserves early attention. We consider that the development of a valuation base for all residential, business, commercial and industrial property in Ireland is a matter which should be addressed in order to provide policy options to broaden and secure the tax base in Ireland for the future. An up-to-date valuation database will also provide a database against which self-assessed property tax returns can be checked as part of the monitoring of our proposed annual property tax by the Revenue Commissioners.

Recommendation 6.1

The provision of an up-to-date valuation base for all property and land in Ireland should be addressed as a priority issue.

Section 3: Proposals for a restructured system of property taxation

3.1 Overview

Our proposals for a restructured system of property taxation comprise four elements:

- An annual property tax on residential housing units
- Stamp duty for purchasers of principal private residences is zero-rated
- Stamp duty on residential housing units purchased for investment purposes is applied at a rate that takes account of the transaction tax rates and thresholds that apply across the EU
- The property tax base is widened through the provision of:
- An annual property tax on zoned development land, and

- A higher rate of CGT on profits or gains from the sale of development land

This approach is consistent with our approach to widening the commercial rates base (see Part 11 of our Report)

3.2 Elements of an annual property tax (APT) on residential housing units

In summary our proposals for an annual tax on residential properties are as follows:

- An annual property tax should be applied to each residential property in Ireland – with the broad exception of houses rented from local authorities and social housing providers and some other limited exceptions set out in section 4.2. As the tax will apply to rented properties, second homes and holiday homes, it should replace the €200 levy introduced in 2009 as a source of finance for local authorities
- The annual property tax should be calculated by reference to valuation bands within which a property owner would value his or her house. Our rationale is that there should be certainty about the tax base. Therefore, the classification of a property for the tax should be easily determined
- The tax should be paid by the owner
- Self-assessment is an appropriate method of assessment for the tax subject to appropriate monitoring and audit mechanisms
- The property tax should have as wide a range of payment options as is feasible
- The tax should be administered by the Revenue Commissioners

In making these proposals, we are aware of two issues which we consider are important aspects of an APT on residential property:

- Firstly, the necessity of developing a tax that could be introduced in the absence of an accurate and up-to-date valuation database, and
- Secondly, the provision of a scheme to mitigate the impact of the recurrent property tax on low-income house owners, including those with relatively low incomes and large, more valuable houses.

These issues underpin our approach to the development of an annual property tax.

Our detailed design proposals for the tax are set out at Section 4 below.

Recommendation 6.2

Provide for an annual property tax on all residential housing units with the broad exceptions of local authority and social housing units and some other limited exceptions set out in section 4.2 of Part 6.

3.3 Reform of stamp duty

Purchasers of principal private residences

The application of stamp duty on some residential housing transactions does not provide a stable revenue base for the Exchequer as the revenues are far too strongly influenced by the housing cycle. This can result in significant windfall receipts from stamp duty during a housing boom and far smaller revenues once the housing market contracts. As we point out in Part 4 of our Report, this

is a structural weakness in the capital tax base that needs to be addressed. In contrast, an annual property tax on residential housing units would provide for a far more stable revenue base.

Stamp duty reduces the efficiency of the property market as it is the most significant part of transaction costs that determine the difference between the price that a buyer pays for a property and the price that the seller receives. This inefficiency can be clearly seen from the perspective of a seller who wishes to 'trade-down'. It is likely that the high levels of stamp duty payable by the purchaser reduces the price received for the house by the vendor. The fact that an individual trading down will themselves most likely have to pay stamp duty on a further house creates an additional degree of 'lock-in'.

As indicated in section 2.5 above, stamp duty may also discourage people from moving to areas where labour is in greater demand.

Investor purchasers of residential housing

We also considered the question of stamp duty on housing units purchased for investment. We consider that the impact of zero-rating residential housing purchased for investment would shift the tax burden that currently falls on investors and some owner-occupiers (who now pay stamp duty on house purchases) to all investors and owner-occupiers including first-time buyers and purchasers of new houses who do not pay stamp duty at present. This would result in a gain (no stamp duty liability) for an investor whilst a first-time purchaser of a principal private residence would have no corresponding stamp duty saving but will have to pay annual property tax. The implication of such a shift is that the tax burden would in a relative sense fall less on investors. It would also mean that investors would be incentivised to focus on investment in residential property and move away from investment in commercial property.

This has the potential to create an undesirable distortion in the overall property market and to have an adverse impact on supporting economic activity if it moves investment away from more productive sectors of the economy.

To ensure that there is appropriate long-term investment in the rented residential housing sector, it is important that the stamp duty rates applicable to housing purchased for investment should not be a barrier to entry to that market. Applying the stamp duty regime applicable to commercial property would not be appropriate as it would result in an increased charge for most purchasers. A lower rate, which would not discourage investment, is appropriate.

Conclusion

Reducing the Exchequer reliance on stamp duty revenues and providing for a more stable revenue base through an annual property tax leads us to the conclusion that stamp duty on owner-occupied residential housing should be zero-rated. We consider, however, that stamp duty for purchasers of principal private residences should begin to be zero-rated only when the annual property tax becomes operational. We also conclude that stamp duty should remain applicable to investors purchasing residential properties. A comparison of stamp duty levels across the EU is difficult because of the interaction of thresholds and rates. However, our view is that the rate that should apply in Ireland should be competitive having regard to the rates of stamp duty and thresholds that apply across the EU so as not to discourage purchasers from purchasing residential housing in Ireland.

Recommendation 6.3

Stamp duty for purchasers of principal private residences should be zero-rated.

Recommendation 6.4

Stamp duty should continue to apply to investor purchasers of residential housing units. The rate should be competitive having regard to the transaction tax rates and thresholds that apply across the EU.

3.4 Broaden the property tax base

In Part 4 we outline our view that, in determining the balance of taxation which will deliver the strongest economic growth, any approach to revenue-raising should focus firstly on base broadening within each tax head. In Part 11 of our Report, we look at options for broadening the base for commercial rates.

However, there are two other specific areas where we propose changes to the taxation of property - windfall gains from 'betterment' of land arising from increased land values from rezoning decisions and a recurrent tax on zoned development land that is not developed.

Windfall gains from 'betterment'

The windfall gains arising from increases in land values due to rezoning decisions should be subject to an additional capital gains tax charge. This is often called 'betterment' or 'value capture' as the increase in property values as a consequence of: planning decisions made by local authorities, typically the rezoning of agricultural land for residential use; the provision of physical infrastructure by local authorities (and other agencies such as the Railway Procurement Agency and the National Roads Authority) and the provision of social infrastructure in an area.

In this respect we recommend that the CGT rate on such windfall gains arising from rezoning decisions, and where the proceeds of disposal reflects the 'hope' or expectation of the land being rezoned, should be increased on the part of the gain that consists of the difference between the sale price of the land and its 'current use value' at the time of its sale.

Recurrent property tax on zoned development land

A recurrent property tax on all land zoned for development should be introduced where the land is not being developed. The recurrent tax should be applied to land rezoned for all types of development. Such a tax would be a useful policy tool to ensure that developers do not hoard land-banks and that land is utilised in accordance with its planning categorisation. We recognise that the design of such a proposal would be difficult and would have to address some anomalies. For example, a farmer owning such property who intends to keep farming should not face such a tax.

We also suggest that each local authority should decide when the recurrent tax should commence having regard to the services available to the rezoned land. In other words, the rezoned land should not be subject to the tax immediately following rezoning but should be subject to the tax as soon as it is capable of being developed, making reasonable allowances for the delays that can occur in the planning process and which are outside the control of the landowner.

Recommendation 6.5

The windfall gains from increases in land values due to rezoning decisions should be subject to an additional capital gains tax charge.

Recommendation 6.6

A recurrent property tax on land zoned for development should be introduced.

Section 4:

The main features of the proposed annual property tax on residential housing

The following are the main components of what we consider should form the design of an annual property tax scheme.

4.1 The annual property tax should be applied to all residential housing units

The proposed annual property tax should have as broad a tax base as is feasible and few exemptions from liability to the tax should be allowed. These exemptions are outlined in section 4.2.

The tax should apply to all residential housing units including holiday homes, second homes and houses that are let or available for letting. It should also apply to vacant houses (subject to some time-limited exemptions set out below) and to bed and breakfast and guesthouse accommodation (where these are not brought within the commercial rates base as a result of our recommendations in Part 11 of our Report).

4.2 Exemptions

The only exceptions to the principle that all residential property be subject to the proposed annual property tax should be as follows:

- Local authorities and other social housing providers (such as Respond and Alone)
- Residential facilities provided solely for the purposes of caring for the elderly or for disabled persons (such as care facilities or nursing homes)
- Residential facilities provided for the exclusive purposes of the provision of education (such as boarding school accommodation)
- Residential facilities provided exclusively for charitable purposes by registered charities (for example, accommodation services provided by Focus Ireland or the Simon Community)

These exemptions are similar to those provided for in the commercial rates base.

4.3 The chargeable housing unit

The annual property tax should be applied to the residential housing unit and garden or grounds of up to one acre (exclusive of the area on which the house is built). The tax should be applied on the gross value of the property without regard to borrowing to fund its purchase.

4.4 The annual property tax should be payable by the owner of the property

- Owners and others beneficially entitled in possession (such as those with a life interest) should be liable for the tax

- Owners of affordable homes, which are initially part-owned by the State, should be subject to the tax. However, the tax should be pro-rated according to the ownership share held by the owner-occupier (but without regard to the owner-occupier's borrowing to purchase the equity in the house)
- Owners of residential housing units that are rented should be liable for the tax
- In the case of a residential housing unit that is held under a lease, agreement or licence, which has more than 50 years to run, the lessee (rather than the lessor) should be liable for the tax

4.5 The annual property tax should be self-assessed

We consider self-assessment is an appropriate method of assessment for the tax, subject to effective monitoring and audit mechanisms. Self-assessment is greatly simplified by the banding of valuations as suggested in Table 6.2 below.

We acknowledge that direct assessment would provide greater certainty for taxpayers. However, in our view, it is not capable of being implemented within an appropriate time-frame due to the lack of an existing valuation database for residential properties.

To assist the introduction of the tax, each householder who is liable to pay the tax and who gets a professional assessment of the value of his or her property should get a tax credit of up to €75 in the first year to compensate for costs incurred.

4.6 The annual property tax should be calculated by reference to the market value of the property using the valuation bands along the lines suggested in Tables 6.2 and 6.3.

We examined market value and floor space as possible bases for the tax. We consider that using floor space alone as a base for the tax would offend the principle of equity. A residential property owner who lives in or owns a 1,200 square foot house in an affluent area should pay more tax than one who lives in a similar sized house in a less affluent area.

We also considered using a combination of floor space and market value as the tax base. The introduction of a new annual property tax will be a significant challenge for Government, who will have to convince taxpayers that it is an appropriate policy approach. For this reason, the rules that govern the assessment and calculation of the tax should be as simple as possible so that taxpayers can calculate their tax with reference to as few parameters as is feasible. We consider that the application of floor space in addition to the market value would add undue complexity for householders liable to pay the tax.

There should be a fixed valuation date, set at a date in advance of the commencement of the tax, so that all house-owners self-assess at the same time.

4.7 Illustrative tables

Tables 6.2 and 6.3 set out a potential yield for an annual property tax using a distribution of houses by valuation bands based on 2004 house price data⁶. They apply tax rates of 0.25% and 0.30% to the mid-point of the valuation band – these rates are for illustrative purposes only. Other rates will achieve lesser or greater yields. The setting of the rate is a matter for Government.

6

We use 2004 house price data (and house price distribution using the number of housing units in 2009) as being broadly equivalent to house prices at the time of writing. Data sourced from the Department of the Environment, Heritage and Local Government housing statistics.

The following assumptions are made in the tables:

- A waiver rate of 25% (for valuation bands A – E) broadly reflects the proportion of the workforce that is now on the Live Register
- A waiver rate of 10% is assumed for those in valuation bands F and G
- 136,000 local authority houses are excluded from valuation bands A and B but are included in the overall total of 1,934,000 houses, and
- A projected yield for Band H is not ascertainable in the absence of values for houses in this category

Table 6.2 – applying a tax rate of 0.25% to the midpoint of the valuation band

	Valuation band	No. of houses	Charge per property	Projected gross yield	Waiver	Net yield
	€		€	€m	€m	€m
A	0 - 150,000	140,000	188	26	7	19
B	150,001 - 300,000	1,165,000	563	656	164	492
C	300,001 - 450,000	330,000	938	310	78	232
D	450,001 - 600,000	120,000	1,313	158	40	118
E	600,001 - 750,000	30,000	1,688	51	13	38
F	750,001 - 1,000,000	11,000	2,188	24	2	22
G	1,000,001 - 1,500,000	2,000	3,125	6	1	5
H	1,500,001 and higher	1,000	MV x 0.25%	–	–	–
	Total	1,934,000		1,231	305	926

Table 6.3 – applying a tax rate of 0.30% to the midpoint of the valuation band

	Valuation band	No. of houses	Charge per property	Projected gross yield	Waiver	Net yield
	€		€	€m	€m	€m
A	0 - 150,000	140,000	225	32	8	24
B	150,001 - 300,000	1,165,000	675	786	197	589
C	300,001 - 450,000	330,000	1,125	371	93	278
D	450,001 - 600,000	120,000	1,575	189	47	142
E	600,001 - 750,000	30,000	2,025	61	15	46
F	750,001 - 1,000,000	11,000	2,625	29	3	26
G	1,000,001 - 1,500,000	2,000	3,750	8	1	7
H	1,500,001 and higher	1,000	MV 0.30%	–	–	–
	Total	1,934,000		1,476	364	1,112

Calculating the charge

For the suggested approach a house-owner, on a self-assessment basis, declares that his or her house is in a particular valuation band. The flat charge that is applicable to that band is applied to the property.

For houses valued at more than €1.5 million (Band H) the actual market value of the house is multiplied by the tax rate, for example, a house valued at €3 million will have a property tax liability of €7,500 at a rate of 0.25% or a property tax liability of €9,000 at a rate of 0.30%.

4.8 The annual property tax should be supported by an accessible valuation database

Information on the location and valuation of property and similar information on the sale or transfer of property should be published online in a database of residential property. In this way all residential property owners can obtain up-to-date information on actual and reported values in their area and distortions in reported valuations should be apparent. This is particularly important in a self-assessment system. Such a database could also assist in the development of a property appreciation index, which could assist self-assessors to value their house for tax purposes. This information is routinely available in jurisdictions (including Northern Ireland) applying an annual tax to residential property.

4.9 The annual property tax should be proportionate

We considered a flat charge per property but rejected it as inequitable. We consider that owners of more valuable properties should pay more tax than those who own less valuable properties.

As can be seen from Tables 6.2 and 6.3, the banded valuation system we are proposing provides for a proportionate system of taxation with owners of more valuable properties paying proportionately more than owners of less valuable properties. Because of the use of valuation bands, the proportionality can only be approximate. However, we believe that the suggested banding approach has significant advantages and will ease compliance for taxpayers.

We also considered but rejected a progressive tax as it would be more difficult to administer than a proportionate tax using valuation bands.

Recognising the fact that very valuable houses may be difficult to categorise within valuation bands, we consider that owners of houses valued at more than €1.5 million should be required to provide a valuation for their house and apply the tax rate to that valuation to calculate their liability – see Tables 6.2 and 6.3.

4.10 An annual property tax should have regard to ability to pay

All residential housing units – with the exception of local authority and social housing provided units – should be liable to the tax. However, account must be taken of cases where there is inability to pay.

- A general waiver provision exempting house-owners under a low income threshold should be provided. The onus should be on the taxpayer to seek a waiver. The income threshold should have regard to criteria such as long-term social welfare rates and the annualised minimum wage
- In other cases where there is inability to pay, and by election of the taxpayer where

appropriate criteria are met, the tax could be deferred and recovered when the property is subsequently sold or transferred. Where a liability is deferred, interest should apply at a rate equivalent to the time value of money and not the rates applicable to outstanding taxes. The principal target group for this deferral option is those on lower income with valuable properties who lack the cash resources to finance an annual tax

- There should be a 10% reduction for owner-occupiers where the principal income earner in the household has a substantial and permanent disability

We considered whether a minimum charge should apply which would not be subject to deferral. Whilst such an approach would protect the tax base and reduce the Exchequer cash-flow loss from deferrals, we considered that it should not form part of the initial implementation of our proposals. However, a provision of this nature could take effect at a future date (for example, after five or ten years), subject to review of the operation of the tax after its implementation.

4.11 The annual property tax should be administered by the Revenue Commissioners

We consider that the Revenue Commissioners should administer the tax – it has the appropriate expertise to administer taxes nationally.

4.12 The annual property tax should be a national tax for use as a source of local government financing

At present second homes and houses held as investments are subject to a levy of €200 which accrues to the local authority. Our proposal to impose an annual property tax on all residential housing would involve removing this levy.

In Section 5 of Part 11 of our Report we recommend that, after an appropriate introductory period, all of the revenues from an annual property tax should be used for local government financing and that, by no later than the next local elections (June 2014), rate-setting powers should be devolved to local government (subject to considerations we set out in section 5.3 of Part 11).

4.13 Provision should be made for an exemption from the annual property tax for purchasers of principal private residences who paid stamp duty during the previous seven years

We consider that this is an important transitional arrangement for purchasers of principal private residences who paid high rates of stamp duty. They would be exempted from paying the annual property tax for a seven year period from the year they paid stamp duty.

This provision reflects the reality that many home-owners paid considerable amounts of stamp duty, particularly over the period early 2000s to 2008. However, we consider that the exemption should not be open-ended and that all house-owners should be liable for an annual property tax after the suggested seven-year period.

4.14 The proposed annual property tax should be applied to vacant housing units

We consider that the annual property tax should be applied to all housing stock, including vacant units. We consider that applying it to vacant houses is preferable to exempting vacant houses as it would incentivise the sale and/or use of those properties and this represents a better economic outcome. There are two exceptions to this:

- Firstly, the trading stock of a builder should be exempted and it will be necessary for this purpose to set criteria distinguishing between such stock and a house available for occupation, and
- Secondly, there should be a time-limited exemption (of no more than, say, twelve months) to avoid a double charge for owner-occupiers who have moved to a newly acquired housing unit and are unable to sell their previous residence (which remains unoccupied)

We considered providing for a time-limited exemption provision for vacant property to deal with the property overhang that is particularly apparent in some areas. However, we decided not to recommend such an exemption. We consider that the imposition of an annual property tax could incentivise the use of property whereas an exemption would more likely lead to property remaining vacant. However, we recommend that in cases of hardship the tax liability that would fall due in respect of vacant houses could be deferred for a period with interest applying (equivalent to the time value of money).

4.15 The Revenue Commissioners should have access to data on house-ownership held by agencies providing public utility services and other public sector organisations

The Revenue Commissioners administration of the proposed tax will be made more difficult by the lack of a database that identifies all residential property. In order to allow the Revenue Commissioners to quickly populate their own annual property tax database they should, in our view, have access to databases which contain details of house ownership and occupation. The Property Registration Authority has a comprehensive record of property ownership. A number of public utility companies and agencies have databases which contain house-ownership data. These include: An Post, Ordnance Survey Ireland (both of whom operate the GeoDirectory), ESB, the Private Residential Tenancies Board (PRTB) and the local authorities.

4.16 To assist compliance with the tax, appropriate monitoring and audit mechanisms should be put in place

As with any self-assessment tax, but particularly so in the case of a new tax such as APT, it is vital that there is a clear understanding from the outset by taxpayers that the tax will be subject to appropriate audit and compliance actions monitoring. The Revenue Commissioners have effective mechanisms in place for this. In addition, the Revenue Commissioners should develop facilities – such as helplines and promotional websites – in advance of the commencement of the tax, to ensure taxpayers are fully informed as to how to comply with the tax.

Other measures which would assist the administration of the tax should be put in place as follows:

- There should be data sharing between local authorities and the Revenue Commissioners so that the latter can update data on residential housing arising from planning applications
- Taxpayers should be required to make a property tax return at least every three to five years and the valuation returned should be used to calculate the tax for the following three to five years. Interim returns should be required when material alterations (such as an extension) are made to a house or a new house is acquired
- Electronic returns should be encouraged as a feature of the administration of the annual property tax

- When a house is sold or transferred, a tax clearance certificate from the Revenue Commissioners should be required to show compliance with the tax. The design of this aspect would need careful consideration including the development of streamlined and automated clearance processes to cater for the majority of tax compliant vendors
- The application of a tax by reference to a valuation date would mean that appropriate relativities between houses could be established by reference to the banding system. The valuation date should be between six and twelve months before the date for submission of the property tax return

4.17 Timing of purchase and liability to pay property tax

Where a house is purchased during the tax year the tax should apply pro-rata between the respective owners.

4.18 A range of payment options should be made available

We consider that a wide range of payment options should be made available to taxpayers. In particular we would like to see PAYE taxpayers have the option to pay their property tax through the PAYE system. The Revenue On-line Service (ROS) should be developed to facilitate on-line payment and the possibility of payment through post offices and banks via direct debit and otherwise should be explored. Payment methods should include periodic (annual, quarterly or monthly) options. Having a range of payment options that avoid a single annual payment should go some way to improving public acceptance of the tax.

Section 5:

Stamp duty on commercial property

We considered whether the rate of stamp duty applicable to commercial properties should be further reduced following the rates reduction provided for in Budget 2009 – (see Table 3.9 in Part 3).

We consider that, whilst the reduction in stamp duty revenues arising from our recommendation to zero-rate residential housing transactions for purchasers of principal private residences can be financed from an annual property tax, there is no scope to finance a reduction in the rate of stamp duty on commercial property through an increase in the annual property tax that already exists on such properties, commercial rates. We do not favour a narrowing of an existing tax base through a reduction of stamp duty on commercial property.

The reduction of the stamp duty rates in Budget 2009 has narrowed the gap between stamp duty rates on commercial property between Ireland and our nearest neighbour, the United Kingdom⁷. We take the view that the rates applicable in Ireland do not differ from rates elsewhere in the EU to such a degree as to merit a further reduction at this time. We also note that transaction costs – including taxes – are not materially higher in Ireland than in most other EU jurisdictions.

The approach to the taxation of commercial property – through stamp duty and commercial rates – should be informed by the principle of bringing a degree of certainty to that market for a longer time period.

⁷ Which has a maximum rate of 4% on transactions of more than Stg£500,000.

At the time of writing, levels of activity in the commercial property market have substantially decreased compared to levels over the past decade or so. There are a number of factors which have contributed to the decline in that market. The primary factor is the worldwide financial crisis, which has led to the withdrawal of financing facilities for commercial property investment.

Conclusion

Stamp duty should continue to apply to commercial property transactions. The rate should take account of the transaction tax rate (and thresholds) that apply to commercial property in other EU jurisdictions, with particular regard to the United Kingdom.

Section 6: Land or site value tax

6.1 Introduction

A land or site value tax is a recurring tax on the land or site value of a property. No tax is levied on the buildings or improvements that are on the land or site. It is therefore different from other property taxes, and commercial rates, where tax is generally applied to the capital or rental value of the property. The basic principle of site or land valuing is that land is valued according to its optimal potential use as defined by the planning authorities. Therefore, a land value tax on a site on which a building is permitted would reflect that value. The tax liability remains the same whether or not a site is utilised in accordance with its planning permission.

6.2 Overview

We consider that there is a sound economic rationale for considering the introduction of a land or site value tax if the problems – outlined below – associated with the practical aspects of its implementation could be addressed. Many of its economic advantages – it is far less distortionary than stamp duty; encourages the productive use of all land; provides for a stable revenue base; and discourages the flow of capital out of more productive areas of the economy into residential construction activity – also underpin our decision to recommend an annual property tax based on capital value.

A land value tax in Ireland may have merit when property registration is recorded under a single system which applies nationally (and no ‘unregistered title’ to land remains) and when all registered property is mapped and a system of valuation can be put in place and is regularly updated.

We consider that, if a land value tax policy proposal were pursued, it would take a number of years to become established and would involve a long and sustained challenge for policy-makers to inform the community of its benefits and to implement the proposal. We therefore recommend that a land or site value tax should not be pursued at this stage.

6.3 Analysis

The basic principle of site or land valuing is that land should be valued according to its optimal potential use as defined by the planning authorities. Therefore, a land value tax on a site on which a building was permitted would reflect this value and hence may encourage the development of land that would not otherwise be developed, or may encourage the earlier development of land.

The site or unimproved land would then form the basis of a property tax. The tax liability remains the same whether a site is left derelict or fully utilised. The principal benefit of a land value tax is the penalty it imposes on a failure to put land to its most efficient use.

It has been argued that the economic case in favour of a land value tax rests not merely on the penalty it imposes on leaving a site vacant or derelict, but on the fact that all suboptimal land use is penalised. However, it would place an additional cost on developers who acquire lots piecemeal for eventual consolidation into a single large development and who allow the existing structures to deteriorate while waiting to consolidate the entire site.

Because the land value tax is based on a valuation where the land or site is valued according to its most remunerative potential use as defined by the planning authorities, it is argued that it can provide a means through which the community or government can tax the benefit that private landholders receive as a result of public or community investments (such as rezoning decisions or the provision of transport infrastructure to an area). NESC, for example,⁸ suggests that it could recoup some of the value created by particular transport investments, such as LUAS or a Dublin Metro.

6.4 Practical considerations: implementation and design of a land value tax

The application of a land value tax on a national, regional or local basis would require a single register of land owners that clearly identifies the land owner, where the site is located and a valuation system that can apply a valuation to the site. These are major challenges.

In technical terms this involves the development of what is known as a cadastre – a comprehensive mapped register of all properties including details of ownership, precise location, dimension and value of all individual parcels of land. The development of a cadastre to form an accurate basis for a land value tax would, in Ireland, require co-operation between a number of public bodies.

Determining an accurate valuation of the site value of land for land value tax purposes would, in our view, be a difficult exercise due to the requirement to distinguish the site value from the value of buildings and improvements. Decoupling the site value from the overall property value would present difficulties. To establish practices and procedures that are acceptable to all would, undoubtedly, take some considerable time to bed down.

One of the most significant challenges presented by a land value tax proposal is the issue of fairness. Taxpayers would consider it very unfair if the same amount of tax was payable in respect of two properties of different sizes, simply because they were located on identical parcels of land. Whilst economically such an outcome might be reasonable we consider that most taxpayers would consider it to be inequitable. Capital values have the advantage of being clearer and more relevant to most householders and business people. In our view, not many people would be familiar with the value of the land on which their property is located.

It is also unclear to us whether a tax based on what could be construed as a theoretical value of the site rather than a value of the property on that site would necessarily be seen as progressive or proportionate.

We are also concerned that a land value tax would involve issues of complexity in valuation which could be a significant obstacle to its implementation. At its most basic level, a land value tax could be

8 The NESC report, *Housing in Ireland: Performance and Policy – Background Analysis 2004*, at 7.4.3.

applied through measurement of the area covered by the ground of a home. Such a basis of valuation would not be sophisticated enough to take account of factors that might influence the value of land locally, such as the provision of schools or transport links or proximity to tourism attractions.

The inclusion of such adjustments, which are necessary for a land value tax, would complicate the valuation process and would be very difficult to communicate to home-owners and land-holders.

We acknowledge that a number of possible methods exist that could be used for the valuation of land parcels for the purpose of a land value tax. However, we consider that no basis of valuation can provide the value of direct and demonstrable supporting evidence that can be presented by using capital values.

The value of land-only transactions is not available in Ireland. Therefore, valuation for the purposes of land value taxation would have to:

- Establish house sales data
- Identify the building value and disregard it
- Identify values relating to the size and location of the land

This is a difficult process and in our view would be likely to lead to much uncertainty about both the definition of land value and the way the value has been calculated.

In addition, the valuation of buildings in multiple occupation or ownership would be problematical. The value for the site of the building would have to be assessed and apportioned among each of the occupiers in the building. Variations in value would arise from different uses within a building (e.g. retail use on the ground floor, office use on the first floor and residential use on the top floor). Whilst there may be robust evidence for capital values relating to such properties, evidence for site values or the apportionment of site values would be most likely either unobtainable or not readily agreed.

6.5 Conclusion

We can see an economic rationale for land value tax. However, we consider that it may not be a pragmatic approach to the restructuring of our property taxation system in the context of the operational difficulties of introducing it and communicating its benefits to home-owners and landholders. We therefore conclude that a land value tax should not be pursued at this stage.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 7

SUPPORTING ECONOMIC ACTIVITY



Part 7:

Supporting Economic Activity — *consider how best the tax system can support economic activity and promote increased employment and prosperity*

Section 1 is an introduction and includes the context within which our deliberations were made.

Section 2 provides an overview of the importance of the corporate tax rate in supporting economic activity.

Section 3 provides key information on employment, labour and the tax wedge.

Section 4 focuses on tax measures to support overall economic activity.

Section 5 covers specific activities and sectors.

Appendices 1 and 2 contain supplementary information.

Our recommendations in this Part are as follows:**Corporation tax**

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| 7.1 | A low stable corporation tax rate should remain a core aspect of Irish tax policy to support economic activity in the long term. |
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Taxes on labour

- | | |
|-----|--|
| 7.2 | A core principle of taxation policy into the medium term should be to keep taxes on labour income, and the labour tax wedge, low in order to reduce the cost of employment and to sustain and stimulate demand for labour. |
| 7.3 | Taxes on labour should be kept low to support economic activity. |
| 7.4 | The degree of progressivity of taxes on labour should take into account the potential economic effects, particularly on job creation and entrepreneurship, as well as equity considerations. |
| 7.5 | Policymakers should take into account the fact that the economic impact of labour taxes is not uniform across the income distribution range and by reference to other demographics. |

Supporting business

- | | |
|------|---|
| 7.6 | The 'corporation tax holiday' for new business should be extended to companies starting out in 2010 or 2011, and a similar scheme should be introduced for the non-corporate sector (see Recommendation 8.65). |
| 7.7 | An optional arrangement should be made available to new non-corporate businesses to allow them to spread their tax payments over the first three years. |
| 7.8 | Stamp duty on all share transactions should be reduced to zero. |
| 7.9 | The tax rate on dividends received by Irish residents should be reduced to the rate applying to deposit interest: <ul style="list-style-type: none"> • The measure should apply to ordinary shares. • Safeguards should be included to ensure that the provision operates as intended. |
| 7.10 | Corporation tax payable on gains on disposal of assets used for trading purposes should be at the rate applicable to trading profits |
| 7.11 | All companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax. |
| 7.12 | The recommendation that all companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax should be implemented having regard to the cash flow costs involved in such a move. In this regard, options might include: <ul style="list-style-type: none"> • Gradually increasing the small company threshold over a number of years, until all companies are covered. • Allowing large companies the option of using a fixed multiple – say 105% – of the previous year's figure. |

7.13	The close company surcharge on professional service companies should be removed.
7.14	The close company surcharge on investment and estate income of companies should be retained. However, the <i>de minimis</i> amount before the provisions come into play should be substantially increased in order to ease the regulatory burden for companies in such cases.
7.15	The Revenue Commissioners should closely monitor the new regime to ensure that it operates as intended.
7.16	The remaining close company surcharge provisions should be examined by the Department of Finance and the Revenue Commissioners to ensure their effectiveness.
7.17	A review should be undertaken by Government to assess the effects of the air travel tax on business in general and tourism in particular. This review should be set in the context of the pending inclusion of air travel in the EU Emissions Trading Scheme (EU ETS) from 2012.
7.18	Taxable income should be computed for business income (Schedule D, Case I and II) based on the accounting profits of a business, with normal statutory disallowances. In particular, we propose that accounts depreciation for tax purposes should replace the capital allowances regime used in business. • In the case of buildings, the new provision should only apply where the buildings qualify for capital allowances under the existing rules (but see Recommendation 7.19). • Businesses should be permitted to change to the new regime at any time in a five-year transitional period. • Existing special regimes should continue.
7.19	The list of buildings that qualify for deductibility for tax purposes should be extended.

Supporting sectors and activities

7.20	Companies should, at their option, be permitted to offset their R&D tax credit against their employer PRSI costs.
7.21	Unilateral credit relief for foreign withholding tax on royalty payments should be extended to all trading companies.
7.22	An overall foreign pooling system for foreign withholding tax on royalty payments should be introduced.
7.23	Persons who are made unemployed should be entitled to offset the retraining costs they incur on certified training courses against income for the previous six years.
7.24	The partial reintroduction of the remittance basis in the Finance (No. 2) Act 2008 should be discontinued.
7.25	A carefully targeted tax incentive, along the lines indicated in Box 7.13, should be introduced to attract skilled persons into Ireland to meet short-term skills gaps.

Section 1:

Introduction

1.1 The supporting economic activity remit

We were invited, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the tax system and specifically to ... *"consider how best the tax system can support economic activity and promote increased employment and prosperity..."*

We were asked to do this against a backdrop of providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term.

We were also asked to have regard to particular commitments in the Programme for Government. Commitments of special relevance to the "supporting economic activity" remit include maintaining the 12.5% corporation tax rate, enhancing the rewards of work and ensuring a flexible, proportionate and modern regulatory framework.

1.2 Broad context of the supporting economic activity remit

The previous Commission on Taxation addressed the role of incentives in economic development in its second report, in March 1984. It placed such incentives in the context of broader economic policy stating that:

"the level and pattern of economic activity is affected much more by the general economic policy of the government than by any set of specific measures labelled incentives."

It espoused a narrow role for taxation incentives, stating that they *"are justified only on very limited grounds"*. These grounds were identified as cases of market failure, competitive concerns with regard to internationally mobile capital investment, and as second-best solutions required to offset shortcomings in other policy areas. This philosophy accords with our recommendations in Part 8, that tax expenditures should only be put in place when one of the following three criteria is met:

1. Correcting market failure
2. Attracting mobile investment, or
3. Offsetting shortcomings in other areas of public policy

This perspective has gained ground among policymakers at home and abroad in the decades since the previous Commission's report. Indeed it is aligned with the terms of reference given to us which focus on how taxation can 'support' economic activity. A well-designed tax system is essential to a well functioning economy, because it ensures that incentives to work, to buy, to invest, and to do business are not unduly distorted by the tax code and rates of taxation.

Tax policies which aim to 'stimulate' or 'drive' certain aspects of economic activity take a different approach by seeking to create incentives in selected sectors/areas, as opposed to minimising the disincentive effect that inevitably comes with taxation.

We affirm this general perspective as appropriate. In particular:

- Firstly, we believe that the best way to achieve low effective tax rates is to broaden the tax base so that tax rates can be kept low. Returning to the previous Commission again: *“if one activity is relieved of its share of taxation then other sectors must bear a correspondingly higher share”* to ensure that the overall level of tax revenue is to be maintained
- Secondly, this perspective highlights a trade-off between supporting overall economic activity and supporting specific economic sectors and activities. We believe that primacy should go to supporting overall economic activity and that tax rates are centrally important in this regard
- Thirdly, we accept that incentives are needed in limited cases. Examples include market failure, attracting mobile investment and offsetting public policy shortcomings as mentioned above. The targeted policy tools that may be appropriate in this regard include:
 - tax reductions (for example, R&D credits)
 - changes in the timing of tax payments, and
 - incentives for investors (for example, BES)
- The fourth issue of importance – which also relates to supporting overall economic activity – concerns the specifics of the tax code. It needs to be internationally competitive – how the Irish tax code compares with those of other jurisdictions has additional consequences for a small open economy with large levels of mobile investment

In deciding “how best the tax system can support economic activity” we considered the key areas of direct tax rates, amendment of the tax code for business, and specific tax incentives to correct market failure and attract mobile investment.

Section 2: Corporation tax

2.1 Introduction

Profits derived by companies from economic activity are primarily subject to corporation tax. This tax yields a significant amount of revenue for the Exchequer, at €5 billion in 2008, down from a peak of €6.7 billion in 2006. The corporation tax rate of 12.5% is a central aspect of Government economic policy. As noted in Section 1, our terms of reference direct us to have regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government, including *“... the guarantee that the 12.5% rate of corporation tax will remain.”* We also note in Part 4 that the 12.5% corporation tax rate is a strong brand for Ireland’s domestic economic activity and inward investment – see section 3.8 of that Part.

In this Section we wish, within our medium to long-term remit, to affirm our own commitment to a low and stable corporate tax rate. We focus on the economic competitiveness issues associated with the corporate tax rate. We begin by looking at international evidence on corporation tax (section 2.2) before turning to the specific circumstances of Ireland (section 2.3). A fuller version of the Section, which contains further analysis of the issues, is presented in Appendix 1.

2.2 International theory and evidence

Overview

Corporation tax influences economic growth by affecting both capital formation and productivity. Corporation tax can have a negative effect on investment (capital formation) by reducing its after-tax return. OECD evidence confirms this at both the firm and industry levels. We focus particularly on mobile investment in the following paragraphs, because Ireland is a small open economy.

Research by the OECD on the relationship between tax and economic growth has highlighted the overall economic impact of corporation tax. It found that, relative to other taxes, *“corporate income taxes appear to have a particularly negative impact on GDP per capita”*.¹ The analysis is part of the rationale for our ranking of tax instruments with respect to their relationship to economic growth presented in Part 4; corporation tax is the least growth-friendly tax in this ranking. We also recognise, of course, that striking the appropriate balance between different tax instruments obviously has important implications beyond supporting economic activity.

Mobile investment

There are many factors that have an impact on mobile investment. These include corporate taxes. Economic evidence suggests that taxes on corporations are a major influence on where mobile investment locates. A literature review by Mooij and Ederveen (2005)² concluded that most of these economic studies find a negative relationship between taxation and foreign direct investment (FDI). There exists a range of estimates of the sensitivity of FDI to tax, the size or elasticity of this relationship, with the average value being -3.72; this is the estimated percentage reduction in FDI in response to a one percentage point increase in the tax rate.

Incidence

It is important from a distributional viewpoint to note that the economic effects of corporation tax are far broader than just the impact on company profits. The concept of tax incidence says that the person who pays a tax does not necessarily bear the economic burden of the tax. The burden of corporation tax falls on the shareholders, the customers and suppliers, or the employees, because all tax burdens are ultimately traced back to individuals.

Recent attempts to measure corporation tax incidence find that a significant part of the effective incidence of the tax falls on wages. To illustrate the scale of this, we note that one study, which uses data on the foreign activities of U.S. multinational firms in more than 50 countries between 1989 and 2004, finds that between 45% and 75% of the burden of corporate taxes is borne by labour, with the balance borne by capital.³

2.3 Irish evidence

Foreign direct investment in Ireland

This international evidence on mobile investment is very relevant to Ireland, given the significant role played by FDI in the Irish economy. A key measure in this regard is the stock of inward

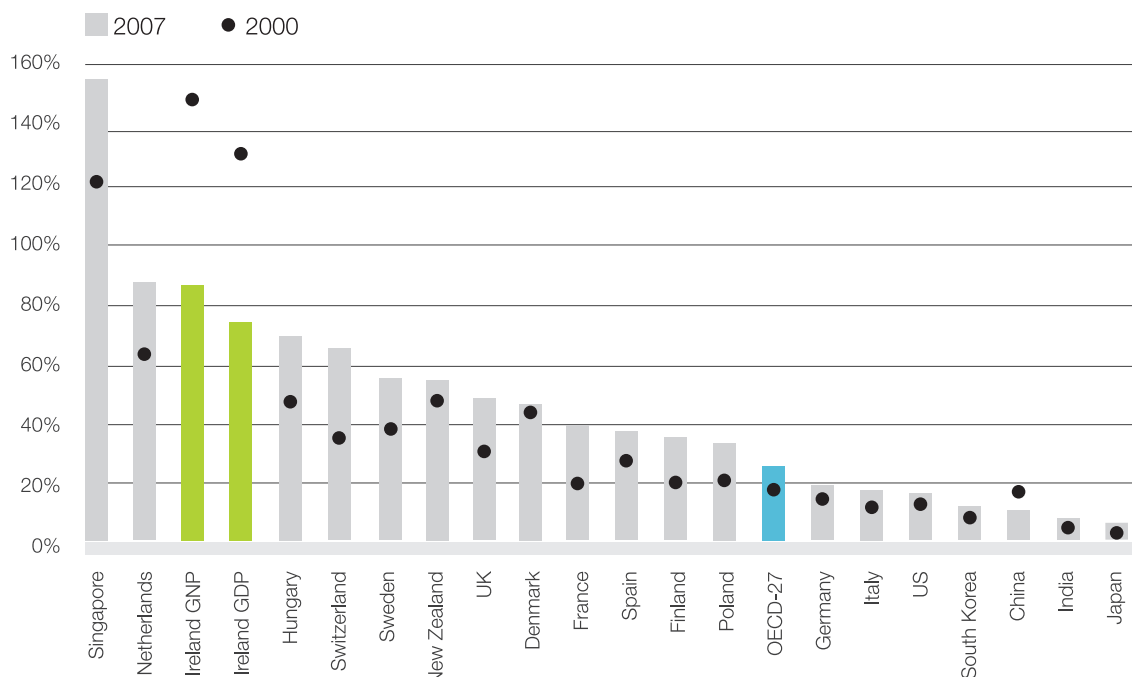
¹ 'Tax and Economic Growth', OECD Economics Department Working Paper No. 620, July 2008.

² See 'Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis', OECD Tax Policy Studies No. 17, 2007.

³ 'Labor and Capital Shares of the Corporate Tax Burden: International Evidence', M.A. Desai, C. F. Foley, J.R. Hines Jr, presented at the International Tax Policy Forum and Urban-Brookings Tax Policy Center conference on *Who Pays the Corporate Tax in an Open Economy?*, 18 December 2007.

investment in Ireland, or the accumulated flow of FDI projects over time. While Ireland's FDI stock, as a percentage of GDP, has declined since 2000, its inward investment levels remain among the highest in the OECD. As shown in Figure 7.1, Ireland ranked third out of 27 OECD countries in 2007 for its stock of inward investment as a percentage of GDP.

Fig 7.1: Stock of inward direct investment (FDI, as a % of GDP), 2007



Source: National Competitiveness Council, 2008.

This large amount of FDI is a significant contributor to the economy. Foreign-owned firms are key drivers of exports, directly employ a significant number of people, have higher rates of R&D, and have a positive impact on the Irish economy through their expenditure.

- Foreign-owned firms assisted by IDA Ireland accounted for 63% of total Irish exports in 2007
- Foreign-owned firms assisted by IDA Ireland employed 153,510 employees in 2007
- R&D expenditure by foreign-owned firms was €1.16 billion in 2007⁴ or 72.4% of total business R&D expenditure in Ireland
- Total expenditure by foreign firms in the Irish economy amounted to €18.1 billion in 2007

The academic literature also stresses the role of FDI in generating technology and knowledge spillovers that can boost the productivity of domestic firms.

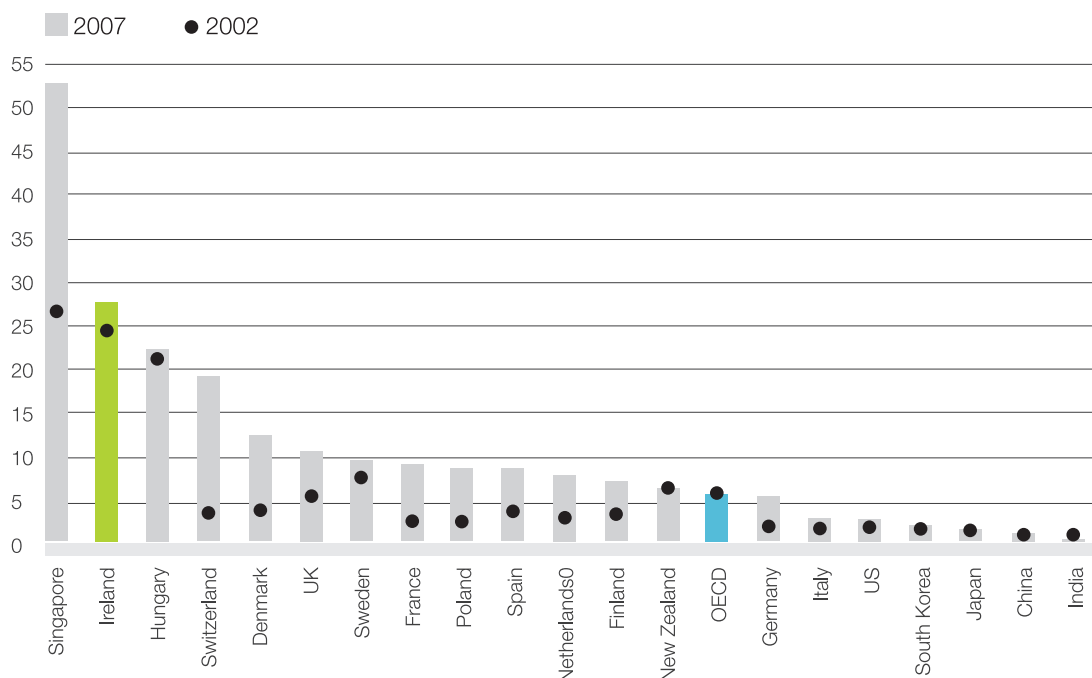
The present situation

The present international trend in tax policy is towards decreasing the rate of corporation tax. The differential between Ireland's rate and that of other countries has narrowed as the average top rate of corporation tax in the EU-15 and EU-27 has declined. Despite this international trend, Ireland still has the lowest corporation tax rate in the EU-15 and the third lowest rate in the EU-27.

International comparisons suggest that Ireland continues to attract a large number of greenfield investment projects relative to its size – see Figure 7.2. We believe that a low corporation tax rate

that is competitive in relation to those of other countries is, and should remain, a core aspect of Irish tax policy.

Fig 7.2: Number of greenfield projects by destination (per million of population), 2007



Source: National Competitiveness Council, 2008.

The attractiveness of Ireland's corporate tax regime will be increased by the implementation of our recommendations in support of economic activity, which are explored in the other sections of this Part.

Recommendation 7.1

A low stable corporation tax rate should remain a core aspect of Irish tax policy to support economic activity in the long term.

Section 3: Taxes on labour

3.1 Introduction

Our terms of reference refer to employment issues twice. In our work we are to have regard to the commitment in the Programme for Government to "keep the overall tax burden low and implement further changes to enhance the rewards of work while increasing the fairness of the tax system", and to "consider how best the tax system can support economic activity and promote increased employment and prosperity".

This Section focuses on taxes on labour. We outline, in turn, the incentive effects of income taxes on labour demand and employment (section 3.2), labour supply (section 3.3) and other aspects of economic activity (section 3.4). We also briefly consider the impact of income taxes on different groups and under different conditions (section 3.5). A fuller version of the Section, which contains further analysis of the issues, is presented in Appendix 2.

3.2 Low taxes on labour and labour demand

Taxes on labour should be kept low to support employment. This crucial link is supported by economic theory and empirical economic evidence, both international and Irish.

The economic theory of the incidence of taxation holds that the person who pays a tax, in an accounting sense, does not necessarily bear the economic burden of the tax. In standard economic models the direct impact of a labour tax is borne by either the employee or the employer depending on how the wage level changes. The tax wedge on labour is useful in illustrating this effect: It is defined by the OECD as:

“the gap between the labour costs the employer pays and the corresponding net take home pay the employee receives”.

Raising labour tax increases the tax wedge resulting in two main effects: (1) an increase in before-tax wages, increasing the cost of employing labour and thus reducing demand for labour and employment; and (2) a decrease in after-tax wages of employees reducing their real take home pay. Thus a key effect of increasing taxes on labour, in theory, is that they reduce the demand for labour and thus levels of employment. Research by the OECD (2006) found that, in 12 out of 17 studies, there was evidence that a higher labour tax wedge increases unemployment.

In the Irish context, there is a need to examine how the supply of labour responds to changes in the wage rate, as this is the key factor determining how the tax burden is shared between the employer and the employee (i.e. where the incidence of the tax falls). In the past Ireland's supply of labour was strongly influenced by emigration (to the UK in particular), such that our labour supply was highly elastic. When labour supply is sensitive to wages, most of the incidence of labour taxes is borne by employers because a decrease in after-tax wage rates (i.e. the alternative where employees bear the burden) could result in an outflow of labour. Academic research confirms that the tax wedge has had a long-run effect on before-tax wages in Ireland, thus increasing labour costs and reducing demand for labour.⁵

It is likely that low taxes on labour have a greater effect on employment in Ireland, than in other countries, because of the nature of Ireland's labour supply explored above. One economic study finds that taxes on labour income are particularly important, relative to other possible economic causes, in explaining Ireland's recent economic history.⁶ Ireland's economic performance between 1973 and 2002 in terms of output and employment is well explained by Ireland's labour tax wedge. Furthermore, the economic importance of the tax wedge in Ireland has increased since Ireland adopted the euro. As a member of a common currency Ireland can no longer devalue its own currency to regain competitiveness when necessary. Instead, any adjustment has to fall on national prices including wages, and we have seen that labour taxes affect wages.

The present situation

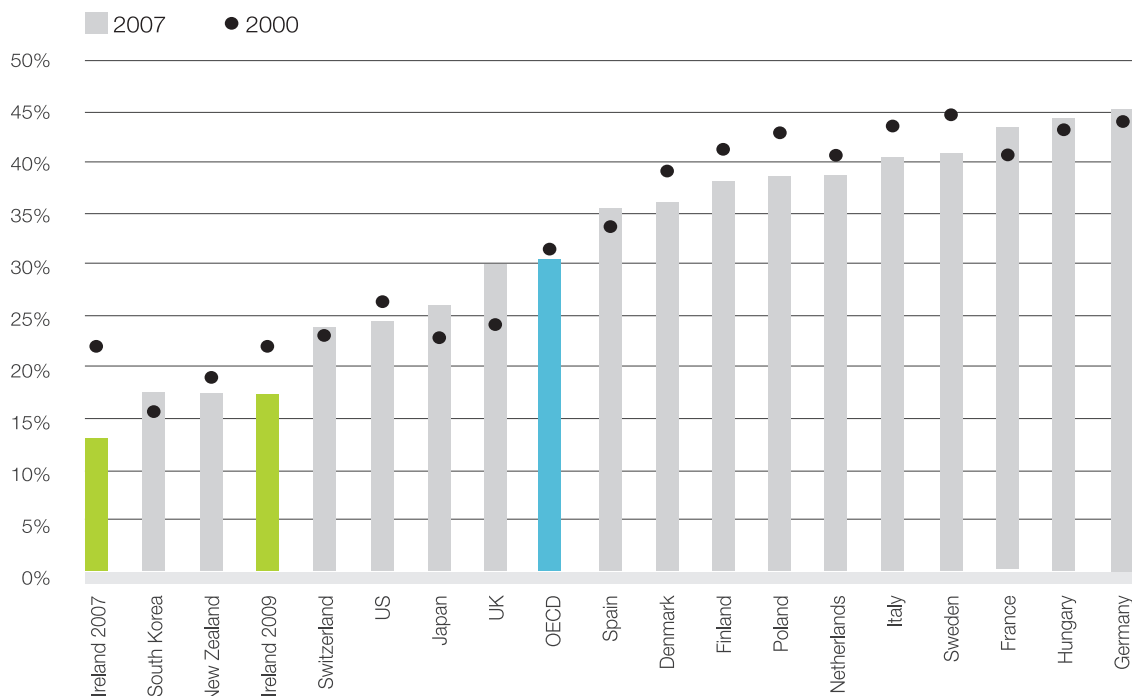
As recently as 2007 Ireland had the smallest tax wedge in the OECD at less than half the OECD average, as illustrated in Figure 7.3. This position has changed in the last two years, and in particular since the April 2009 budget, as Ireland's tax wedge has now increased to approximately 17.4%. This represents a significant 36% increase in the tax wedge in only two years. It reverses the

⁵ 'Wage Determination in Economies in Transition: Ireland, Spain and Portugal', J. Fitz Gerald and J. Hore, ESRI Working Paper No. 147, August 2002.

⁶ 'Ireland's Great Depression', A. Ahearne, F. Kydland, and M.A. Wynne, The Economic and Social Review, Vol. 37, No. 2, 2006.

trend where the value of Ireland's tax wedge had fallen significantly in the last decade, from 25.6% in 1998 to 12.8% in 2007, and at a faster rate than the average OECD tax wedge.

Fig 7.3: Total tax wedge on labour (as a % of average earnings), 2007



Source: National Competitiveness Council, 2008; Ireland 2009 Commission Secretariat's own calculations.

The nature of the Irish labour market changed during the last decade and the effect of the tax wedge may be different in 2009. Recent evidence suggests that the supply of labour is not infinitely elastic in Ireland. It is, however, still more sensitive to wage levels than most international countries. Therefore the impact of income taxes and the tax wedge on demand for labour and employment levels continues to be more significant in Ireland than it is in other countries.⁷ Thus policymakers should aim to keep the labour tax wedge low, in absolute terms and relative to other countries.

Recommendation 7.2

A core principle of taxation policy into the medium term should be to keep taxes on labour income, and the labour tax wedge, low in order to reduce the cost of employment and to sustain and stimulate demand for labour.

In the economic environment that Ireland faces in the short-term, a process has already started where tax revenue is being increased to correct the public finances. With specific regard to the Exchequer contribution made by labour taxes, it has been well documented that the share of overall tax revenues accounted for by labour tax has fallen significantly over the last decade. This does not, however, suggest that further policy changes are needed to increase the share of labour tax. This increase is already happening due to recent tax increases (including levies) and also because of the present economic downturn, where the revenue from labour taxes is decreasing at a slower rate than that of other taxes.

The total tax wedge on labour is composed of income tax and social security contributions from

both employees and employers. Employers' social security contributions (employer PRSI) are paid directly by the employer. This direct payment refers to the imposition of the tax but in the short run the effective economic incidence of a change in employer PRSI will also fall primarily on the employer, as it takes time for nominal wages, the price mechanism in labour markets, to adjust. Therefore, a temporary reduction in employer PRSI could be a suitable tax-related policy tool to decrease the cost of employment and sustain demand for labour in a weak economic environment.

3.3 Low taxes on labour and labour supply

When the incidence of taxation falls on the employee (see section 3.2 above) it is after-tax wages that are affected. This has an incentive effect on the supply of labour. Higher taxes decrease the return to employment in the form of after-tax wages which then can affect the decision to enter the labour force (participation) and the decision of how many hours to work. Policymakers have a particular interest in the effect of labour tax increases on incentives to participate in the labour market, because not only does non-participation mean a decrease in income earned but it can also mean an increase in government expenditure on social welfare.

Empirical evidence of a labour supply effect in Ireland predicts that a general increase in wages of 1% would see preferred hours at work rise by 0.18% for men and by 0.48% for women.⁸

Labour force participation levels involve those who switch labour force (migration), as well as those who drop out of the labour force. The issue of migration has grown in importance for labour tax policy as labour mobility has increased with globalisation and the advent of the single European labour market. In this regard, Irish tax policy needs to observe closely the tax wedge differentials between Ireland and other countries, particularly the UK. It should also be noted that multinational companies attach importance to the overall tax package of a country, including labour tax because of its implications for attracting skilled labour. Preliminary research shows that FDI is less likely to be located in countries where average labour taxes or their progression are relatively high, because of the need for skilled workers and managers.⁹

3.4 Low taxes on labour and other aspects of economic activity

Taxes on labour also affect other aspects of economic activity, including entrepreneurship and human capital.

Entrepreneurship

Entrepreneurship is an important factor in generating employment and economic growth. The case for government support of entrepreneurship depends on a positive externality argument, that the benefits flowing from entrepreneurship are not necessarily captured by the entrepreneurs themselves and thus not enough entrepreneurship is carried out. High taxes discourage entrepreneurs by reducing the return from the undertaking of risky entrepreneurial projects and thus impact negatively on job creation and growth.

The progressivity of labour taxes is an important consideration here. Progressive taxes reduce the post-tax income differential between the cases where an entrepreneur is successful and the alternative case of a business failure. Gentry and Hubbard (2000)¹⁰ find that the probability of

8 'Tax Cuts, Tax Reform and Labour Supply Responses', Tim Callan, Arthur Van Soest, and John R Walsh, ESRI Budget Perspectives 2004, October 2003.

9 'Labour Taxation and Foreign Direct Investment', P. Egger and D. M. Radulescu, CESIFO Working Paper No. 2309, May 2008.

10 Tax Policy and Entrepreneurial Entry', W.M. Gentry and R.G. Hubbard, American Economic Review, May 2000.

entry into self-employment increases as tax rates become less progressive. OECD research also finds that a greater progressivity of personal taxes on labour seems to be associated with lower long-run GDP per capita.¹¹ Progressivity is of course an important consideration with regard to the equity of a tax system; here we note that progressivity also has economic effects which must be taken into account, and that these are prominent when it comes to the progressivity of labour taxes in particular.

Human capital

Taxes on labour affect the decision to pursue education or training because taxation affects the extra returns to work that are earned by this higher human capital. A recent paper on the policy determinants of investment in tertiary education finds that, in particular, lower marginal tax rates on labour earnings have a positive effect on returns to education.¹² The development of human capital is important because levels of education and skill are important determinants of economic growth.

Our recommendations in relation to taxes on labour, labour supply, entrepreneurship and other aspects of economic activity are as follows:

Recommendation 7.3

Taxes on labour should be kept low to support economic activity.

Recommendation 7.4

The degree of progressivity of taxes on labour should take into account the potential economic effects, particularly on job creation and entrepreneurship, as well as equity considerations.

3.5 The impact of taxes on labour is not uniform

The economic impact of taxes on labour is not the same for different demographic groups and for different conditions in the labour market. In other words, the effects of labour taxes are not uniform.

Demographics

The international evidence on labour supply responses to tax changes includes the following findings:¹³

- Married women and lone mothers respond more strongly than men in terms of hours worked to financial incentives created by tax changes
- Taxation and welfare benefits affect the decision whether or not to take paid work at all - this applies to women more than men, and to mothers in particular
- Male participation decisions for those with low or medium levels of education can be responsive to tax changes, but this is to do with a combination of tax and welfare benefits
- The participation decision for men with high levels of education is very unresponsive to tax changes

Irish evidence already cited above predicts that a general increase in after-tax wages of approximately 1% would see labour supply, in terms of preferred hours at work, rise by 0.18%

11 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', Jens Arnold, OECD Economics Department Working Paper No. 643, October 2008.

12 'The Policy Determinants of Investment in Tertiary Education', OECD Economics Department Working Paper No. 576, J. O. Martins et al., September 2007.

13 'Labour Supply and Taxes', C. Meghir and D. Philips, March 2008. Paper prepared for The Mirrlees Review, "Reforming the Tax System for the 21st Century".

for men and by 0.48% for women. The labour supply of married women is significantly more responsive to an increase in their wage rate than men (with respect to the male wage rate).

Income distribution and the poverty trap

An important factor affecting the participation in the labour force of those on low income is the minimum wage. Research indicates that higher taxes on labour income appear to have the most detrimental effects on employment when wages do not fall because of the minimum wage. Bassanini and Duval (2006)¹⁴ find that increases in the tax wedge have a greater impact in raising unemployment the higher the minimum wage is set relative to average wages.

A second factor is the interaction of the tax system with social welfare benefits. Those on lower incomes make the decision to enter the workforce based on a combination of the social welfare benefits they may lose and increased tax payments they will have to pay. ESRI research shows that the highest effective tax rates tend to arise from the withdrawal of welfare benefits, including withdrawal of such benefits from a spouse or partner.¹⁵ This can create a poverty trap where financial incentives exist to remain outside of the labour force.

We conclude that the economic impact of labour taxes is not uniform, across the income distribution and other demographics.

The present situation

The tax wedge in Ireland and internationally for different earners and family situations is shown in Table 7.1. A feature of the Table is that the tax wedge is higher for higher income earners. This is the progressive nature of the Irish labour income tax system. However it is a factor in regard to highly skilled internationally mobile workers: while it is still below the average it is close to the corresponding figures for competitor countries like Switzerland, the UK and the USA for single workers (column 3).

The tax wedge continues to increase in Ireland for salaries above the level of these OECD comparisons. For a single earner with no children earning five times the average wage the tax wedge is 49.2%, after the April 2009 budget, and the marginal tax rate, including levies, on additional income is 50%. The economic effects of the tax wedge at this level of income are broader than just the effect on the individuals themselves. Top earners include the highly skilled workers necessary to attract mobile investment and entrepreneurs who help create wealth and employment.

(We recommend the introduction of a carefully targeted incentive to attract highly-skilled employees in Section 5 of this Part.)

14 'Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions', A. Bassanini and R. Duval, OECD Economics Department Working Paper No. 486, 2006.

15 'Work Incentives, Poverty and Welfare in Ireland', T. Callan, J. Walsh, K. Coleman, ESRI Policy Research Series, No. 60, December 2006.

Table 7.1: Income tax and PRSI less cash benefits, as % of labour costs

Family-type	S	S	S	S	M	M	M	M
No. of children	0	0	0	2	2	2	2	0
Wage (as % of average wage; for 1st & 2nd earner)	67	100	167	67	100-0	100-33	100-67	100-33
Ireland	15	22.3	33.1	-35.8	-1.1	7.4	12.8	15.6
Germany	47.4	52.2	53.1	34.5	36.4	41.5	45.3	47.3
Switzerland	26.8	29.6	33.9	12.8	18.3	20.8	23.8	27.4
UK	30.8	34.1	37.9	15.5	28.3	26.4	29.9	30.8
USA	27.8	30	35.3	7.6	18.1	22.2	24.5	27.8
OECD	33.8	37.7	42.1	18.2	27.3	29.5	32.4	34.5
EU-15	38	42.5	47.7	21.7	31.9	33.4	36.6	38.5

Source: 'Taxing Wages 2006 – 2007', OECD (2007). The shorthand of the table is best explained through an example: the last column presents the tax wedge for a married couple [M] with no children [0] where the two earners earn the average wage and one-third of the average wage respectively [100-33].

Recommendation 7.5

Policymakers should take into account the fact that the economic impact of labour taxes is not uniform across the income distribution range and by reference to other demographics.

Section 4: Supporting business

4.1 Introduction

This Section focuses on overall tax measures to support business. Our premise is that a tax system that supports economic activity generally will also help specific sectors. In the first instance, we draw a distinction between businesses that are starting up and those already established. Fostering business growth is a key factor in the support of economic activity and the promotion of employment. We examine tax measures that help businesses to start up and to grow in section 4.2.

Any proposed business decision will take account of the tax consequences. A tax system which supports economic activity is one in which tax provisions do not act as a barrier to business activities. In section 4.3, we examine tax rules which we believe could hinder businesses in their operations and which we recommend be changed.

In section 4.4, which deals with the tax base on business income, we explore the case for aligning the tax treatment of capital expenditure on business assets with the accounting treatment.

Section 4.5 looks at international tax issues. This is of importance to growing Irish businesses that are looking outwards beyond the domestic market. It is also important in the context of mobile investment. The international tax issues examined in this section are also relevant to companies in the specific activities covered in Section 5.

4.2 Helping businesses in the early stages

There are a number of measures in the tax code that are designed to assist enterprise in the start-up and early stages. Some of these – such as the EU-approved Business Expansion Scheme (BES) and Seed Capital Scheme (SCS) are also analysed in Part 8 of our Report, which covers tax expenditures.

BES and SCS give tax incentives to individuals to invest in companies, and also help the companies concerned by providing finance in the start-up stages. Other measures, such as the corporation tax holiday introduced in Finance (No. 2) Act 2008, give tax incentives directly to new, small companies to assist them in the early years.

Existing tax measures to help new business specifically are summarised in Box 7.1. There are, of course, a number of other tax measures which will help such businesses and which are dealt with elsewhere in this Report. These include tax incentives for purchasing energy-efficient plant and machinery (Part 9) and R&D tax credits (Section 5 of this Part). In addition, small companies (defined as those with annual corporation tax liabilities of up to €200,000) have easier rules for paying preliminary tax.

Box 7.1: Existing tax measures to help new business

- **Start-up costs may be tax deductible:** Pre-trading organisational and start-up costs incurred up to three years before the start of a business are deductible as an expense, provided they would have been deductible if the business were trading.
- **New small companies get a corporation tax holiday:** Companies taxable at 12.5% that begin to trade during 2009 do not pay corporation tax (CT), where the CT liability does not exceed €40,000 annually. This applies for each of the first three years of operation. New companies with a CT liability of up to €60,000 pay reduced tax.
- **Some new businesses do not pay preliminary tax in the first year:** New companies which do not expect their CT liability to exceed €200,000 in their first year do not have to pay preliminary tax. Startup non-corporate trades also get a deferral of preliminary tax in their first year.
- **Tax incentives can help new companies to access finance:** Companies can raise up to €2 million (€1.5 million in any one year) under the Business Expansion Scheme (BES), with income tax relief available to investors (who may each invest up to €150,000) at their marginal rate. Individuals can get tax refunds on amounts up to €100,000 per annum which they invest in their own new companies under the Seed Capital Scheme (SCS).

We considered a number of possibilities to improve the position of start-up businesses. On the whole, we found that new businesses were provided with a comprehensive range of supports and incentives through the tax system.

- Tax deductibility for pre-trading expenses follows OECD norms. This measure is available to all new businesses, both inside and outside the corporate sectors of the economy
- The recent introduction of a three-year corporation tax holiday for small businesses starting

out removes a significant tax barrier to new business at a critical period in their development. New businesses can make profits of €320,000 per annum before paying tax, with marginal relief in respect of profits up to €480,000 annually

- Many of the proposals in relation to BES/SCS that were proposed by the Small Business Forum (2006) have been implemented. In particular, the tax relief limits have been substantially increased. BES/SCS are state aids, approved by the EU up to end-2013. Our recommendations on the schemes are contained in Part 8 of our Report; we recommend *inter alia* that any extensions beyond 2013 should be subject to an evaluation as to whether market failure exists, and that the administrative burden placed on BES-assisted companies should be reviewed

Recommendations for start up businesses

We examined the three-year corporation tax holiday for start-up small businesses in some detail in our review of tax expenditures. We concluded that companies starting up in 2010 and 2011 should also be eligible for exemption (for two years or one year respectively), and also that a similar scheme should be made available to new non-corporate businesses¹⁶. A further additional measure is appropriate to support self-employed (non-corporate) taxpayers in start-up situations. The existing arrangements regarding the payment of preliminary tax, and the nature of the associated problem, are outlined in Box 7.2.

Box 7.2: Preliminary tax payment rules for self-employed (non-corporate) taxpayers in start-up situations

- Self-employed persons pay income tax on income arising in Ireland in a calendar year
- They must pay preliminary tax for a year by 31 October. This is based on either 100% of their prior year income tax liability or 90% of their current year income tax liability
- In a new business, self-employed people can get a preliminary tax deferral, because the calculation rules allow them to base their preliminary tax on the previous year's liability, which is zero
- However, the newly self-employed person has to find tax for two years before the end of the second year. For example:
 - A new business starts on 1 January 2007 and has regular monthly cash income. It puts money aside every month, to cover its tax obligations
 - It does not pay any tax in 2007
 - When it comes to 31 October 2008, the self-employed person must pay his/her full liability for 2007, plus preliminary tax for 2008 (100% of previous year or 90% of current year)
 - The self-employed person may not have enough set aside to pay the tax, even if he or she was setting aside regular amounts each month. For a new business working on invoices (rather than cash receipts), there may be even less savings on hand at 31 October 2008

A situation where individuals have to borrow to pay tax is unsatisfactory and, in particular, is difficult in a tight credit market. We considered an arrangement under which taxpayers might pay a proportion of their first year tax in the first year and, after that, gradually build up payments over three years. They would have a more established track record after three years that would facilitate easier access to funding to pay the tax.

¹⁶ Details are given in section 12.20 of Part 8.

The proportions we suggest are:

- 1/3 of first year tax in year one
 - The rest (2/3) of first year tax in year two, plus 2/3 of second year tax
 - The rest (1/3) of second year tax in year three, plus preliminary tax for the third year.
- As for year two in the existing system, there may not be enough savings to fully cover the preliminary tax payment, but by now the taxpayer has nearly completed three years of self-employment

A potential difficulty with the proposed arrangement is that it asks new businesses to pay tax in their first year, in cases where they may not do so under the current system. As this is part of a package to ease the regulatory burden on business, we recommend that the scheme be made optional.

We suggest that our proposed arrangement should be made available to new unincorporated businesses that do not qualify for the three-year tax holiday proposed by us. If our tax holiday recommendation is not implemented, then this proposal should apply to all unincorporated businesses.

We conclude that there should not be tax barriers to new business formation, in the context of supporting economic activity. We recommend two additional measures for new businesses as follows:

Recommendation 7.6

The 'corporation tax holiday' for new business should be extended to companies starting out in 2010 or 2011, and a similar scheme should be introduced for the non-corporate sector (see Recommendation 8.65).

Recommendation 7.7

An optional arrangement should be made available to new non-corporate businesses to allow them to spread their tax payments over the first three years.

Costings

Recommendation 7.6: The total cost of extending the corporation tax holiday scheme to companies starting out in 2010 or 2011 has been estimated at €30 million. No cost is available for the introduction of a similar scheme for the non-corporate sector.

Recommendation 7.7: No costs are available. However, there could be some cash flow effects on the Exchequer.

4.3 Removing tax barriers

4.3.1 Introduction

This subsection examines tax barriers to the effective functioning of business across six specific areas:

- Stamp duty on securities transactions
- Tax rate on dividends
- Business assets disposed of by companies
- Preliminary tax payment arrangements for large companies

- Close company surcharges, and
- Air travel tax

In each case, we examine the existing tax arrangements, to assess whether they mitigate against the proper functioning of business. We propose some amendments to the rules.

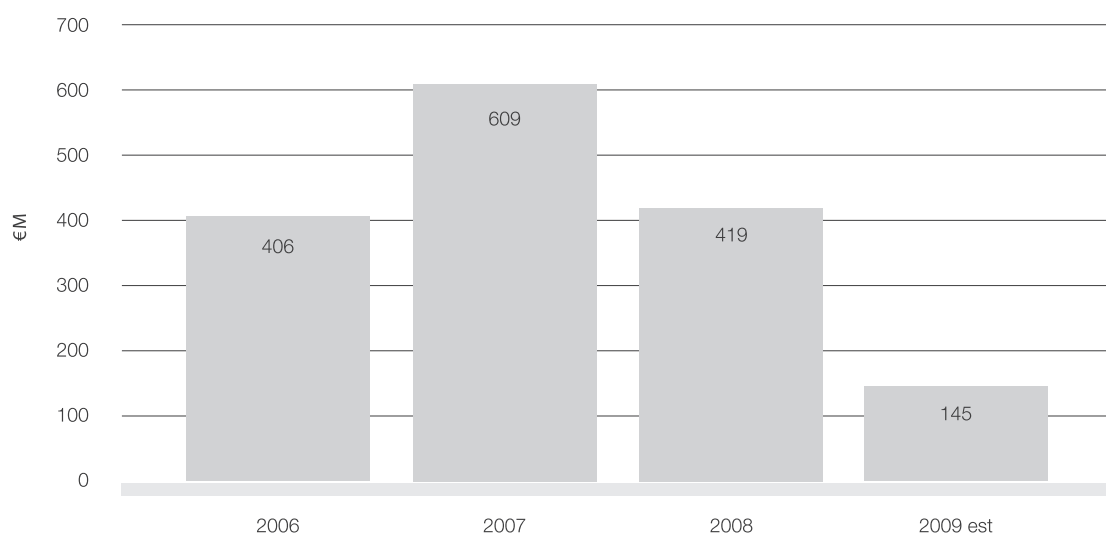
Our recommendations on reducing tax barriers caused by regulatory burdens for enterprise are in Part 5

4.3.2 Stamp duty on securities transactions

Stamp duty of 1% applies to share transfers. The duty applies to transfers of shares in Irish incorporated companies, whether the transfer takes place through the Irish Stock Exchange or through a foreign exchange (typically, London). Stamp duty also applies to transactions in non-quoted shares of Irish incorporated companies – these transfers account for about 12% of total stamp duty yield on shares. Transfers of shares in non-Irish incorporated companies are generally exempt from stamp duty.

The yield from stamp duty on shares has been significant in recent years. However, the expected yield for 2009 is considerably lower than earlier years. Figures range from €406 million (2006) to €145 million (2009 estimate). Summary details are provided in Figure 7.4.

Fig. 7.4: Stamp duty yield from shares 2006-2009



Source: Revenue Commissioners (2009)

A number of bodies requested the removal and/or substantial reform of the stamp duty on securities transactions. The arguments presented to us included the fact that the tax increased the cost of capital for Irish companies and had a detrimental effect on competitiveness and economic activity. Most jurisdictions outside Ireland and the UK apply no (or in some cases, very low) tax on securities transactions. France, Germany, Italy, the Netherlands and Luxembourg have abolished stamp duty on shares in recent years.

A 2007 study commissioned by the Association of British Insurers (ABI), the City of London Corporation, the Investment Managers Association and the London Stock Exchange concluded (*inter alia*) that the UK rate of 0.5% reduced the value of savings and investments, made the markets less competitive,

encouraged the development of alternative trading mechanisms and damaged transparency.

We were also mindful of the work of the European Commission's Clearing and Settlement Fiscal Compliance expert group (FISCO). FISCO advises on the removal of fiscal compliance barriers to the clearing and settlement of cross-border securities transactions within the EU. One of the key issues considered by the Group relates to barriers on transaction tax procedures.

We considered investment in securities which do not attract stamp duty as part of our analysis. This included:

- Shares purchased to hedge a Contract For Difference (CFD), which have been specifically exempted from stamp duty since the introduction of intermediary relief in Finance Act 2007 and
- American Depositary Receipts (ADRs), which are certificates representing a shareholding in an Irish company that is listed on a recognised stock exchange in North America. An exemption from stamp duty was introduced for ADRs in 1992, to facilitate Irish businesses raising capital in the US and Canada. Depositary receipts structures – collectively known as Global Depositary Receipts (GDRs) – are also used in European and global markets (other than London); investors in Irish companies that raise capital by GDRs do not pay stamp duty on their certificates, by practice of the Revenue Commissioners

Irish-resident companies incorporated outside Ireland are also exempt from Irish stamp duty on share transfers. We have concerns about any trend towards incorporation outside Ireland, because it removes the company from Irish company law and corporate governance provisions.

The case for removing stamp duty on share transactions is compelling on the grounds of supporting economic activity and sustaining a capital market in Ireland. Stamp duty on shares increases the cost of raising capital on the Irish market and in London, relative to other markets and other forms of finance. Removing stamp duty encourages companies to incorporate in Ireland.

We considered recommending that the stamp duty rate on share transfers might be reduced (to say, 0.5% to match the UK), with a view to its eventual abolition some time in the future. We are not in favour of this course of action, for the following reasons:

- Current market conditions make this the ideal time for removal of the duty, as the cost of the change is relatively low
- A reduction in the rate of duty on share transactions leaves unanswered the question of the possible taxation of securities that do not currently attract stamp duty
- Removal of the duty is a very positive measure to encourage internationally mobile capital to locate (and incorporate) in Ireland; lowering the rate to 0.5% would not have the same effect

In framing our recommendation we propose that the charge to stamp duty should be removed by reducing the rate to zero, rather than by abolishing the tax. This leaves open the policy option of reintroducing the charge at some level in the future should circumstances warrant such a policy change.

Recommendation 7.8

Stamp duty on all share transactions should be reduced to zero.

Costings

Using estimated figures for 2009, the cost to the Exchequer of reducing the duty to 0% would be approximately €145 million. About 12% of this total (€17.4 million) is accounted for by transfers of unquoted shares. Continuing to apply stamp duty to such transfers is an option, as the case for its removal on the grounds of supporting economic activity is less relevant.

4.3.3 Tax rate on dividends

The tax treatment of savings and investment income of Irish-resident individuals is noted in Part 3 of our Report. In general:

- An individual investing in funds (i.e. 'collective investments' where he or she does not have any control over the selection of the assets/property) will pay exit tax of 25% or 28% in respect of monies received; tax is also paid every eight years¹⁷
- If he or she puts the money on deposit in a financial institution, deposit interest retention tax of 25% is payable on the interest received
- If the individual invests in property, he or she will pay tax at the marginal rate on the rental income¹⁸
- An individual who buys shares in a company will pay tax at the marginal rate on the dividends received

In the context of supporting economic activity, we consider that it is not appropriate that the tax rate on dividends should be higher than the rate on deposit interest. Equalising the tax rate on dividend income and deposit interest would encourage investment in the productive sectors of the economy which could support economic growth and lead to job creation.

We concluded that the rate should be the same as the funds and deposit interest rate and that a similar rate should apply to capital gains on the sale of shares by individuals¹⁹. In our view, this is a rational and coherent approach to the taxation of equity capital (dividends and capital gains). In addition, it rebalances the tax preference given under the current system for interest income on bank deposits.

The measure should apply to dividends on ordinary shares in trading companies (trading income is taxable at the 12.5% corporation tax rate) and in investment companies (investment income is taxable at the 25% corporation tax rate). The inclusion of all companies is in accordance with our rationale that there should be parity of treatment for different forms of savings and investment income. It also avoids significant complexities and compliance burdens that would result if the measure was confined to trading income.

The impact of our proposals on distributed trading income is that such income will suffer a tax rate of 34.375% (before PRSI and levies) by comparison with the maximum income tax rate of 41%. Under our proposal, distributed investment income will suffer a tax rate of 43.75% (before PRSI and levies). Non-distributed investment income will suffer a tax rate (while still in the company) of 40%²⁰. This means that the close company surcharge fulfils its original purpose of bringing the rate

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

18 The tax deduction on interest on funds borrowed to purchase rental residential property is restricted by 25%

19 See section 4.3.4 of this Part, where we propose a lower rate of CGT for disposals of business assets in certain circumstances.

20 The percentage tax rates of 43.75% and 40% are calculated as follows: €100 x 25% = €25 corporation tax. Balance of €75 x 25% = €18.75 dividend tax at the new rate. Total tax = €43.75 per €100. In the second case, €100 x 25% = €25 corporation tax as before. Applying a 20% surcharge to the balance (ignoring the discount available in a trading company), €75 x 20% = €15. Total tax = €40 per €100.

of tax on distributed and undistributed profits closer together.

The proposed measure would apply to dividends received by Irish resident individuals from ordinary shares in Irish companies. In order to comply with our EU Treaty obligations it would also apply, at a minimum, to dividends from companies outside Ireland in the EU or the European Economic Area. Safeguards would be required to ensure that the provision was not manipulated (for example, by shareholder employees taking income as dividends rather than as salary from a company).

We conclude that dividend income should be taxed at a lower rate in order to encourage enterprise. We recommend that the tax rate on dividends should be reduced to the rate applying to deposit interest. As a general principle, and as part of a rational and coherent approach to the taxation of capital, we also conclude that the tax rate on deposit interest, on funds, on capital gains and on dividends received by individuals should be the same.

Recommendation 7.9

The tax rate on dividends received by Irish residents should be reduced to the rate applying to deposit interest.

- The measure should apply to ordinary shares.
- Safeguards should be included to ensure that the provision operates as intended.

Costings

It is estimated that recommendation 7.9 would cost in the region of €53 million.

4.3.4 Capital gains tax on disposals by companies of trading assets

The tax system should not discourage companies to invest in their businesses for future growth. In general, companies have two possible sources of internal funds for reinvestment – after-tax trading profits and the proceeds of disposal of capital assets. We believe that it is inappropriate that these two sources of funds for reinvestment should bear very different tax rates – 12.5% in the case of trading profits and 25% in the case of profits on the sale of capital assets. Accordingly, we propose that capital gains on disposal of trading assets by companies should be taxed at the applicable corporation tax rate (rather than the capital gains tax rate)²¹. This will equalise the tax treatment of reinvested retained earnings and reinvested asset disposals.

The proposed rule means that, where a company that is subject to corporation tax at 12.5% disposes of a trading asset and makes a capital gain, the gain would be taxed at 12.5% rather than at the CGT rate (currently 25%). Thus, there would be more money available to the company to reinvest (for example, in other trading assets) or to build up reserves. Should the company choose instead to distribute the proceeds of the asset disposal to its shareholders (for example, by paying a dividend), then the shareholders would, of course, be subject to income tax on the distribution.

Recommendation 7.10

Corporation tax payable on gains on disposal of assets used for trading purposes should be at the rate applicable to trading profits.

21 Specifically, the companies covered would be those taxable under Case I (trading) or II (professional) of Schedule D.

Costings

It is estimated that this measure would cost approximately €75 million.

4.3.5 Preliminary corporation tax payment rules for large companies

Broadly, all non-start up companies pay 'preliminary tax' before the end of their accounting period, and the balance of corporation tax after the end of the year.

For the purposes of payment, the tax code distinguishes between 'small companies', defined as those enterprises with a corporation tax liability of €200,000 or less in the preceding year, and companies above that threshold ('large companies'). Small companies have the option of basing their preliminary tax on the amount of tax that was due for the previous year. Large companies do not have this option.

The regulatory burden on large companies, which must compute their preliminary tax before the end of their accounting period and before the profits are known, is considerable. New instalment arrangements introduced in the Finance (No. 2) Act 2008, that oblige large companies to pay a proportion of tax some five months earlier than before, have added to the burden. The new rules are as follows:

- A first instalment of preliminary tax is paid six months before the end of the accounting period (50% of the previous year's liability or 45% of the current year's liability)
- A second instalment of preliminary tax is paid one month before the end of the accounting period, to bring the total preliminary tax up to 90% of the current year's liability, and
- The balance of tax is paid with the tax return, nine months after the end of the accounting period

Because interest is payable on underpayments of tax²², the tendency for large companies has been to 'overpay' the 90% preliminary tax figure, increasing the burden even further.

Our general conclusion is that the preliminary tax rules for large companies impose a disproportionate compliance burden and cause significant uncertainty to business. This was reflected by a number of bodies during the consultation process. Approximately 2,500 companies would benefit if the rule were abolished and all companies were entitled to avail of the 'small companies' option.

Allowing large companies to base their preliminary tax on 100% of the previous year's figure rather than 90% of the current year's figure means that tax, expected in one tax year, is moved forward into the following tax year. This is the cash flow cost to the Exchequer of making such a change. Figures produced by the Revenue Commissioners suggest it would be in the order of €460 million. This estimate assumes that the new first instalment arrangements introduced in the Finance (No. 2) Act 2008 continue to apply; we do not recommend any changes to the first instalment rules.

The current economic climate makes now the ideal time to implement this change, in terms of minimising cash flow costs to the Exchequer. If the costs of doing so are considered to be excessive (in view of other measures being proposed), we suggest that there is some scope for a gradual move toward full implementation, as indicated in the following recommendations.

22 Although in certain cases, interest can be reduced for large companies in the same group.

Recommendation 7.11

All companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax.

Recommendation 7.12

The recommendation that all companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax should be implemented having regard to the cash flow costs involved in such a move. In this regard, options might include:

- Gradually increasing the small company threshold over a number of years, until all companies are covered.
- Allowing large companies the option of using a fixed multiple – say 105% – of the previous year's figure.

Costings

Recommendation 7.11: Allowing large companies to base their preliminary tax on 100% of the previous year's figure rather than 90% of the current year's figure would result in a cash flow cost to the Exchequer of some €460 million based on the instalment arrangements introduced in Finance (No. 2) Act 2008.

Recommendation 7.12: Examples of cash flow costs are as follows:

- Increasing the small company threshold to €500,000
(cash-flow cost €50 million (1,330 companies still classed as 'large'))
- Increasing the small company threshold to €1,000,000
(cash-flow cost €90 million (750 companies still classed as 'large'))
- Allowing large companies the option of paying 105% of the previous year's figure
(cash-flow cost €410 million)

4.3.6 Close company surcharges

Many Irish companies are 'close companies', controlled by five or fewer participators (persons having an interest in the income or capital of the company) or by any number of participators who are directors.

- A surcharge of 20% is payable on the investment (non-trading) income of a close company that is not distributed to shareholders (for example, by the payment of a dividend) within 18 months of the end of the accounting period
- Close companies supplying professional services are separately liable to a surcharge of 15% on one-half of their undistributed after-tax trading income

The close company surcharges were introduced as an anti-avoidance measure in 1976. Their purpose was to deter individuals from holding or earning income in a company in order to avail of lower tax rates. Corporation tax at the time was 50% and the top rate of income tax was 77% – a difference of 27%. There is still an issue today, given the difference between corporation tax and income tax when PRSI and levies are taken to account. While the current differential does not justify complete abolition, the case for abolition of the surcharge provisions for companies supplying professional services is

strong on equity grounds, and we recommend this step is taken. We also suggest that the *de minimis* provision for the surcharge on passive income should be substantially increased.

The example in Table 7.2 illustrates how the operation of the professional services surcharge increases the effective rate of corporation tax for such companies from 12.5% to over 19%.

Table 7.2: Professional services company - surcharge provisions

Pre-tax profits (professional income)	€100.00
Corporation tax at 12.5%	€12.50
After-tax income before surcharge	€87.50
Amount subject to surcharge = 50% of income = €43.75	
Surcharge, if no distribution = €43.75 x 15%	€6.56
Effective corporation tax rate, including surcharge (12.5 + 6.56)	19.06%

The close company surcharge provisions featured strongly during the consultation process. It was put to us that the surcharges were an obstacle to business, something that belonged to a different age and that they had outlived their usefulness. Arguments made against the surcharges include the following:

- Private owner-managed companies are established for commercial, not tax avoidance, reasons: For example, professionals (such as architects or engineers) may operate through a corporate structure for limited liability reasons, or because it is part of the practice in the industry, or for insurance/professional indemnity reasons
- The regime for companies is very different nowadays, compared with the tax regime that operated when the provisions were introduced. The introduction of dividend withholding tax and of self-assessment for companies, in addition to the bringing forward of preliminary corporation tax payments, have achieved the acceleration of payment of tax on the profits of companies generally

It is also the case that the surcharge provisions can limit the ability of companies to reinvest. Analysis done in the EU suggests that retained earnings are often an important source of financing for growth and investment for Small and Medium Enterprises (SMEs)²³.

They help survival during economic downturns, when it is harder for businesses to make structural changes or to obtain credit.

Surcharge on professional services companies

Our investigation of ways to support economic activity and grow employment is based on a pro-business ethos. The close company surcharge on professional services companies inhibits such companies from re-investing their trading income. Similar restrictions do not apply to other trading companies. We cannot see an objective rationale for distinguishing between professional services companies and other trading companies and we therefore recommend the abolition of the surcharge for professional services companies.

23 See, for example: http://ec.europa.eu/enterprise/entrepreneurship/action_plan/index.htm

Surcharge on passive income of close companies

The case for removal of the surcharge on investment and estate income is less robust. Equity issues do not arise, and we are not convinced by an argument that the passive income surcharge inhibits the growth of Irish business.

However, we recommend a change to improve the position of SMEs. The rules currently allow for a *de minimis* amount of €635 of investment or estate income to be retained in the close company before the surcharge provisions come into operation. We suggest that this amount should be increased substantially. Operating the surcharge provisions imposes a regulatory burden on companies - particularly small companies - including: calculating the amount that must be paid to ensure that the surcharge does not apply, paying dividends, making dividend withholding tax returns and meeting deadlines.

It was also brought to our attention during the consultation process that the surcharge provisions may not always operate as intended, and that the legislation can be circumvented to avoid the charge on passive income. We recommend that the provisions should be reviewed by the Department of Finance and the Revenue Commissioners to ensure their effectiveness.

Recommendation 7.13

The close company surcharge on professional service companies should be removed.

Recommendation 7.14

The close company surcharge on investment and estate income of companies should be retained. However, the *de minimis* amount before the provisions come into play should be substantially increased in order to ease the regulatory burden for companies in such cases.

Recommendation 7.15

The Revenue Commissioners should closely monitor the new regime to ensure that it operates as intended.

Recommendation 7.16

The remaining close company surcharge provisions should be examined by the Department of Finance and the Revenue Commissioners to ensure their effectiveness.

Costings

Corporation tax liability from all close company surcharges was about €19 million in 2007. It is difficult to predict the losses to the income tax system that might result if the surcharge on professional services companies is removed. Distributions that are currently made to avoid the surcharges would be eliminated. Available data do not distinguish between the various types of surcharge. The tax impact of any behaviour change on the part of professional services businesses (not currently incorporated) is also not clear.

To give indicative examples of the impact of the *de minimis* recommendation, an increase in the amount from €635 to €5,000 would cost approximately €1 million and remove some 2,000 close companies from the surcharge provisions. An increase in the *de minimis* amount to €10,000 would cost some €1.3 million and remove approximately 3,550 close companies from the surcharge provisions.

4.3.7 Air travel tax

Another potential barrier to growth is the air travel tax introduced in the October 2008 Budget. A broad outline of the measure is given in Box 7.3.

Box 7.3: Air travel tax – main features

- This is an excise duty, which applies from 30 March 2009 to passengers on planes departing from Irish airports. There are two rates:
 - €2 where the flight is to a destination within 300 kilometres of Dublin Airport (this covers all flights within Ireland and flights to Cardiff, Glasgow, Prestwick, Liverpool, Manchester, Blackpool, Isle of Man)
 - €10 for the rest of the UK and any other destination
- The tax is payable by the airline operator in respect of passengers departing on its planes
- There are various exemptions – for example, for transit passengers, for disabled persons and their helpers and for non-fare paying passengers (crew, children under two years of age). There are also exemptions for small planes (less than 20 passengers) and small airports (passengers less than 50,000 in the previous year)

We considered whether the tax was supportive of economic activity, given the possible damage to inbound tourism and damage to business – for example, businesses with high numbers of employees regularly travelling between Dublin and London. The fact that we are an island nation, and the fact that air travel tends to be very sensitive to price, are important factors in this regard. Submissions to us also pointed to the economically detrimental nature of the tax.

The investigation of fiscal measures to protect and enhance the environment is also part of our remit. We recognise that the air travel tax has merit from an environmental perspective (although its effectiveness in this regard would be enhanced if the charge were calibrated to reflect greenhouse gas emissions). In this context, we note that the airline sector will be brought into the EU Emissions Trading Scheme from 2012; it may be appropriate to review the air travel tax once a pan-European price for carbon emissions from air travel is in place.

Details on the EU Emissions Trading Scheme are in Part 9.

Recommendation 7.17

A review should be undertaken by Government to assess the effects of the air travel tax on business in general and tourism in particular. This review should be set in the context of the pending inclusion of air travel in the EU Emissions Trading Scheme (EU ETS) from 2012.

4.4 The tax base on business income

4.4.1 Introduction

Expenditure is deductible as a business expense for tax purposes when it is incurred wholly and exclusively for the purpose of the trade, and is revenue (not capital) in nature. Expenditure of a capital (as opposed to revenue) nature is not deductible for tax purposes. However, capital allowances may be available on some capital expenditure. Capital allowances are a form of

depreciation for tax purposes. In general, expenditure on plant and machinery, on motor vehicles and on industrial buildings attracts capital allowances, subject to conditions. A brief overview is given in Box 7.4.

Box 7.4: Overview of capital allowances tax regime

- An allowance is given for wear and tear of plant, machinery and motor vehicles in use for the purposes of a trade at the end of an accounting period
- It is calculated by reference to the cost of the item (less any grants received and less any recoverable value-added tax) and the allowable expenditure may be written down at the rate of 12.5% on a straight line basis
- Capital allowances are also available in respect of expenditure on transmission capacity rights, computer software, energy efficient equipment (including electric and alternative fuel vehicles), and some buildings. The rate at which the expenditure may be written down varies according to the type of expenditure incurred
- On the disposal of an asset that has qualified for capital allowances, the sale proceeds are compared with the tax written down value and any resultant profit or loss (up to the original amount qualifying for capital allowances), known as a balancing charge or balancing allowance, is taxable or tax deductible accordingly

4.4.2 Aligning tax treatment with accounting treatment

Our proposal is that taxable income should be the accounting profits of the business (subject to statutory disallowances such as entertainment expenses). In particular, we consider that the existing tax treatment of capital expenditure for business purposes does not meet the needs of a modern economy. In our view, there is a strong case for aligning the tax treatment with the accounting treatment. Currently, the depreciation of capital assets as computed for accounting purposes is not an allowable business expense against income for tax purposes.

An accounts depreciation regime makes sense from the point of view of a modern, up to date tax system that is capable of adapting to change. For example, the 'tools of the trade' have changed in business over the years and will change again. Rather than make piecemeal additions to the capital allowances regime (for instance, the rules for transmission capacity rights came into operation in March 2003), a closer alignment between the tax treatment and the accounting treatment is appropriate.

As a company is required to prepare its accounts in accordance with standard accounting rules – Irish Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) – an objective method of allowing for deductibility would be available if such a system were implemented.

Income as computed for GAAP or IFRS purposes should also form the basis of business taxation in the non-corporate sector (sole traders and partnerships). It does not make sense that two systems – GAAP/IFRS accounts depreciation for companies and capital allowances for others – should be used. We suggest that the Revenue Commissioners publish ranges of acceptable depreciation rates for various asset classes for small businesses to simplify compliance obligations.

4.4.3 How the proposed change would benefit business – an example

The capital allowances regime for computer software usefully illustrates our proposal on the most appropriate way to give a tax deduction to trading companies for capital expenditure. Under existing tax provisions, expenditure on software is covered by capital allowances rules. The details are summarised in Box 7.5. A key difficulty with the capital allowances regime is that it generally does not apply allowances to a time period which fits with the economic life of the business asset.

Box 7.5: Existing tax regime for expenditure on software

- Software used for business purposes is written off over 8 years at 12.5% on a straight line basis (i.e. equal annual instalments)
- The tax provision deems the software to be plant and machinery and applies the capital allowances wear and tear rules to it
- Balancing allowances and balancing charges rules also apply in the event of a disposal of software

GAAP or IFRS depreciation charged should be deductible for software. It was put to us during the consultation process that the eight year writing-down period of the capital allowances regime is generally too long for software, which may have a life of two to three years – for example, if it is software for a game.

A problem with capital allowances is that the writing-down period ('tax life') may not reflect the actual life ('economic life'). By adopting a regime where a tax deduction would be given for the depreciation figure in the accounts of the business, issues that may arise in relation to the setting of appropriate time periods are addressed. This is more flexible than a capital allowances regime, as different amortisation periods – depending on the economic life of the asset – are used. Other advantages were noted earlier - new 'tools of the trade' which will emerge as business develops can be accommodated more easily, and the system is objective and certain. This is particularly likely for assets related to 'green' technology that may develop in the future and for assets such as carbon credits which do not qualify for capital allowances.

We conclude, in the light of the above, that taxable income should be computed for business income (Schedule D, Case I and II) based on the accounting profits of a business, with normal statutory disallowances. In particular, we propose that accounts depreciation for tax purposes should replace the capital allowances regime used in business for assets other than buildings.

4.4.4 Special issues in relation to buildings

As well as contributing to certainty and being more responsive to the realities of modern business, a tax base for capital expenditure that is aligned with accounting treatment could also mean that expenditure, which is not deductible for tax purposes under the existing regime, would become eligible for relief. The impact of this on the tax regime for buildings raises particular issues; the existing capital allowances rules for buildings are outlined in Box 7.6.

Box 7.6: Existing tax regime for expenditure on buildings

- The general rule is that an annual allowance of 4% straight line is available in respect of industrial buildings (factories and mills)
- Property-related accelerated capital allowance schemes, under which capital allowances are calculated at the rate of 1.5% per annum for six years and 10% in the seventh year, have been available for property in various regions or relating to particular asset types. *See Part 8 for details on these*
- Tax incentives for research facilities are also available:
 - 100% of capital expenditure incurred on buildings and plant used for the purpose of scientific research is available upfront.
 - Tax credits of 25% are also available for capital expenditure on R&D building facilities
- There are two schemes of capital allowances for farm buildings
 - Under the first scheme, expenditure on the net cost of farm buildings is claimed as an expense against income over seven years, at the rate of 1.5% for the first six years and 10% in the final year
 - Under the second scheme, expenditure on buildings necessary for the control of pollution is deductible over three years, when certain conditions are met. *See Part 8 for details*
- Capital allowances are not available for shops and offices

Because capital allowances are not allowed on many buildings, permitting a deduction for depreciation (for the office and retail sector, for example) would significantly reduce the tax base on business income. For pragmatic reasons, therefore, we recommend that accounts depreciation should replace capital allowances for buildings that qualify for capital allowances under the existing regime, but should not be deductible for other buildings.

The tax system should be responsive to the realities of modern business. Call centres for example, which have been described as the ‘modern industrial buildings’ do not currently qualify for capital allowances and we believe that there is a strong case for allowing them to qualify. There may be other categories of buildings with an equally strong case. We recommend that consideration should be given to extending the classes of buildings that qualify for an accounting depreciation deduction, as the existing capital allowances regime is not reflective of modern business.

4.4.5 Impact of special tax rules for capital expenditure

There are a number of areas in the capital allowances tax code where special regimes have been introduced. Box 7.6 indicates for example, that there are special rules for capital expenditure on buildings used for R&D and for farm buildings. While a tax base for capital expenditure that is aligned with accounting treatment is in our view appropriate, we propose that existing “special” regimes should continue²⁴.

4.4.6 Conclusions on tax base for business

Our general conclusion is that business income for tax purposes should be determined on the basis

²⁴ For example, the accelerated capital allowances scheme for expenditure on energy-efficient equipment for business is evaluated in Part 8 of our Report, where we recommend that it be continued for its current term, and then evaluated in accordance with the criteria we developed for tax expenditures. There are also businesses that currently have an asset base which benefits from a capital allowance regime which is shorter than the economic life of those assets. It is not the intention of our proposals to interfere with these regimes.

of accounting profits for both companies and non-corporate bodies. This would lower compliance costs on business, contribute to certainty for business, be more responsive to the realities of the business environment and be more capable of adapting to change.

As part of our proposal, we recommend that a provision would be available to allow businesses to elect to cross over to the new rules at any time in a transitional period of five years, with safeguards to ensure that a tax deduction would not be given more than once for any expenditure item. We do not propose that the new rules should apply in cases where deductions for buildings are not available, nor do we propose that special provisions should be superseded by the new rules on deductibility. We do, however, propose that the deductibility regime for buildings should be extended, as we consider that the existing deductions do not adequately reflect modern business needs.

Recommendation 7.18

Taxable income should be computed for business income (Schedule D, Case I and II) based on the accounting profits of a business, with normal statutory disallowances. In particular, we propose that accounts depreciation for tax purposes should replace the capital allowances regime used in business.

- In the case of buildings, the new provision should only apply where the buildings qualify for capital allowances under the existing rules (but see Recommendation 7.19).
- Businesses should be permitted to change to the new regime at any time in a five-year transitional period.
- Existing special regimes should continue.

Recommendation 7.19

The list of buildings that qualify for deductibility for tax purposes should be extended.

Costings

Recommendation 7.18 could be implemented at no cost to the Exchequer

No costs are available for recommendation 7.19.

4.5 International issues

4.5.1 Introduction

Fiscal incentives to assist new businesses and employment (section 4.2), the removal of tax provisions that act as barriers to business (section 4.3) and a more appropriate tax base for business income (section 4.4) will go some way to improving the tax system in order to support economic activity and promote increased employment.

This section looks at international issues in connection with supporting economic activity. The international dimension is important for both the indigenous business looking outwards and the mobile foreign investor looking to Ireland as a possible location of choice.

The EU, OECD and wider international dimension to our deliberations are particularly important in the context of supporting economic activity. Two international tax issues are considered in this section. These are (i) the taxation of dividend income received from abroad, and (ii) withholding

taxes on interest and royalty streams from Irish companies to companies that are located abroad. We conclude the section with an endorsement of the policy focus on the continued expansion of Ireland's tax treaty network.

4.5.2 International tax issue (i) – taxation of dividend income received from abroad

Participation exemption for dividends means that dividends received by a holding company from its subsidiaries are exempt from tax. The proposal that dividends received by an Irish-resident holding company from its foreign subsidiaries should be exempt from tax featured strongly during the consultation process. The point was made that such an exemption on dividends – along with the exemption on capital gains in respect of disposals of shares in subsidiaries that is already available – would be seen as a major part of a holding company regime.

The current tax treatment of dividends received by an Irish resident company is summarised in Box 7.7.

Box 7.7: Tax treatment of dividends received by Irish companies - main features

- The tax treatment depends on where the dividends come from:
 - From Irish subsidiary, exempt
 - From EU or tax treaty country:
 - If paid out of trading income, taxable at 12.5%
 - If paid out of non-trading income, taxable at 25% (but see note*)
 - From elsewhere, taxable at 25%
 - Trading profits may be traced up through a chain of companies to the top Irish company
 - Credit is given for foreign tax paid. Unused credits can be pooled. There are two pools, one for 12.5% credits and one for 25% credits
- * Dividends from EU and tax treaty countries that are received by portfolio investor companies are taxed at 12.5%, whether or not they come out of trading profits. (These are companies with less than 5% of the share capital of the foreign company.)

Under the current system, there is a charge to tax with a credit for foreign tax, which may result in no net liability to Irish tax. The rules place a compliance burden on Irish recipient companies. Participation exemption could be simpler from a regulatory burden point of view.

An examination of the taxation system for dividends in several countries reveals that there is some international trend towards participation exemption for foreign dividends. While participation exemption schemes already exist in many countries, virtually no country had full participation exemption, without complex rules.²⁵ We concluded that each participation exemption regime came with its own different level of intricacies and therefore we are not recommending any change at this time.

4.5.3 International tax issue (ii) – outbound payments of interest or of royalties

Interest payments to non-residents must be paid under deduction of tax at the standard rate of income tax. Also, Irish resident companies (and Irish branches of non-resident companies) must withhold tax on patent royalty payments or on other annual payments.²⁶ Payments outside of these categories are generally not subject to withholding tax.

25 The United Kingdom, for example, is amending its dividend taxation rules in 2009. The UK, however, also has Controlled Foreign Companies (CFC) legislation, under which foreign income is, in certain circumstances, taxed on the UK parent company as it arises, without it being received in the UK.

26 Under case law, these are payments that the recipient earns without incurring any expenses in so doing – i.e. what is known as “pure income profit” in the hands of the recipient.

Exemptions from the requirement to withhold tax on these outbound payments may be available under double tax treaties, under the EU Interest and Royalties Directive, or under provisions in the Irish tax code. The rules are broadly summarised in Box 7.8.

Box 7.8: Payments of interest or royalties from Ireland to other countries - main features

- Withholding taxes on royalties paid out of Ireland can be reduced or eliminated under the provisions of double tax agreements; prior approval from the Revenue Commissioners is currently required
- Under the EU Interest & Royalties Directive, payments of interest and royalties to companies in other EU countries are exempt from Irish withholding tax if:
 - the Irish company directly controls at least 25% of the voting power of the other EU company (or vice versa), or
 - a third EU company directly controls at least 25% of the voting power of each of the other two companies
 This can be applied on a self-assessment basis
- Exemptions from the withholding tax requirement also apply (on a self-assessment basis) for:
 - Interest paid by companies in the course of a trade to companies in the EU or in territories with which Ireland has a double tax agreement
 - Interest paid by securitisation companies to persons resident in the EU/tax treaty countries, and
 - Interest on financial instruments such as quoted Eurobonds and wholesale debt securities

Reductions or exemptions from withholding tax are not always available (for example, where the payments are made to non-treaty countries outside the EU) and in these cases, the Irish company must withhold tax at 20% on the payment. The question of removing the withholding tax requirement for such outbound payments was raised with us during the consultation process. Having regard to the policy focus on the continued expansion of Ireland's tax treaty network (see section 4.5.4 following) we do not consider that any changes to the current system of withholding tax on outbound payments are warranted at this time.

4.5.4 Tax treaty network

We received a number of submissions calling for Ireland's tax treaty network to be extended. Ireland has 46 treaties and there are plans to add significantly to this number. We endorse this policy focus on the expansion of Ireland's tax treaty network. We also note that the Finance (No. 2) Act 2008 provides that it is no longer necessary for both jurisdictions to have ratified a treaty in order to avail of some of the domestic tax provisions which require treaty residence, and that this was widely welcomed.

Section 5:

Supporting sectors and activities

5.1 Introduction

Section 4 covered fiscal measures to support economic activity generally. This Section examines possible fiscal measures and incentives in relation to specific sectors and activities. It considers how tax policy might be used to help foster the knowledge-based economy and an innovation-friendly business environment.

We focus initially on research and development (section 5.2) and some issues in relation to royalties (section 5.3). Upskilling the domestic labour force, as well as encouraging highly skilled workers to locate in Ireland, are important components of the overall package and are considered in section 5.4.

The environmental agenda also creates businesses opportunities for Ireland. The fiscal measures we propose in Section 4 to assist business generally, as well as the incentives that we discuss in this Section, have a role to play in this. Issues in relation to the “Green Economy” are considered in Part 9 of our Report.

5.2 Research and development

The definition of research and development (R&D) in the tax code requires a systematic, investigative or experimental approach to be taken in a field of science or technology. The definition is based on that in the OECD Frascati Manual and accords with international norms. It covers the full range of R&D activities from basic research to applied research to experimental development.

The market on its own will fail to generate the optimum level of R&D because it is difficult, and typically impossible, for investors to capture the full benefits of their investment; others free ride on the fruits of their efforts. The market failure problem is compounded because of the great uncertainties that apply in terms of securing a commercially viable payoff²⁷.

Two tests are applied to determine if an activity is R&D:

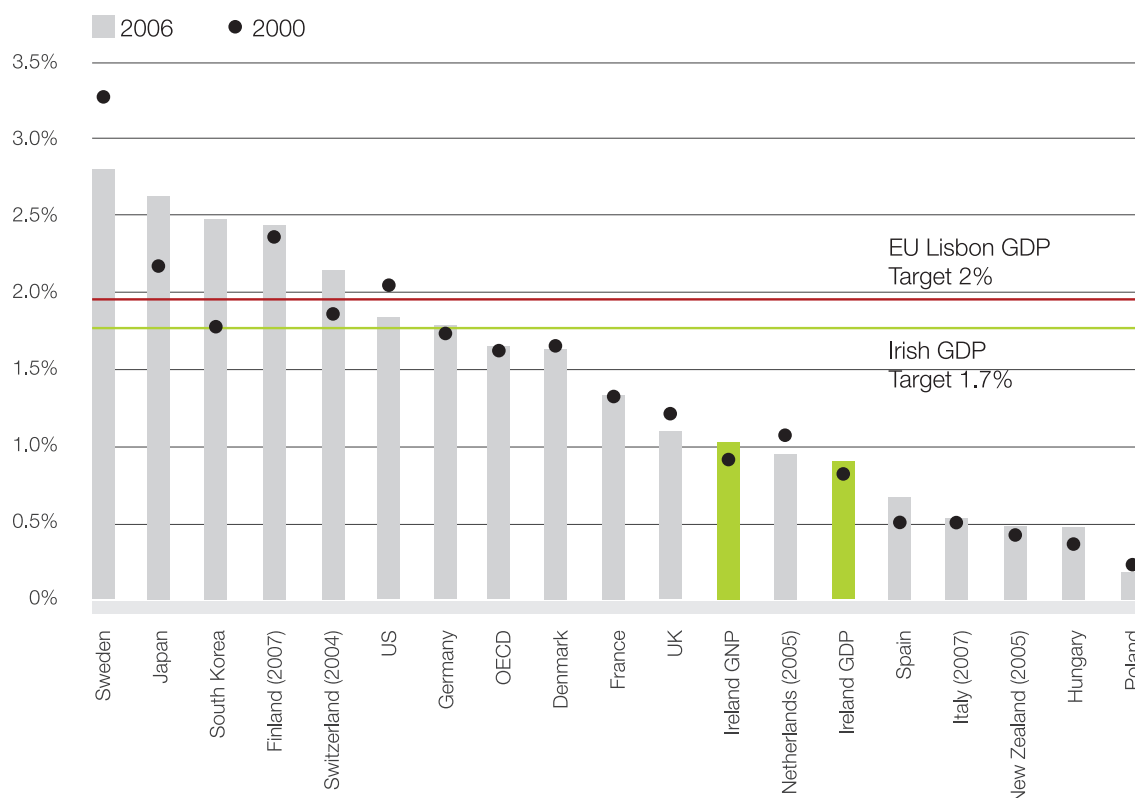
- It must seek to achieve scientific or technological advancement
- It must involve the resolution of scientific or technological uncertainty

In terms of economic structure, Ireland’s industrial policy places a high value on research and development, innovation and commercialisation. The report of the Enterprise Strategy Group highlighted as one of its two key policy issues the need to build *“technological and applied research and development (R&D) capability, to support the development of high-value products and services”*. The Irish Strategy for Science, Technology and Innovation has set a target of €3 billion for business expenditure on R&D by 2013, double the level of 2006. A related issue here is Ireland’s sectoral structure, with modern manufacturing and internationally traded services increasingly prominent. In 2007 modern manufacturing accounted for 58% of industrial value-added and 14% of total national gross value-added.

Ireland’s performance in relation to business expenditure on R&D is shown in Figure 7.5.

27 In this context, we note the recent appointment of an Innovation Taskforce to advise the Government on strategy for positioning Ireland as an International Innovation Hub as part of the Smart Economy.

Figure 7.5: Business Expenditure on R&D as a % of GDP, 2006



Source: National Competitiveness Council, 2008.

Ireland operates an R&D tax credit system under which credits against corporation tax are available on buildings used for R&D and for incremental expenditure (relative to a base year of 2003) incurred by a company on R&D. Key features are outlined in Box 7.9.

Box 7.9: Main features of Ireland's existing R&D tax credit schemes

- tax credit of 25% of incremental expenditure (relative to a base year of 2003) incurred by a company on R&D is provided
- The credit is initially available for offset against corporation tax payable by companies in the same group
- Unused credits can be carried forward. They may also be carried back and offset against corporation tax paid in the previous year. Any unused credits can be refunded over a three year period
- Tax credits are also available on a volume basis for expenditure on buildings used for R&D
- The R&D must be carried out by a company in the European Economic Area; spending is not eligible to the extent that it is grant-aided
- Simple example of company availing of scheme:

Expenditure on R&D in 2003	€100.00
Expenditure on R&D in 2004	€120.00
Incremental spend 2004/2003	€20.00
Tax credit* = €20 x 20%	€4.00
Expenditure on R&D in 2009:	€140.00
Incremental expenditure 2009/2003	€40.00
Tax credit** = €40 x 25%	€10.00

*Tax credit available for offset against CT liability, or carried forward or surrendered to a group company.

** Credit refundable since Finance (No. 2) Act 2008 and rate increased to 25%.

A competitive system for attracting R&D is an integral part of the development of the knowledge-based economy. International comparisons (OECD 2006)²⁸ that there is aggressive competition between countries for R&D based investments. Incentive schemes were operated in 19 of the 27 countries surveyed. Over 40% of Foreign Direct Investment in Ireland is now in high-value R&D.

Ireland's R&D tax credit schemes have been enhanced on a number of occasions since their introduction with effect from 1 January 2004. Proposals in relation to research and development featured in several submissions to us, and some amendments – such as refunds of unused credits – were introduced in the Finance (No. 2) Act 2008 while we were in session.

We considered whether further enhancements to the R&D tax regime are warranted. We examined the offsetting provisions, the case for changing to a volume basis, and definitions of R&D for the purposes of the reliefs.

5.2.1 Utilisation of R&D credit

Under the current rules, the R&D tax credit is available for offset against corporation tax payable by the company. During the consultation process, the argument was made that making the credit available for offset against employer PRSI would be of more benefit to some companies. The kind of companies affected are typically members of an international group, where investment decisions are made on a plant by plant basis and are based on pre-tax comparisons between investment locations in different jurisdictions. In such a scenario, the Irish R&D tax credit, which affects the after-tax position of a company, is not considered in weighing up location decisions.

The argument has merit²⁹. In the context of supporting economic activity, we recommend that companies should have the option of offsetting their R&D tax credits against employer PRSI.

- Any change should be implemented at no cost to the Exchequer
- The measure should be optional (because many businesses prefer the current arrangements)
- An option made should be binding on the company or group concerned for a fixed period

(The possibility of allowing for offset of R&D tax credits against payroll costs or taxes other than employer PRSI was considered but is not recommended, because of the fiduciary nature of such taxes.)

5.2.2 Changing from an incremental to a volume basis

As shown in the example in Box 7.9, the current incremental regime allows for expenditure on R&D that is in excess of that undertaken in the base year of 2003 to qualify for the credit. A volume-based approach would mean that the full expenditure in any given year would qualify for the credit – using the figures shown in Box 7.9, for instance, the R&D spending of €140 in 2009 would be eligible for relief.

International trends with R&D tax credits have shown a move from an incremental to a volume basis, which is a simpler system. However, we do not propose any change in this area. In particular:

28 'Tax treatment of business investments in intellectual assets: an international comparison', OECD Science, Technology and Industry (STI) working paper 2006/4.

29 The accounting treatment of the R&D tax credit under IFRS (International Financial Reporting Standards) and Irish GAAP (Generally Accepted Accounting Principles) became topical since we began our deliberations. We note that the Revenue Commissioners have acknowledged (eBrief No. 36/09 (29/5/09) that some companies may account for the R&D tax credit through the profit and loss account or income statement in arriving at the pre-tax profit or loss rather than recognising it as a reduction to their tax charge.

- The incremental approach provides an incentive to companies to increase their levels of R&D spending and it reduces deadweight costs (i.e. R&D activities that would happen in any event without any incentive)
- The incremental approach also minimises Exchequer costs, and
- The credit on buildings is, in any event, volume based

The establishment of 2003 as a permanent base year in the Finance (No. 2) Act 2008 means that all companies that began operations after 2003 (or other companies with zero spending on R&D in 2003) effectively have a volume-based scheme.

5.2.3 Definitions of R&D

Calls to broaden the definition of R&D (for example, in relation to the eligibility of software tools and clinical trials) were made during the consultation process. The definition of qualifying R&D that is contained in the corporation tax code and that follows international best practice – see introduction to section 5.2 above – is supplemented by regulations made by the Minister for Enterprise, Trade and Employment (in consultation with the Minister for Finance) which provide that certain categories of activities are, and certain categories are not, R&D activities. As the current definition accords with international norms, no change is recommended.

5.2.4 Conclusions on R&D

To conclude, we recommend one change to the R&D tax credit system, as indicated below.

Recommendation 7.20

Companies should, at their option, be permitted to offset their R&D tax credit against their employer PRSI costs.

Costings

This change is cost neutral to the Exchequer. It is recognised that some form of Exchequer crediting system will be required to compensate the Social Insurance Fund if offsets against employer PRSI are introduced.

5.3 Foreign tax credit on royalties

5.3.1 Tax treatment of royalties payable to Irish businesses from abroad

This section covers the tax treatment of royalties payable to Irish-based businesses in respect of intellectual property that is used abroad. Typically, the issue relates to software that is licensed from Ireland to businesses located outside Ireland – foreign withholding taxes imposed on income in respect of the software may not be fully relieved under Irish tax rules. The withholding tax rules are summarised in Box 7.10.

Box 7.10: Withholding tax rules for royalty payments into Ireland

- The imposition of foreign withholding tax on royalties paid into Ireland depends in the first instance on the tax rules in the paying company's jurisdiction
- Foreign withholding tax can be imposed at whatever rate applies under the law of the jurisdiction from which the royalties are paid
- Foreign withholding tax may be reduced under the terms of the tax treaty between the paying country and the country of residence of the recipient
- Where withholding tax is imposed, credit relief may be available under the terms of the EU Interest and Royalties Directive, or under the terms of a double tax agreement between the paying country and Ireland
- There are two provisions under Irish tax law in respect of royalty payments from non-treaty countries that have been subject to withholding tax:
 - Companies subject to corporation tax at the 10% rate may avail of unilateral relief, under which the foreign withholding tax may be credited in Ireland against Irish tax;
 - Other companies may deduct the withholding tax as a trading expense. This is a significantly less generous form of relief than a credit system.

To illustrate the operation of the rules, Table 7.2 gives an example of an Irish company that licences software to a foreign company and receives a royalty payment (subject to withholding tax) for it:

Table 7.2: Foreign withholding tax on royalty payments to an Irish company

Royalty income from abroad	€100.00
Expenses incurred	€80.00
Taxable profits in Ireland (net royalty income)	€20.00
Irish tax before credit = €20 × 12.5%	€2.50
Withholding tax paid abroad @ 20% (on the gross royalty)	€20.00

The foreign tax of €20 may be treated as follows:

- If the royalty comes from a country with which Ireland has a double taxation agreement, the foreign tax will be credited against the Irish tax on the royalty. Because the amount of credit is limited to the Irish tax referable to the income (which is €2.50 in the example), this will reduce the Irish tax borne to zero. (Company pays €20.00 total)
- If the royalty comes from a non-treaty country
 - If the recipient is a company availing of the 10% manufacturing rate of tax, then under the unilateral credit relief provisions, foreign credit of €2.00 will be available³⁰. (Company pays €20.00 total)
 - Otherwise, the €20 is allowed as a deduction against the taxable profits. The Irish profits are reduced to nil, and no further tax is payable. (Company pays €20 total tax, despite having no profits)

In our view, all trading companies should be able to avail of unilateral credit relief. Currently, such relief is available, but only to manufacturing companies that are subject to the 10% corporation

30 In this case, the Irish tax is €20 × 10% = €2.00

tax rate, which will expire at the end of 2010. Our proposal means that foreign withholding tax would be credited in Ireland against Irish tax, in cases where the payment comes from a country with which Ireland does not have a tax treaty. Such relief would improve the position of Irish companies expanding into foreign markets.

However, unilateral credit relief with a separate limit for each country is not, in our view, sufficient. In summary:

- The foreign withholding tax is imposed on the gross royalty (€100 in the example above)
- The Irish tax is imposed on the profit margin (net royalty income) (€20 in the example)
- The amount that can be credited is limited to the relevant Irish tax (€2.50 in the example)
- So the only time that the company in the example above will get full relief and be able to credit all the foreign withholding tax is where no expenses are incurred

Pooling of foreign tax credits on royalties should be permitted with an overall foreign pool. Royalty pooling in this way would allow the foreign withholding tax to be absorbed against all foreign royalty income and would reduce the effective rate of tax for companies paying foreign tax. In the example above, the company has €17.50 'unused' credit under the double tax treaty or unilateral credit system. Pooling allows this to be utilised for offset against Irish tax on other foreign royalty income. Table 7.3 adds two new columns to Table 7.2, to show a second royalty.

Table 7.3: Foreign withholding tax on royalty payments to Ireland - pooling

Royalty income from country A	€100.00	Royalty No 2 from country B	€100
Expenses incurred	€80.00	Expenses incurred	€10
Taxable profits in Ireland	€20.00	Taxable profits in Ireland	€90
Irish tax before credit = €20 x 12.5%	€2.50	Irish tax before credit = €90 x 12.5%	€11.25
Withholding tax paid abroad @ 20% (on the gross royalty)	€20.00	There is no withholding tax in country B	

In the absence of pooling:

- With the first royalty, the €20 foreign credit is available; the company pays no Irish tax
- With the second royalty, the company pays tax of €11.25
- The company's total tax is €20.00 (foreign) plus €11.25 (Irish) – an effective tax rate of 28.49% on its profits - and it has "excess" foreign tax credits of €17.50

Under a pooling arrangement, the 'excess credit' from the first royalty would be used to reduce the tax borne by a further €11.25, thereby reducing the Irish tax to zero. The company's total tax liability would thus be the foreign tax of €20.00 (its effective tax rate is reduced to 18% and would eventually reach 12.5% if it had more income in country B).

Pooling arrangements for foreign tax paid on profits of overseas branches and on interest and dividend payments coming into Ireland are already in place. The introduction of pooling for royalties seems entirely appropriate and we recommend it.

Recommendation 7.21

Unilateral credit relief for foreign withholding tax on royalty payments should be extended to all trading companies.

Recommendation 7.22

An overall foreign pooling system for foreign withholding tax on royalty payments should be introduced.

Costings

Recommendation 7.21: This measure would cost approximately €6 million.

Recommendation 7.22: Estimated cost in the region of €50 million³¹.

5.4 Skills and training

The skills profile of the labour force is a key component in the creation of an environment that supports economic activity and promotes increased employment. Skills and training featured significantly in the submissions. Our work in this area was also informed by the National Skills Strategy set down by the Expert Group on Future Skills Needs (2008). Skills shortages were brought to our attention during the consultation process. Our analysis focussed on two issues:

Skills shortages were brought to our attention during the consultation process. Our analysis focussed on two issues:

- The need to develop the domestic skills base by upskilling the Irish labour force, and
- The need to bring skilled people to Ireland in the short run, to meet immediate demands for experienced personnel

5.4.1 Upskilling the Irish labour force

Existing tax treatment of expenditure on education and training is summarised in Box 7.11. A cross-country comparison on the tax treatment of expenditure on training/education by employers (OECD 2006)³² indicated that full deductibility of training expenses in the year incurred was the main method of tax treatment. This is also the case in Ireland. Further details on training-related tax breaks for employees are given in Part 8, where we recommend that these tax incentives should be continued.

Box 7.11: Summary of tax treatment of training and education costs

- Costs incurred by employers on employee training and education (such as course fees and membership subscriptions for professional bodies) are normally tax deductible as a revenue expense
- Pre-trading expenditure on training incurred by a business before trading starts may be written off over a three-year period
- Tax credits (at the standard rate) are allowed to individuals for fees paid for third-level education; tax credits are also available for expenditure on FÁS-approved language or information technology courses
- There is an income tax exemption for employees in respect of retraining costs incurred by their employers as part of a redundancy package, up to a limit

³¹ Based on information from Forfás and the development agencies, who point out that it does not factor in any behavioural change.

³² STI working paper 2006/4, op cit.

Our consideration of whether extensions to the tax reliefs would be desirable was informed by the following considerations:

- State funding on education and training is considerable - apart from expenditure on the educational institutions, grants and services to employers to provide education and training are available through FÁS and the development agencies, among others
- Training is needed by both unemployed and employed persons; using tax as a policy instrument is not appropriate for persons outside the tax net
- The deadweight costs associated with tax incentives for upskilling are considerable

We concluded that, by and large the current system caters adequately for relevant courses; the deadweight costs associated with tax incentives for upskilling/training staff suggests that other policy instruments may be more effective. However, there is one area where amendments to the current tax provisions are warranted.

Tax relief is currently available where an employee who is made redundant retrains, and the cost of the course is borne by the employer (see Box 7.11). We propose a further incentive for unemployed persons who incur their own retraining/upskilling costs, under which tax refunds (up to an annual limit) would be made available for offset against income for the previous six years. This mirrors the seed capital scheme, which provides tax refunds to unemployed individuals who set up their own companies. (There is further detail about the seed capital scheme in Part 8 of our Report.)

Recommendation 7.23

Persons who are made unemployed should be entitled to offset the retraining costs they incur on certified training courses against income for the previous six years.

Costings

No cost estimate is available for this measure.

5.4.2 Attracting key skills into Ireland

The remittance basis of taxation, and the measure for foreign domiciled individuals introduced in Finance (No. 2) Act 2008, are briefly summarised in Box 7.12.

Box 7.12: Summary of tax measures geared towards foreign nationals working in Ireland

- Prior to 2006, the remittance basis applied under which foreign nationals coming to reside in Ireland could confine their Irish income tax liability on foreign income to the income they brought into Ireland
- The Finance Act 2006 abolished the remittance basis in respect of employment income derived from employments exercised in Ireland. Foreign nationals were brought into the PAYE net, and Irish income tax was deductible from earnings relating to employment duties in Ireland
- The Finance (No. 2) Act 2008 introduced a new regime for foreign employees coming to work in Ireland from non-EEA countries with which Ireland has a double tax treaty. The employer must operate Irish PAYE on the employment income and the relief applies by way of repayment of Irish tax on up to 50% of remitted earnings in excess of €100,000 per annum

The remittance basis of taxation is considered in Part 5 of our Report. A targeted tax incentive to allow Ireland to compete in world markets for mobile employees who are in demand internationally was an issue we considered in some detail. We examined, in the first instance, the provision introduced by the Finance (No. 2) Act 2008, which applies to a limited category of employments exercised in Ireland. Broadly, the measure only applies

- To persons earning in excess of €100,000 per annum
- To individuals who are not Irish domiciled and who, before they came to Ireland, were living and working in a country:
 - that is not in the European Economic Area, but
 - that has a tax treaty with Ireland
- Where the individual is sent by his or her foreign employer to work in Ireland for that employer or for an associated company of that employer and continues to be paid from abroad

Individuals availing of the provision may reduce their income to the greater of:

- €100,000 plus 50% of the employment income over that amount, or
- The income from that employment remitted to Ireland

We concluded that the measure introduced in Finance (No. 2) Act 2008 has limited value as a measure to encourage key workers with required skills to locate in Ireland, because it is confined to employees from non-EEA countries and is not based on skills that are in demand in this country. On the one hand, it is too narrow (certain territories) while on the other hand, it is too broad (all skills covered). We recommend that it should be discontinued.

We favour a targeted scheme based on skills rather than nationality. The skills we are focusing on are ones that are strategically important to the development of defined sub-sectors of the economy, and which are simply not available in Ireland. Our proposal is presented in Box 7.13.

Box 7.13: Attracting key skills into Ireland – a carefully targeted incentive

- A targeted scheme, based on specific skills, rather than salary criterion, would be more effective in meeting identified needs
- The Department of Enterprise, Trade and Employment (DETE) would be advised by the Expert Group on Future Skills in developing a 'critical skills list'
- The burden of proof would be on the employer, to show that the necessary skills could not be met domestically – this would be done on a company by company basis; employers would apply to DETE and would be given evidence of their qualification for the incentive, which could be provided to the Revenue Commissioners
- Relief would be given by way of deduction from a person's taxable income; there would be a limit on the amount of relief that would be given, so that:
 - There would be a cap on the relief set at 25% of total income, and
 - This would be subject to an income ceiling of €250,000
 This means that the maximum reduction available to an individual would be €62,500 (€250K x 25%)
- Relief would be time-limited: An individual could claim relief under the scheme for a maximum of three years.
- The scheme would cover critical skills only, and these would also be time-limited
- Focus would be on skills, not nationality
- The inclusion of a skill on the list would only be allowed if it was considered to be the best way for Ireland to fill the gap. In other words, skills which are strategically important for the development of defined sub-sectors of the economy

Such a scheme would address the need to bring key employees to Ireland to meet immediate, short-run demands for experienced personnel. We consider that the benefits that flow from the location here of these mobile workers could be considerable. This is due to the positive externalities, including the development of those sectors of the economy that have been identified as being of strategic importance - development which will not happen in the absence of a targeted incentive, as the skills are not available domestically.

Recommendation 7.24

The partial reintroduction of the remittance basis in the Finance (No. 2) Act 2008 should be discontinued.

Recommendation 7.25

A carefully targeted tax incentive, along the lines indicated in Box 7.13, should be introduced to attract skilled persons into Ireland to meet short-term skills gaps.

Costings

No cost estimates are available for these measures.

Appendix 1

Supplementary information on Section 2 - the economics of corporation tax

International theory and evidence

Overview

Corporation tax influences economic growth through affecting both capital formation and productivity. Corporation tax can have a negative effect on investment (capital formation) by reducing its after-tax return. OECD evidence confirms this at both the firm and industry level. This section focuses particularly on mobile investment because Ireland is a small open economy. The impact of corporate taxation on productivity can occur through several channels. First, corporation tax can result in a re-allocation of resources towards possibly less productive sectors by distorting relative factor prices. Second, corporation tax, when complex, can impose high compliance administrative costs. Third, the effect of corporation tax on investment may have knock-on effects on innovation. Fourth, the effect of corporation tax on mobile investment may hinder technology transfers and knowledge spillovers.

Recent empirical research by the OECD on the relationship between tax and economic growth has highlighted the overall economic impact of corporation tax, finding that relative to other taxes, "corporate income taxes appear to have a particularly negative impact on GDP per capita."³³ This analysis ranks tax instruments with respect to their relationship to economic growth. Property taxes are the most growth-friendly, followed by consumption taxes, then personal income taxes, and finally corporate income taxes.³⁴ The OECD paper estimates the effect on GDP per capita of changing the tax mix while keeping the overall tax-to-GDP ratio constant: a shift of 1% of tax revenues from income taxes to consumption and property taxes would increase GDP per capita by between a quarter of a percentage point and one percentage point in the long run. This is because direct taxes like corporation tax are more distortionary as they have a greater effect on economic incentives. Economic theory suggests that this effect is likely to be greater in a small open economy where capital is more mobile.

Mobile investment

One of the key results in the optimal tax setting literature is that, in the absence of location-specific rents, a government in a small open economy should not levy any (source-based) taxes on capital.³⁵ This is because a small open economy faces a perfectly elastic supply of capital from abroad. In formal economic models, a rise in the tax on the return to capital located in an open economy will raise the required pre-tax rate of return on capital in that economy, inducing an outflow of capital.

Griffith, Hines and Sørensen (2008) list a number of caveats to this result. First, if by investing in a particular location, firms can earn location-specific rents, which are immobile as opposed to mobile firm specific rents, the government of that jurisdiction may impose some amount of source tax without deterring investors. This relates to the new economic geography perspective which emphasises the role of 'agglomeration economies' and the business concentration benefits of a particular country. A further

33 'Tax and Economic Growth', OECD Economics Department Working Paper No. 620, July 2008.

34 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', Jens Arnold, OECD Economics Department Working Paper No. 643.

35 'International Capital Taxation', Rachel Griffith, James Hines, and Peter Birch Sørensen, March 2008, Paper prepared for The Mirrlees Review, "Reforming the Tax System for the 21st Century".

example is the issue of market access with firms choosing to locate production in large markets even if they maintain relatively high tax rates. Second, capital may not be perfectly mobile. Third, a corporate income tax may be a necessary 'backstop' to the personal income tax. Fourth, even though it may be inefficient to tax capital income at source, a source-based corporation tax may be a political necessity. Only the first two caveats are based on economic efficiency grounds specific to corporation tax. The first caveat is an empirical issue to which we will return below. On the second issue, capital is more mobile in a small open economy.

Turning to the empirical work in this area, most of the research concentrates on foreign direct investment (FDI). A literature review carried out for the OECD by Mooij and Ederveen (2005) finds that most studies report a negative relationship between taxation and FDI, but with a wide range of estimates of the tax elasticity of FDI.³⁶ The average elasticity value is -3.72; this is the estimated percentage change in FDI in response to a one percentage point change in the tax rate. Distribution analysis finds that a majority of the estimated elasticities occur in the range of -5 to 0. Within these general findings it is noteworthy that the share of FDI that comprises real investment in physical capital is more responsive to taxes than other components of FDI. Also, it seems that FDI is becoming more responsive to taxation over time, as studies using more recent data are found to produce larger elasticities.

A more recent survey of the academic research concludes that "it is clear from this accumulated evidence that taxation does play a role in affecting the choices made by multinational companies".³⁷ In particular, average tax rates tend to play a significant role in discrete location choices, and hence in the overall allocation of capital. Devereux and Griffith (1998), for example, presented evidence that the discrete location decisions of US multinationals within Europe were affected by average tax rates rather than marginal tax rates.³⁸ This is as predicted by economic theory, with marginal tax rates more relevant for the level of investment.

Incidence

It is important from a distributional viewpoint to note that these economic effects of corporation tax are far broader than just the impact on company profits. The concept of tax incidence says that the person who pays a tax doesn't necessarily bear the economic burden of the tax. The cardinal rule of tax incidence analysis is that only individuals can bear the burden of taxation and that all tax burdens should be traced back to individuals.³⁹ Thus, the burden of corporation tax ultimately falls on the shareholders, the customers/suppliers, or the employees. This can be illustrated by examining capital formation, the key channel identified in the literature. Lower company profits decrease the incentive to invest and thus decrease the capital stock, which in turn reduces the marginal productivity of labour, and thus wages.

Recent attempts to measure corporate tax incidence find that a significant part of the effective incidence of the tax falls on wages. One study using data on 23,000 companies located in 10 countries over the period 1993-2003 estimates that approximately 54% of any additional tax is passed on in lower wages.⁴⁰

36 'Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis', OECD Tax Policy Studies No. 17, 2007.

37 'The Impact of Taxation on the Location of Capital, Firms and Profit: A Survey of Empirical Evidence', Michael P. Devereux, Oxford University Centre for Business Taxation, WVP 07/02

38 'Taxing Corporate Income', Alan J. Auerbach, Michael P. Devereux, and Helen Simpson, March 2008, Paper prepared for The Mirrlees Review, "Reforming the Tax System for the 21st Century".

39 'Who Bears the Corporate Tax? A review of What We Know', Alan J. Auerbach, National Bureau of Economic Research Working Paper Series, No. 11686, 2005.

40 'The direct incidence of corporate income tax on wages', Wiji Arulampalam, Michael P. Devereux and Giorgia Maffini, Oxford University Centre for Business Taxation, WP 07/07.

Another report using data on the foreign activities of US multinational firms in more than 50 countries between 1989 and 2004 finds that between 45% and 75% of the burden of corporate taxes is borne by labour with the balance borne by capital.⁴¹ In smaller countries the domestic labour force is likely to bear more of the burden of the tax because capital is more mobile in a small open economy.⁴²

Irish evidence

Foreign direct investment in Ireland

This international evidence on mobile investment is very relevant to Ireland as the importance of FDI to the Irish economy is well known. A key measure in this regard is the stock of inward investment in Ireland which is the accumulated flow of FDI projects over time. While Ireland's FDI stock, as a percentage of GDP, has declined since 2000, its inward investment levels remain among the highest in the OECD. In 2007, Ireland ranked third out of 27 OECD countries for its stock of inward investment as a % of GDP.⁴³

This large amount of FDI is a significant contributor to many key economic aggregates. Foreign owned firms are key drivers of exports, directly employ a significant number of people, have higher rates of R&D, and impact the Irish economy through their expenditure.⁴⁴

- Foreign-owned firms assisted by IDA Ireland accounted for 63% of total Irish exports in 2007. Over various time periods, the growth rate of exports by these foreign-owned firms (as well as the level) exceeds the growth rate of exports by agency-assisted indigenous enterprise: the respective rates for these two groups are 11.5%, 21.8% and 5.8% for foreign-owned firms versus 6%, 8% and 3.8% for indigenous firms, for the time periods 1990-1994, 1995-1999, and 2000-2007
- Foreign-owned firms assisted by IDA Ireland employed 153,510 employees in 2007
- R&D expenditure by foreign-owned firms was €1.16 billion in 2007 or 72.4% of total business R&D expenditure in Ireland. Thus foreign-owned firms are playing a significant role in Ireland's attempt to move up the value chain as it tries to match competitor countries in its level of R&D intensity
- Total expenditure by foreign firms in the Irish economy amounted to €18.1 billion in 2007. This comprises €7.2 billion on services purchased in Ireland, €3.3 billion on materials produced in Ireland, and €7.6 billion on payroll costs. Measuring this expenditure relative to GNP we get a figure of 11.3%, a decline from 19.7% in 2000
- The academic literature also stresses the role of FDI in generating technology and knowledge spillovers that can boost the productivity of domestic firms.

Empirical evidence.

A recent paper estimates the economic impact of the rate of corporation tax in Ireland by examining a natural experiment, the extension in the early 1990s of the low tax regime to the non-manufacturing economy, in particular to the business and financial services sector.⁴⁵ The rate of corporation tax in the market services sector fell gradually from 40% in 1994 to 32% in 1998 and finally to 12.5% by 2003.

41 'Labor and Capital Shares of the Corporate Tax Burden: International Evidence', Mihir A. Desai, C. Fritz Foley, James R. Hines Jr, presented at the International Tax Policy Forum and Urban-Brookings Tax Policy Center conference on Who Pays the Corporate Tax in an Open Economy?, 18 December 2007.

42 'The direct incidence of corporate income tax on wages', Wiji Arulampalam, Michael P. Devereux and Giorgia Maffini, Oxford University Centre for Business Taxation, WP 07/07.

43 The ranking does not change when GNP is used as the denominator.

44 Much of this data is from 'Annual Business Survey of Economic Impact 2007', Forfás.

45 'The Macroeconomic Impact of Changing the Rate of Corporation Tax', Thomas Conefrey and John Fitz Gerald, ESRI Working Paper No. 273, January 2009.

This paper finds that the fall in the tax rate had a significant positive long-run impact on the sector in the form of a substantially higher level of exports and output. The reduction in the corporate tax rate from 40% to 12.5% accounted for an increase in exports of services of over 60%.

The overall macroeconomic effects of the change in the tax rate, allowing for multiplier and competitiveness effects, are then estimated. To isolate the impact of the tax change from other economic factors, two simulations of the *HERMES* macroeconomic model are undertaken: one simulation with the corporation tax rate held at 40% and one where it is cut to 12.5%. The reduction in corporation tax rates for non-manufacturing sectors is estimated to have increased the level of GNP in 2005 by over 3.7%. The paper concludes that the increase in output arising from the change the in corporation tax regime applying to the business and financial services sector was significant, but that it was not the main factor driving increased output in Ireland as the level of GNP in Ireland rose by 87% over the period 1995-2005.

An earlier paper uses a cross-country approach to examine the effect of corporation tax rates on FDI, with a particular focus on Ireland. It finds that 10% higher statutory corporate tax rates are associated with 44% less foreign investment from the United States, controlling for income, population, and European location.⁴⁶ This simple model accounts for the Irish experience very well.⁴⁷

The present situation

The present international trend in tax policy is towards decreasing the rate of corporation tax. Thus, the differential between Ireland's rate and that of other countries has narrowed as the average top rate of corporation tax in the EU-15 and EU-27 has declined. There is, however, a danger in just comparing the headline rates of tax because when the exact tax base is taken into account the effective tax rate applicable to companies will be different from the headline rate.

Despite this international trend Ireland still has the lowest corporation tax rate in the EU-15 and the third lowest rate in the EU-27.⁴⁸ Ireland continues to attract a large number of greenfield investment projects, relative to its size. In 2007, only Singapore attracted more greenfield projects per capita [see Figure 7.2 in Section 2].

Appendix 2

Supplementary information on Section 3: The economics of labour-related taxes and employment

Low taxes on labour are important for supporting demand for labour

Taxes on labour income should be kept low to support demand for labour and employment levels. This crucial link is supported by economic theory and empirical economic evidence, both international and Irish.

The economic theory of the incidence of taxation highlights that the person who pays a tax, in an accounting sense, does not necessarily bear the economic burden of a tax; instead this burden can be shifted to others as other economic variables change in response to the tax change. In standard economic models, the direct impact of a labour tax is borne by either the employee or the employer depending on how the wage level changes. The tax wedge on labour is useful in illustrating this effect; it is defined by

46 'Sensible Tax Policies in Open Economies', James R. Hines Jr., *Journal of the Statistical and Social Inquiry Society of Ireland*, Vol. XXXIII, 2004.

47 This last issue is examined by analysing the change in the Irish residuals from the cross-country regressions.

48 'Annual Competitiveness Report 2008 volume 1', National Competitiveness Council.

the OECD as the gap between the labour costs the employer pays and the corresponding net take home pay the employee receives.⁴⁹ An increase in labour tax will increase the tax wedge resulting in two main effects: an increase in before-tax wages, increasing the cost of employing labour and thus reducing demand for labour and employment; and in a decrease in after-tax wages of employees reducing their real take home pay. Thus a key effect of taxes on labour, in theory, is that they reduce the demand for labour and thus levels of employment.

International empirical evidence shows that labour taxes influence employment, supporting this demand for labour channel. The OECD's 2006 reassessment of its jobs strategy surveyed the econometric evidence of the impact of the tax wedge and a majority of the studies, 12 out of 17, found evidence that a higher labour tax wedge increases unemployment.⁵⁰ The OECD's own research found an economically large effect with baseline estimates implying that a "historically typical" reform of the tax wedge by 2.8 percentage points would increase the employment rate by 1.1 percentage points in the average OECD country.

An earlier survey of the economic evidence found that a 10 percentage point rise in the tax wedge reduces labour input by somewhere between 1% and 3% of the working age population. It concluded that tax rates are a significant factor, though not the main factor, in explaining differences in the amount of market work undertaken by the working age population in different countries.⁵¹

In turning to the Irish evidence, we must examine how the supply of labour responds to changes in the wage rate (the elasticity of labour supply), as this is the key factor determining how the tax burden is shared between the employer and the employee (i.e. where the incidence of the tax falls). In the past Ireland's supply of labour was strongly influenced by emigration to the UK, in particular, such that our labour supply was highly elastic.⁵² When labour supply is elastic, most of the incidence of labour taxes is borne by employers as a decrease in after-tax wage rates (i.e. the alternative where employees bear the burden) would result in an outflow of labour. Thus when labour taxes were decreased in Ireland (e.g. in the first partnership agreement of 1987) most of the incidence fell to employers, decreasing the upward pressure on before-tax wages, increasing competitiveness and ultimately employment. Academic research confirms this analysis that the tax wedge has had a long-run effect on before-tax wage formation in Ireland.⁵³ Fitz Gerald and Hore (2002) find almost full pass through of taxes to wages in the long run in Ireland over the period 1960-1999. In the short run a 1% increase in the Irish tax wedge increased wage rates by 0.75%. Thus the tax wedge in Ireland has raised labour costs and decreased the demand for labour, decreasing employment.

The relative importance of this labour tax effect in Ireland's recent economic history is highlighted in a recent paper which conducts a business-cycle accounting exercise on Ireland's economic performance between 1973 and 2002.⁵⁴ This paper attempts to isolate the different impacts of total factor productivity, government spending and taxes on labour income and investment. The estimate used for Ireland's labour tax wedge is driven primarily by movements in explicit tax rates and it is this measure and the productivity measure that are found to be the key factors, such that "the labour wedge acting in isolation would have generated a severe downturn in economic activity in the 1970s and 1980s." Turning to unemployment

49 'Taxing Wages 2006 / 2007', OECD, 2007. The OECD tax wedge is an average tax rate measure.

50 'OECD Employment Outlook: Boosting Jobs and Incomes', OECD 2006.

51 'Employment and Taxes', Stephen Nickell, CEP Discussion Paper No 634, London School of Economics, May 2004.

52 ESRI 'Medium-Term Review 2008-2015', J. Fitz Gerald et al., May 2008. Empirical studies show that this phenomenon explained the behaviour of Irish wage rates up to the mid-1990s

53 'Wage Determination in Economies in Transition: Ireland, Spain and Portugal', John Fitz Gerald and Jonathan Hore, ESRI Working Paper No. 147, August 2002. This confirms earlier research by Anderton & Barrell (1995) and Bradley et al (1993).

54 'Ireland's Great Depression', A. Ahearne, F. Kydland, and M.A. Wynne, The Economic and Social Review, Vol. 37, No. 2, 2006.

specifically, a second result is that “only the labour wedge generates a decline in the labour input”. Thus taxes on labour income are particularly important in explaining Ireland’s recent economic history.

The economic importance of the tax wedge in Ireland has increased alongside the growing importance of price and wage competitiveness since Ireland adopted the euro. As a member of a common currency, Ireland can no longer devalue its own currency to regain competitiveness when necessary, thus the adjustment has to fall on national prices, including wages. Our recent history in this regard is that Ireland has experienced a 32% loss in international price competitiveness between January 2000 and September 2008, with approximately one-third of the loss due to higher price inflation in Ireland.⁵⁵

The present situation

As recently as 2007 Ireland had the smallest tax wedge in the OECD at less than half the OECD average (see Fig 7.3 in Section 3). This position has changed in the last two years, since the April 2009 budget, as Ireland’s tax wedge has now increased to approximately 17.4%. This represents a significant 36% increase in the tax wedge in only two years. This reverses the trend where the value of Ireland’s tax wedge had fallen significantly in the last decade, from 25.6% in 1998 to 12.8% in 2007, and at a faster rate than the average OECD tax wedge.⁵⁶

The effect of the tax wedge may be different now because recent evidence suggests that the supply of labour is not always infinitely elastic in Ireland because the nature of the Irish labour market changed during the last decade.⁵⁷ Thus part of the recent reductions in labour taxation accrued to employees in the form of higher wages, with the positive impact on competitiveness and employment less than in earlier times.

However, despite this recent decrease, a recent estimate suggests that labour supply is still quite elastic by international standards.⁵⁸ Therefore the impact of income taxes and the tax wedge on demand for labour and employment levels is still greater in Ireland than it is in other countries. Thus policymakers should aim to keep the labour tax wedge low, in absolute terms and relative to other countries.

In relation to the economic environment the country faces in the short-term, a process has already started where tax revenue is being increased to correct the public finances. With specific regard to the Exchequer contribution of taxes on labour, it has been well documented that the share of labour tax in overall tax revenues has fallen significantly over the last decade. From a peak of 36.6% in 1997 the income tax share fell to a trough of 27.2% in 2006, a fall closely mirrored by a corresponding rise in the share of asset-related tax revenues.⁵⁹ This does not, however, suggest that further policy changes are needed to increase the share of labour tax in overall tax revenues. This increase is already happening due to recent tax increases (including levies) and also because of the present economic downturn, where the revenue from labour taxes is decreasing at a slower rate than that of other taxes. By 2008, the income tax share had already risen back to 32.3%.

The total tax wedge on labour is composed of income tax and social security contributions from both employees and employers. Employers’ social security contributions (employer PRSI) are paid directly

55 ‘Annual Competitiveness Report 2008 volume 2’, National Competitiveness Council.

56 The total tax wedge is based on a two-earner family with two children with wage levels of 100% and 67% of the average wage for the two earners; ‘100-67%’ in the OECD shorthand (OECD, ‘Taxing Wages’, various years).

57 The ESRI note two specific changes that affect the labour supply curve through migration: the nature of the migration has changed and is no longer primarily between Ireland and the UK, and large inflows of migration result in rising costs of living in the short run when the stock of infrastructure is fixed.

58 ESRI ‘Medium-Term Review 2008-2015’, J. Fitz Gerald et al., May 2008. By comparison the “consensus estimate” is that labour supply is “very inelastic” according to recent surveys of the literature; these studies primarily use American data (‘Labour Economics’, G.J. Borjas, 2005).

59 Source: Central Budget Office, Department of Finance. These data are income tax revenue as a percentage of total tax revenue, not including social insurance contributions.

by the employer. This direct payment refers to the imposition of the tax but in the short run the effective economic incidence of a change in employer PRSI will also fall primarily on the employer, as it takes time for nominal wages, the price mechanism in labour markets, to adjust. Therefore, a temporary reduction in employer PRSI could be a suitable tax-related policy tool to decrease the cost of employment and sustain demand for labour in a weak economic environment.

Low taxes on labour are important for supporting labour supply

When the incidence of taxation falls on the employee it is after-tax wages which are affected which then has an incentive effect on the supply of labour. Higher taxes decrease the return to employment in the form of after-tax wages which then can affect the decision to enter the labour force (participation) and the decision of how many hours to work. Policymakers have a particular interest in the effect of labour tax increases on incentives to participate in the labour market because not only does non-participation mean a decrease in income earned but it can also mean an increase in government expenditure on social welfare.

Empirical evidence of a labour supply effect in Ireland predicts that a general increase in wages of 1% would see preferred hours at work rise by 0.18% for men and by 0.48% for women.⁶⁰ Specific results of further interest are that increased participation accounts for the major part of the response, with increases in hours of work playing a lesser role, for both men and women; and that the labour supply response to different forms of a tax cut is rather similar in terms of the overall change in participation (male and female combined) and in the rise in average desired hours.

These results are important for the policy balance between targeting the average or the marginal rate of tax. Increased participation accounts for the major part of the labour supply response and participation is a binary decision to enter the labour force or not driven by average tax rates; whereas increases in hours of work is a relative decision more influenced by marginal tax rates. Thus, on this evidence average tax rates are of greater economic importance. This is confirmed by the result that the labour supply response in terms of the rise in average desired hours is rather similar for different forms of a tax cut: if marginal rates were more important than average rates, then cuts in tax rates should be more important than changes to the bands or credits.

Targeting average tax rates and labour force participation involves those who switch labour force, i.e. migration, as well as those who drop out of the labour force. The issue of migration has grown in importance for labour tax policy as labour mobility has increased with globalisation and the advent of the single European labour market. In this regard, Irish tax policy needs to observe closely the tax wedge differentials between Ireland and other countries, particularly the UK. It should also be noted that multinational companies consider the overall tax package of a country, including labour tax, because of its implications for attracting skilled labour. Preliminary research shows that FDI is less likely to be located in countries where average labour taxes or their progression (because of the need for skilled workers and managers) are relatively high.⁶¹

Tax evasion is also relevant here as higher taxes on labour increase the incentive to evade tax through not reporting all the labour that is supplied. The shadow economy comprises all economic activities that would generally be taxable were they reported to the tax authorities. As such it includes not only illegal activities but also unreported income from the production of legal goods and services. Several macroeconomic and

60 'Tax Cuts, Tax Reform and Labour Supply Responses', Tim Callan, Arthur Van Soest, and John R Walsh, ESRI Budget Perspectives 2004, October 2003.

61 'Labour Taxation and Foreign Direct Investment', P. Egger and D. M. Radulescu, CESIFO Working Paper No. 2309, May 2008.

microeconomic studies based on data for several countries suggest that a major driving force behind the size and growth of the shadow economy are an increasing burden of tax and social security payments.⁶² As one example of this, the labour supply of men with high levels of education is very unresponsive to tax changes but the amount of taxable income they earn does seem responsive; Meghir and Phillips (2008) believe it is likely that this is due to income shifting.

Low taxes on labour support other aspects of economic activity

Labour taxes also affect other aspects of economic activity, including entrepreneurship and human capital. Entrepreneurship is an important factor in generating employment and economic growth. The case for government support of entrepreneurship depends on a positive externality argument, that the benefits flowing from entrepreneurship are not necessarily captured by the entrepreneurs themselves and thus not enough entrepreneurship is carried out. High taxes discourage entrepreneurs by reducing the return from undertaking risky entrepreneurial projects.

Many empirical studies, however, have found a positive relationship between income taxes and entrepreneurship.⁶³ This incongruity is thought to be due to the use of data from the USA where the tax law allows the self-employed to deduct losses against highly-taxed labour income. In this scenario an increase in labour tax can encourage self-employment as it makes loss-offsetting more valuable while not affecting net gains as the profits are taxed as corporate income.⁶⁴ A recent study uses Sweden to focus on the negative relationship between taxes and entrepreneurship because Swedish tax law provides less generous loss-offsetting.⁶⁵ This study finds that average and marginal taxes negatively influence the propensity to become self-employed in Sweden. Turning to the ongoing decisions of existing entrepreneurs, Carroll *et al.* find that higher tax rates reduce investment, hiring, and small business income growth.⁶⁶

The progressivity of taxes on labour is also important here as progressive taxes reduce the post-tax income differential between the cases where an entrepreneur is successful and the alternative case of a business failure. OECD research finds that a stronger progressivity of personal labour taxes seems to be associated with lower long-run GDP per capita.⁶⁷ This is interpreted to partly reflect higher entrepreneurship and risk-taking, as well as the responsiveness of labour supply.⁶⁸ In related research, Gentry and Hubbard (2000) found that the probability of entry into self-employment increased as tax rates became less progressive.⁶⁹

Progressivity is of course an important consideration with regard to the equity of a tax system; here we note that progressivity also has economic effects which must be taken into account, and that these are prominent when it comes to the progressivity of labour taxes in particular.

Turning to human capital, its development is important because levels of education and skill are important determinants of economic growth. Taxes on labour affect the decision to pursue education or training because taxation affects the extra returns to work that are earned by this higher human capital. A recent

62 'Hiding in the Shadows: The Growth of the Underground Economy', F. Schneider and D. Enste, International Monetary Fund, 2002.

63 'Entrepreneurship and the Policy Environment', Y. Georgellis and H. J. Wall, Federal Reserve Bank of St. Louis Review, March/April 2006.

64 See 'Taxes and Entrepreneurial Activity: Theory and Evidence for the US', J. B. Cullen & R.H. Gordon, NBER Working Paper, No 9015, 2002.

65 'Income taxes and the probability to become self-employed: The case of Sweden', A. Hansson, Ratio Working Paper No 122, 2008.

66 This research is in a series of papers of which the latest is 'Personal Income Taxes and the Growth of Small Firms', R. Carroll, D. Holtz-Eakin, M. Rider, and H.S. Rosen, in J.M. Poterba (ed.) *Tax Policy and the Economy*, Volume 15, 2001.

67 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', Jens Arnold, OECD Economics Department Working Paper No. 643, October 2008.

68 Human capital is already controlled for in the statistical analysis.

69 'Tax Policy and Entrepreneurial Entry', W.M. Gentry and R.G. Hubbard, American Economic Review, May 2000.

OECD paper on the policy determinants of investment in tertiary education includes tax reforms in its analysis although acknowledging that they are rarely motivated with reference to their effects on incentives for investment in higher education.⁷⁰ This paper finds that, in particular, lower marginal tax rates on labour earnings have a positive effect on returns to education.

The effects of taxes on labour are not uniform

The economic impact of labour taxes is not the same for different demographic groups and for different conditions in the labour market.

Demographics

Meghir and Phillips (2008) survey the international evidence on labour supply responses to tax changes and find different elasticities for different demographic groups. They conclude “that hours of work do not respond particularly strongly to the financial incentives created by tax changes for men, but they are a little more responsive for married women and lone mothers. On the other hand, the decision whether or not to take paid work at all is quite sensitive to taxation and benefits for women and mothers in particular.” The consensus in the literature is that participation elasticities for married women are quite high and is perhaps more important than weekly hours of work. A “strong consensus” is that the participation elasticity for lone mothers is among the highest of all demographic groups.

The same authors find a very low hours worked adjustment to changes in marginal wages for men and conclude that it “can almost be ignored for welfare purposes”. This is influenced by a key characteristic of male labour supply that men work primarily full time. Male participation decisions for those with low or medium levels of education can be responsive, but this is to do with a combination of tax and welfare benefits. The work decision is very unresponsive to tax changes for men with high levels of education.

Irish evidence already cited in Section 3 predicts that a general increase in after-tax wages of approximately 1% would see preferred hours at work rise by 0.18% for men but by 0.48% for women. The labour supply of married women is significantly more responsive to an increase in their wage rate than men (with respect to the male wage rate).

This study also found that the gender distribution of the labour supply response to a tax cut varied for different tax cutting options. A cut in the top rate of tax, or a widening of the standard rate band, prompts a greater increase in female participation and average desired hours and much less in male participation. A cut in the standard rate of tax, or an increase in personal allowances, leads to similar increases in participation rates for both genders.

Income distribution

An important factor for those towards the bottom of the income distribution is the minimum wage. Research indicates that higher taxes on labour income appear to have the most detrimental effects on employment when wages do not fall because of the minimum wage.⁷¹ Minimum wages can impede employers from shifting all or part of the incidence of pay-roll taxes onto low-productivity workers by lowering wages, increasing the negative effect of the tax wedge on the demand for labour. Bassanini and Duval (2006) find that increases in the tax wedge have a greater impact in raising unemployment the higher the

70 ‘The Policy Determinants of Investment in Tertiary Education’, OECD Economics Department Working Paper No. 576, J. O. Martins et al., September 2007.

71 ‘Boosting Jobs and Incomes: Policy Lessons from Reassessing the OECD Jobs Strategy’, OECD 2006.

minimum wage is set relative to average wages.⁷² OECD research estimates that an increase in the ratio of minimum to median wages by 10 percentage points would increase the impact of the tax wedge on unemployment by about 50% in the 'average' OECD country.

A second factor is the interaction of the tax system with social welfare benefits. The participation decision to enter the labour force, for those towards the bottom of the income distribution, is affected by a combination of withdrawn social welfare benefits and increased tax payments. ESRI research shows that the highest effective tax rates tend to arise from the withdrawal of welfare benefits, including withdrawal of such benefits from a spouse or partner.⁷³ The replacement rate is an important measure of this dynamic and much international evidence finds a statistical link between the replacement rate and the unemployment rate.⁷⁴ In Ireland "there is a great deal of co-movement in the replacement rate and unemployment rate series" from 1975 up to the turn of the century, with this relationship seeming to break down from 2001 onwards.⁷⁵

The present situation

The tax wedge in Ireland and internationally for different earners and family situations is shown in Table 7.1 in Section 3.

A feature of the Table is that the tax wedge is higher for higher income earners. This is the progressive nature of the Irish labour income tax system. However it is a factor in regard to attracting highly skilled internationally mobile workers: while it is still below the average it is close to the corresponding figures for competitor countries like Switzerland, the UK and the USA for single workers (column 3). The tax wedge continues to increase in Ireland for salaries above the level of these OECD comparisons. A single earner with no children earning five times the average wage faces a total tax wedge of 49.2%, after the April 2009 budget, and the marginal tax rate, including levies, on additional income is 50%.⁷⁶ The tax wedge at this level of income is important as the economic effects are broader than the effects on the individuals themselves, because such earners include highly-skilled workers necessary to attract mobile investment and entrepreneurs who create wealth and employment.

72 'Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions', A. Bassanini and R. Duval, OECD Economics Department Working Paper No. 486, 2006.

73 'Work Incentives, Poverty and Welfare in Ireland', T. Callan, J. Walsh, K. Coleman, ESRI Policy Research Series, No. 60, December 2006.

74 For example see 'Unemployment in the OECD since the 1960s: what do we know?' S. Nickell, L. Nunziata and W. Ochel, Economic Journal, 2005. The replacement rate can be defined as the ratio of 'out of work' family disposable income to 'in work' family disposable income.

75 'Replacement Rates and Unemployment: from Bust to Boom', T. Callan, K. Coleman, J.R. Walsh, in the 'The Irish Labour Market Review 2006: A FAS Review of Irish Labour Market Trends and Policies, 2006.

76 This example is for 'S, 0, 500' in the shorthand of the table. The tax wedge includes tax, levies, PRSI and employers PRSI, for a wage of €170,000; the 50% effective marginal tax rate consists of a 41% income tax rate, a 5% health levy and a 4% income levy with employer's PRSI omitted.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 8

REVIEW OF TAX EXPENDITURES



Part 8:

Review of Tax Expenditures — *review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds*

Section 1 is an introduction.

Section 2 sets out the international and national context of our analysis of tax expenditures.

Section 3 proposes adoption of the OECD definition of tax expenditures.

Section 4 discusses the use and control of tax expenditures in Ireland.

Section 5 establishes principles and review mechanisms for the introduction and review of tax expenditures in Ireland.

Section 6 provides our determination of the benchmark tax system.

Section 7 summarises our review process for tax expenditures

Section 8 analyses tax expenditures relating to children.

Section 9 analyses tax expenditures relating to housing.

Section 10 analyses tax expenditures relating to health.

Section 11 analyses tax expenditures relating to philanthropy.

Section 12 analyses tax expenditures relating to enterprise including farming.

Section 13 analyses tax expenditures relating to employment.

Section 14 analyses tax expenditures relating to savings and investments.

Section 15 analyses other tax expenditures.

Section 16 lists tax expenditures not examined by us.

Appendix 1 contains information on the benchmark tax system.

Our recommendations in this Part are as follows:**General**

8.1	The OECD definition of a tax expenditure – as a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure – should be adopted.
8.2	Measures that are part of the benchmark tax system should not be considered as tax expenditures.
8.3	In general, direct Exchequer expenditure should be used instead of tax expenditures.
8.4	There are three instances where it would be appropriate to examine the possibility of introducing a tax expenditure. These are: • To correct market failure • To attract mobile investment • To offset shortcomings in other areas of public policy Where a tax expenditure is proposed, or an existing expenditure's timescale extended, the following questions should be asked, in sequence: • Does the expenditure fall within one or more of the three instances outlined above? • If so, does the proposal adhere to each of the following principles: - Efficiency - Stability, and - Simplicity • If so, can a departure from the equity principle, which the tax expenditure invariably necessitates, be justified? A tax expenditure should only be introduced, or extended, if it answers affirmatively to each of these questions.
8.5	For all future tax expenditures, and reforms of tax expenditures, there should be: • An <i>ex ante</i> evaluation process in advance of decisions to implement or extend any tax expenditure, including an assessment of the costs and benefits of proposals and consideration of the alternative of a direct expenditure approach. • Better measurement and data collection on the costs and benefits associated with the introduction or extension of the tax expenditure and the review of its impact. • Publication of an annual tax expenditures report by the Department of Finance as part of the annual budget process and subject to Oireachtas scrutiny. • Spending through the tax system should be controlled by, for example, the imposition of thresholds and ceilings and reductions in the rate at which tax relief is given or in the quantum of a base figure to which tax relief might apply.
8.6	Transitional arrangements should be put in place where appropriate in relation to tax expenditures which are being discontinued.

Relating to children

8.7	Child benefit should be taxable income. - The taxing of child benefit should be benchmarked against alternatives, including means testing, to ascertain the most effective method of achieving the aims and objectives of the child benefit programme. - If taxation is applied, we recommend the introduction of a child tax credit to offset the additional tax payable in respect of child benefit for those in the lower half of the income scale.
8.8	The exemption of foster care payments from income tax should continue.
8.9	The one-parent family tax credit should continue and the credit should be allocated to the principal carer only and in a similar way to the current arrangements for child benefit.
8.10	The home carer tax credit should continue.
8.11	The widowed parent tax credit should continue.
8.12	The capital allowances for childcare facilities should be discontinued.
8.13	The income tax exemption for childcare service providers should be discontinued.
8.14	The exemption of employer-provided childcare from benefit-in-kind charge should be discontinued.

Relating to housing

8.15	Mortgage interest relief should be continued in the case of first-time buyers and discontinued for those who are outside this category. The current step down arrangements for first-time buyers regarding the rate at which relief is given should continue to apply.
8.16	Income tax relief for rent paid for private rented accommodation should be discontinued.
8.17	The capital gains tax exemption on the disposal of a principal private residence should be continued.
8.18	Income tax relief for service charges should be discontinued.
8.19	The rent-a-room relief should be discontinued.
8.20	The capital gains tax and stamp duty exemptions on the disposal of site to a child should be discontinued.

Relating to health

8.21	Medical insurance relief should be continued on a more limited basis.
8.22	Relief for health expenses should continue at the standard rate.
8.23	Once the Fair Deal system for nursing home care has been implemented, removal of the tax relief for nursing home expenses should be considered.

8.24	The range of treatments contained within the scope of the relief for health expenses should be subject to regular review.
8.25	Tax relief for contributions paid to permanent health benefit schemes should continue.
8.26	Tax relief for long-term care policies should be discontinued.
8.27	When direct expenditure support at the appropriate level is in place, the incapacitated child tax credit should be discontinued.
8.28	The allowance for employing a carer for an incapacitated individual should continue. However, the rate of relief should be the same as that available under health expenses relief.
8.29	The dependent relative tax credit should be discontinued. • The entitlement to mortgage interest relief that is derived from entitlement to the credit in relation to a principal private residence occupied by a dependent relative should continue. A person should be able to avail of first-time buyer levels of relief once in respect of himself or herself and once in respect of a dependent relative who has not claimed for himself or herself. • The separate entitlement to CGT relief on the disposal of a principal private residence occupied by a dependent relative should be discontinued.
8.30	When direct expenditure support at the appropriate level is in place, the blind person's tax credit should be discontinued.
8.31	The arrangements for the scheme of accelerated capital allowances for palliative care units should be modified by the introduction of a termination date for the scheme.
8.32	The Disabled Drivers and Disabled Passengers Scheme should be modified in accordance with the recommendations of the 2002 Interdepartmental Review Group.
Relating to philanthropy	
8.33	The scheme for payment of tax by means of donation of heritage items should be retained but should be modified so that the tax relief is limited to 50% of the value of the item donated.
8.34	The scheme for payment of tax by means of donation of heritage property should be retained but should be modified so that the tax relief is limited to 50% of the value of the property donated.
8.35	The capital gains tax exemption on works of art loaned for public display should be retained but the exemption should only apply to the gain accruing in the period for which the work of art has been so loaned.
8.36	Income tax relief for expenditure on heritage buildings and gardens should be discontinued.
8.37	The benefit-in-kind exemption on employer-provided art objects in a heritage building or garden should be discontinued.
8.38	The CAT exemption of heritage property and heritage property of companies should be retained.
8.39	The threshold on the eligibility of individual donations to charities and approved bodies to attract tax relief should be reduced from €250 to €100.
8.40	The relief for individuals under Recommendation 8.39 should be at the standard rate in all cases.

8.41	An upper limit of €500,000 per person on the annual value of donations which may attract tax relief is recommended. This limit should be enforced using the principles of self-assessment and audit.
8.42	The self-employed should be treated in the same way as PAYE earners under the scheme with the tax relief being paid to the charity or approved body.
8.43	In relation to donations from companies, the amount that would attract tax relief should be the same as for individuals, i.e. a maximum of €500,000 per annum. The rate of tax relief on corporate donations should be the corporate tax rate and, as with donations from individuals, the tax relief should be paid to the charity or approved body.
8.44	The tax relief scheme available on donations to sports bodies should be modified. The tax relief regime that is recommended in respect of donations to charities and other approved bodies should also apply in relation to relief for donations to sports bodies and aggregate limits should apply to both reliefs.
8.45	Relief for gifts made to the Minister for Finance should continue.
8.46	The tax-exempt status of philanthropic and sports bodies should continue. However, the capital gains tax exemption should be discontinued where development land is disposed of.
Relating to Enterprise (including Farming)	
8.47	The restriction of balancing charges on a building to the relevant holding period for that building should be discontinued for future acquisitions.
8.48	Grants to meet revenue expenditure should be taken into account in calculating taxable trading income and capital allowances should be available on expenditure net of capital grants. However, in the case of employment-related grants, there may be a case for postponing the approach we suggest until more favourable labour market conditions apply.
8.49	The tax credit for research and development should continue.
8.50	Tax exemption for patent royalties should be discontinued.
8.51	The tax deduction for capital expenditure on scientific research should continue.
8.52	Film relief should be continued but should be subject to regular review in accordance with our principles as set out in Section 5 of this Part.
8.53	- The Business Expansion and Seed Capital schemes should remain in place up to their 2013 deadline. - The schemes should be reviewed to evaluate their effectiveness and the extent to which market failure exists in advance of any further extension beyond 2013. - The administrative burden placed on companies seeking to benefit from the schemes is onerous and should be reviewed.
8.54	Stock relief for farming businesses should be discontinued.
8.55	Income tax relief for farm land leasing income should be continued. However, the measure should be reviewed in 2012 in accordance with our principles as set out in Section 5 of this Part.
8.56	The accelerated allowance for capital expenditure on farm buildings for pollution control should not be continued when it expires in 2010. For subsequent years, normal capital allowances should apply.
8.57	The tax relief for the purchase of milk quota should be discontinued.

8.58	The restructuring aid for sugar beet growers should continue.
8.59	The tax exemption for payments to National Co-operative Farm Relief Services Ltd. and payments made to its members, should be discontinued.
8.60	The accelerated capital allowances for energy efficient equipment should continue.
8.61	Relief for investment in renewable energy generation should continue. Any extension should adhere to our general principles as set out in Section 5 of this Part.
8.62	The Mid-Shannon corridor scheme should not be continued beyond its current expiry date.
8.63	The investment allowance for machinery and plant and for exploration expenditure should be discontinued.
8.64	The tax treatment of the decommissioning of fishing vessels should continue.
8.65	The relief from tax for start-up companies should be continued. However, the scheme should be modified so that companies who begin trading in 2010 or 2011 would benefit from the exemption for two-years or one-year, respectively, within the existing three-year timeframe for the relief. In addition, the exclusion which applies to service companies should be removed. • A new scheme for unincorporated businesses should be established which would have its own three-year time cycle in line with the approach we recommend for the existing scheme. • Both the existing scheme and the proposed new one for unincorporated business should be subject to review in accordance with our general principles as set out in Section 5 of this Part after a reasonable period of time.
8.66	The tax treatment of venture fund managers should be modified such that in the case of an individual who is a venture capital fund manager: • Where the investment return on a carried interest represents income, it should be taxed at the appropriate marginal rate, and • Where the investment return on a carried interest is a capital gain, it should be subject to capital gains tax at the normal rate (25%).
8.67	The tonnage tax regime should be continued.
8.68	The capital gains tax relief for family transfers should be continued but limited so that it applies to asset values up to €3 million. Where the value of the asset transferred exceeds €3 million, only the part of the gain that is attributable to the excess over €3 million should be charged to tax.
8.69	Capital gains tax relief for disposal of a business or a farm on retirement should continue.
8.70	For business relief for CAT, a reduction of no more than 75% of the value of the business should be allowed before tax is calculated. The reduction should be subject to an overall monetary limit of €3 million.
8.71	For agricultural relief for CAT, a reduction of no more than 75% of the value of the property should be allowed before tax is calculated. The reduction should be subject to an overall monetary limit of €3 million. A condition of the relief should be that a farm asset is owned and operated as a farm for period of six years after the transfer.
8.72	Business relief and agricultural relief should be amalgamated into a single relief.
8.73	Stamp duty relief for transfers of land to young trained farmers should continue.
8.74	The stamp duty exemption relating to the sale or transfer of EU Single Farm Payment Entitlements should be continued.

8.75	The tax incentives relating to forestry should be continued.
Relating to employment	
8.76	Income tax relief for trade union subscriptions should be discontinued.
8.77	The relief for benefit-in-kind for employer-provided personal security assets and services should continue to apply where arrangements are made for all employees at risk.
8.78	The relief for benefit-in-kind and PRSI exemption for employer-provided public transport travel passes should continue.
8.79	The relief for benefit-in-kind and PRSI exemption on employer-provided bicycles and related safety equipment should continue.
8.80	The income tax exemption for scholarships should continue.
8.81	The income tax relief for fees paid for third level education should continue.
8.82	Income tax relief for fees paid for training courses should continue.
8.83	The exemption from income tax of statutory redundancy payments should continue.
8.84	Income tax relief for <i>ex-gratia</i> termination payments should continue but the quantum of the exempt payment should be limited to €200,000 and the reliefs for Standard Capital Superannuation Benefit and top-slicing relief should be simplified.
8.85	<i>Ex-gratia</i> termination payments related to death or disability should be subject to a limit in relation to the tax-free amount permissible.
8.86	Income tax relief for termination payments where an employment involves foreign service should continue. However, it should be subject to an overall monetary cap of €200,000 in line with our recommendation for termination payments in excess of the statutory redundancy amount.
8.87	The exemption from income tax for retraining on redundancy should continue.
8.88	There are grounds for discontinuing the systematic short-time relief for equity reasons. However, discontinuation should not be implemented until more favourable labour market conditions apply.
8.89	Income tax relief for long-term unemployed and double deduction in respect of payroll costs should continue.
8.90	Income tax relief for employees on payments related to compensation for loss of future earnings should continue.
8.91	The PRSI exemption for employee (unapproved) share options should be discontinued.
8.92	Continue the income tax exemption for approved profit-sharing schemes (APSSs) and remove the PRSI, health contribution levy and income levy exemptions.
8.93	The tax treatment which applies to employee share ownership trusts (ESOTs) should continue.
8.94	• The income tax exemption for approved share option schemes (APSOs) should be discontinued. • The taxable value of option gains should also be liable to both employer and employee PRSI and to the health contribution levy and the income levy.
8.95	Continue the income tax exemption for Save As You Earn (SAYE) schemes and remove the PRSI, health contribution levy and income levy exemptions.

8.96	Extend the SAYE rules to permit a broader range of employee stock purchase plans (offered to all employees on similar terms and subject to an overall share purchase limit) to be eligible for income tax relief.
8.97	The income tax exemption for new shares purchased on issue by employees should be discontinued.
8.98	The artist's exemption should be discontinued; consideration should be given to introducing income averaging in the taxation of income from creative work.
8.99	The sportsperson's relief should continue. • The total repayment of tax for any 10-year period should be capped at €350,000 as adjusted for inflation. • The sportsperson can only select a block of 10 consecutive years for which to claim the relief as opposed to the best 10 non-continuous years. • The relief should be subject to review after five years of operation under these new arrangements.
8.100	The seafarer's allowance should be discontinued.
8.101	The expenses of members of the Oireachtas should be treated in the same way under the tax code as expenses paid to employees and office holders generally. • A monetary limit should be put in place on the dual abode allowance and the flat rate element of the relief which applies in relation to hotel and guesthouse accommodation should be discontinued.
8.102	The income tax exemption for payments under Scéim na bhFoghlaimeoirí Gaeilge should be discontinued.
Relating to savings and investments	
8.103	Tax exemption for the income of credit unions should be continued.
8.104	The annual exemptions for interest and dividends on special term accounts and special term share accounts should be continued.
Relating to other expenditures	
8.105	The age tax credit should continue.
8.106	The age exemption and marginal relief should continue.
8.107	The tax relief for income under dispositions for short periods (deeds of covenant) should continue.
8.108	The tax relief available to Veterans of the War of Independence should continue.
8.109	The relief from income tax of military and other pensions, gratuities and allowances should continue. In future, the tax treatment of military service gratuities should be consistent with the tax treatment of lump sum payments in other public service employments.
8.110	The exemption from income tax of profits from lotteries should continue.
8.111	Consanguinity relief within the stamp duty code should continue.

Section 1:

Introduction

Our terms of reference asked us to “review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds”.

We identified this task as comprising the following elements:

- Establish a comprehensive list of all tax relieving measures in the Irish taxation system
- Identify those measures that are structural reliefs and therefore part of the benchmark tax system
- Identify those measures that are tax expenditures
- Establish evaluation criteria against which these tax expenditures may be assessed
- Identify the policy rationale for each tax expenditure
- Assess its economic and social benefits
- Evaluate its cost and benefits, and
- Make a recommendation to continue, discontinue or modify each expenditure

We examined tax expenditures introduced in legislation up to and including Finance (No. 2) Act 2008 and that had not been repealed by legislation up to Finance Act 2009. In total 245 tax relieving measures¹ were identified. Having reviewed these, we concluded that 130 were benchmark tax system measures and 115 were tax expenditures.

To facilitate the review, we classified these expenditures into eight categories:

1. Children
2. Housing
3. Health
4. Philanthropy
5. Enterprise and Farming
6. Employment
7. Savings and investment
8. ‘Other’ tax expenditures

We also considered those tax expenditures that have recently been discontinued.

This Part first outlines the context of our analysis and our assessment of the definition and role of tax expenditures. It then establishes a set of principles that we believe should apply to all current and future tax expenditures. It outlines our determination of the tax measures that are part of the benchmark tax system. Following this, each of the tax expenditure categories is reviewed and a summary report of our considerations and the expenditures classified within them is presented.

¹ A number of these involve more than one legislative provision.

Section 2:

International and national context

Over time the increasing number, scope and estimated cost of tax expenditures has raised issues for governments about their appropriate use, their control and their measurement. Detailed reporting began in Germany and the United States in the late 1960s with other countries following in the late 1970s (Austria, Canada, Spain and the UK) and 1980s. In many cases an annual report on tax expenditures was published and/or incorporated into the government budgetary process.

Since the 1980s, the OECD has undertaken various studies and reviews aimed at advancing general knowledge and understanding among member countries in the use, control and measurement of tax expenditures. While there are difficulties associated with cross-country identification and comparison of these expenditures, we have drawn upon the work of the OECD in undertaking our review. Similarly, we have been informed by the work of various academics and research institutes (nationally and internationally) who have examined tax expenditures.

In Ireland, tax expenditure information has been published by the Revenue Commissioners in their annual Statistical Report and as part of the Department of Finance Tax Strategy Group papers. Both have provided estimates of the annual costs of the major tax expenditures in the areas relating to income taxes, corporation taxes, pensions and savings and capital taxes. In addition the Revenue Commissioners' reports have presented a list of tax expenditures "where costs are not currently quantifiable or are negligible or are not identifiable within total aggregates".

There have also been a number of detailed examinations of tax expenditures, in particular associated with a review of property-based tax incentive schemes as announced in Budget 2005 and introduced in Budget 2006.

However, when taken together and compared to the more extensive list of tax expenditures, included in this report, official publications to date have not comprehensively set out all the tax expenditures in the Irish taxation system. Traditionally, these expenditures have been most readily identified with direct taxes. However, as can be seen from this report, they are spread widely through the tax system and across all categories of tax.

Section 3:

Definition of a tax expenditure

We note that, to date there has been no generally accepted definition of what constitutes a tax expenditure in Ireland. Tax incentives, which are introduced as alternatives to direct Government spending so as to achieve given economic and social objectives, are generally considered tax expenditures. In addition, modifications of the tax system in the form of reliefs, exemptions, deductions from tax due, rate reliefs and tax deferrals may also be viewed as tax expenditures. One of our tasks, therefore, has been to seek to address the lack of a comprehensive definition that might formally apply in the Irish context.

In that context, we note the OECD definition of a tax expenditure as:

"a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure"².

2 OECD Committee on Fiscal Affairs, discussion document dated 20 December 2007 - Update on Tax and Growth: Issues for Discussion 20 December 2007.

We adopted the OECD definition for the purposes of our review and we recommend that this definition should be consistently used in classifying tax expenditures in Ireland.

A second definitional task for us has been to identify those tax measures which, although they reduce the tax base, should more properly be regarded as part of the benchmark tax system. There are valid reasons why a tax system might need to incorporate relieving measures and exemptions, for example to help it function equitably and efficiently and to interact with other systems at an international level. Such measures, while they may reduce the tax base as compared with circumstances where they did not apply, may reasonably be regarded as part of the structure of the tax system or, if not inherently structural, are desirable elements that make the tax system function efficiently. We refer to these as benchmark measures³. The OECD definition above captures this concept. Later in this Part we provide further detail of that process. However, in the context of establishing a definition of tax expenditures, we recommend that measures which are part of the benchmark tax system should not be considered as tax expenditures.

While we have attempted to be as comprehensive as possible in our application of the above definition to the Irish taxation system, there are a number of items that could be classified as tax expenditures which we have not included. These cover areas such as exemptions from local authority commercial rates, most PRSI exemptions and differential rates applying to the various taxes, in particular VAT and excise duties.

Recommendation 8.1

The OECD definition of a tax expenditure – as a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax, rather than by direct expenditure – should be adopted.

Recommendation 8.2

Measures that are part of the benchmark tax system should not be considered as tax expenditures.

Section 4:

The use and control of tax expenditures in Ireland

International literature on tax expenditures ascribes the growth in their use to a number of factors including the possibility of administrative efficiency, political attractiveness and the potential for less regular scrutiny than might be the case with programmes of direct spending. Tax expenditures, it is argued, can support an activity without the need to put in place administrative agencies or discrete payment arrangements. In addition, difficulties associated with measuring the cost and benefits of schemes, or the absence of measurement activity altogether, combined with the benefit of lower taxes for the recipients, make such programmes politically attractive.

In the Irish context, tax expenditures have been identified as having a number of objectives including:

- Encouraging investment – such as the business expansion scheme
- Encouraging business activities – such as the tax credit for research and development
- Subsidising costs incurred by individuals – such as mortgage interest and health expenses, and
- Administrative efficiency in delivering a transfer of resources

3 These are equivalent to measures which the OECD might refer to as those which are part of the benchmark tax.

Tax expenditures can involve a number of undesirable characteristics. These include:

- A lack of equity as between different taxpayers, particularly through the redistribution of resources to individuals with higher levels of income or capital
- A lack of transparency and visibility in the allocation of public resources
- The potential to facilitate tax avoidance
- Inefficient allocation of scarce resources that may also involve a deadweight element
- No time limits or time limits that are not adhered to
- No cost constraints, and
- Neither regular nor rigorous reviews

The potential unequal distribution of public resources, which arises from the use of tax expenditures, was a key consideration for us. It informed both our review of existing tax expenditures and our recommendations for the future approach to tax expenditures. Tax expenditure necessarily involves the imposition of a corresponding financial burden on others as a result of the tax forgone through the tax expenditure. In the case of tax expenditures intended to meet a social need (such as, for example, the costs of childcare) we sought to assess whether the existing tax expenditures were appropriately targeted at those in greatest need of support. Where we have found this not to be the case we have recommended alternative approaches such as direct expenditures.

With regard to tax expenditures designed to meet economic objectives (such as job creation) we sought evidence that the initial cost of the expenditure was justified by the consequent increase in economic activity. Where this was not evidenced, we have recommended discontinuance.

To the extent that the beneficiaries of tax expenditures are those with higher incomes or substantial capital, this results in a transfer of financial resources to these beneficiaries by the rest of the taxpaying community, including those on low incomes. In other circumstances, tax expenditure not replaced by increased taxation may lead to reduced public expenditure on essential projects.

As regards the lack of transparency of tax expenditures, throughout our review we encountered many instances where basic cost and benefit data were not available for tax expenditures. Where costs were available, we note that the quality of these estimates was variable. For example, the cost estimate for mortgage interest relief which is derived from the tax relief at source system operated by the financial institutions is likely to be reasonably accurate but the estimated costs of tax expenditures for occupational pensions are less certain because of a lack of data and variability in the assumptions used to calculate them. It is difficult to see how accountability and control in the allocation of public resources can be adequately secured where basic information on the annual cost of so many tax expenditures remains unavailable or unreliable.

We note that many of the tax expenditures where one might expect to see a time constraint were not subject to any time limitation. Further, while there has been more activity in reviewing tax expenditures in recent years, including evaluating proposed new measures on an *ex-ante* basis and introducing them on a time limited basis, there is scope for a periodic review of resource allocation through the tax system that is comprehensive, systematic and rigorous.

Tax expenditures are equivalent to direct public spending and, as such, they should be reviewed as regularly and as carefully. This suggests that an evaluation process which is similar to that which exists in

relation to direct expenditure might appropriately be considered in relation to tax expenditure programmes. For example, on the expenditure side, various Oireachtas Committees have a role in examining the estimates of Government Departments and expenditure is reviewed by the Comptroller and Auditor General. Also, the detailed approach outlined in the Guidelines for the Appraisal and Management of Capital Expenditure Proposals in the Public Sector published by the Department of Finance is relevant as a template for the evaluation process.

We have concluded that, in general, direct Exchequer expenditure should be used instead of tax expenditures. This allows greater transparency and control of public resources and avoids many of the aforementioned undesirable characteristics. While this is our general view, we also believe that tax expenditures, if carefully designed and controlled as is suggested in Section 5, have a role to play in delivering desired behavioural responses.

Recommendation 8.3

In general, direct Exchequer expenditure should be used instead of tax expenditures.

Section 5:

Template for introduction and review of tax expenditures

5.1. Conditions for tax expenditures

We recommend that where a tax expenditure is proposed, or an existing expenditure's timescale extended, it should be consistent with the principles outlined in this section.

In all cases, the following questions should be asked in sequence:

- Is a tax expenditure more appropriate than direct expenditure?
- If so, does the proposal adhere to each of the following principles:
 - Efficiency
 - Stability, and
 - Simplicity
- If so, can a departure from the equity principle, which the tax expenditure invariably necessitates, be justified?

A tax expenditure should only be introduced, or extended, if it answers positively to each of these questions. We outline details on each of the questions below.

5.2. Appropriateness of tax expenditure

We considered the circumstances in which it might be appropriate for Government to introduce a tax expenditure. In that regard, we noted a conclusion in the second report of the previous Commission on Taxation that:

"... it is not sufficient to show that the activity at which the incentive is directed is worthy and would benefit. If this criterion were accepted to justify incentives, virtually all items would qualify for incentives ... because there is almost no activity which cannot be shown to benefit from a selective reduction in taxation."⁴

The Commission placed such incentives in the context of broader economic policy stating that:

“the level and pattern of economic activity is affected much more by the general economic policy of the government than by any set of specific measures labelled incentives”.

It, therefore, espoused a narrow role for taxation incentives stating that they “are justified only on very limited grounds” which were identified as cases of market failure, competitive concerns with regard to internationally mobile capital investment, and as second-best solutions required to offset shortcomings in other policy areas.

We concur with the conclusion of the previous Commission on Taxation that there are three instances where it would be appropriate to examine the possibility of introducing a tax expenditure. These are:

- To correct market failure
- To attract mobile investment
- To offset shortcomings in other areas of public policy

5.3. Efficiency

The previous Commission on Taxation stated that:

“Efficient incentives should be designed to achieve specific results and examined to see to what extent they are achieving their objective. They should also be flexible so that they may be tailored to individual circumstances. Such flexibility is essential if payments are not to be made in cases in which the particular activity would take place in any event. Flexibility implies selectivity. A balance must be struck between the costs arising from additional bureaucracy needed to provide incentives selectively and the waste of resources that arises if they are given universally”.

It further stated that:

“In order to be efficient, the number of incentives provided must be strictly limited to the encouragement of activities that have a high national priority. They cannot be used to encourage all desirable activities. The provision of an incentive increases the amount of resources devoted to the favoured activity by increasing the relative rewards for that activity. It follows that the provision of an incentive for additional activities dilutes the effectiveness of each existing incentive. If incentives are provided for every activity, none benefits; but the administrative complexities increase and overall efficiency suffers”.

An implication of the contextual commitment in our terms of reference to keep the tax burden low, enhance rewards to work and increase the fairness of the tax system is that there is no room for inefficient instruments of policy, if all these objectives are to be met. We concur with this view. If expenditures in a tax system are to be efficient, they must be responsive and capable of being revised, refocused or ended in the light of new circumstances. In addition, the requirements of efficiency and flexibility suggest that tax expenditures should invariably be time-limited and subject to regular review.

5.4. Stability

A stable tax expenditure is one that is clearly defined to serve a set objective within a specified time period. Such stability is desirable as it diminishes uncertainty for both Government and the recipients of the incentive.

5.5. Simplicity

Tax expenditures should be as simple as possible. Simplicity implies that they should be accessible and the associated rules should be clear. Tax expenditures should be transparent so that the potential benefits to the recipients and the costs and benefits to the Exchequer are easily understood. The administrative and compliance burden that they impose should be proportionate.

5.6. Equity

Of their nature, tax expenditures necessarily offend against the principle of equity. Typically, they only immediately benefit those taxpayers who are in a position to have their liability reduced or eliminated and are of no immediate financial benefit to those outside the tax system. They result in a more favourable tax position for the beneficiaries of the tax expenditure. Within differential rate band structures, tax expenditures may confer a greater benefit on those higher up the income scale who are liable to pay at the higher rate of tax as compared with those lower down that scale. We consider that the inconsistency with the equity principle is the overarching reason why tax expenditures should be used sparingly.

Recommendation 8.4

There are three instances where it would be appropriate to examine the possibility of introducing a tax expenditure. These are:

- To correct market failure
- To attract mobile investment
- To offset shortcomings in other areas of public policy

Where a tax expenditure is proposed, or an existing expenditure's timescale extended, the following questions should be asked, in sequence:

- Does the expenditure fall within one or more of the three instances outlined above?
- If so, does the proposal adhere to each of the following principles:
 - Efficiency
 - Stability, and
 - Simplicity
- If so, can a departure from the equity principle, which the tax expenditure invariably necessitates, be justified?

A tax expenditure should only be introduced, or extended, if it answers affirmatively to each of these questions.

5.6. Introduction and review process for tax expenditures

Where, based on the above analysis, it has been decided that a tax expenditure is appropriate, the path to its introduction should incorporate the following steps:

- Policy analysis
- Initial design of tax expenditure (including duration, reporting, compliance and administration issues)
- Impact analysis
- Consultation with stakeholders
- Final proposals and
- Legislative process

For all future tax expenditures, and reforms of tax expenditures, we recommend that there should be:

- An *ex-ante* evaluation process in advance of decisions to implement or extend any tax expenditure. As part of this process, the costs and benefits of the proposal should be assessed and the alternative of a direct expenditure approach should be considered. Only those which can be justified by reference to that test should be put in place or continued.
- Better measurement and data collection of the costs and benefits associated with the introduction or extension of the tax expenditure and the review of its impact. This is an essential prerequisite to tighter measurement and control of public resources. Consequently, we believe that data collection on costs and benefits needs to be considered in the design or modification of tax expenditures. While acknowledging the compliance burden, consideration needs to be given to requiring beneficiaries of tax expenditures and the sponsoring State agency, to play a greater role in this area.
- The publication of an annual tax expenditures report by the Department of Finance which should be a part of the annual budget process and subject to Oireachtas scrutiny. We note that there are a number of models available in this regard in OECD countries. This report should include both the costs of the various tax expenditures and also the evaluation of the impact of tax expenditures reviewed during the period.

In addition, as a means of exerting control over spending through the tax system, a number of devices might usefully be considered including the imposition of thresholds and ceilings (outside of which no tax relief would be available) and reductions in the rate at which tax relief is given or in the quantum of a base figure to which tax relief might apply.

While tax expenditures are introduced on the basis that benefits will outweigh costs, it must be acknowledged that, due in part to the aforementioned data deficiencies, we have found it very difficult to measure and assess this for the tax expenditures that we reviewed. Nonetheless, through the implementation of the above proposals these impediments should be removed and the aim should be to move to a position where measurement and robust assessment of costs and benefits are possible.

Recommendation 8.5

For all future tax expenditures, and reforms of tax expenditures, there should be:

- An *ex ante* evaluation process in advance of decisions to implement or extend any tax expenditure, including an assessment of the costs and benefits of proposals and consideration of the alternative of a direct expenditure approach.
- Better measurement and data collection on the costs and benefits associated with the introduction or extension of the tax expenditure and the review of its impact.
- Publication of an annual tax expenditures report by the Department of Finance as part of the annual budget process and subject to Oireachtas scrutiny.
- Spending through the tax system should be controlled by, for example, the imposition of thresholds and ceilings and reductions in the rate at which tax relief is given or in the quantum of a base figure to which tax relief might apply.

Section 6:

Determination of the benchmark tax system

A key part of our task was to define the tax reliefs which form part of the benchmark tax system. This task was important for a number of reasons:

- It enabled us to identify the tax expenditures for review
- It had never been undertaken previously
- It may serve as a useful template for the future

At an international level there are a variety of views about what should appropriately be incorporated in a benchmark tax system and the definition of what constitutes a tax expenditure can be controversial. As a consequence, countries' practices in presenting tax expenditure accounts vary substantially. According to the OECD, the benchmark tax system incorporating the set of benchmark reliefs and exemptions, may comprise "the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and provisions relating to international fiscal obligations". Where the tax system deviates from the benchmark, a tax expenditure is said to exist⁵.

We identified that some 130 measures are appropriate to the benchmark tax system within the following five categories:

1. Measures that are inherent in the design of the tax system including avoidance of double taxation and complying with international (fiscal) obligations together with minor reliefs and measures to facilitate tax administration
2. Measures related to the unit of taxation and measures that are tax neutral
3. Deductions for expenses incurred in earning income
4. Measures related to the State and
5. Court awards and compensation payments

We consider that the status of items which are currently designated as part of the benchmark tax system is not immutable and that Government properly retains the right to alter that status. The system should be responsive to the needs of the community and the economy and reviewed on a regular basis.

A list of the 130 measures contained in the benchmark tax system is contained in Appendix 1.

⁵ OECD (1996) Tax Expenditures: Recent Experiences, OECD, Paris. This report outlined the position as it obtained in 14 OECD countries, including Ireland. The 14 countries were Australia, Austria, Belgium, Canada, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain, the UK and the US.

Section 7:

Review process for current tax expenditures

Our terms of reference asked us to review all current tax expenditures and in doing so to consider the costs and benefits associated with each measure. To complete this task we took the following steps:

- Identify tax expenditures relating to each of the eight categories for each type of tax
- Liaise with the Revenue Commissioners and the Department of Finance to ensure all the reliefs were captured and to identify those reliefs for which costs were available
- Critically assess the costs associated with the reliefs in the group
- Identify the policy objectives and considerations which underpin these tax reliefs
- Evaluate the extent to which the reliefs are consistent with the principles as set out in Section 5 of this Part
- Identify and consider the social and economic benefits which accrue from the provision of the reliefs
- Identify methods for quantifying benefits in a manner which enabled comparisons with the costs of the reliefs to be made
- Consider the extent to which benefits might otherwise be evaluated
- Seek to assess the costs against benefits
- Seek to determine the distributional impact of the reliefs across various income groups, and
- Make other relevant observations as appropriate

Throughout the remainder of this Part we list each of the reliefs by category and present corresponding data for costs, numbers benefiting, year of estimate and statutory reference. In all cases, the data we use is the most recent available to us. The cost figures presented have been calculated using the initial revenue loss/gain (revenue forgone) method. This method measures the amount by which tax revenue is reduced or increased as a consequence of the introduction or abolition of a tax expenditure, based on the assumption of unchanged behaviour and unchanged revenues from other taxes. While this approach has limitations it has been the method used to date by the Department of Finance and the Revenue Commissioners.

Transitional arrangements

In a number of instances we recommend that particular tax expenditures be discontinued. In some cases, it may be appropriate to put in place suitable transitional arrangements so that individuals are not unfairly disadvantaged by discontinuation of a relief.

Recommendation 8.6

Transitional arrangements should be put in place where appropriate in relation to tax expenditures which are being discontinued.

Section 8:

Tax expenditures relating to children

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓
		Cost €m	Numbers benefiting		Discontinue ✕ Modify ❄
Exemption of child benefit from income tax	S194 TCA	427 ⁶	384,500	2009	✕
Exemption of foster care payments from income tax	S192B TCA	30 ⁷	3,326	2007	✓
One-parent family tax credit	S462 TCA	186	123,100	2006	❄
Home carer tax credit	S466A TCA	62	85,000	2006	✓
Widowed parent tax credit	S463 TCA	5	2,300	2006	✓
Capital allowances for childcare facilities	S843A TCA	6	304	2006	✕
Income tax exemption for childcare service providers	S216C TCA	<1	230	2006	✕
Exemption of employer-provided childcare from BIK charge	S120A TCA	6 ⁸	N/A	2000	✕

N/A – Not available

8.1 Exemption of child benefit from income tax

Child Benefit⁹ is a universal support payment which is payable to parents or guardians of children under 16 years of age, or under 19¹⁰ years of age if the child is in full-time education. The purpose of the payment is to assist parents with the costs of raising children as well as with childcare costs. In 2008 it was paid to 580,000 families in respect of 1.1 million children at an estimated cost of €2.5 billion.

⁶ This estimate does not include the yield from income earners whose current income levels are below the threshold to taxation and who could be brought into the tax net if child benefit payments were included as taxable income. The estimate includes the cost of the exemption of benefit for children aged 18 in 2009.

⁷ Estimate calculated by the Revenue Commissioners using average marginal rate. The figure is likely to be an overestimate as it takes no account of the expenses which foster parents incur while caring for a foster child.

⁸ Details of cost and take up are not collected by the Revenue Commissioners. Summary of Budget measures 1999 estimated a yearly cost of €6.35 million (£5 million).

⁹ In 2009, parents with children under 5½ years also receive the Early Childcare Supplement. This payment is being discontinued and is being replaced with effect from 1 January 2010 with a pre-school Early Childhood and Education Scheme (ECCE) for all children between the ages of 3 years 3 months and 4 years 6 months. A capitation grant will be payable to service providers who provide free pre-school services.

¹⁰ With effect from 1 January 2009, only half the payment is available in respect of children aged 18 and, with effect from 2010, the payment is being discontinued in respect of such children. These changes were provided for in Budget 2009.

In 2009, the amounts of child benefit payable are:

No. of children	Annual value of child benefit payment*
1	€1,992
2	€3,984
3	€6,420
4	€8,856

* figures assume children are under 18 years old. Higher amounts are payable where the number of children is greater than four.

Income from child benefit is specifically excluded from the calculation of income for taxation purposes. The Revenue Commissioners provided us with the following estimate of the distribution of recipients of the tax relief who number approximately 384,500¹¹:

- 20% of the families who benefit from the relief have income below €40,000
- 65% of the families who benefit have an income between €40,000 and €100,000 and
- 15% of the beneficiaries are families with income above €100,000

Child benefit was introduced to provide parents with direct support for children. The payment was increased significantly in value in recent years with the aim of assisting parents and enhancing the level of support provided in respect of the costs of raising children, including childcare costs. Child benefit does not present barriers to parents taking up employment because it is payable regardless of income, is not taxable and is not reduced as income increases.

The tax exemption is one of very long standing; children's allowance, which was the forerunner of child benefit, was also statutorily exempt from tax¹². Untaxed child benefit delivers the full value of intended assistance to the principal carer in a household. NESC¹³ cites three objectives underlying the provision of child benefit:

- An anti-poverty objective
- Support for working parents with the cost of childcare, and
- Recognition of the value of women's work caring for children in the home

Child benefit is payable irrespective of family income or need. The exemption of child benefit from tax means that the payment may be of greater benefit to individuals liable at the higher rate of tax as compared with recipients liable at the standard rate or those who are outside the tax net. This raises questions about the equity of the tax treatment of the payment. An efficiency question also arises about the payment of child benefit to families in the higher income ranges regardless of need.

One option to address the equity and efficiency issues would be to make child benefit subject to taxation. Another would be to means test the payment. The Government has indicated publicly that it is considering both options. We have not examined means-testing in detail on the basis that it is not within our terms of reference. We note also the proposal from the Special Group on Public Service Numbers and Expenditure Programmes that child benefit rates should be reduced and standardised. Implementation of such a proposal would reduce child benefit cost but leave

11 Those who are outside the tax system are not included in this figure.

12 Section 354 of the Income Tax Act, 1967 refers.

13 NESC Research Series, Paper No. 6, Winter 2007, Ireland's Child Income Supports: The Case for a New Form of Targeting

unresolved the equity and efficiency issues which we highlight above.

Research from both NESF and the ESRI suggests ways in which equity and efficiency could be addressed and taxation of child benefit is suggested as a possible approach as part of these:

- A NESF working paper suggested the introduction of a second tier payment (i.e. paid in addition to child benefit) which would replace Family Income Supplement (FIS) and Child Dependent Allowances (CDAs) and would be paid to low income families only. The proposals suggest that the cost of the new arrangements could be met through for example rescinding the higher rate of child benefit for third or subsequent children or taxing child benefit
- The ESRI¹⁴ suggested that one way of achieving greater targeting with child benefit would be to increase it while making the payments taxable. This would result in full payment to those on low incomes, who would have more need of it, while giving a reduced net payment to those paying at the standard rate and a further reduced net payment to those paying at the higher rate. The ESRI stated that:

“the taxable status of child benefit could have been changed more readily at the same time as substantial increases in payment levels were introduced. In the absence of substantial further increases in child benefit, making the payment taxable would require the ‘clawing back’ of some of the net benefit for high earners”.

There are a number of legal and policy issues which need to be addressed satisfactorily as a pre-requisite to taxation. These include:

- Legal ownership of the child benefit payment
- Whether there would be an entitlement to an employee tax credit and standard rate band in respect of child benefit
- Ownership, allocation and impact of the child tax credit which we propose in Section 2 of Part 5, including how it would relate to the employee tax credit, and
- Impact on entitlement to the home carer tax credit consequent on the withdrawal of the tax exemption for child benefit

In relation to legal ownership of the child benefit payment, we are aware of independent legal advice obtained previously in the context of the deliberations of the Tax and Welfare Integration Group (TWIG) in the early 1990s which suggested that the taxation of child benefit could be problematic within the present social welfare legislative structures.

Overall we do not consider that the significance of any of these issues is such that it would deflect us from the view that, in principle, the taxation of child benefit would improve the equity and efficiency of the child benefit payment.

Conclusion

The exemption of child benefit from tax confers a greater benefit to those higher up the income scale as compared with recipients who are liable only at the standard rate or who are outside the tax net altogether. We consider that this raises questions about the equity of the tax treatment of the payment; there is also an efficiency question related to giving the payment to families regardless of need. These issues arise regardless of the quantum of the payment.

14 (2007) “Child poverty and child income supports: Ireland in comparative perspective” – Tim Callan, Kieran Coleman, Brian Nolan, John R Walsh.

The taxation of child benefit would improve the distributive impact of child benefit support.

In the course of our analysis, we explored the impact of the application of income tax to child benefit. Based on that analysis, we are satisfied that the taxation of child benefit, once in place, would be equitable and would improve the efficiency of the payment. After taxation, child benefit would give those who remain outside the tax net the full gross benefit of child benefit; those higher up the income scale would get the benefit less tax at the standard rate while those taxable at the higher rate would get the benefit less tax at that rate.

Because child benefit increases with the number of children, the move to taxation would impact most on larger families. This may not be an intended outcome and minimising the impacts in this regard will present a challenge to policy makers. As noted above, the Government has indicated that it is also considering the option of means-testing child benefit. It seems to us that this option also presents implementation challenges. The Government will presumably also consider the Special Group recommendation as mentioned above. Overall, however, on equity grounds and with the objective of improving the targeting of the support, our view is that the payment should be taxed. However, we consider that the option of taxing the benefit should be benchmarked against alternatives (including means-testing) to ascertain the most effective method of achieving greater equity and improved targeting of the support.

When implementing this recommendation, we believe that care will be needed to deal with the legal and policy issues identified above and to avoid possible employment disincentive effects that may arise. We also note that a successful implementation of this recommendation necessitates further and closer co-ordination between the Revenue Commissioners and the Department of Social and Family Affairs.

Recommendation 8.7

Child benefit should be taxable income.

- The taxing of child benefit should be benchmarked against alternatives, including means testing, to ascertain the most effective method of achieving the aims and objectives of the child benefit programme.
- If taxation is applied, we recommend the introduction of a child tax credit to offset the additional tax payable in respect of child benefit for those in the lower half of the income scale.

8.2 Exemption of foster care payments from income tax

Description

Payments made by the Health Service Executive to foster parents and relatives in respect of children in their care are exempt from income tax. The 2008 rates of payment were €16,588 per annum for a child under 12 years and €17,992 per annum for a child over 12 years. In 2007 a total of €97.7 million was paid to 3,326 foster carers.

Conclusion

Children in foster care are in the care of the State, under the Child Care Act 1991. Foster carers undertake to care for foster children on the State's behalf and as such are a unique group in often difficult circumstances. Given the particular nature of this exemption and having regard to the fact that the primary aim of foster care payments is to reimburse foster parents for the expenses incurred

in raising foster children, we recommend that this exemption should continue.

Recommendation 8.8

The exemption of foster care payments from income tax should continue.

8.3 One-parent family tax credit

Description

A single parent, whether widowed, single, separated or divorced, with a dependent child or children may be entitled to receive the one-parent family tax credit. The value of this credit is €1,830 per annum. The one-parent family tax credit, where due, is given in addition to the basic personal tax credit. The tax credit can be claimed in full by each parent provided the child resides with the claimant for a whole or part of the year of claim. This condition is deemed by the Revenue Commissioners to be fulfilled if a child resides with a parent for at least one night in the year. The relief was originally introduced to assist single and widowed parents who work outside the home and who have dependants. The underlying purpose of the relief, therefore, is to support labour market participation of single parents with sufficient income to avail of the value of the credit.

Conclusion

We acknowledge that this tax relief plays a role in supporting and incentivising the labour market participation of single and widowed parents. We therefore recommend that the tax credit should continue. However, we also note that the annual cost of this relief is considerable. We recommend that Government should seek to minimise or eliminate the inefficiency (or deadweight element) associated with this relief in relation to the allocation of the full credit (and the additional standard band which applies as a result) to both parents. Such a move would help restore greater balance between the cost of the tax credit and the benefit derived from it. Accordingly, we recommend that the credit be allocated to the principal carer only in accordance with the current arrangements for child benefit.

Recommendation 8.9

The one-parent family tax credit should continue and the credit should be allocated to the principal carer only and in a similar way to the current arrangements for child benefit.

8.4 Home carer tax credit

Description

A tax credit of €900 is available for married couples, jointly assessed to tax, where one spouse works in the home caring for a dependent child, a person over 65 or a person who is permanently incapacitated. A dependent person does not include a spouse. To qualify for the full credit, the annual income of the carer must not exceed €5,080. A reduced tax credit is given where the annual income of the carer is between €5,080 and €6,880. Where annual income exceeds €6,880 no tax credit is given. The Carer's Allowance payable by the Department of Social and Family Affairs is disregarded for determining entitlement to the tax credit.

The home carer tax credit was introduced in 2000 in the context of individualisation of the tax bands. The credit compensates for partial band individualisation where families have dependants.

Conclusion

In Section 2 of Part 5, we recommend that the present arrangements with regard to band structure and credits which apply to married one-earner and married two-earner couples should remain in place. The credit forms part of the current “hybrid” structure relating to band individualisation and it would not be realistic to contemplate its withdrawal while the current arrangements in relation to the tax bands continue to exist or in circumstances where band individualisation is completed. In addition, we considered that, as a general principle and subject to resource constraints which may apply, the value of the credit should be increased generally in line with the value of other personal tax credits.

Recommendation 8.10

The home carer tax credit should continue.

8.5 Widowed parent tax credit

Description

In the year of bereavement a widowed person may receive a personal tax credit which is equivalent to the married tax credit. Following the year of bereavement, a widowed parent with a qualifying child may qualify for the one-parent family tax credit in addition to the single personal tax credit. A further credit, the widowed parent tax credit, is also available, on a sliding scale, for the first five years after bereavement. For 2008 and subsequent years, this credit is worth €4,000 in the first year of entitlement and €2,000 in the fifth year. In determining whether a child is qualifying or not, the conditions applicable to the one-parent family tax credit apply.

Conclusion

We consider that this credit helps widowed parents to cope financially with the transition from married to widowed life, particularly in circumstances where commitments may have been entered into previously. It also assists widowed parents accessing or remaining in the labour market in the years immediately following bereavement.

Recommendation 8.11

The widowed parent tax credit should continue.

8.6 Capital allowances for childcare facilities

Description

Capital expenditure incurred on the construction, extension and refurbishment of a building or part of a building used as a childcare facility qualifies for accelerated capital allowances. The premises must be in use for the purpose of providing a pre-school service or a pre-school service and a day care or other service to cater for children other than pre-school children.

Conclusion

While we acknowledge the need for policy initiatives in the area of childcare we consider that these accelerated capital allowances for the construction, conversion and refurbishment of childcare facilities, like the other tax expenditures for property, raise issues of effectiveness, deadweight and adverse equity impact. We do not consider accelerated capital allowances to be an appropriate

policy instrument in this area and we recommend that they be discontinued.

Recommendation 8.12

The capital allowances for childcare facilities should be discontinued.

8.7 Income tax exemption for childcare service providers

Description

This relief provides an income tax exemption of up to €15,000 where a childcare service is provided in a carer's home.

Conclusion

We note that this relief does not require minimum standards of care as a precondition for entitlement and that the take-up of this relief has been limited with a total of 230 cases in 2006.

Recommendation 8.13

The income tax exemption for childcare service providers should be discontinued.

8.8 Exemption of employer-provided childcare from BIK charge

Description

Where an employer provides free or subsidised childcare facilities (which meet appropriate standards) for employees, no taxable benefit arises to the employee.

Taxpayers are not required to provide details of this benefit-in-kind in their tax returns and therefore we have not been able to assess the cost, availability and progress of this measure. However, given that the employer must finance and manage the facility, or provide capital for the construction or refurbishment of the premises, it is likely such facilities can only be provided by larger employers. It is unlikely that smaller employers could afford to provide such facilities.

Conclusion

We consider that this tax expenditure is an inappropriate instrument to address the provision of childcare for employees. While it can assist labour force participation, it raises equity issues in relation to those parents whose employment does not provide such facilities. Accordingly, we recommend that it should be discontinued.

Recommendation 8.14

The exemption of employer-provided childcare from the benefit-in-kind charge should be discontinued.

Section 9:

Tax expenditures relating to housing

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓ Discontinue ✕ Modify ❄
		Cost €m	Numbers benefiting		
Mortgage interest relief	S244 TCA	705	750,000	2008	❄
Income tax relief for rent paid	S473 TCA	48	144,500	2005	✕
Capital gains tax exemption on principal private residence	S604 TCA	2,440	47,340	2006	✓
Income tax relief for service charges	S477 TCA	21	363,900	2006	✕
Renta-room relief	S216A TCA	4	3,560	2006	✕
Capital gains tax and stamp duty relief for disposal of a site to a child	S603A TCA; S83A SDCA	38	5,450	2007/08	✕

9.1 Mortgage interest relief

Description

Income tax relief is provided at source through financial institutions for interest paid on a loan that finances a principal private residence. The loan must be used for the purchase, repair, development or improvement of the taxpayer's principal private residence. The principal private residence may be located in Ireland, Northern Ireland or Great Britain. The limits on relief with effect from 1 May 2009 are as follows.

	First-time buyers				Others	
	Maximum interest	Rate of tax relief			Maximum interest	Rate of tax relief
		Years 1 - 2	Years 3 - 5	Years 6 - 7		
Single	€10,000	25%	22.5%	20%	€3,000	15%
Married/widowed	€20,000	25%	22.5%	20%	€6,000	15%

Conclusion

We noted the distributional impact of the relief for the year 2005¹⁵ with those in the top two income deciles accounting for close to half of the tax foregone. Considering the tax relief in isolation, this raises issues of equity, although a range of other housing supports are available which have a greater impact on those in the lowest income deciles.

Mortgage interest relief has been part of a very generous tax regime for owner-occupied housing and there are strong grounds for considering its withdrawal having regard to considerations

of efficiency and equity. We concur with the NESC view that any policy which seeks to improve affordability for buyers through offering higher levels of relief is unlikely to do so and may only result in higher prices. The discontinuation of mortgage interest relief might be expected in the longer term to help improve the efficiency of the housing market as well as releasing resources for other purposes.

A case for retention can be made in relation to firsttime buyers who, generally speaking, come to the market without the equity that is available to other buyers. NESC has observed that removal of mortgage interest relief would impinge most on firsttime buyers who would see their monthly payments rise and the value of their recently acquired property decline.

Recommendation 8.15

Mortgage interest relief should be continued in the case of firsttime buyers and discontinued for those who are outside this category. The current step down arrangements for firsttime buyers regarding the rate at which relief is given should continue to apply.

9.2 Income tax relief for rent paid

Description

Income tax relief at the standard rate is available to individuals for rent paid for private rented accommodation which is their sole or main residence. The maximum levels (at 1 January 2009) of rent paid for private rented accommodation on which rent relief can be claimed and the current maximum levels of relief available annually are as follows:

Maximum interest	Single		Married	
	Rent	Tax relief	Rent	Tax relief
Aged under 55	€2,000	€400	€4,000	€800
Aged 55 and over	€4,000	€800	€8,000	€1,600

Conclusion

In the same way as mortgage interest relief increases the cost of housing, rent relief increases the cost of private rented accommodation. In its document, *Housing Policy in Ireland: Performance and Policy*, NESC indicated that:

“...it is likely that the relief benefits not only tenants, but also landlords, since it tends to increase demand and therefore rents”.

Consistent with our recommendation on mortgage interest relief for non firsttime buyers we consider that rent relief should also be discontinued. There is a case for discontinuing the relief over a number of years, particularly having regard to the scale of the relief available to those aged 55 or over.

Recommendation 8.16

Income tax relief for rent paid for private rented accommodation should be discontinued.

9.3 Capital gains tax exemption on principal private residence

Description

There is an exemption from capital gains tax on the disposal of a principal private residence (including grounds up to 0.4047 hectare (one acre)), except to the extent that the gain derives from development land. The exemption is proportionately restricted where the property was rented out, used for business purposes or left unoccupied during the period of ownership.

Conclusion

Although the efficiency and equity of this tax expenditure is debatable, we recommend its retention in the context of our recommendation to introduce a comprehensive annual tax on residential property.

Recommendation 8.17

The capital gains tax exemption on the disposal of a principal private residence should be continued.

9.4 Income tax relief for service charges

Description

Income tax relief is available for local service charges that are paid in full and on time either by the person liable for them or by another person who resides in the premises to which the service relates. The service charges may be paid to a local authority or an independent contractor. The relief is given at the standard rate of tax for any service charges paid, including “bin tags”, in the previous year. Our views in relation to tax relief for service charges are set out in further detail in Section 8 of Part 11.

Conclusion

We consider that there is no sound rationale for tax relief on service charges. We therefore recommend that the relief be discontinued.

Recommendation 8.18

Income tax relief for service charges should be discontinued.

9.5 Rent-a-room relief

Description

Where an individual rents a room or rooms in a ‘qualifying residence’ and the gross rent received (including sums arising for food, laundry or similar goods and services) does not exceed €10,000 (in 2009), the income is exempt from income tax. A ‘qualifying residence’ is a residential premises in Ireland, which is occupied by an individual as his or her principal private residence during the year of assessment. The income is also exempt from PRSI, health levy and income levy but it must be reported on the annual income tax return.

Conclusion

Rent-a-room relief was introduced in 2001 on grounds of market failure in the supply of rented accommodation. The relief may also have enabled property buyers to secure higher mortgage facilities by providing extra income on which lending levels were based. The market failure relating to undersupply of rental accommodation and rental affordability no longer applies. On

equity grounds, it is inappropriate to distinguish between income from renting out a room and other income which is subject to tax.

We consider, therefore, that the original rationale for this relief no longer applies and that it should be discontinued.

Recommendation 8.19

The rent-a-room relief should be discontinued.

9.6 Capital gains tax and stamp duty exemption on disposal of site to a child

Description

Exemption from capital gains tax is provided in respect of any gain on a disposal of a site by a parent to his or her child (including foster children). The land must be used by the child to build a house which is to be used as the child's only or main residence. The market value of the land must not exceed €500,000 at the date of the disposal and the area of the land must not exceed 0.4047 hectare (exclusive of the area on which the house is to be built). If the child disposes of the land without a dwelling house having been built on the site and occupied by the child as his or her only or main residence for three years, the gain which was exempted is treated as accruing to the child and tax is payable on the gain.

A corresponding exemption from stamp duty is provided to the child who may only benefit from the measure once. If the site value exceeds €500,000, stamp duty is charged on the entire value.

Conclusion

By definition, the exemption confers an advantage on persons who are in possession of an asset (land) which they are in a position to dispose of with a resultant capital gain. While the disposal might not take place in the absence of the exemption, the child would, presumably, acquire a site at another location in the normal way - albeit at, perhaps, a higher cost than would be charged by the parent. We consider that equity requires that the gain should be treated in the same manner as would a gain from the disposal of any other asset and be taxed accordingly. Similarly, the stamp duty exemption should be discontinued.

Recommendation 8.20

The capital gains tax and stamp duty exemptions on the disposal of site to a child should be discontinued.

Section 10:

Tax expenditures relating To health

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓ Discontinue ✕ Modify ❄
		Cost €m	Numbers benefiting		
Relief for medical insurance	S470 TCA	321	1,017,400	2008	❄
Relief for health expenses	S469 TCA	167	348,800	2006	❄
Relief for contributions paid to permanent health benefit schemes	S471 TCA	3	23,000	2006	✓
Long-term care policies	S470A TCA	–	–	–	✕
Incapacitated child tax credit	S465 TCA	16	11,000	2006	✕
Allowance for employing a carer for an incapacitated individual	S467 TCA	3	820	2006	❄
Dependent relative tax credit, mortgage interest relief and principal private residence relief	S466, 244 and 604(10) TCA	1 N/A N/A	15,500 N/A N/A	2006	❄
Blind person's tax credit	S468 TCA	>1	880	2006	✕
Palliative care units	S268(2BA) TCA	N/A	N/A	–	❄
Tax concessions for disabled drivers/passengers	S92 FA'89	68	12,500	2008	❄

10.1 Relief for medical insurance

Description

Tax relief is provided at the standard rate of income tax for medical insurance premiums paid to cover a range of medical expenses. The relief also covers premiums paid on dental insurance policies for non-routine dental treatment. For the payments to qualify for relief, they must be made to an authorised insurer listed in the Register of Health Benefit Undertakings established under the Health Insurance Act 1994. Relief is available in respect of an individual, his or her spouse and the children or other dependants of the individual or his or her spouse.

The relief is granted under a tax relief at source system to all holders of medical insurance irrespective of whether or not they have a tax liability to offset the value of the relief. The subscriber pays the premium net of the tax relief and the insurer obtains a refund of the relevant amount from the Revenue Commissioners.

Conclusion

We acknowledge that medical insurance is expensive and that medical insurance relief plays a role in attracting and retaining individuals within the medical insurance system. However, there is a sizeable deadweight element as many individuals would pay these premiums in the

absence of the tax relief. We also acknowledge that without medical insurance, it would be necessary for the State to provide treatment to more individuals through the public health system.

We have concluded that there is a case for continuing this relief but on a more limited basis. A new arrangement should be put in place whereby the tax relief is limited to a fixed amount per individual regardless of the level of cover purchased by the individual. This amount should then be index-linked to the Consumer Price Index in subsequent years. Under this approach, the relief for family premiums would be based on the number of individuals to which the cover related.

We note the proposals contained in the Health Insurance (Miscellaneous Provisions) Bill, 2008 which envisage that additional age-related tax relief will be provided for those aged 50 or over. We understand that the proposed arrangement is intended to prevent costs for those over 50 years rising rapidly against the background where the former risk equalisation scheme was found to be unlawful. We also understand that it is intended that the additional tax relief will apply for a three-year period in the context of broader plans by the Department of Health and Children to replace the risk equalisation scheme with a new scheme. We believe that it is appropriate that such arrangements should be made on a temporary basis.

Recommendation 8.21

Medical insurance relief should be continued on a more limited basis.

10.2 Relief for health expenses

Description

Health expenses relief is provided against income tax for the unreimbursed cost of a specified list of health expenses. The relief is provided at the standard rate of income tax except in the case of nursing home expenses which are provided at the marginal rate. There is no requirement that there be a relationship between the taxpayer receiving the relief and the person who is the subject of the claim.

Conclusion

We consider that the tax relief for health expenses may give rise to the costs of some treatments being higher than they might otherwise be in the absence of the relief. However, the relationship between the tax relief and the cost of health care is not a direct one in all cases. We believe that a case can be made for the continuation of the relief particularly in the case of costs which are unavoidable rather than discretionary in nature. However, we note that the relief is of no benefit to individuals on low income levels who have no income tax liability.

We conclude that there is a case for continuation of this relief but that it should be standard rated in its entirety and we note the measure in Finance (No. 2) Act 2008 to standard rate most elements of the relief. We also consider that the range of treatments contained within the scope of the relief should be subject to regular review.

We separately considered the issue of nursing home expenses. We concluded that the proposed Fair Deal¹⁶ system for nursing home care offers an equitable basis for determining the level of financial support to be provided by the State to those who need nursing home care. Consequently, we recommend that, once the Fair Deal system has been implemented, removal of the tax relief should be considered.

16 Based on our understanding of the proposed Fair Deal scheme at July 2009.

Recommendation 8.22

Relief for health expenses should continue at the standard rate.

Recommendation 8.23

Once the Fair Deal system for nursing home care has been implemented, removal of the tax relief for nursing home expenses should be considered.

Recommendation 8.24

The range of treatments contained within the scope of the relief for health expenses should be subject to regular review.

10.3 Relief for contributions paid to permanent health benefit schemes

Description

Tax relief at the marginal rate (and PRSI) relief is available on the full cost of contributions to permanent health benefit (income continuance) schemes subject to the contributions not exceeding 10% of total income. The schemes provide for regular payments to individuals in the event of loss or diminution of income as a result of ill-health. All benefits from these schemes are liable for tax.

Conclusion

We considered that the current arrangements should continue.

Recommendation 8.25

Tax relief for contributions paid to permanent health benefit schemes should continue.

10.4 Long-term care policies

Description

This relief, introduced in 2001, is available in respect of premiums paid on qualifying insurance policies designed to cover in whole or in part the future needs of individuals who are unable to perform at least two activities of daily living or who are suffering from severe cognitive impairment. The relief is standard-rated and is given under a tax relief at source system. Qualifying policies must be approved by the Revenue Commissioners and benefits payable are not taxable.

Conclusion

We consider it inequitable that, unlike pension schemes and permanent health schemes, contributions to these policies are relieved of tax and the benefit paid is not subject to tax. Were this scheme to continue, its taxation structure should conform to that of comparable schemes. However, we note that, despite this relief being in place since 2001, no products are available and there have been no claimants under the scheme. We consider it undesirable to have a relief in the tax code that is not being used and we therefore recommend that it be discontinued.

Recommendation 8.26

Tax relief for long-term care policies should be discontinued.

10.5 Incapacitated child tax credit

Description

The incapacitated child tax credit may be claimed by a parent or guardian of a child who is permanently incapacitated, either physically or mentally, from maintaining himself or herself and had become so before reaching 21 years of age or had become so after reaching the age of 21, but while still in full-time education or while training full time for a trade or profession for a minimum of two years. Where more than one child is incapacitated, a tax credit may be claimed for each child. Where the child is maintained by one parent only, that parent is entitled to claim the full amount of the tax credit. However, where the child is maintained by more than one person, the tax credit is divided between them in proportion to the amount paid by each towards the maintenance of the child. In 2008, the value of the tax credit was €3,660.

Conclusion

We concluded that while parents and guardians of permanently incapacitated children are deserving of additional support from the State, it is inequitable that individuals on low incomes who are not liable to taxation, yet are caring for an incapacitated child, obtain no benefit from the tax credit. Indeed it may be argued that such individuals may have greater need of additional support. We recommend that the appropriate level of State support be provided to all incapacitated children through direct expenditure and that the tax credit be discontinued. However, the direct expenditure support at the appropriate level should be put in place first; only then should the tax credit be withdrawn.

Recommendation 8.27

When direct expenditure support at the appropriate level is in place, the incapacitated child tax credit should be discontinued.

10.6 Allowance for employing a carer for an incapacitated individual

Description

This allowance is for the employment of a carer for an incapacitated individual. The allowance is claimable where an individual employs a person to care for a family member who is totally incapacitated by old age or infirmity. Where two or more persons employ the carer, the allowance will be apportioned between them. Carers may be employed on an individual basis or through an agency and the relief is not due if the carer is employed as a housekeeper only or if the dependent relative tax credit or incapacitated child credit has been given in respect of the employed carer. The allowance is up to €50,000 and is available at the marginal rate of tax.

Conclusion

We acknowledge that there is a strong social aspect to this relief. It allows incapacitated individuals to remain in the home which is in their best interests and consistent with various policy objectives. We recommend that the relief should be continued. However, it is inequitable that the relief confers a greater benefit to an individual paying at the higher rate of tax as compared with that conferred on an individual paying tax at the standard rate or who is outside the tax net. Consequently, we recommend that the rate of relief should be the same as that available under health expenses relief.

Recommendation 8.28

The allowance for employing a carer for an incapacitated individual should continue. However, the rate of relief should be the same as that available under health expenses relief.

10.7 Dependent relative tax credit and related reliefs

Description

The tax credit is claimable if a person maintains at his or her own expense: a relative who is incapacitated by old age or infirmity from maintaining himself or herself; a widowed mother or mother in law, widowed father or father in law – regardless of age and state of health; or a son or daughter who is resident with the claimant and upon whom the claimant is dependent by reason of old age or infirmity.

The value of the credit is €80 per annum and is only available where the dependent relative has income that does not exceed a limit (€13,873 in 2009). An individual entitled to claim this credit may by virtue of entitlement also claim mortgage interest relief in respect of interest paid to provide the relative with his or her sole main residence. There is an exemption from capital gains tax on a principal private residence occupied by a dependent relative (regardless of level of income).

Conclusion

While the nominal value of the dependent relative tax credit is too small to be of any material benefit to a claimant (and we recommend that it be discontinued), we recommend that the entitlement to mortgage interest relief, that is derived from entitlement to the credit in relation to a principal private residence occupied by a dependent relative, should continue. The nominal value of the credit is not significant but the fact that it acts as a key to other tax concessions is an important consideration.

We note that the purpose of this tax concession is generally to assist people in old age or infirmity who may be in need of accommodation. It is not to facilitate the sale of a house and the distribution of the proceeds by a person whose relative would then provide them with a further house with assistance from this relief. Therefore, having regard to our recommendation in respect of mortgage interest relief, a person should be able to avail of first-time buyer levels of relief once in respect of himself or herself and once in respect of a dependent relative who has not claimed for himself or herself. We also recommend that the separate entitlement to CGT relief on the disposal of a principal private residence occupied by a dependent relative should be discontinued.

Recommendation 8.29

The dependent relative tax credit should be discontinued.

- The entitlement to mortgage interest relief that is derived from entitlement to the credit in relation to a principal private residence occupied by a dependent relative should continue. A person should be able to avail of first-time buyer levels of relief once in respect of himself or herself and once in respect of a dependent relative who has not claimed for himself or herself.
- The separate entitlement to CGT relief on the disposal of a principal private residence occupied by a dependent relative should be discontinued.

10.8 Blind person's tax credit

Description

A tax credit (2009 value of €1,830) is claimable by a person who is blind throughout the year of assessment. Where both husband and wife are blind the tax credit is doubled. Additionally, relief (€825 in 2009) at the standard rate of income tax is claimable for a guide dog.

Conclusion

We consider it inequitable that this tax expenditure only benefits blind persons who are liable to tax and with sufficient income to absorb the credit; blind persons on lower incomes or those dependent on social welfare obtain no benefit from this credit. We recommend that the appropriate level of State support be provided to blind persons through the direct expenditure route and that the tax credit be discontinued. However, as in the case of the incapacitated child tax credit, direct expenditure support at the appropriate level should be put in place first; only then should the tax credit be withdrawn.

Recommendation 8.30

When direct expenditure support at the appropriate level is in place, the blind person's tax credit should be discontinued.

10.9 Palliative care units

Description

The 2008 Finance Act introduced a scheme of accelerated capital allowances for palliative care units. Capital allowances are available at 15% for the first six years and at 10% for the seventh year. To qualify a unit must be regarded as a hospital or hospice within the meaning of the Public Health (Tobacco) Act 2002 as amended, or other similar facility mainly involved in palliative care. The unit must have a minimum of eight in-patient beds and make available 20% of its capacity annually for the treatment of public patients.

Conclusion

We have been unable to examine this tax expenditure empirically given that it was only introduced in 2008 and no data on its operation is available. However, this scheme is a property-related tax incentive and we have reviewed it as such. Our conclusions are relevant to this scheme and more broadly to the category of property-related tax incentives, which have been a common form of tax expenditure in the Irish tax system.

We believe that these property tax incentives have been measures through which the general body of taxpayers has provided transfers to investors who could participate in these schemes. Issues of effectiveness, deadweight and adverse equity impact arise in relation to them and we are reluctant to recommend them as appropriate policy instruments.

As regards the scheme for palliative care units, we consider that there may be a role for this measure in very limited circumstances where, for example, the normal operation of the market fails to deliver a required response quickly enough or at all. This incentive should only be available in accordance with the general principles on tax expenditures outlined earlier in this Part, including the requirement for *ex-ante* evaluation. Even then, the scheme should only be used in circumstances

where a clear and identified market failure or deficiency exists and where it can be focussed to address such a failure in a pre-defined and targeted way.

Control mechanisms such as a requirement that potential qualifying projects be approved by an independent body should be an intrinsic feature of the arrangements. Overall, the incentive should operate within strict time constraints and be subject to fixed statutory termination dates. It should not be extended without a review of whether there is a continuing need for support through the tax system.

Recommendation 8.31

The arrangements for the scheme of accelerated capital allowances for palliative care units should be modified by the introduction of a termination date for the scheme.

10.10 Tax concessions for disabled drivers and disabled passengers

Description

The Disabled Drivers and Disabled Passengers Scheme applies to persons with physical disabilities and to those responsible for the transportation of disabled persons (e.g. family members or voluntary organisations). Under the terms of the scheme, an individual can claim remission or repayment of vehicle registration tax (VRT), repayment of value-added tax (VAT) on the purchase of a vehicle and repayment of VAT on the cost of adapting a vehicle, up to a maximum of €9,525 for a disabled driver and €15,875 for a disabled passenger or for a family member. Individuals who qualify for the scheme can also claim repayment of excise duty on fuel used for the transport of a disabled person, up to a maximum of 2,728 litres (600 gallons) per year (all figures relate to 2009). In addition, a vehicle which has been admitted to the scheme will also be entitled to an exemption from payment of annual road tax. The individual's means are not taken into account for the purposes of determining eligibility for the scheme. A 2002 Interdepartmental Review Group quoted its broad objective as: "improving the quality of lives of disabled persons through enhancing their overall mobility in a manner consistent with not imposing an unreasonable burden on scarce Exchequer resources".

Conclusion

We note that this scheme was reviewed in detail by an Interdepartmental Review Group in 2002. We endorse the recommendations of that group, which we have summarised below, and urge their implementation.

**Recommendations of the 2002 Interdepartmental Review Group
(summarised by this Commission)**

- Consider replacing the medical criteria based on lack of limbs with a more general mobility-focussed medical assessment
- Provide an overall assessment of the mobility level of the individual rather than concentrating purely on the specifics of the physical disability
- Separate the two parts of the scheme, leaving a vehicle tax-based scheme for drivers and replacing the passenger side of the scheme with a direct payment or allowance scheme
- Widen the scope for access to voluntary groups to the scheme
- Introduce minimum age limits for passengers
- Increase the claim period from two years to three years or reduce the level of tax relief in the case of second and subsequent applications. It is estimated that this would reduce the cost of the scheme by 50%
- Introduce a common monetary limit for both drivers and passengers

In addition, the Review Group set down core principles against which the options for the future might be measured.

Recommendation 8.32

The Disabled Drivers and Disabled Passengers Scheme should be modified in accordance with the recommendations of the 2002 Interdepartmental Review Group.

Section 11:

Tax Expenditures Relating to Philanthropy

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓ Discontinue ✕ Modify ❄
		Cost €m	Numbers benefiting		
Payment of tax by means of donation of heritage items	S1003 TCA	5	5	2008	❄
Payment of tax by means of donation of heritage property to the Irish heritage trust	S1003A TCA	4	4	2008	❄
Capital gains tax exemption on works of art loaned for public display	S606 TCA	N/A	N/A	–	❄
Income tax relief for expenditure on heritage buildings and gardens	S482 TCA	6	180	2006	✕
BIK exemption for employer-provided art objects in a heritage building or garden	S236 TCA	–	–	–	✕
CAT exemption for heritage property and heritage property of companies	S77 CATCA	1	2	2003	✓
	S78 CATCA	–	–	2008	
Tax relief for donations to charities and approved bodies	S848A TCA	50	107,100	2006	❄
Tax relief for donations to sports bodies	S847A TCA	>1	580	2006	❄
Tax relief for gifts made to the Minister for Finance	S483 TCA	N/A	N/A	–	✓
Income tax exemption for sports bodies	S235 TCA	N/A	2,015	2009	❄
Capital gains tax exemption for sports bodies	S610 TCA	N/A	N/A	–	✓
Stamp duty exemption for sports bodies	S82B SDCA	3.0	94	2008	✓
CAT exemption for gifts/inheritances taken by charities	S76 CATCA	N/A	N/A	–	✓
Income tax exemption for charities and similar bodies	SS207-211 and S213 TCA	–	–	–	✓
CGT exemption for charities and similar bodies	S609 TCA	N/A	N/A	–	❄
Stamp duty exemption for charities and similar bodies.	S82, 82A and 102 SDCA	20 ¹⁷	720	2008	✓

17 Cost refers to Section 82 only.

11.1 Payment of tax by means of donation of heritage items

Description

This relief facilitates the payment of tax by means of donation of heritage items. Any item used in this way must be approved by a selection committee¹⁸ and donated to a specified national cultural institution¹⁹. The relief consists of a tax credit equal to 80% of the value of the heritage item(s) donated which can be credited against the donor's tax liabilities. To qualify for the relief, an item must be considered an outstanding example of the type of item involved, pre-eminent in its class, whose export would constitute a diminution of the accumulated cultural heritage of Ireland, or whose import into Ireland would constitute a significant enhancement of the accumulated heritage of Ireland. The item must be considered suitable for acquisition by the by the national cultural institution to which the heritage item is being donated. The minimum value of the item must be €150,000, or in the case of a collection must be worth at least €50,000²⁰.

Conclusion

This relief, along with a number of other heritage-related measures, aims to promote and enhance the cultural heritage of Ireland and also supports tourism. The items which may be the subject of the relief are a finite resource and their transfer into public ownership is worthy of support through the tax system. We consider that the scheme should be continued. However, it should be modified so that the tax relief is limited to 50% of the value of the item donated.

Recommendation 8.33

The scheme for payment of tax by means of donation of heritage items should be retained but should be modified so that the tax relief is limited to 50% of the value of the item donated.

11.2 Payment of tax by means of donation of heritage property to the Irish Heritage Trust

Description

This relief facilitates the payment of tax by means of donation of heritage property to the Irish Heritage Trust and has a similar structure and quantum of relief to the scheme of payment of tax by means of donation of heritage property. This scheme was introduced in 2006 and extended in 2007 and 2008 to allow for the donation to the Trust of a particular collection of paintings and furniture.

Conclusion

As with the scheme for payment of tax by means of donation of heritage items, this measure aims to promote and enhance the cultural heritage of Ireland and also supports tourism. Heritage properties are a finite resource and their transfer into public ownership is worthy of the support through the tax system. We consider that the scheme should be continued. However, it should be modified so that the tax relief is limited to 50% of the value of the property donated.

Recommendation 8.34

The scheme for payment of tax by means of donation of heritage property should be retained but should be modified so that the tax relief is limited to 50% of the value of the property donated.

18 An officer of the Minister for Arts, Sport and Tourism (Chairperson), the Chief Executive of the Heritage Council, the Director of the National Library of Ireland, the Director of the Arts Council, the Director of the National Archives, the Director of the Crawford Art Gallery Cork Ltd., the Director of the National Gallery of Ireland, the Director of the National Museum of Ireland, and the Director and Chief Executive of the Irish Museum of Modern Art.

19 Modern Art, the Crawford Art Gallery Cork Ltd. or any other such body as may be approved.

20 The €50,000 limit does not apply in the case of any one item for collections consisting wholly of manuscript or archival material that are at least 30 years old.

11.3 Capital gains tax exemption on works of art loaned for public display

Description

This section provides an exemption from capital gains tax on the disposal of a work of art that has previously been loaned to an approved gallery or museum or to the Irish Heritage Trust for a period of not less than 10 years (six years for loans made before February 2nd 2006). This exemption was introduced in 1991 to enable galleries and museums around the country, which are approved by the Revenue Commissioners, to enhance their collections. Such bodies may receive on loan valuable works of art for display to the public and will enable the public have access to a considerable body of significant artistic work which might not otherwise be on display. The categories of objects to which the section applies are "any picture, print, book, manuscript, sculpture, piece of jewellery or work of art". 'Work of art' would encompass other categories not specifically mentioned, for example, silver, glass and porcelain.

To qualify for the exemption, the object must have a value of not less than €31,740 at the date it is loaned. The Revenue Commissioners may consult with such person or body of persons as, in their opinion, may be of help to them to enable them decide as to the market value of any particular object. A gallery or museum, which is to receive the object, must be approved by the Revenue Commissioners.

The object loaned must be the subject of, or included in, a display to which the public is afforded reasonable access and the minimum period of the loan must be for a period of not less than 10 years from the date of the loan. It is not necessary that the object be on display to the public during the entire period of the loan.

Where after the end of the loan period the object is disposed of by the person who lent it, the disposal is treated for capital gains tax purposes, as if neither a gain nor a loss arises on the disposal. This treatment arises only to a disposal by the person who lent the object. It does not apply to a disposal by a successor in title.

Conclusion

This exemption enables public access to significant artistic work which might not otherwise be on display. We consider that the measure should be retained but that it should be modified so that the exemption only applies to the gain accruing over the period for which the work of art has been loaned to an approved gallery or museum or the Irish Heritage Trust.

Recommendation 8.35

The capital gains tax exemption on works of art loaned for public display should be retained but the exemption should only apply to the gain accruing in the period for which the work of art has been so loaned.

11.4 Income tax relief for expenditure on heritage buildings and gardens

Description

This tax expenditure provides relief to the owner or occupier for expenditure incurred on the repair, maintenance or restoration of a building which is intrinsically of significant scientific, historical, architectural or aesthetic interest and to which reasonable access is afforded to the public or which is a guest house approved by the National Tourism Development Authority (Fáilte Ireland). The

relief also applies to expenditure incurred on the maintenance or restoration of a garden which is intrinsically of significant horticultural, scientific, historical, architectural or aesthetic interest. The building or garden must afford reasonable access to the public and the dates and times it is open to the public must be advertised. In the case of a guest house, it must be registered or listed by the National Tourism Development Authority (Fáilte Ireland) and must be in use as a guest house for at least six months of the year, four of which must be in the period 1 May to 30 September.

Relief of up to €6,350 is also provided annually for expenditure incurred on the repair, maintenance or restoration of approved objects on display in approved buildings and gardens. Alternatively, this relief may be used to cover expenditure incurred in respect of an approved building or garden:

- On the installation, maintenance or replacement of an alarm system or
- For public liability insurance

Qualifying expenditure which cannot be offset against a person's income for a chargeable period may be carried forward to the two subsequent chargeable periods. The scope of this section is affected by the high earner restriction.

Since the inception of this tax expenditure, 264 properties have availed of the relief of which 152 determinations were made in the 10-year period to 2007. Almost 40% of heritage property owners in Ireland have availed of the relief at some point in time. Non-compliance with the public access requirements can result in removal of the property from the list, revocation of public access determination and subsequent withdrawal of the relief.

Conclusion

As with other heritage-related tax reliefs, this measure aims to promote and enhance the cultural heritage of Ireland and also supports tourism. While the desirability of State support for heritage buildings and gardens is acknowledged, and the number of these properties is finite, our view in relation to this measure is that assistance through the tax system is not the most appropriate means of support. In our view, if the aim is correction of market failure or offsetting shortcomings in other areas of public policy, the direct expenditure route is more appropriate in this case. We recommend that the measure be discontinued.

Recommendation 8.36

Income tax relief for expenditure on heritage buildings and gardens should be discontinued.

11.5 BIK exemption on employer-provided art objects in a heritage building or garden

Description

This relief exempts an individual from a benefit-in-kind income tax charge and from a charge to tax in respect of any distributions to participants in respect of certain benefits. The benefit must consist wholly of a loan to the individual of a work of art or a scientific collection which is owned by the company in which the individual is an employee or director and which is available for viewing by the public in a building approved for the purposes of the scheme of tax relief for expenditure on significant buildings and gardens.

Conclusion

We conclude that this relief raises issues of equity. It is narrowly focussed in terms of potential

beneficiaries and the majority of taxpayers, who bear the costs arising, would not be in a position to avail of it. We believe that a charge to tax should arise on such a benefit and therefore recommend that the relief be discontinued.

Recommendation 8.37

The benefit-in-kind exemption on employer-provided art objects in a heritage building or garden should be discontinued.

11.6 CAT exemption of heritage property and heritage property of companies

Description

There is an exemption from capital acquisitions tax in respect of a gift or inheritance of objects of national, scientific, historic or aesthetic interest or a heritage house or garden that is situated in Ireland and not held for the purposes of trading, subject to conditions. Similarly, shares in a family-controlled private company are exempt from tax to the extent that their value is derived from heritage property that would qualify for exemption if the property was heritage property not owned by a company. The exemption only applies to a company where the property is owned by that company on or before 12 April 1995.

This exemption is granted to pictures, prints, books, manuscripts, works of art, jewellery, scientific collections and other items not held for trading which are kept permanently in Ireland and which reasonable viewing facilities for viewing are available to the public, recognised bodies or associations of persons. Temporary absences outside Ireland which are approved by the Revenue Commissioners may be allowed.

To qualify for the exemption, the objects must form part of the gift or inheritance both at the date of the gift or inheritance and at the valuation date. The exemption is withdrawn if reasonable viewing facilities to the public are unavailable or if the object, house or garden, or the shares deriving their value from such heritage property, are sold by the beneficiary within six years of the valuation date of the gift or inheritance. However, the exemption will still be granted where the sale of the object, house or garden, is a sale by private treaty, to the National Gallery of Ireland, the National Museum of Science and Art or other bodies specified in legislation.

Conclusion

This exemption aims to promote and enhance the cultural heritage of Ireland and supports tourism. The exemption enables public access to significant heritage houses and gardens and to objects of national, scientific, historic or artistic interest which might not otherwise be on display. Heritage properties are a finite resource and worthy of support through the tax system. We consider that the scheme should be continued.

Recommendation 8.38

The CAT exemption of heritage property and heritage property of companies should be retained.

11.7 Donations to approved bodies

Description

This scheme provides tax relief in respect of donations made by individuals or companies to eligible charities and other approved bodies where the donation is at least €250 in any year. The relief also applies to donations of quoted securities.

The structure of this scheme differentiates between donations made by PAYE taxpayers, self-employed taxpayers and companies. Where the donor is a PAYE taxpayer, the relief is granted at the individual's marginal rate of tax and the tax refund goes to the charity. In the case of donations made by the self-employed, who pay tax on a self-assessment basis, and by companies, it is the donor who claims the relief and not the recipient of the donation.

The relief is restricted to 10% of the donor's income where the donor is associated with the approved body. The relief is not available where a benefit is conferred on the donor or any person associated with the donor. It is also not due where the donation is conditional on, or associated with, any arrangement involving the acquisition of property by the charity or approved body. It is also a specified relief for the purposes of the high earners restriction.

Conclusion

We consider that there is a general benefit to society from donations to charities and other approved bodies and that the State should continue to support this activity. However, we believe that the State's exposure to costs in this area should not be unlimited. Given this, we recommend the introduction of an upper limit of €500,000 per person on the annual value of donations which may attract tax relief.

This limit should be enforced using the principles of self-assessment and audit. In addition, the relief should be standard rated for all and the threshold on the eligibility of individual donations to attract tax relief should be reduced from €250 to €100.

We also conclude that it is not possible to justify the different treatment of self-employed and PAYE earners under the scheme. As part of the revised arrangements for the scheme, measures should be introduced to address this. We have a preference for a simple approach with a payment representing the tax relief being made to the charity or approved body in respect of donations made by self-employed persons in line with the current approach for donations made by PAYE earners. We also believe that there is merit in simplifying the administrative process associated with the scheme.

In the light of our recommendation that the tax relief should go to the charity or approved body, the relief should be removed from the scope of the measure to restrict the annual tax relief available to high earners. Finally, in relation to donations from companies, the amount that would attract tax relief should be the same as for individuals, i.e. a maximum of €500,000 per annum. The rate of tax relief on corporate donations should be the corporate tax rate and, as with donations from individuals, the tax relief should be paid to the charity or approved body.

Recommendation 8.39

The threshold on the eligibility of individual donations to charities and approved bodies to attract tax relief should be reduced from €250 to €100.

Recommendation 8.40

The relief for individuals under Recommendation 8.39 should be at the standard rate in all cases.

Recommendation 8.41

An upper limit of €500,000 per person on the annual value of donations which may attract tax relief is recommended. This limit should be enforced using the principles of self-assessment and audit.

Recommendation 8.42

The self-employed should be treated in the same way as PAYE earners under the scheme with the tax relief being paid to the charity or approved body.

Recommendation 8.43

In relation to donations from companies, the amount that would attract tax relief should be the same as for individuals, i.e. a maximum of €500,000 per annum. The rate of tax relief on corporate donations should be the corporate tax rate and, as with donations from individuals, the tax relief should be paid to the charity or approved body.

11.8 Donations to sports bodies

Description

Tax relief is available on donations to specified sports bodies for the funding of capital projects. To be regarded as an approved sports body, an organisation must obtain from the Revenue Commissioners both a valid tax clearance certificate and a statement that, in accordance with the provisions of the Taxes Consolidation Act 1997, the body is exempt from tax because it is established solely for the purpose of promoting athletic or amateur games or sports and its income is applied solely for that purpose. The project must be approved by the Minister for Arts, Sport and Tourism and the estimated aggregate cost of the project must be less than €40 million. The types of projects which are eligible to be approved include the purchase, construction or refurbishment of a building to be used for sporting or recreational activities, the purchase of land for such activities, the purchase of permanently based sports equipment and the improvement of pitches and playing surfaces. Tax relief is granted at the individual's marginal rate of tax. The arrangements for allowing the tax relief for donations are similar to those for the scheme of donations to approved bodies.

Conclusion

We concluded that the tax relief regime that is recommended in respect of donations to charities and other approved bodies should also apply in relation to this relief.

Recommendation 8.44

The tax relief scheme available on donations to sports bodies should be modified. The tax relief regime that is recommended in respect of donations to charities and other approved bodies should also apply in relation to relief for donations to sports bodies and aggregate limits should apply to both reliefs.

11.9 Relief for gifts made to the Minister for Finance

Description

Tax relief is available in respect of a gift of money “made to the Minister for Finance for use for any purpose for or towards the cost of which public moneys are provided and which is accepted by that Minister”. ‘Public moneys’ is defined as moneys charged or issued out of the Central Fund provided by the Oireachtas. Where an individual makes a qualifying gift, he or she is entitled to deduct the amount of the gift from his or her income chargeable to income tax for the year in which the gift is made. There is no minimum or upper limit on the amount that may be gifted.

The primary purpose of this relief is to facilitate individuals and companies who wish to make voluntary gifts of money to the State. This has included facilitating State office holders in voluntarily reducing their income during periods of fiscal difficulty.

Conclusion

We note that the State stands to benefit in cash terms from the existence of this relief. The gain to the Exchequer resulting from a gift being made exceeds the associated tax foregone. We consider that it is sensible to retain this measure.

Recommendation 8.45

Relief for gifts made to the Minister for Finance should continue.

11.10 Tax exemptions for philanthropic bodies and sport bodies

Description

The remaining seven items in this Section relate to the taxable status of philanthropic and sports bodies. The collective effect of these provisions is that charities and sports bodies are exempt from taxation (income tax, capital gains tax, stamp duty and, in the case of charities, CAT). Sections 2 and 3 of the Charities Act 2009, respectively, define the terms “charitable organisation” and “charitable purpose”. However, these are not relevant for tax purposes.

Conclusion

We consider that the tax-exempt status of philanthropic and sports bodies should continue. However, we believe that the capital gains tax exemption should be discontinued to the extent development land is disposed of.

Recommendation 8.46

The tax-exempt status of philanthropic and sports bodies should continue. However, the capital gains tax exemption should be discontinued where development land is disposed of.

Section 12:

Tax expenditures relating to enterprise (including farming)

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓ Discontinue ✗ Modify ❄
		Cost €m	Numbers benefiting		
Restriction of balancing charges on a building to the relevant holding period for that building	S274 TCA	N/A	N/A		✗
Tax treatment of grants	S223–S226 and S317 TCA	N/A	N/A		✗
Research and development tax credit	S766 and 766A TCA	54	162	2006	✓
Tax exemption for patent royalties	S234 and 141 TCA	84	1,100	2006	✗
Deduction for capital expenditure on scientific research	S765 TCA	N/A	N/A		✓
Relief for investment in films	S481 TCA	31		2007	✓
Business Expansion Scheme and Seed Capital Scheme	S488-508A TCA	18		2007	✓
Stock relief for farmers	S666-667B TCA	2	N/A	2007	✗
Tax relief for income from leasing farm land	S664 TCA	27	6,000	2005	✓
Accelerated capital allowances for farm buildings for the control of pollution	S659 TCA	N/A	N/A	–	✗
Capital allowances on purchase of milk quota	S669B TCA	N/A	N/A	–	✗
Restructuring aid for sugar beet growers	S657B TCA	10	N/A	2008	✓
Payments made to National Cooperative Farm Relief Services Ltd. and payments made to its members	S221 TCA	N/A	N/A	–	✗
Accelerated capital allowances for energy efficient equipment	S285A TCA	N/A	N/A	–	✓
Relief for investment in renewable energy generation ²¹	S486B TCA	N/A	N/A	–	✓
Mid-Shannon Corridor Tourism Infrastructure Investment Scheme ²²	S372AW-372AZ TCA	N/A	N/A	N/A	✗
Investment allowance in respect of mining exploration expenditure and plant and machinery	S677 and 678 TCA	N/A	N/A	–	✗

21 No annual cost available. However, the cumulative cost of the measure in the period 1999 to 2006 was estimated at €10 million.

22 No annual cost available.

Decommissioning of fishing vessels	S288(6) TCA	N/A	N/A	–	✓
Tax exemption for startup companies	S486C TCA	25 ²³	N/A	–	✱
Tax treatment of venture capital fund managers	S541C TCA	N/A	N/A	–	✱
Tonnage Tax	Part 24A Sch 16B TCA	N/A	N/A	–	✓
Capital gains tax relief for disposal of a business or farm on retirement	S598 TCA	N/A	N/A	–	✓
Capital gains tax relief for disposal within the family of a business or farm	S599 TCA	N/A	N/A	–	✱
Business relief for CAT	S92 CATCA	30	201	2008	✱
Agricultural relief for CAT	S89 CATCA	100	1,594	2008	✱
Stamp duty relief for young trained farmers	S81A SDCA	71	1,604	2008	✓
Stamp duty exemption for single farm payment entitlements	S101A SDCA	N/A	N/A	–	✓
Forestry tax incentives	S232 and 564 TCA	5	N/A	2006	✓

12.1 Restriction of balancing charges on a building to the relevant holding period for that building

Description

The measure provides that, in some cases, a balancing charge arising on the disposal of a building will not be charged to tax.

In general, where capital expenditure has been incurred on a building and the expenditure has qualified for capital allowances, any disposal of the building will give rise to a balancing allowance or charge to equate the total capital allowances over the period of ownership to the reduction in value, if any, over that period.

However, no balancing charge is made where the disposal occurs after the end of the 'holding period' in relation to the building or structure for balancing event purposes. The length of this period depends on the type of building or structure involved and the time when the expenditure on its construction was incurred and ranges between 10 and 25 years.

Normal capital allowances are included in the benchmark tax system and are not regarded as a tax expenditure - see recommendation 7.18 in Part 7 on the appropriate tax base for business income. This is because they reflect an expense taken into account in calculating income. The non-charging of a balancing charge on a building that is sold after the relevant period is not a normal capital allowance matter. It involves a write-off of tax and is thus regarded as a tax expenditure rather than a benchmark tax system issue.

23 Estimated full year cost when introduced in Budget 2009.

Conclusion

Where capital allowances are available, the tax system should compensate the owner of a building for depreciation sustained from its use for business purposes. It should not under-compensate or over-compensate. The restriction of the balancing charge to disposals of a building in the holding period results in an over-compensation for depreciation and should be discontinued for future acquisitions²⁴.

Recommendation 8.47

The restriction of balancing charges on a building to the relevant holding period for that building should be discontinued for future acquisitions.

12.2 Tax treatment of grants

Description

A range of grants received by a taxpayer to meet expenditure may be disregarded for tax purposes.

Under first principles, a grant towards a revenue expense of a trader would be taken into account in calculating taxable trading income as this applies to most grants. However, there are a number of exceptions to this treatment, including small enterprise grants and employment grants. Similarly, capital grants would reduce the base for capital allowances on capital assets, but again there are exceptions to this.

Conclusion

All grants are paid to meet expenditure. Where they are paid to meet revenue expenditure that is tax deductible, it is logical that they should be taxable and where they are paid to meet capital expenditure that qualifies for capital allowances, it is equally logical that capital allowances should be available on the expenditure net of grant. We do not consider it appropriate that the tax system should treat any grants in a different way.

We recommend that all grants to meet revenue expenditure should be taken into account in calculating taxable trading income and capital allowances should be available on expenditure net of capital grants. However, in the case of employment-related grants, there may be a case for postponing the approach we suggest until more favourable labour market conditions apply.

Recommendation 8.48

Grants to meet revenue expenditure should be taken into account in calculating taxable trading income and capital allowances should be available on expenditure net of capital grants. However, in the case of employment-related grants, there may be a case for postponing the approach we suggest until more favourable labour market conditions apply.

12.3 Tax credit for research and development

Description

A tax credit is available to a company that is engaged in in-house qualifying research and development (R&D) that is undertaken in Ireland (or within the European Economic Area if it is not eligible for tax relief outside Ireland). Expenditure will not qualify for the credit to the extent that it is covered by grant aid.

²⁴ If recommendation 7.18 is adopted, this recommendation will no longer be relevant.

The credit is given for qualifying R&D expenditure that is incremental over the amount of R&D spending in 2003. The credit is calculated as 25% of qualifying expenditure and is offset against the corporation tax payable by the company for the accounting period in which the expenditure was incurred. If the credit exceeds the corporation tax for that year, it can be offset against corporation tax for the previous year. Any surplus is carried forward for offset against liability in subsequent years. As an alternative, a company may claim to have any credit that cannot be offset against the current or the previous year repaid to it over a period of up to three years.

The credit does not cover expenditure on buildings. A separate non-incremental credit of 25% of expenditure on buildings used for R&D purposes is available over four years on a straight line basis with similar rules regarding use of the credit.

Expenditure by companies on R&D work subcontracted to unconnected parties qualifies under the scheme up to a limit of 10% of qualifying R&D expenditure in any year. This is in addition to provisions by which the cost of R&D subcontracted to universities in the EU and EEA is allowed.

Conclusion

Given that the R&D tax credit scheme has only been in place since 2004, there is limited information available against which to assess its cost effectiveness.

We consider that it is very important in terms of incentivising economic activity that there be properly focussed and genuinely effective incentives in the area of research and development. The tax credit for expenditure on research and development scheme does this and incentivises important research and development activities. We consider that the tax credit for expenditure on research and development scheme should continue.

Recommendation 8.49

The tax credit for research and development should continue.

12.4 Tax exemption for patent royalties

Description

Royalty income derived from qualifying patents is exempt from income tax and corporation tax subject to an annual limit. A qualifying patent is a patent on an invention for which the research and development work was carried on in a country in the European Economic Area. An individual who owns a patent is only entitled to an exemption as inventor or co-inventor. There is an annual limit of €5 million on the amount of exempt royalty income.

Dividends paid by a company out of patent income are also exempt from tax. If the patented invention does not involve radical innovation, the amount of exempt patent income that can be distributed tax-free in any accounting period is limited to the amount of expenditure incurred on research and development in that period.

Conclusion

We have reservations about the effectiveness of the measure in incentivising companies to engage in R&D activities in Ireland. We are of the view that the relief has not resulted to any great extent in companies carrying out R&D activity and that, where it was being used by such companies, it was being used in some cases as a tax avoidance device to remunerate employees.

We also believe that the deadweight element of the scheme is significant and that the patent income exemption is a windfall gain after a successful invention rather than an incentive to encourage research and development.

Our view is that it is very important in terms of incentivising economic activity that there be properly focussed and genuinely effective incentives in the area of research and development. The R&D tax credit incentivises research and development activity more directly than the patent royalty scheme and available resources should be focused on that scheme. The patent royalty exemption should therefore be discontinued.

Recommendation 8.50

Tax exemption for patent royalties should be discontinued.

12.5 Tax deduction for capital expenditure on scientific research

Description

This section gives an allowance in respect of capital expenditure on scientific research incurred by a person carrying on a trade to which the expenditure relates. An allowance is also available where the capital expenditure on scientific research is incurred by a person carrying on a trade but the expenditure is not related to the person's trade. Unused allowances in respect of capital expenditure on scientific research may be carried forward against future trading income.

Conclusion

We consider that this allowance complements the R&D tax credit and that it should be continued.

Recommendation 8.51

The tax deduction for capital expenditure on scientific research should continue.

12.6 Film relief

Description

The measure allows a deduction from income for investments in films by individuals and companies. Individual investors may invest a minimum of €250 and up to a maximum of €50,000 under the scheme in any tax year. Corporate investors may invest up to €10,160,000 under the scheme in any 12-month period²⁵.

Investors can claim tax relief on 100% of their investment. Any part of their investment that has not been relieved can be carried forward to the following tax year should earnings in the year of investment be insufficient to absorb the full deduction.

The maximum amount of funding that can be raised for an individual film production was increased to €50 million in Finance Act (No. 2) Act 2008. A maximum of 80% of the total cost for a film budget can be raised through the relief. Where shares are held for more than one year, the relief claimed on the investment is ignored for CGT purposes. Any loss on disposal of the shares is restricted by the amount of the relief.

²⁵ Subject to a cap of €3,810,000 on investment in any single film, and subject to the requirement that, if €3,810,000 has been invested in films with budgets greater than €5,080,000, the rest of the investments are in films with budgets of €5,080,000 or less.

Conclusion

We note the following points which were contained in the 2007 Indecon review²⁶ of film relief:

- For every €100 raised under section 481, the Exchequer cost is €34 but only €19 goes as a subsidy to the film producers²⁷ (Page 35)
- On average, investors receive back only 76% of their investment and their return is entirely due to the tax subsidy received (Page 36)
- Ireland is almost unique in Europe for offering a tax incentive for television production (Page 21)
- The film sector in Ireland is primarily dependent on competing on the basis of tax incentives which can easily be replicated in other countries. This vulnerability was highlighted by Indecon as far back as 1998 (Page 66)

Indecon's cost-benefit analysis indicated that the relief over the years 2003 to 2006 had produced small net gains to the Exchequer. The figures indicate that while total tax and other benefits exceed the costs, when even relatively low level of opportunity costs are taken into account, the benefits of the scheme to the Irish economy are very low and have declined over recent years.

The structure of the relief and the manner in which it may be used by investors also raises a question of equity. Those lower down the income scale are unlikely to be in a position to have the initial capital to leverage a loan in order to avail of the relief.

At the same time, however, we are aware of the competitive international environment which exists in the film industry. Ireland competes with other countries and locations for productions. These include, for example, Australia, New Zealand, the UK, Canada, New York, Fiji and Hungary. We also acknowledge the role which the sector plays in supporting a significant number of jobs in the economy. We consider that film relief should be continued.

Recommendation 8.52

Film relief should be continued but should be subject to regular review in accordance with our principles as set out in Section 5 of this Part.

12.7 Business Expansion Scheme and Seed Capital Scheme

Description - Business Expansion Scheme (BES)

Under the scheme, an investor qualifies for tax relief, at the marginal tax rate, on investments, in shares of a qualifying company, of up to €150,000 per annum (minimum €250). The relief applies provided that the shares are held for a minimum period of five years. The shares must be new ordinary shares that carry no preferential rights and there must not be any condition which would eliminate the investors' risk. An investor may not be connected with the company.

The aggregate amount of tax relieved funds that a company can raise under the BES is €2 million, subject to a maximum of €1.5 million in any one 12-month period.

With effect from 1 January 2007, the company must be either:

- A micro or small enterprise, as defined
- A medium sized enterprise, as defined, which is located in an 'assisted' area or

²⁶ 'Review of Section 481 Film Relief', Indecon International Economic Consultants, November 2007.

²⁷ Indecon indicated that the figures were derived by them from a survey of a sample of leading Irish film producers.

- A medium sized enterprise not located in an assisted area, which is at a stage of development not beyond start up stage, as defined. Medium sized enterprises operating in “non-assisted” areas of Ireland may only qualify for BES in their seed/start up phase of development

The money subscribed must be used with a view to the creation or maintenance of employment to enable the company to:

- Undertake one of the qualifying trading operations, or 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 develop its existing markets, or
- Increase its sales of products or services

Description - Seed Capital Scheme (SCS)

The Seed Capital Scheme (SCS) was introduced to encourage individuals currently or formerly in employment to establish new business ventures. Where an individual invests in new ordinary shares of a newly incorporated company, relief will be given against income of the person for any of the previous six years prior to the year of investment and any tax overpaid will be refunded. To qualify for the relief, applications must be approved by a certifying agency. 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 paid in previous years, subject to a limit of the tax paid on total income of €100,000 per annum with an overall limit for the previous six years of the tax paid on total income of €600,000. SCS projects can also seek BES funding but the overall company limit of €2 million applies.

Conclusion

The Small and Medium Enterprises (SME) sector is important to the Irish economy in terms of output, competitiveness and employment.

We consider that the Business Expansion Scheme, including the Seed Capital Scheme, helps to address the issue of market failure in relation to the availability of equity capital and that it should remain in place up to its 2013 deadline. The schemes should be reviewed to assess whether market failure continues to exist and whether the schemes continue to be effective in advance of any extension to it beyond 2013.

We hold the view that the administrative burden placed on companies seeking to benefit from the schemes is onerous and should be reviewed.

Recommendation 8.53

- The Business Expansion and Seed Capital schemes should remain in place up to their 2013 deadline.
- The schemes should be reviewed to evaluate their effectiveness and the extent to which market failure exists in advance of any further extension beyond 2013.
- The administrative burden placed on companies seeking to benefit from the schemes is onerous and should be reviewed.

12.8 Stock relief for farming businesses

Description

Relief from income tax for increases in trading stock (inventory) values is given to farming businesses. The relief is calculated by reference to the increase in the value of trading stock of the farming trade in an accounting period.

Broadly speaking, the relief takes the form of a deduction, to be allowed in calculating the trading profits of an accounting period, of 25% of the amount of the increase in value of trading stock at the end of the accounting period over and above the opening value. Stock relief may not be used to create or augment a loss.

An enhanced rate of stock relief applies to 'young trained farmers', i.e. farmers who are under 35 years of age and who meet applicable training or education requirements. In the case of these farmers, the stock relief deduction allowed is 100% of the increase in stock values instead of the usual 25%, beginning in the year in which the individual commences farming. This higher rate of stock relief applies for four years and thereafter reverts to 25% annually.

Farming stock is the basis from which income is derived and it can take a number of years to build up that stock. The relief can also help new entrants to farming.

Conclusion

Although the relief assists new entrants to farming, we believe that it is not equitable that this measure is only given to one sector of the economy. The original justification for stock relief – high inflation – no longer exists and it has long been abolished for other sectors of the economy. We consider, therefore, that the relief should be discontinued.

Recommendation 8.54

Stock relief for farming businesses should be discontinued.

12.9 Income tax relief for farm land leasing income

Description

Relief from income tax is granted to persons aged 40 and over (and all persons permanently incapacitated from farming through infirmity) for income arising from the leasing of farm land to an unconnected farmer (under a written arm's length lease for five years or more).

For leases made on or after 1 January 2007, a tax allowance of up to €20,000 is available for a lease of at least 10 years or more, €15,000 for a lease of between seven and 10 years and €12,000 in any other case.

The minimum lease period was intended to allow farmers time to gain the benefits from improvement work they might carry out on the leased land. Its objective is to improve the scale and efficiency of commercial farming at a reasonable cost; the means whereby that is to be achieved is by seeking to change the behaviour of some landowners whose main occupation is other than farming.

There are unique structural factors pertaining to Irish farming that need to be taken into account. Providing a tax relief for the owner of the land is one way of doing this. Because the supply of land is fixed, it is reasonable to treat the owner's leasing income differently to his or her income

from renting other assets. The preponderance of short-term letting and conacre, and the desirable policy goal of shifting the balance towards long-term leasing which would facilitate better planning and farm management are features of agriculture that are not found in other sectors.

Conclusion

The measure (in its current form) is only in place since 2007. It may therefore be premature to evaluate its effectiveness.

The measure is intended to facilitate the more productive use of the land. Providing a tax relief for the owner of the land is one way of doing this. We, therefore, consider that this relief should be continued. However, it should be reviewed in accordance with our principles as set out in Section 5 of this Part after five years of operation.

Recommendation 8.55

Income tax relief for farm land leasing income should be continued. However, the measure should be reviewed in 2012 in accordance with our principles as set out in Section 5 of this Part.

12.10 Capital expenditure on farm buildings for pollution control

Description

Farmers who incur capital expenditure on the construction of specified buildings or structures (e.g. waste storage facilities, effluent tanks and housing for cattle) used for the control of pollution can claim accelerated allowances in respect of that expenditure. The scheme covers expenditure incurred between April 1997 and the end of December 2010.

To qualify for these accelerated allowances a farmer must have a farm nutrient management plan in place. That plan must accord with official guidelines and the buildings or structures must be constructed in accordance with the farm nutrient management plan and must be certified as being necessary for the control of pollution by the agency or planner who drew up the plan.

Recommendation 8.56

The accelerated allowance for capital expenditure on farm buildings for pollution control should not be continued when it expires in 2010. For subsequent years, normal capital allowances should apply.

12.11 Tax relief for purchase of milk quota

Description

Capital expenditure incurred on the purchase, after 1 April, 2000, of a milk quota by a milk producer may be written off over a seven-year period (15% per annum over six years and 10% in year seven).

Conclusion

We note that the milk quota system is due to expire in 2013. Expenditure on milk quotas will be subject to the regime we suggest in Part 7 (see Recommendation 7.18) to replace capital allowances for tax purposes with accounting depreciation. On this basis, the relief should be discontinued.

Recommendation 8.57

The tax relief for the purchase of milk quota should be discontinued.

12.12 Restructuring aid for sugar beet growers

Description

Payments made to individual sugar beet growers under the EU scheme of aid for the restructuring of the sugar beet industry would normally be chargeable to income tax in the year these payments are made. The aid is paid under the EU temporary scheme for the restructuring of the sugar beet industry. It also involves payments in the form of diversification aid under the same scheme. Under this relieving measure, the payments can instead be spread over six years beginning in the year in which the payment is made. Once the grower has opted for this method of dealing with the payments, they cannot subsequently opt out - this is to ensure that all the income received will eventually be taxed.

Conclusion

This is a limited measure targeted at a specific sector of the farming community in respect of a particular tranche of income. This aid could, in some circumstances, have moved some farmers into a higher income tax bracket in the year of receipt through events entirely outside their control. All the income will eventually be subjected to a charge to income tax, albeit at a rate that may be lower than would obtain if it were to be taxed in the year of receipt. Final payments under the scheme will be paid in the period up to 2012. We consider that the tax treatment should be retained.

Recommendation 8.58

The restructuring aid for sugar beet growers should continue.

12.13 Tax exemption for payments to National Co-operative Farm Relief Services Ltd and payments made to its members

Description

Exemption from corporation tax applies in respect of payments made by the Minister for Agriculture and Food to National Co-operative Farm Relief Services Ltd and to payments made by that body to its member co-operatives.

Conclusion

This exemption from corporation tax was introduced in 1994. It covers payments of financial support made by the Minister for Agriculture and Food under specific agreements made in 1991 and 1995 (and subsequent amendments of those agreements) to the National Co-operative, that is, the society registered in 1980 as "National Co-operative Farm Relief Services Limited". These payments are intended for the support of farm relief services throughout the country. This exemption applies only to the named body and is targeted at assisting it and the farm relief services which operate around the country.

We see no basis for this exemption and consider that it should be discontinued.

Recommendation 8.59

The tax exemption for payments to National Co-operative Farm Relief Services Ltd. and payments made to its members should be discontinued.

12.14 Accelerated capital allowances for energy efficient equipment

Description

The measure provides for accelerated capital allowances for expenditure on new energy efficient equipment acquired by trading companies. It allows capital allowances of 100% in the year in which the expenditure is incurred on the equipment covered by the scheme.

The initiative applies for a trial period of three years from 2008 to 2011 to new equipment in designated classes of technology. The tax incentive scheme was approved for EU state aid purposes.

Conclusion

There is a market failure to the extent that companies do not use energy efficient equipment. However, to the extent that companies may be using such equipment in any event, some deadweight cost arises. Getting increased use of such equipment should assist in improving cost competitiveness while helping to reduce overall energy demand and carbon emissions. The incentive is in the nature of a 'pump-priming' exercise and applies for a period of three years. It is proposed that the scheme will be reviewed to ascertain its effectiveness. The time limited nature of the scheme is a welcome feature and is consistent with our principles.

There may be some inequity in that the measure applies only to companies. However, the scheme is a pilot one and the question of its extension to other taxpayers can be considered in due course.

We recommend that the measure should continue for its current term.

Recommendation 8.60

The accelerated capital allowances for energy efficient equipment should continue.

12.15 Relief for investment in renewable energy generation

Description

The tax relief for investment by corporate enterprises to invest in renewable energy production was introduced in 1999 for a three-year period and has been extended on a number of occasions since then and will now expire on 31 December 2011.

The measure provides that a company will be entitled to obtain a deduction from its total profits for an investment that it makes in shares of a qualifying company. The funds must be used by the qualifying company for a renewable energy project that has been certified by the Minister for Communications, Marine and Natural Resources. The relief is restricted to 50% of the relevant cost of the project subject to an overall limit of €9,525,000, whichever is the lesser. An individual company or group of companies may not invest more than €12,700,000 in such projects.

Conclusion

The purpose of the measure was to encourage investment in renewable energy with the aim of facilitating the growth of electricity generation capacity using these sources. The measure is aimed at protecting the environment and reducing CO₂ and other greenhouse gas emissions by promoting sustainable energy and tackling climate change. The take-up of the scheme has been low because of the low corporation tax rate in Ireland. We note that the scheme recommenced on 27 February 2009. We recommend that it should adhere to our general principles as set out in Section 5 of this Part.

Recommendation 8.61

Relief for investment in renewable energy generation should continue. Any extension should adhere to our general principles as set out in Section 5 of this Part.

12.16 Mid-Shannon corridor tourism infrastructure investment scheme

Description

The measure provides for capital allowances to be available in relation to tourism infrastructure facilities. The qualifying period for the scheme runs until 31 May 2013. Relief is provided by way of accelerated capital allowances over seven years for qualifying construction and refurbishment expenditure incurred in the qualifying period²⁸. In the case of refurbishment, the qualifying expenditure must exceed 20% of the market value of the property before work commences.

Conclusion

We are of the view that, while area-based tax schemes may be intended to address regional imbalances, they may in fact give rise to further such imbalances. We recommend that the Mid-Shannon corridor scheme should not be continued beyond its current expiry date.

Recommendation 8.62

The Mid-Shannon corridor scheme should not be continued beyond its current expiry date.

12.17 Investment allowance for machinery and plant and for exploration expenditure

Description

There is an investment allowance of an additional 20% of expenditure incurred on mining exploration expenditure and for new machinery and plant used in a mine.

Conclusion

It is inappropriate that tax allowances in excess of the expenditure incurred should be available to the mining industry. We are of the view that the investment allowances should be ended.

Recommendation 8.63

The investment allowance for machinery and plant and for exploration expenditure should be discontinued.

12.18 Decommissioning of fishing vessels

Description

Any balancing charge arising as a result of the receipt of a decommissioning payment under the EU scheme for compensation in respect of the decommissioning of fishing vessels is spread evenly for tax purposes over five chargeable periods, the first of which is the year of receipt. The impact is to spread the tax due over five years.

Conclusion

This is a limited measure targeted at a specific sector in respect of a particular tranche of income. This aid could, in some circumstances, have moved some recipients into a higher income tax

28 In areas which are not in the Border Midlands West (BMW) region only 80% of construction and refurbishment expenditure can qualify for relief.

bracket in the year of receipt. All the income will be subjected to a charge to income tax over the five-year period, albeit at a rate that may be lower than would obtain if it were to be taxed in the year of receipt. In the circumstances, we recommend that the scheme should be continued.

Recommendation 8.64

The tax treatment of the decommissioning of fishing vessels should continue.

12.19 Tax exemption for start-up companies

Description

This measure provides a new relief from corporation tax for companies commencing to trade in 2009. The exemption is granted in respect of the profits of a new trade and chargeable gains on the disposal of any assets used for the purposes of a new trade.

The exemption is granted by reducing the total corporation tax (including the tax referable to capital gains) relating to the trade to nil. Full relief is granted where the total amount of corporation tax payable by a company for an accounting period does not exceed €40,000. Marginal relief is granted where the total amount of corporation tax payable by a new company for an accounting period amounts to between €40,000 and €60,000. No relief applies where corporation tax payable is €60,000 or more.

Conclusion

We note that this scheme has not been the subject of a commencement order at the time of writing. However, we consider that it has a role to play on market failure grounds and should remain in place having regard to its potential benefits.

We consider that the scheme could benefit from a number of modifications to help support business, particularly in the very challenging economic environment which is likely to exist for some time. First, the requirement for companies to commence in 2009 should be altered so that those who begin trading in 2010 or 2011 would benefit from the exemption for two years or one year, respectively, within the existing three-year timeframe for the relief. Second, the exclusion which applies to service companies should be removed.

In addition to our recommendations which apply to the existing scheme, we recommend that a new scheme for unincorporated businesses be established which would have its own three-year time cycle in line with the approach we recommend for the existing scheme. To reduce potential deadweight costs, such businesses should be full-time enterprises and should be required to file tax returns throughout the period of the exemption.

Both the existing scheme and the new one which we propose for unincorporated business should be subject to review in accordance with our general principles as set out in Section 5 of this Part after a reasonable period of time.

Recommendation 8.65

The relief from tax for start-up companies should be continued. However, the scheme should be modified so that companies who begin trading in 2010 or 2011 would benefit from the exemption for two-years or one-year, respectively, within the existing three-year timeframe for the relief. In addition, the exclusion which applies to service companies should be removed.

- A new scheme for unincorporated businesses should be established which would have its own three-year time cycle in line with the approach we recommend for the existing scheme.
- Both the existing scheme and the proposed new one for unincorporated business should be subject to review in accordance with our general principles as set out in Section 5 of this Part after a reasonable period of time.

12.20 Tax treatment of venture capital fund managers

Description

A reduced rate of tax is applicable to the share of profits of a relevant investment that a venture capital manager receives for managing the investment. A relevant investment is an investment that is maintained for a period of at least six years in a private trading company that carries on a business, set up after 1 January 2009, of research, development and innovation activities. "Innovation activities" means new technological, telecommunication, scientific or business processes.

These profits are known as "carried interests" and are separate from the profits made by the general investors in a venture capital fund. The amount of "carried interest" in relation to a relevant investment that can benefit from the tax relief cannot exceed 20% of the total profits from the relevant investment.

For tax purposes, the profits derived from the carried interest are deemed to be chargeable gains and special rates of capital gains tax are then applied. A capital gains tax rate of 15% applies to carried interest in respect of partnerships and 12.5% in respect of companies.

Conclusion

The 12.5% rate that applies to investment returns on carried interests of venture fund managers that are companies is appropriate as, in most cases, the investment return would in any event constitute trading income so that the return would be taxable at the normal corporate rate.

In the case of an individual who is a venture capital fund manager, equity requires that:

- Where the investment return on a carried interest represents income, it should be taxed at the marginal income tax rate, and
- Where the investment return on a carried interest is a capital gain, it should be subject to capital gains tax at the normal rate of 25%.

Recommendation 8.66

The tax treatment of venture fund managers should be modified such that in the case of an individual who is a venture capital fund manager:

- Where the investment return on a carried interest represents income, it should be taxed at the appropriate marginal rate, and
- Where the investment return on a carried interest is a capital gain, it should be subject to capital gains tax at the normal rate (25%)

12.21 Tonnage tax

Description

Tonnage tax is an alternative method of calculating profits from shipping activities for corporation tax purposes based on the tonnage of the ship rather than the actual profit. Tonnage tax allows Irish-based companies to compete with competitors benefiting from tonnage tax regimes and additional tax and social security incentives in their own jurisdictions. Tonnage tax regimes within Member States are also supported at EU level on competitive grounds. Other drivers for the introduction included developing the maritime transport industry in Ireland, facilitating the growth of the indigenous sector and attracting interest from foreign direct investors.

Conclusion

We note that the tonnage tax regime plays a role in supporting the retention in Ireland of the operational base of the main Irish shipping companies. We consider that the regime should be continued on the grounds that it supports economic activity in the shipping sector.

Recommendation 8.67

The tonnage tax regime should be continued.

12.22 Capital gains tax relief for disposal within the family of a business or farm on retirement

Description

There is an exemption from capital gains tax where an individual, who is aged 55 or over, disposes of a business or farm or shares in a family company or holding company to a child (which includes a nephew or a niece²⁹, a foster child, and the child of a deceased child) without an upper limit on the qualifying consideration. If the assets acquired by the child are disposed of within six years from the date of acquisition, the capital gains tax which would have been payable becomes due.

Conclusion

In our view, there is a case on both economic and social grounds to support the transfer of smaller farms or businesses within families. However, the same argument does not apply in the case of larger farms or businesses. There is a need for structural reform as regards the viable scale and efficiency of farm units and to facilitate succession within farming. We consider that the capital gains tax relief for family transfers should be continued but limited so that it applies to asset values up to €3 million, with capital gains tax payable on an apportionment basis for values in excess of that.

Recommendation 8.68

The capital gains tax relief for family transfers should be continued but limited so that it applies to asset values up to €3 million. Where the value of the asset transferred exceeds €3 million, only the part of the gain that is attributable to the excess over €3 million should be charged to tax.

12.23 Capital gains tax relief for disposal of a business or farm on retirement

Description

There is an exemption from capital gains tax where an individual, who is aged 55 or over, disposes of a business or farm or shares in a family company or holding company and the consideration does not exceed €750,000. Where the consideration exceeds €750,000, marginal relief which

²⁹ A nephew or niece must have worked substantially on a full-time basis, for the period of five years ending with the disposal, in trade, business or a profession.

restricts the tax payable to one-half of the difference between the consideration and the limit applies.

Conclusion

The relief encourages the timely and efficient transfer of businesses and farms to new owners and may provide an income in retirement to those who may not otherwise have made pension provision. We recommend that it be continued.

Recommendation 8.69

Capital gains tax relief for disposal of a business or a farm on retirement should continue.

12.24 Business relief for CAT

Description

This relief was introduced to treat gifts and inheritances of business assets more favourably than other gifts and inheritances. Currently the relief reduces the taxable value by 90%.

The relevant business property must have been owned for a minimum period of five years prior to the transfer of the gift (two years in the case of an inheritance). The relief is withdrawn if the property is disposed of within six years and is not replaced by other qualifying property or if the property ceases to be a qualifying property.

Conclusion

In our view, there is a case on social grounds to support the transfer of smaller businesses. However, the same argument does not apply in the case of larger businesses.

We consider, therefore, that the business relief for CAT should be limited, by reducing the level of discount on market value from 90% to 75% and by introducing a ceiling on the amount qualifying for discount.

We also consider that the reduction should be subject at an overall monetary limit that would facilitate the transfer of small and medium enterprises. The limit we suggest is €3 million, i.e. the maximum amount by which the value of a business may be reduced is €3 million.

Recommendation 8.70

For business relief for CAT, a reduction of no more than 75% of the value of the business should be allowed before tax is calculated. The reduction should be subject to an overall monetary limit of €3 million.

12.25 Agricultural relief for CAT

Description

Relief from capital acquisitions tax is provided, subject to conditions, in respect of gifts and inheritances of agricultural property as defined (see below). The relief (which is analogous to business relief, described above) operates by reducing the market value of agricultural property by 90% so that gift or inheritance tax is calculated on an amount – known as the “agricultural value” – which is substantially less than the market value. In general, the relief applies provided the beneficiary qualifies as a farmer.

For the purposes of this relief, a 'farmer' means an individual (regardless of occupation) in respect of whom at least 80% of his or her assets, after taking a gift or inheritance, consist of agricultural property on the valuation date of the gift or inheritance. The 80% test does not apply in the case of agricultural property consisting of trees and underwood. The term 'agricultural property' means agricultural land, pasture and woodland in an EU Member State; crops and trees growing thereon; houses and other farm buildings appropriate to the property; livestock, bloodstock and machinery on the land; and an EU single farm payment entitlement.

There are a number of circumstances in which the relief can be wholly or partly withdrawn. This will happen:

- If the property is sold. Other than in relation to timber in woodlands, the relief is withdrawn where the agricultural property is sold (or compulsorily acquired) within six years of the date of the gift or inheritance and is not replaced within one year of the sale or within six years of the compulsory acquisition by other agricultural property
- If a residency requirement is not met. In the case of a gift or inheritance the relief is withdrawn unless the individual in receipt of the benefit is resident in Ireland for all of the three subsequent tax years

Conclusion

As with business relief, there is a case on social grounds to support the transfer of smaller farms to a new generation. However, the same argument does not apply in the case of larger farms.

We consider, therefore, that the agricultural relief for CAT should be limited, by reducing the level of discount on market value and by introducing a ceiling on the amount qualifying for discount.

We consider that a reduction of no more than 75% of the asset value should be allowed before tax is calculated.

We also consider that the reduction should be subject at an overall monetary limit that will facilitate the intergenerational transfer of small farms. The limit we suggest is €3 million, i.e. the maximum amount by which the value of the property may be reduced is €3 million. In the same way as business relief requires that a business is carried on for a period of six years after a transfer, we consider that this measure should require that the farm asset is owned and operated as a farm for a period of six years after the transfer.

Recommendation 8.71

For agricultural relief for CAT, a reduction of no more than 75% of the value of the property should be allowed before tax is calculated. The reduction should be subject to an overall monetary limit of €3 million. A condition of the relief should be that a farm asset is owned and operated as a farm for a period of six years after the transfer.

We consider that there is a case for the amalgamation of business relief and agricultural relief in a single measure. However, the requirement under business relief that the business must have been carried out for a period of five years before the transfer could, in the case of farming, act as an impediment to leasing of land. In recognition that leasing of farm land contributes to increased efficiency in the sector, the "leasing out of farm land" before the gift or inheritance should qualify as a "business" in a single relief system.

Recommendation 8.72

Business relief and agricultural relief should be amalgamated into a single relief.

12.26 Stamp duty relief for transfers of land to young trained farmers

Description

Deeds of transfer executed on or after 2 April 2007 and before 31 December 2012 are exempt from stamp duty when land is transferred by way of gift or sale to a 'young trained farmer'. The farmer in question must be under 35 years of age on the date of the execution of the deed of transfer and at that date must have attained appropriate qualifications. A declaration must also be made by the farmer that he or she will, for a period of five years from the date of execution of the deed of transfer:

- Spend not less than 50% of his or her normal working time farming the land, and
- Retain ownership of the land

Relief can be withdrawn if the land is disposed of within five years from the date of execution of the deed of transfer and is not replaced by other land within one year of disposal. The relief subsidises the acquisition of farm land by young trained farmers and applies whether the land is acquired by gift from a family member or by purchase from a third party.

Conclusion

In looking at this relief, we took account of the demographic profile of the farming population. The most recent CSO data on the labour input in Irish farming shows that 26% of farmers are in the 55-64 age bracket and 25% are over 65 years, while only 8% are under 35 years. While equity and efficiency issues arise in relation to this exemption, on balance we consider that it should be continued.

Recommendation 8.73

Stamp duty relief for transfers of land to young trained farmers should continue.

12.27 Stamp duty exemption for single farm payment entitlement

Exemption from stamp duty is provided on the sale, transfer or other disposition of an EU single farm payment entitlement. The entitlement is property in its own right and would be liable to duty at the non-residential rates on a transfer. Any contract or agreement for sale, or a mortgage, of the entitlement is covered by the exemption and the exemption applies to instruments executed on or after 1 January 2005. While other support schemes continue to apply, the single farm payment scheme will constitute the main EU support for farmers from 2005 until at least 2012. To be eligible, farmers must meet certain conditions which cover issues such as land being at their disposal for a minimum period and also engaging in good farming and environmental practices.

Conclusion

This relief exempts farmers from a liability to stamp duty that they would otherwise have to discharge. The rationale is that it encourages the transfer of the entitlements along with eligible land in order to promote viable land holdings. We consider that the relief is one of a number of measures which facilitate the more productive use of land and that it should be continued.

Recommendation 8.74

The stamp duty exemption relating to the sale or transfer of EU Single Farm Payment Entitlements should be continued.

12.28 Forestry tax incentives

Description

Profits or gains from the occupation of woodlands in Ireland that are managed on a commercial basis and with a view to realising profits are exempt from income tax and corporation tax.

Where an individual makes a disposal of woodland, the consideration for the disposal of the trees growing on the land and saleable underwood are not taken into account for capital gains tax purposes. Likewise, in calculating the gain, the attributable cost of trees growing on the woodland is excluded. Thus, where land held by an individual is sold with standing timber on it, the consideration for the disposal is to be apportioned and the part of the consideration attributable to the trees or saleable underwood is excluded for capital gains tax purposes. Insurance proceeds received by an individual in respect of the destruction of or damage to standing timber or saleable underwood are also excluded for capital gains tax purposes. This measure does not apply to companies or other bodies of persons.

Conclusion

We acknowledge that there is a market failure issue in relation to afforestation which public policy ought to address. Pending a review of the appropriate means (i.e. direct expenditure or tax expenditure) of State support for woodlands, we recommend the forestry tax expenditures be continued.

Recommendation 8.75

The tax incentives relating to forestry should be continued.

Section 13:

Tax expenditures relating to employment

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓ Discontinue ✕ Modify ✨
		Cost €m	Numbers benefiting		
Employee tax credit	S472 TCA	2,522	1,626,700	2006	✨
Income tax relief for trade union subscriptions	S472C TCA	19	294,300	2006	✕
Benefit-in-kind exemption for employer-provided personal security assets and services	S118A TCA	N/A	N/A	–	✓
Benefit-in-kind and PRSI exemption for employer-provided public transport travel passes	S118(5) TCA	N/A	41,338 ³⁰	–	✓
Benefit-in-kind exemption on employer-provided bicycles	S118(5G) TCA	2 ³¹	N/A	–	✓
Income tax exemption for scholarships	S193 TCA	1	4,028	2006	✓
Income tax relief for fees paid for third-level education	S473A TCA	16	30,800	2006	✓
Income tax relief for fees paid for training courses	S476 TCA	N/A	N/A	–	✓
Income tax exemption for statutory redundancy payments	S203 TCA	78	22,100	2006	✓
Income tax relief for termination payments in excess of the statutory redundancy amount	S201(3) TCA and Sch 3	20	2,050	2006	✨
Income tax exemption for termination payments related to death, injury or disability	S201(2) TCA	N/A	N/A	–	✨
Tax relief for termination payments where employment involves foreign service	S201(4) TCA	N/A	N/A	–	✨
Benefit-in-kind exemption for retraining provided as part of a redundancy package	S201(1A) TCA	N/A	N/A	–	✓
Systematic short-time relief	S126 (3)(c) TCA	2	1,800	2008	✕
Income tax relief for the long-term unemployed and double payroll deductions for employers	S472A and S88A TCA	<1	360	2006	✓
Income tax relief for reorganisation payments	S480 TCA	N/A	N/A	–	✓

30 Based on data provided by transport companies.

31 Budget estimate of cost over a five-year implementation period.

PRSI exemption for share options	S985A (1A) TCA	18	3,900	2006	✕
Approved profit-sharing schemes	S509-518 TCA	57	59,300	2006	✱
Employee share-ownership trusts	S519 TCA	6	16,300	2006	✓
Approved share-option schemes	S519D TCA	3	1,400	2006	✕
Approved savings-related share option schemes	S519A TCA	2	3,000	2006	✱
Relief for new shares purchased on issue by employees	S479 TCA	<1	184	2006	✕
Artist's exemption	S195 TCA	66	2,890	2006	✕
Sportsperson's relief	S480A	<1	32	2006	✱
Seafarer's allowance	S472B TCA	<1	170	2006	✕
Allowances for expenses of members of Oireachtas	S836 TCA	–	–	–	✱
Payments under Scéim na bhFoghlaimeoirí Gaeilge	S216B TCA	N/A	N/A	–	✕
Remittance basis of taxation	S18(2)(f), 29(4) and S825B TCA	N/A	N/A	–	✕

13.1 Employee tax credit

Description

The employee tax credit, also known as the PAYE tax credit, may be claimed by an individual, who is in receipt of emoluments chargeable to income tax under Schedule E. The value of the credit is €1,830 per annum. It is provided on an individualised basis and this has been the case since it was first introduced as an allowance. It is not applicable to emoluments paid by a company to proprietary directors or their spouses or to those who are self-employed.

The employee tax credit is considered in Section 2 of Part 5.

13.2 Income tax relief for trade union subscriptions

Description

An income tax credit of €70 (2008) is available for individuals paying trade union subscriptions.

Conclusion

We consider that membership of a trade union is likely to be influenced by the benefits of membership and may be a condition of employment. The value of the tax credit is unlikely to be a factor. Having regard to the significant element of deadweight associated with the tax relief, we consider that the relief should be discontinued.

Recommendation 8.76

Income tax relief for trade union subscriptions should be discontinued.

13.3 Benefit-in-kind exemption for employer-provided personal security assets and services

Description

An exemption from an income tax benefit-in-kind charge applies where an employer provides a security asset or service for use by a director or employee and there is a work-related credible and serious threat to the employee's security.

Conclusion

The relief has strict conditions, is narrowly focussed and may be justified by reference to the 'policy failure' condition in our guiding principles. However, we consider that it is important that appropriate security protection should be available to all employees and directors who are at risk.

Recommendation 8.77

The relief for benefit-in-kind for employer-provided personal security assets and services should continue to apply where arrangements are made for all employees at risk.

13.4 Benefit-in-kind and PRSI exemption for employer provided public transport travel passes

Description

Where an employer provides an employee with a monthly or annual bus or rail pass, the employee is exempt from income tax benefit-in-kind and PRSI and the employer is exempt from PRSI. Employees' salaries may be reduced without tax consequences to finance the cost of the scheme.

Conclusion

This scheme should be continued having regard to its aim of encouraging the use of public transport.

Recommendation 8.78

The relief for benefit-in-kind and PRSI exemption for employer-provided public transport travel passes should continue.

13.5 Benefit-in-kind exemption on employer-provided bicycles and associated safety equipment

Description

An exemption from an income tax benefit-in-kind charge and employer PRSI are available where an employer gives a bicycle and related safety equipment to an employee or director which is used to travel to work. There is a €1,000 limit on the cost incurred and the exemption can be claimed once in any five-year period. Employees' salaries may be reduced without tax consequences to finance the cost of the scheme.

Conclusion

The benefits of the introduction of a tax relief scheme to encourage more employees to cycle to and from work can be seen in terms of lowering carbon emissions, reducing traffic congestion and increasing the fitness levels of those who take up the scheme.

This scheme may have incentive effects in encouraging a shift from car transport and in helping to increase awareness of the merits of such a move. At the same time, we acknowledge that it is

likely to involve a deadweight element as employees that are already cycling to and from work are those most likely avail of the scheme. On balance, however, we recommend that the scheme should continue having regard to the potential social and economic benefits which may arise.

Recommendation 8.79

The relief for benefit-in-kind and PRSI exemption on employer-provided bicycles and related safety equipment should continue.

13.6 Income tax exemption for scholarships

Description

There is an income tax exemption for scholarship payments to individuals receiving full-time instruction at a university, college, school or other educational establishment in respect of undergraduate or postgraduate courses.

Conclusion

The tax expenditure supports exceptional individuals to realise their academic potential which is both economically and socially worthwhile. We recommend that it be continued.

Recommendation 8.80

The income tax exemption for scholarships should continue.

13.7 Income tax relief for fees paid for third-level education

Description

Income tax relief is available for the payment of fees for third-level education courses in approved colleges. The relief is granted at the standard rate of tax for fees for an approved course whether paid on the student's own behalf or on behalf of another individual. In the case of a parent, claims for more than one child can be made. The relief applies to fees up to €5,000 for each individual course. Tuition fees paid for full-time and part-time undergraduate courses of at least two years' duration and for postgraduate courses between one and four years duration are eligible for relief. Fees which are met from any other source, e.g. grant or scholarship, are not allowable.

Conclusion

The measure supports investment in education and human capital development. We recommend that it be continued.

Recommendation 8.81

The income tax relief for fees paid for third-level education should continue.

13.8 Income tax relief for fees paid for training courses

Description

Income tax relief is available for tuition fees paid for a training course of up to two years duration on information technology and foreign languages, where the courses and the course providers have been approved by FÁS. The tax relief is granted at the standard rate of income tax, and applies to fees ranging from €315 to €1,270 incurred by a taxpayer or his or her spouse.

Conclusion

The measure has human capital development and employment support dimensions and is consistent with national education and training policy. We recommend that it be continued.

Recommendation 8.82

Income tax relief for fees paid for training courses should continue.

13.9 Income tax exemption for statutory redundancy payments**Description**

Statutory redundancy payments made to employees are exempt from income tax. The amount payable under the Redundancy Payments Acts 1967-2007 is related to the employee's length of service and normal weekly earnings, up to a maximum wage of €600 per week. Payments by employers are part-funded from the Social Insurance Fund.

Conclusion

The exemption for statutory redundancy payments has a role to play in facilitating business rationalisation and also assists employees to meet financial commitments while seeking alternative employment or making the transition to retirement.

Recommendation 8.83

The exemption from income tax of statutory redundancy payments should continue.

13.10 Income tax relief for termination payments in excess of the statutory redundancy amount**Description**

Ex gratia termination payments (whether the employee is made redundant or not) in excess of the statutory redundancy amount may also be free of income tax to the extent that they are covered by tax exemptions and reliefs. The basic income tax exemption is €10,160 plus €765 per full year of service. An individual may avail of this exemption each time he or she is made redundant from unconnected employments.

In addition, the basic exemption may be increased by an 'additional amount' of up to €10,000. The additional amount may be availed of by an individual every 10 years.

As an alternative to the basic exemption (or the basic exemption increased by any additional amount), a taxpayer may claim SCSB (Standard Capital Superannuation Benefit) where this is higher. This relief, which generally benefits those with high earnings and long service, is calculated at 1/15th of the yearly salary (averaged over the last three years of service) per complete year of service, less any tax-free lump sum which is received or receivable under any approved or statutory pension scheme.

If an employee is liable to tax on any of his or her *ex-gratia* termination payment an additional relief known as 'top-slicing relief' may be due. Any amount liable to tax is charged, not at the taxpayer's marginal rate for the year in which the payment is made, but at an average tax rate calculated by reference to the previous three years.

Conclusion

Tax reliefs relating to termination payments have, similarly to statutory redundancy exemption, a

role to play in facilitating business rationalisation and have a business function as well as assisting employees to meet financial commitments while seeking alternative employment or making the transition to retirement. We formed the view that, although some level of relief should continue, the exemption should be subject to an overall monetary limit of €200,000. Simplification, particularly in relation to SCSB and top slicing relief is also desirable.

Recommendation 8.84

Income tax relief for *ex-gratia* termination payments should continue but the quantum of the exempt payment should be limited to €200,000 and the reliefs for Standard Capital Superannuation Benefit and top-slicing relief should be simplified.

13.11 Income tax exemption for *ex-gratia* termination payments related to death, injury or disability

Description

The following payments are exempt from income tax:

- Any *ex gratia* termination payment made due to the death of the employee, and
- Any *ex gratia* termination payment made due to injury or to disability of the employee

Conclusion

On the death of an employee, there may be a case on compassionate grounds for a payment to a surviving spouse, for example, to enjoy tax-free status to some degree. Similarly, where the employee suffers injury or disability and his or her ability to carry out the duties of the office or employment is curtailed or eliminated, it may also be possible to make a case for a tax exemption.

However, there is no limit on the scale of payment that can be made in either of the circumstances mentioned. In the case of injury or disability, there is also no requirement for the employee's ability to carry out his or her duties to be impaired or eliminated in order for the payment to be tax-free. There is, therefore, a case for imposing a limit on the tax-free amount. In addition, consideration might be given to linking the tax-free element of a disability payment to the level of disability which exists but we recognise that there may be significant practical difficulties in implementing such a proposal.

Recommendation 8.85

Ex-gratia termination payments related to death or disability should be subject to a limit in relation to the tax-free amount permissible.

13.12 Income tax relief for termination payments where an employment involves foreign service

Description

Where a termination payment is made in respect of an office or employment in which an individual's service includes a period of foreign service, full relief from income tax is available where the foreign service comprised:

- Three-quarters of the whole period of service
- Where the period of service up to the termination date exceeded 10 years, the whole of the last 10 years, or

- Where the period of service up to termination date exceeded 20 years, half of that period, including any 10 of the last 20 years

Partial relief is available where an individual does not qualify in full for the foreign service exemption. In this case, the taxable amount is determined by time apportionment by reference to the time of foreign service.

Conclusion

To qualify for the relief, the remuneration from the office or employment must not be chargeable to Irish tax. An individual concerned would not be entitled to the yearly increase in the basic exemption provisions in respect of the time spent working abroad and the SCSB only applies to Irish employment income. We consider that it is inequitable that full exemption without any cap should be available only to a small category of individuals.

Recommendation 8.86

Income tax relief for termination payments where an employment involves foreign service should continue. However, it should be subject to an overall monetary cap of €200,000 in line with our recommendation for termination payments in excess of the statutory redundancy amount.

13.13 Exemption for retraining on redundancy

Description

An exemption from income tax benefit-in-kind of up to €5,000 is available for the cost of employee retraining, where the retraining is provided as part of a redundancy package.

Conclusion

Because this provision has recently (2008) commenced, no information is available as yet on its take-up or effectiveness. We consider that the relief should continue. However, a mechanism should be put in place an operational level to ensure that data are collected on issues such as take-up of the relief and annual cost.

Recommendation 8.87

The exemption from income tax for retraining on redundancy should continue.

13.14 Systematic short-time relief

Description

Jobseeker's benefit payable to a person in systematic short-time employment is exempt from income tax. Systematic short-time working arises where short-time working is introduced on a temporary basis for persons who are working full-time.

For a single person earning €34,000 who goes on a systematic three-day working week and gets jobseeker's benefit for the other two-days, the tax relief is worth about €820 over a full year or just under €17 per week. However, a single person on the minimum wage whose circumstances similarly change will derive no income tax benefit because his or her income is outside the tax net both before and after the short-time arrangements are put in place.

Conclusion

The exemption from taxation is provided as an incentive to workers to agree to systematic short-time working and may prevent lay-offs or plant closure.

This relief is an employment support incentive. The costs may be justified by virtue of the role of the relief in supporting companies during adverse conditions by securing the agreement of employees to move to short-time work.

However, the relief is only of benefit to those with sufficient income to pay tax and where a person loses his or her job, the jobseeker's benefit is fully taxable. In contrast, under systematic short-time relief, a person who retains a job on a short-time work arrangement will not pay tax on the jobseeker's benefit. There are grounds for discontinuing the relief for equity reasons. However, discontinuation should not be implemented until more favourable labour market conditions apply.

Recommendation 8.88

There are grounds for discontinuing the systematic short-time relief for equity reasons. However, discontinuation should not be implemented until more favourable labour market conditions apply.

13.15 Income tax relief for long-term unemployed and double deduction in respect of payroll costs

Description

These provisions provide incentives to encourage the long-term unemployed to take up employment and also encourage employers to employ the long-term unemployed.

There are two parts to the scheme. The first is an additional tax deduction, tapered over three years, for the unemployed person returning to work. A tapering child allowance in respect of dependent children may also be due.

Year	Tax deduction	Allowance for each qualifying child
Year 1	€3,810	€1,270
Year 2	€2,540	€850
Year 3	€1,270	€425

The second part of the scheme provides a double payroll deduction (in the first 36 months of employment) for employers in respect of payroll costs of the qualifying employee and the related employer PRSI contribution.

Conclusion

These provisions have a continuing role to play in assisting the long-term unemployed to take up employment and participate in the labour force.

Recommendation 8.89

Income tax relief for long-term unemployed and double deduction in respect of payroll costs should continue.

13.16 Income tax relief for employees on payments related to compensation for loss of future earnings

Description

Lump sum payments made to employees to compensate them for a reduction or possible reduction in future remuneration arising from a reorganisation of a business or change in work procedures, work methods or a change of place where the duties of the office or employment are performed may be tax relieved. The relief operates to tax the payment at the tax rate that would have applied if one-third of the payment had been made and therefore may limit exposure to higher rate income tax for employees not otherwise taxable at that rate.

Conclusion

This relief can play a role in providing a measure of support to businesses and to employment by encouraging workforce flexibility. We consider that the relief should be continued.

Recommendation 8.90

Income tax relief for employees on payments related to compensation for loss of future earnings should continue.

13.17 PRSI exemption for employee (unapproved) share options

Description

An exemption from PRSI (for employer and employee) and health contribution levy (but not income levy) applies to gains arising from the exercise of stock options (which are subject to income tax).

Conclusion

The PRSI treatment is not in accordance with the treatment in most OECD countries where social insurance contributions are payable on share option gains. The OECD reported in 2005³² that Ireland, and six other countries³³, provided an exemption from employee and employer social insurance contributions whereas 19³⁴ other countries did not.

Share option gains (and all share-based remuneration) should be liable to PRSI and health contributions given that they are a form of remuneration. Employer and employee PRSI should be payable so as to preserve the PRSI base, which should not be eroded by tax expenditure. We acknowledge that there are likely to be significant administrative issues associated with the implementation of this recommendation.

Recommendation 8.91

The PRSI exemption for employee (unapproved) share options should be discontinued.

13.18 Approved profit-sharing schemes (APSSs)

Description

Employees participating in an approved profit-sharing scheme may be allocated shares in the employing company (or its parent) with a market value of up to €12,700 each year without a liability to income tax.

32 The Taxation of Employee Share Options – OECD 2005

33 Hungary, Japan, New Zealand, Poland, Portugal and Slovakia give an exemption from social insurance contributions.

34 Austria, Czech Republic, Denmark, Finland, Germany, Greece, Iceland, Italy, Korea, Luxembourg, Mexico, Netherlands, Norway, Spain, Sweden, Switzerland, Turkey, United Kingdom and USA charge social insurance contributions on share option gains.

To be eligible for participation, the shares must be quoted and all employees must participate on similar terms. The employee participants must hold the shares for at least three years to be eligible for the income tax exemption. On a subsequent disposal the employee is liable to capital gains tax on any difference between the sale proceeds and the market value at date of acquisition. Employees' salaries may be reduced by up to 7.5% without tax consequences to finance the cost of the scheme.

Neither PRSI, income levy nor health contribution levy is payable by employees or employers on shares awarded under approved profit-sharing schemes.

Conclusion

We recommend that the income tax relief in respect of approved profit-sharing schemes should continue in view of the role these schemes play in enhancing employees' interest in the competitiveness and performance of the employer and in supporting economic activity.

However, we consider that the value of shares awarded should be liable to both employer and employee PRSI as normal remuneration so as to preserve the PRSI base, which should not be eroded by tax expenditure. They should also be liable to the health contribution levy and income levy.

Recommendation 8.92

Continue the income tax exemption for approved profit-sharing schemes (APSSs) and remove the PRSI, health contribution levy and income levy exemptions.

13.19 Employee share ownership trusts (ESOTs)

Description

ESOTs have been used mainly as a mechanism to give trusts for employees of State-owned companies shares free of charge on sale or on privatisation of the companies concerned. The scheme is designed to allow employees to acquire a significant interest in or take over their employer company in a more tax-efficient manner than was available under different incentives.

The ESOT operates in tandem with an APSS that appropriates shares to employees over time. The ESOT in conjunction with the APSS is referred to as an Employee Share Ownership Plan. To be eligible for the tax incentives, all employees must participate on similar terms.

No tax arises on the employees on establishment of the ESOT and APSS tax treatment applies to shares awarded from the ESOT to the employees.

Conclusion

ESOTs may continue to play a role in the modernisation and privatisation of State-controlled businesses and we recommend no change in the tax treatment of ESOTs. APSSs related to ESOTs should be treated in accordance with our recommendations for APSSs above.

Recommendation 8.93

The tax treatment which applies to employee share ownership trusts (ESOTs) should continue.

13.20 Approved Share Option Schemes (APSOs)

Description

Under an APSO, employees are granted options to purchase the shares in their employer company exercisable over a period. The option price is typically the market value of the shares at the date of grant of the option and the option is exercised at a later date. Any gain arising on exercise of the option by the employee is exempt from income tax. The shares must be held for three years after the option is granted in order to benefit from the tax exemption.

The requirement that exists for other tax-advantaged share schemes for all employees to participate on similar terms is significantly diluted in APSOs and there is no upper limit on the number or value of options granted. Up to 30% of the options can be granted each year without regard to this condition.

Neither PRSI, income levy nor health contribution levy is payable by employees or employers on shares awarded under APSOs.

Conclusion

An efficiency question arises in relation to APSOs. Specifically, there does not seem to be a need to provide support through the Exchequer for such schemes where the participation would likely have happened in the absence of the tax incentives. In this regard, we note that the tax yield on unapproved share option schemes in 2006 was about €88 million with 3,900 beneficiaries. Accordingly, we recommend that the income tax relief in relation to approved share option schemes be discontinued.

As with unapproved share options, the taxable value of option gains should also be liable to both employer and employee PRSI as normal remuneration so as to preserve the PRSI base, which should not be eroded by tax expenditure. Similarly the option gain should be liable to health contribution levy and income levy.

Recommendation 8.94

- The income tax exemption for approved share option schemes (APSOs) should be discontinued.
- The taxable value of option gains should also be liable to both employer and employee PRSI and to the health contribution levy and the income levy.

13.21 Save As You Earn (SAYE) share option scheme

Description

This scheme is a savings-related share option scheme, which permits employers to offer options at a fixed price with a discount of up to 25% on the market value of shares when the option is being granted. No income tax, PRSI, health contribution levy or income levy is charged on the amount of the discount. When the employees actually purchase shares, the difference in the value of the shares, between the time that the option is granted and the time of appropriation, is exempt from income tax, PRSI, health contribution levy and income levy. Shares purchased under the scheme can be disposed of immediately, though any gain (i.e. the difference between the option price and the proceeds of sale) may be liable to capital gains tax.

The shares are financed by a contractual savings scheme which is the means used by employees to save the money required to purchase the shares. Any bonus or interest paid on the savings is exempt from income tax, health contribution levy, income levy and PRSI. The scheme must

be available to all employees on similar terms and the shares must be quoted. Members of a scheme must save for a three to five-year period an amount between €12 and €500 per month. Employees are not required to purchase the shares at the end of the savings period. This provision ensures that employees are not required to buy shares where the price of the shares has fallen below the option price.

Conclusion

We recommend that the income tax relief in respect of SAYE schemes should continue in view of the role these schemes play in enhancing employees' interest in the competitiveness and performance of the employer and in supporting economic activity.

We note that the majority of companies for which SAYE schemes have been approved are Irish or UK based. In order to enable SAYE schemes such as the Employee Stock Purchase Plans (ESPPs) operated by, in particular, US companies in Ireland to be eligible for tax relief on a similar basis, we recommend that the conditions for approval of SAYE schemes be amended to facilitate inclusion of these schemes. This would primarily involve reducing the savings period to six months and permitting salary deductions to be retained by the employer outside an approved savings mechanism.

Income arising from SAYE schemes (i.e. the option gain and interest income) should be liable to both employer and employee PRSI as normal remuneration so as to preserve the PRSI base, which should not be eroded by tax expenditure. Similarly, the income should be liable for health contribution levy and income levy.

Recommendation 8.95

Continue the income tax exemption for Save As You Earn (SAYE) schemes and remove the PRSI, health contribution levy and income levy exemptions.

Recommendation 8.96

Extend the SAYE rules to permit a broader range of employee stock purchase plans (offered to all employees on similar terms and subject to an overall share purchase limit) to be eligible for income tax relief.

13.22 Income tax relief for new shares purchased on issue by employees

Description

This is a single lifetime deduction of up to €6,350 available to an employee who subscribes for shares in the employer company. The shares must generally be held for three years. On a disposal of the shares, an amount equal to the tax deduction granted is excluded from the base cost of the shares in calculating any capital gains tax liability arising.

Conclusion

We recommend that this relief be abolished in view of the very low level of participation.

Recommendation 8.97

The income tax exemption for new shares purchased on issue by employees should be discontinued.

13.23 Artist's exemption

Description

Income derived from original and creative artistic works (of artists, writers, composers and sculptors), which are recognised as having cultural or artistic merit, is exempt from income tax.

Conclusion

This exemption is not compatible with the equity principle. In addition, it is likely that the exemption involves a significant deadweight element in that the beneficiaries of the relief are likely to engage in their creative activities regardless of the existence of the relief. It is of no benefit to artists whose income does not reach the taxable threshold.

While the tax exemption may have created an environment in which the arts can flourish, considerations of equity and efficiency outweigh this factor and, accordingly, we recommend that the exemption be discontinued. To the extent that there is a need for recognition of income from artistic activity in the tax system, this should focus on those who derive their income solely or predominantly from creative work and in this context, income averaging³⁵ may have a role to play.

In making this recommendation we note also the fact that the Arts Council operates a system of grants in support of all arts disciplines.

Recommendation 8.98

The artist's exemption should be discontinued; consideration should be given to introducing income averaging in the taxation of income from creative work.

13.24 Sportsperson's relief

Description

Sportspersons in this context means athletes, badminton players, boxers, cyclists, footballers, golfers, jockeys, motor racing drivers, rugby players, squash players, swimmers and tennis players. The relief is available to sportspersons who are employees or self-employed on a professional basis but it is not available to persons engaged in sport primarily as a leisure activity or on an amateur basis.

The relief, given by way of repayment of tax, takes the form of a deduction against earnings which have arisen wholly and exclusively from sporting activity. The amount of the deduction is set at 40% of the gross receipts (before deducting expenses) of the sportsperson. The relief can be claimed for up to any 10 years of assessment back to and including the tax year 1990/1 for which the sportsperson was resident in Ireland.

The receipts eligible for the 40% deduction include:

- in the case of an employee, salaries, fees, wages, bonuses or perquisites received as a direct consequence of playing the game and
- in the case of a self-employed person, all match or performance fees, prize moneys and appearance moneys received directly from playing the game

Income such as sponsorship fees, advertising fees, income from interviews or articles or the income from endorsements is excluded from the scope of the relief.

³⁵ Under this approach, income received over a number of years is averaged out to arrive at a representative figure for tax purposes.

The relief is to be claimed in the year the sportsperson ceases permanently to be engaged in the sport provided the individual is resident in Ireland that year. There is provision in the legislation for the relief to be withdrawn if the person later engages in the sport on a professional level.

Conclusion

We consider that there is a case for the retention of this relief based on the contribution that is made to economic activity arising from the relief and the potential social benefits at a relatively modest cost to the taxpayer, including the encouragement of positive role models which younger people may seek to emulate.

The sportsperson's relief should continue but it should be modified by the introduction of the following conditions:

- The total repayment of tax for any 10-year period is capped at €350,000 as adjusted for inflation
- The sportsperson can only select a block of 10 consecutive years for which to claim the relief as opposed to the best 10 non-continuous years
- The relief should be subject to review after five years of operation under these new arrangements

We recognise that, generally speaking, a sportsperson's career is a relatively short one. As such, there may be a legitimate expectation that this relief would be available to them, especially for those who are now coming close to retirement. Accordingly, we consider that sportspersons who are currently active and who retire in the next six years would calculate their relief without the proposed alterations above applying.

It should not be possible for a person to avail of the relief for termination payments in addition to this measure.

Recommendation 8.99

The sportsperson's relief should continue.

- The total repayment of tax for any 10-year period should be capped at €350,000 as adjusted for inflation.
- The sportsperson can only select a block of 10 consecutive years for which to claim the relief as opposed to the best 10 non-continuous years.
- The relief should be subject to review after five years of operation under these new arrangements.

13.25 Seafarer's allowance

Description

There is an annual income tax allowance of €6,350 for seafarers who are at sea for at least 161 days in a tax year. The allowance is designed to give an income tax concession to seafarers engaged on a sea-going ship which is registered in an EU Member State's register and is used solely for the trade of carrying by sea of passengers or cargo for reward; the allowance does not apply to a fishing vessel.

Conclusion

This relief is one of the few remaining personal tax reliefs available at the marginal rate of tax. Its cost and take-up are small in scale. While we note that other EU Member States provide support through tax and other concessions for seafarers, the relief is available to an Irish resident seafarer regardless of whether or not he or she works on an Irish registered vessel. In these circumstances, the value of the measure in supporting national competitiveness is open to question and we recommend that it be discontinued.

Recommendation 8.100

The seafarer's allowance should be discontinued.

13.26 Allowances for expenses of members of the Oireachtas

Description

There is an income tax exemption on allowances for expenses of members of the Oireachtas and an income tax deduction known as the 'dual abode allowance' for Ministers, Ministers of State and the Attorney General.

The expense allowances are in respect of expenses which a member is obliged to incur in the performance of his or her duties as a member of the Oireachtas and which are not otherwise directly reimbursed.

In addition to the expense allowances a Minister or a Minister of State, or the Attorney General, whose official duties as an office holder or as a member of the Oireachtas require him or her to maintain a second residence in addition to his or her main residence, can claim an income tax deduction in respect of expenses incurred in maintaining that second residence. The allowance is confined to office holders who represent constituencies outside the Dublin area and is known as the dual abode allowance. The second residence may be owned or rented or may include hotel or guesthouse accommodation.

Conclusion

In the interests of equity, it is desirable that allowances paid to members of the Oireachtas be treated in the same way under the tax code as allowances paid to employees generally.

On balance, we consider that the dual abode allowance should be continued. However, the relief should not apply in an open-ended way without limit. A monetary limit should be put in place up to which the allowance could be claimed on the basis of vouched expenses. The flat rate element of the relief which applies in relation to hotel and guesthouse accommodation should be discontinued.

Recommendation 8.101

- The expenses of members of the Oireachtas should be treated in the same way under the tax code as expenses paid to employees and office holders generally.
- A monetary limit should be put in place on the dual abode allowance and the flat rate element of the relief which applies in relation to hotel and guesthouse accommodation should be discontinued.

13.27 Income tax exemption for payments under Scéim na bhFoghlaimeoirí Gaeilge

There is an exemption from income tax for income received by persons in Gaeltacht areas in providing board and lodgings to students attending Irish colleges under the scheme known as Scéim na bhFoghlaimeoirí Gaeilge. The scheme is administered by the Department of Community, Rural and Gaeltacht Affairs.

Conclusion

Notwithstanding the social and cultural policy reasons which lie behind this tax exemption, the relief raises a question of equity. It is inequitable that the beneficiaries should be treated differently under the tax code than others in similar circumstances, e.g. bed and breakfast operators, and, on this basis, we recommend withdrawal of the scheme.

Recommendation 8.102

The income tax exemption for payments under Scéim na bhFoghlaimeoirí Gaeilge should be discontinued.

13.28 Remittance basis of taxation

Description

The remittance basis applies to foreign sourced income and capital gains of:

- individuals who are resident but not domiciled in Ireland, and
- citizens of Ireland who are not ordinarily resident in Ireland

The general scheme is that, where the remittance basis applies, income and capital gains arising outside Ireland are charged to tax only to the extent that they are remitted to Ireland.

The remittance basis of taxation is considered in Section 6 of Part 5 and Section 5 of Part 7 of our Report.

Section 14:

Savings and investments

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓ Discontinue ✕ Modify ❄
		Cost €m	Numbers benefiting		
Tax preferences for approved pension schemes*	S774 and 776 TCA	663	–	2006	❄
Exception to charge to tax under Section 777*	S778 TCA	510	–	2006	❄
Tax exemption for income of superannuation funds	S 608(2) TCA	1,200	N/A	2006	✓
Tax relief for retirement annuity premiums	S784 TCA	436	125,900	2006	❄
Tax relief for personal retirement savings accounts*	S787C TCA	56	45,200	2006	❄
Tax exemptions for pension lump sum payments	S201 TCA	130	N/A	2006	❄
Tax exemption on income of credit unions	S219A TCA	N/A	N/A	–	✓
Taxation of interest and dividends on special term accounts	S261A and S267C TCA	N/A	N/A	–	✓

*Note: PRSI relief on employer and employee contributions to superannuation schemes and relief on employee health contributions also apply and are provided for in the Social Welfare Consolidation Act 2005 and associated regulations and the Health Contributions Act 1979 and associated regulations.

14.1 Tax expenditures for retirement saving

Of the reliefs listed above, which may be categorised under the general heading of tax expenditures for savings and investments, the first six listed are reliefs relating to occupational pension schemes.

The Green Paper on Pensions (2007) estimated the cost of tax and PRSI (including the health contribution levy) relief at €2.9 billion for 2006. A breakdown of this figure is set out in Table 8.1.

Table 8.1: Estimate of the cost of tax and PRSI reliefs for occupational pension provision 2006³⁶

	Estimated costs €m
Total cost of the tax expenditure on pensions listed above	3,000
Estimated cost of PRSI and health contribution levy relief on employee and employer contributions	220
Gross cost of tax relief	3,220
Estimated tax yield from payment of tax on pension benefits	320
Net cost of tax, PRSI and health contribution levy relief	2,900

36 The figures shown do not include costs related to unfunded occupational pension arrangements.

A review of the estimates, which was carried out for the Irish Association of Pension Funds by Life Strategies Consultants³⁷, questions this number and suggests that €2.0 billion is a more credible estimate. In particular they noted that the sensitivity to market developments of the tax exemption on the income of superannuation funds is a significant element of the overall cost estimate and needs to be borne in mind.

Our recommendations on long-term savings for retirement are contained in Part 10 of our Report.

14.2 Tax exemption for credit unions

The income of credit unions (including income from investments) is exempt from corporation tax. The exemption was first introduced in 1972 to acknowledge the social purpose and community self-help nature of the credit union movement.

Conclusion

Credit unions receive preferential tax treatment compared with that available to other financial institutions. They are non-profit making community-based or work-based organisations that play a role in encouraging members to save and to act co-operatively for the benefit of all members. Having regard to the general social benefit which the credit union movement delivers we consider that the exemption from corporation tax should continue to apply.

Recommendation 8.103

Tax exemption for the income of credit unions should be continued.

14.3 Taxation of dividends on special term accounts

Annual exemptions from tax are provided for in relation to interest arising on special term accounts held in financial institutions i.e. €480 per tax year in relation to a three-year account and €635 per tax year in relation to a five-year account. A similar exemption applies in relation to dividends arising on special term share accounts held in credit unions.

Conclusion

We consider that the tax reliefs should continue to apply.

Recommendation 8.104

The annual exemptions for interest and dividends on special term accounts and special term share accounts should be continued.

37 [2008] An Analysis of certain tax aspects of the Irish system of pension provision, Life Strategies Actuarial and Strategic Consulting, May 2008

Section 15:

Other tax expenditures

Tax expenditure	Statutory reference	Estimated		Year of estimate	Continue ✓ Discontinue ✕ Modify ✨
		Cost €m	Numbers benefiting		
Age tax credit	S464 TCA	28	76,700	2006	✓
Age exemption and associated marginal relief	S188 TCA	62	50,100	2006	✓
Income under dispositions for short periods (deeds of covenant)	S792 TCA	–	–	–	✓
Veterans of War of Independence	S205 TCA	<1	770	2006	✓
Military and other pensions, gratuities and allowances	S204 TCA	<2 ³⁸	N/A	2009	✓
Profits from lotteries	S216 TCA	N/A	N/A	–	✓
Consanguinity relief (stamp duty)	Sch. 1 SDCA	51	7,450	2008	✓

15.1 Age tax credit

Description

An age credit of €325 (2009 value) is available to a person (single or widowed) aged 65 or over in the year of assessment. In the case of a married couple where one spouse is, or both spouses are, aged 65 or over the age credit is worth €650 per annum (2009 value). Where such persons are in the tax net, the age tax credit applies in addition to other personal reliefs as applicable such as personal credits and the employee tax credit. The age credit is given regardless of the income of an individual.

Conclusion

The age tax credit, along with the age exemption and marginal relief discussed below, provides preferential treatment for older persons. While the age tax credit is available regardless of income, we consider that it performs a valuable social role in relation to older people and we recommend that it be continued.

Recommendation 8.105

The age tax credit should continue.

15.2 Age exemption and marginal relief

Description

Under the age exemption limits, an exemption from income tax is available to individuals aged 65 years or over whose income does not exceed specified limits. In 2009 these limits are: single/

38 The 2009 Budget booklet indicates that the cost of these pension in 2009 is expected to be €9.6 million. Assuming an average tax of 20%, the cost of the relief is likely to be less than €2 million in 2009.

widowed €20,000; married couples (either spouse aged 65 years or over) €40,000. The limits are increased by €575 per annum for each of the first two qualifying children living with a claimant at any time during the tax year. The limit is increased to €830 per annum for the third and each subsequent child.

Where an older person's or couple's income exceeds the relevant exemption limit by a small amount, a system of marginal relief applies. Under this system, the person or couple pays tax on the income which exceeds the exemption limit at a rate of 40%. This applies up to the point where it is more beneficial for the person or couple to be taxed under the normal system of credits and bands.

The primary purpose of the age exemption limits is to keep older persons on low incomes outside of the tax net. At 2009 values, the age exemption limit for a single person (€20,000) is just marginally above the level of income exempted in the case of a person in the PAYE system that avails of the personal credit, the employee credit and the age credit combined (€19,925). In such circumstances, the exemption limit confers very little additional benefit on the claimant, so the main beneficiaries are likely to be non-PAYE taxpayers.

Conclusion

We consider that the age exemption limit and associated system of marginal relief performs a valuable social role and we recommend that it continue.

Recommendation 8.106

The age exemption and marginal relief should continue.

15.3 Income under dispositions for short periods (deeds of covenant)

Description

Tax relief is available in respect of payments made under deeds of covenant. A deed of covenant is a legally binding written agreement made by an individual to pay an agreed amount to another individual, without receiving any benefit in return. To be legally effective, it must be properly drawn up, signed, witnessed, sealed and delivered to the individual receiving the payments. Any amounts can be paid under a deed but only covenants in favour of prescribed individuals qualify for tax relief.

A deed of covenant must be capable of exceeding a period of six years to qualify for tax relief.

The following covenants, in favour of specified individuals, qualify for tax relief:

Covenants to adults

- Unrestricted tax relief can be claimed on covenants in favour of permanently incapacitated adults
- Tax relief can be claimed on covenants in favour of adults aged 65 or over. However, the tax relief is subject to the restriction that the total relief available on one or more covenants cannot exceed 5% of the covenantor's total income

Covenants to minor children

- Unrestricted tax relief can be claimed on covenants in favour of permanently incapacitated minors except on covenants from parents to their own incapacitated children.

The amount of the tax expenditure in any particular case depends on the amount of tax paid by the covenantor and the amount of the covenantee's income, if any. The covenantor will always get

relief at the marginal rate. However, the covenantee is taxed on the income. As such, if the rates of tax paid by the covenantor and the covenantee are the same there is no net benefit. A covenantee whose total income (including the income received under the deed of covenant) is less than the exemption limit qualifies for a refund of the standard rate of tax deducted by the covenantor.

The benefits of this relief may be said to include the following: provides an incentive to individuals to give financial support to individuals who may need it; assist with the cost of care of incapacitated individuals; and provide additional financial support to individuals on low income.

Conclusion

Equity issues arise insofar as those higher up the income scale may derive greater benefit in terms of tax relief as compared with those lower down the income scale. There is no cost to the Exchequer where the covenantor and the covenantee pay tax at the same rate. If the covenantor pays tax at the higher rate, and the covenantee is exempt or pays tax at the standard rate, a net cost to the Exchequer will arise. We recognise that there are strong social aspects to this relief and we consider, therefore, that the relief should be continued.

Recommendation 8.107

The tax relief for income under dispositions for short periods (deeds of covenant) should continue.

15.4 Veterans of the War of Independence

Description

This tax expenditure exempts from income tax any pension, allowances, benefits or gratuities insofar as it related to relevant military service of a Veteran of the War of Independence or to an event which happened during or in consequence of such relevant military service and which is paid under the relevant legislation. The exemptions cover payments to veterans, their widows and dependants. Any such pension, allowance, benefit or gratuity is ignored in computing the recipient's total income for the purposes of the Income Tax Acts.

Conclusion

We consider that it would not be credible to seek to withdraw the relief and recommend that it should continue.

Recommendation 8.108

The tax relief available to Veterans of the War of Independence should continue.

15.5 Military and other pensions, gratuities and allowances

Description

Exemption from income tax applies to military pensions, gratuities and allowances. It applies to army wound and disability pensions; gratuities in respect of army wounds or disabilities; demobilisation pay and gratuities paid to officers of the National Forces or the Defence Forces of Ireland on demobilisation; deferred pay (within the meaning of any regulation under the Defence Act, 1954) and gratuities granted in respect of service with the Defence Forces.

Conclusion

At the level of the individual this measure recognises, through the provision of tax relief, the personal contribution to the State made by members of the defence forces and, in particular, those who have suffered wounds or disability as a result of that service. In this regard we consider this exemption to have a social dimension and we recommend that it continue. We also recommend that in future, the tax treatment of military service gratuities should be consistent with the tax treatment of lump sum payments in other public service employments.

Recommendation 8.109

The relief from income tax of military and other pensions, gratuities and allowances should continue. In future, the tax treatment of military service gratuities should be consistent with the tax treatment of lump sum payments in other public service employments.

15.6 Profits from lotteries

Description

The income of lotteries licensed under Part IV of the Gaming and Lotteries Act, 1956 is exempt from income tax. This refers to the income of those who organise the lotteries and not the gains which may arise to individuals from winning a relevant lottery. The National Lottery is exempt from the provisions of this Act and the relief is concerned with the income of lotteries licensed under the Gaming and Lotteries Act 1956, which may have a maximum prize in any one week of no more than €10,000. That Act also stipulates that the licensee "shall derive no personal profit" from the lottery.

Conclusion

We recommend that the exemption for lotteries provided by section 216 of the Taxes Consolidation Act 1997 should continue to apply.

Recommendation 8.110

The exemption from income tax of profits from lotteries should continue.

15.7 Consanguinity Relief

Description

Transfers between specified relatives qualify for a reduced rate of stamp duty. The reduced rate is half the rate of stamp duty which would otherwise apply.

Conclusion

We are recommending elsewhere in our Report (section 3.3 of Part 6) that stamp duty should be zero-rated in case of the purchase by an individual of his or her principal private residence. This proposal will diminish the relative benefit to be derived from consanguinity relief. We are also recommending that the stamp duty exemption for young trained farmers should continue to apply. While there are equity arguments in favour of withdrawal of the consanguinity relief, on balance we consider that it should continue.

Recommendation 8.111

Consanguinity relief within the stamp duty code should continue.

Section 16:

Tax expenditures not examined by the Commission

A number of tax expenditures relating to property-based tax incentive schemes have not been examined by us because some had been reviewed in the run up to Budget 2006 and others in Budget 2009 with decisions taken to discontinue them. We note that transitional arrangements 'for pipeline projects' were also provided for and that the writing down periods for the schemes will run on into the future for some time yet. However, they are no longer open to new investors. The schemes in question are:

1. Urban renewal scheme
2. Town renewal scheme
3. Rural renewal scheme
4. Living over the shop scheme
5. Registered holiday cottages
6. Multi-story car parks
7. Hotels accelerated allowances
8. Registered holiday cottages
9. Student accommodation
10. Third-level educational buildings
11. Sports injuries clinics
12. Private hospitals
13. Nursing homes and convalescent facilities
14. Residential units attached to nursing homes
15. Mental health centres
16. The park and ride scheme, and
17. The general rental refurbishment scheme

While we did not review all of these schemes as part of our work we are satisfied that the decision to discontinue is the correct one in each case³⁹. Having regard to the nature of the findings which emerged from the 2005 reviews which, for example, raised issues of effectiveness, deadweight and adverse equity impact, and to our recommendations in Section 5 for the future approach to tax expenditures, we are reluctant to recommend them as appropriate policy instruments.

In addition to the above property based schemes, we did not review the following tax expenditures on the basis that decisions have been taken by Government to discontinue them:

- Measures⁴⁰ in respect of greyhound and stallion stud fees which are no longer in operation, and
- VRT relief in respect of short-term car hire (Section 134 Finance Act 1992, as amended)⁴¹

It is our view that decisions about tax expenditures in the above areas should also be similarly guided by our recommendations in Section 5 of this Part.

³⁹ We reviewed items 12 to 15 above before they were abolished in Finance Act 2009.

⁴⁰ Sections 140, 231 and 233 of the Taxes Consolidation Act refer.

⁴¹ This relief is being phased out over 2009 and 2010 and will cease to apply as and from 1 October 2011 (Finance (No. 2) Act 2008 refers).

Appendix 1:

130 Reliefs that are part of the benchmark tax system

	Reference	Description
Category 1 – Measures which are inherent in the design of the tax system including avoidance of double taxation and complying with international fiscal obligations together with minor reliefs and measures to facilitate tax administration		
1	S128D and 128E TCA	Where employees receive shares that are subject to restriction on sale, the value for income tax purposes of a restricted share is reduced by reference to a formula depending on the length of the restriction period; where employees receive shares that are subject to forfeiture, when a share is forfeited, tax previously charged is repaid.
2	S153 TCA	Non-residents are exempt from income tax on dividends from Irish companies.
3	S172C TCA	There is an exemption from dividend withholding tax where the dividend is paid to a pension fund, company, charity etc.
4	S198 TCA	Income tax exemptions apply for non-residents on Irish source interest income.
5	S200 TCA	Foreign social security pensions are exempt from income tax if residents of the paying country are tax exempt there. The pensions must correspond to Irish social welfare pensions and US pensions are ineligible for exemption.
6	S267 TCA	DIRT may be repayable where deposit interest is receivable by persons aged 65 or over or permanently incapacitated.
7	S 381-409E and 243-243B TCA	Tax relief is available for trading losses and charges on income for income tax or corporation tax.
8	S410-429 TCA	Trading losses may be surrendered between members of a corporate group.
9	S573 TCA	The transfer of assets on death is not regarded as a disposal and death is therefore not an occasion of charge to capital gains tax. The assets held by a deceased person are deemed to be acquired on his or her death by the personal representatives or legatees at their market value at the date of death.
10	S601 TCA	Gains up to €1,270 per individual per year are exempt from capital gains tax.
11	S602 TCA	Any item of tangible movable property that is sold for €2,540 or less is exempt from capital gains tax.
12	S603 TCA	Tangible movable property with an expected useful life of not more than 50 years asset is exempt from capital gains tax.
13	S613 TCA	There is an exemption from capital gains tax on National Instalment Savings, Prize Bonds, personal injury compensation and pension fund rights.
14	S626B and 626C TCA	Participation exemption for holding companies on capital gains.

15	S822 TCA	Immigrants are liable to income tax from the date of their arrival in Ireland and emigrants are liable to income tax up to the date of their departure from Ireland.
16	S825A TCA	The tax liability of cross-border workers paying tax in the country where they work is proportionally reduced by excluding the foreign income (and related tax) in computing Irish tax.
17	S826-835 TCA	Double taxation relief is provided for foreign tax, usually by the credit method.
18	S69 CATCA	Capital acquisitions tax is not payable on gifts not exceeding €3,000 per year per donor.
19	S72 and 73 CATCA	The proceeds of insurance policies that insure CAT liabilities are themselves exempt from CAT (and exit tax on approved retirement funds) to the extent that they are used to meet the tax liability.
20	S74 and 75 CATCA	Non-residents are not liable to CAT on Irish insurance policies or units in collective investment undertakings or common contractual funds where both the donor and beneficiary are foreign-domiciled and foreign-resident.
21	S81 CATCA	Irish government securities may be exempt from CAT. No Irish CAT is payable where both the donor and beneficiary are foreign-domiciled and foreign-resident; otherwise the securities must be held for 15 years before the date of the disposition.
22	S82 CATCA	There are exemptions from CAT for normal and reasonable payments within the family, payments to incapacitated individuals, normal and reasonable payments from trusts towards the support, maintenance or education of minor orphaned children, compensation and damages and winnings from betting and lotteries.
23	S83 CATCA	Gifts to oneself are exempt from CAT. The exemption also applies to gifts to (or by) companies owned by the donor.
24	S87 CATCA	Gifts and inheritances that are made free of CAT include the tax paid by the donor as part of the gift or inheritance, but there is no further grossing-up of the benefit.
25	S103 CATCA	A multiple CAT charge is eliminated where the same property is taxable more than once in the same event.
26	S104 CATCA	Capital gains tax may be credited against CAT where both taxes arise on the same property in a single event.
27	S105 CATCA	A multiple CAT charge is eliminated where the same property is taxable more than once in the same event.
28	S75 and 75A SDCA	There is a stamp duty exemption for intermediaries and clearing houses.
29	S84 SDCA	Stamp duty is repayable when a member of an approved profitsharing scheme transfers (sells) shares under the scheme.
30	S85 SDCA	There are stamp duty exemptions for transfers of loan capital.

31	S87 SDCA	Stamp duty is not chargeable on transactions related to stock lending and borrowing.
32	S87A SDCA	Stamp duty is not chargeable on repo transactions (sale and repurchase of stock).
33	S88 SDCA	There are stamp duty exemptions for transfers of units in regulated collective investment undertakings and also for transfers of shares in companies incorporated outside Ireland.
34	S89 SDCA	There is an exemption from stamp duty on transfers of securities issued by a foreign government.
35	S90 SDCA	There are stamp duty exemptions on transfers of instruments used primarily in the financial services industry.
36	S93, 93A and 103 SDCA	There are stamp duty exemptions for social housing - houses acquired from industrial and provident societies and voluntary bodies are exempt. Shared ownership leases are also exempt.
37	S95 SDCA	There is a stamp duty exemption to the extent that the value of transferred land is represented by growing timber.
38	S98 SDCA	There is a stamp duty exemption on transfers of foreign immovable property.
39	S101 SDCA	There is a stamp duty exemption on transfers of intellectual property.
40	S109 SDCA	There is a stamp duty exemption on documents such as cover notes which are made in anticipation of the issue of a formal policy of non-life insurance.
41	S110 and 110A SDCA	Health, permanent health and critical illness insurance policies are exempt from stamp duty.
42	S113 SDCA	Stamp duty is not payable on transfer of ships and aircraft, on wills, and on instruments made by, to or with the Commissioners for Public Works.
43	Schedule 1 SDCA	Where the lease of a dwelling-house is for a period not exceeding 35 years or for an indefinite term and the rent does not exceed €30,000 per annum, the lease is exempt from stamp duty
44	S138C FA 1992	VRT is reduced for hybrid vehicles, flexible fuel vehicles, electric vehicles and electric motorcycles.
45	S96, 100 and FA 1999	Full relief from, or a reduced rate of, mineral oil tax applies to marked diesel used for certain purposes.

Category 2 – Measures related to the unit of taxation and measures which are tax neutral

46	S129 TCA	Resident companies are tax exempt on dividends from other resident companies.
47	S461 TCA	Personal tax credits for single and married persons for income tax.
48	S461A TCA	An additional personal tax credit for income tax is available to widowed persons.
49	S536 TCA	No capital gains tax is payable where insurance proceeds or compensation receipts are used to restore or replace an asset.
50	S584-587 TCA	Capital gains tax is deferred on amalgamation or reorganisation of a company.

51	S616-626 TCA	Capital gains tax is deferred on transfers of assets within a corporate group.
52	S630-638 TCA	These provisions implement the EC Mergers Directive into Irish law and provide corporation tax and capital gains tax reliefs for mergers and reorganisations.
53	S657 TCA	Farm stock may be transferred at book value for income tax purposes by a retiring farmer to his or her successor.
54	S747F TCA	Tax is deferred in an offshore fund reorganisation.
55	S751A TCA	Income tax or corporation tax is deferred where shares held as trading stock are exchanged in a corporate reorganisation.
56	S 593 TCA	Life policies are taxed only at the life company level.
57	S600 TCA	Capital gains tax is deferred when a business is transferred by an individual to a company.
58	S615 TCA	Capital gains tax is deferred on reorganisation or amalgamation of a company.
59	S751B TCA	Income tax or corporation tax is deferred on an exchange of Irish Government bonds.
60	S1025 TCA	Maintenance payments by separated spouses are deductible to the payer and taxable on the recipient for income tax purposes.
61	S1026 TCA	Separated and divorced persons may elect to be taxed jointly.
62	S1027 TCA	Payments pursuant to orders under the Family Law Acts may be made without deduction of tax.
63	S1028 TCA	Capital gains tax is deferred where assets are transferred between married persons.
64	S1030 and 1031 TCA	There is a capital gains tax exemption for transfers of assets as part of a separation or divorce agreement.
65	S70 and S71 CATCA	CAT is not payable on gifts and inheritance from one spouse to the other.
66	S79 CATCA	There is an exemption from CAT where a parent inherits from a deceased child an amount previously received as a gift or inheritance by the child from either parent.
67	S86 CATCA	There is a CAT exemption on dwelling houses transferred to other occupants of the house.
68	S88 CATCA	Transfers of property between former spouses on dissolution of a marriage are exempt from CAT.
69	S79 SDCA	There is a stamp duty exemption for transfers within a corporate group.

70	S80, 88A, 88B, 88C SDCA	Stamp duty is not payable on reconstruction or amalgamation of a company, a collective investment undertaking, a fund or a common contractual fund.
71	S80A SDCA	Stamp duty is not payable on demutualisation of assurance companies.
72	S81C SDCA	No stamp duty is payable where land is exchanged to consolidate land in a farm.
73	S96 SDCA	Stamp duty is not payable on transfers between spouses.
74	S97 SDCA	There is a stamp duty exemption for transfers of assets as part of a divorce agreement.

Category 3 – Deductions for expenses incurred in earning income

75	S83 TCA	Management expenses are tax deductible by an investment company.
76	S84 TCA	An income tax or corporation tax deduction is available for the cost of establishing or altering an employee superannuation scheme.
77	S86 TCA	An income tax or corporation tax deduction is available for the cost of registration of a trade mark.
78	S97 (2)(e) TCA	Interest expense incurred in acquiring rented property is tax deductible for income tax or corporation tax. ⁴²
79	S101 TCA	An income tax or corporation tax deduction is available where rent receivable is irrecoverable.
80	S102 TCA	Premiums on leases are deductible against income by a trading tenant over the life of the lease.
81	S103 TCA	Premiums on leases are deductible against rental income by a landlord over the life of the lease.
82	S115 TCA	Standard expense allowances are prescribed by the Minister for Finance for specific public service occupations and may be paid free of income tax; employees may alternatively deduct actual expenses incurred.
83	S118 TCA	No benefit-in-kind charge is imposed where an employer pays the cost of mobile phone, internet connection, computer equipment or professional subscription used for business purposes by an employee.
84	S195A TCA	Travel and subsistence expenses at public sector rates may be paid free of income tax to non-executive members of public and private sector non-commercial bodies where the members earn less than €14,000 pa (€24,000 for a chairman)
85	S196 TCA	Standard expense allowances paid to members of the judiciary in respect of the expenses they incur in the performance of their duties are not subject to income tax.

42 In the Supplementary Budget 2009, the level of relief which investors can claim on the interest for mortgages and loans on residential rental properties was reduced to 75%.

86	S196A and 196B TCA	Foreign service allowances of civil servants, gárdaí, defence force members and employees of State enterprise agencies are not subject to income tax. The allowances compensate for additional costs of living outside Ireland.
87	S247 TCA	Interest expense is tax deductible by a company where the loan is used to acquire a trading company.
88	S248, 250 and 253 TCA	Interest expense is deductible for income tax where the loan is used by an individual to acquire a trading company or an interest in a partnership.
89	S268-282 TCA	There is a tax depreciation allowance for industrial buildings for income tax or corporation tax.
90	S283-301 TCA	There is a tax depreciation allowance for machinery and plant for income tax or corporation tax.
91	S301 and 302 TCA	There is a tax depreciation allowance for expenditure on dredging for income tax or corporation tax.
92	S658 TCA	There is a tax depreciation allowance for farm buildings for income tax or corporation tax.
93	S669G-669K TCA	There is a four-year write-off period for stallions.
94	S673 and S674 TCA	Mine development and exploration expenditure is tax deductible for income and corporation tax.
95	S680 TCA	There is a tax depreciation allowance for mineral depletion for income tax or corporation tax where a mine is purchased.
96	S693 TCA	Petroleum exploration expenditure is deductible for income tax or corporation tax.
97	S699 TCA	An industrial and provident society may deduct rebates, discounts and dividends to members for corporation tax.
98	S837 TCA	Business expenses incurred may be deducted against the income of a clergyman or a minister of religion for income tax.
Category 4 – Measures relating to the Government, public sector bodies and holders of Government securities		
99	S36-50 TCA	Tax exemptions are available for income from Government and other public securities.
100	S197 TCA	Bonus and interest paid in respect of National Instalment Savings are exempt from income tax.
101	S206 TCA	Income derived by the Minister for Finance from investment of the social insurance fund is exempt from tax.
102	S214 TCA	Local authorities, the Health Service Executive, vocational education committees and committees of agriculture are exempt from corporation tax.
103	S218 TCA	The Housing Finance Agency plc is exempt from corporation tax on business and investment income.
104	S219 TCA	The Irish Takeover Panel is exempt from corporation tax.

105	S219B TCA	The Investor Compensation Company Ltd is exempt from corporation tax.
106	S220 TCA	The National Lottery, The Dublin Docklands Development Authority and any of its wholly owned subsidiaries, The Pensions Board, Horse Racing Ireland, Irish Thoroughbred Marketing Limited, Tote Ireland Limited and The Commission for Electricity Regulation are exempt from corporation tax.
107	S227 TCA	Non-commercial semi-state bodies are exempt from corporation tax on investment income.
108	S228 TCA	Bodies designated under the Securitisation (Proceeds of Certain Mortgages) Act, 1995 are exempt from income tax and corporation tax.
109	S230 TCA	The National Treasury Management Agency is exempt from corporation tax.
110	S230A TCA	The National Pensions Reserve Fund Commission is exempt from corporation tax.
111	S230AB TCA	The National Development Finance Agency is exempt from corporation tax.
112	S607 TCA	Various Government and other public securities are exempt from capital gains tax.
113	S610 TCA and Sch 15 TCA	The public bodies listed in the Schedule are exempt from capital gains tax.
114	S86 SDCA	Loan stock of state bodies is exempt from stamp duty.
115	S99 SDCA	The Dublin Docklands Development Authority and its subsidiaries are exempt from stamp duty on acquisition of land.
116	S99A SDCA	The Courts Service is exempt from stamp duty on acquisition of land.
117	S100 SDCA	Temple Bar Properties Limited is exempt from stamp duty on acquisition or leasing of property.
118	S105 SDCA	Securities issued by the special purpose vehicle established under the Securitisation (Proceeds of Certain Mortgages) Act, 1995 are exempt from stamp duty.
119	S106 SDCA	Instruments which secure money advanced by the Housing Finance Agency are exempt from stamp duty.
120	S106A SDCA	The National Building Agency Limited is exempt from stamp duty. bn
121	S106B SDCA	Housing authorities and affordable homes partnerships are exempt from stamp duty.
122	S108 SDCA	A range of documents which are executed by the National Treasury Management Agency in the course of the management of the national debt is exempt from stamp duty.
123	S111 SDCA	Instruments payable out of Oireachtas funds are exempt from stamp duty.
124	S112 SDCA	Certificates of indebtedness (of the State) are exempt from stamp duty.

Category 5 – Court orders, court awards and compensation payments

125	S189 TCA	Income and gains derived from the investment of funds received in compensation of personal injury are tax exempt where the income represents more than 50% or more of total income.
126	S189A TCA	Funds in trust for permanently incapacitated persons that were raised by public subscription are exempt from tax.
127	S190 TCA	Payments made by the Haemophilia HIV Trust are exempt from income tax
128	S191 TCA	Payments made by the Hepatitis C Tribunal and HIV compensation payments are exempt from income tax.
129	S192 TCA	Compensation payments in respect of thalidomide children are exempt from income tax and income and capital gains arising on investment of the compensation are also tax exempt.
130	S192A TCA	Payments in compensation for breach of an employee's rights (e.g. discrimination, harassment etc) are exempt from income tax.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 9

TAX AND THE ENVIRONMENT



Part 9:

Tax and the Environment — *investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax*

Section 1 is an introduction.

Section 2 gives the context within which our deliberations were made. It also gives a broad outline of current environmental measures and issues.

Section 3 looks in detail at the case for a carbon tax, a tax aimed at limiting emissions of carbon dioxide and other “greenhouse gases” which are capable of being converted to carbon dioxide equivalent measures.

Section 4 examines other environmental taxes and fiscal measures that might be appropriate to support a sustainable environment.

Section 5 considers revenue neutrality in the context of the carbon tax.

Section 6 provides an overview of the ‘green economy’ and summarises our recommendations in this area.

Our recommendations in this Part are as follows:**Taxing carbon dioxide emissions**

9.1	A carbon tax on fossil fuels should be introduced.
9.1.1	The carbon tax should be based on a standardised measure of CO ₂ content of the energy product. Measurement factors used should accord with international norms.
9.1.2	The carbon tax should apply to energy products released for consumption in Ireland.
9.1.3	• The tax rate should approximate the ETS price of carbon. • The price should be established annually, on a recognised market place for trading carbon credits. • A floor price for carbon should be set.
9.1.4	Any phasing in of the tax rate should depend on the scale of the price.
9.1.5	• The tax should be collected at the earliest practical point of supply and linked into the existing 'mineral oils tax system where appropriate. • The tax should be clearly visible at the point of final consumption to ensure it is not seen as 'just another tax'. • Working capital problems caused to small distributors/suppliers with slow stock turnover by the imposition of a tax at the earliest point of supply should be accommodated where practicable.
9.1.6	• In general, there should not be preferential rates of carbon tax. • Binding action-based and/or target-based monitored agreements to reduce emissions should be accommodated under the carbon tax design.
9.1.7	• Carbon tax should not apply to ETS participants. • Tax should not be imposed at this time on ETS participants in order to capture the gains they made from the free allocation of permits; the issue should be monitored and taxation may be appropriate in the future.
9.1.8	Administrative rules for the carbon tax should fit in with existing tax provisions where practicable.

Tax on other greenhouse gases

9.2	Research into measures to reduce agricultural emissions – such as alternative technologies and feeding systems – should continue and be intensified.
9.3	If methane and nitrous oxide emissions from agriculture become capable of being monitored, reported and verified with sufficient accuracy, their exclusion from the carbon tax should be reconsidered.

Other proposed fiscal measures to improve the environment

Product taxes

- 9.4
- Environmental product taxes should be considered where voluntary initiatives are unsuccessful.
 - If such taxes were to be considered, the criteria developed by us (see Box 9.8) should be met.

Energy efficiency

- 9.5
- Continue the Accelerated Capital Allowance for energy-efficient equipment scheme for its current term; evaluate the potential for expanding the scheme to incentivise innovation (based, for example, on the Dutch model).
- 9.6
- Ireland should support amendments to the EU VAT Directive that would allow the implementation of lower VAT rates for energy-efficient goods and services.
- 9.7
- Businesses that are not in the emissions trading scheme should be given a rebate on their carbon tax payments if they participate in an approved mandatory energy reduction programme.

Transport

- 9.8
- The VRT system should be replaced by a system based on car usage, in the longer term. Such a system should be introduced over a 10-year period in order to minimise adverse impacts (in relation, for example, to the existing fleet of tax-paid vehicles).
- 9.9
- A focussed scrappage scheme, targeted at encouraging a switch to the purchase of electric and very low carbon emitting vehicles, should be considered.

Section 1:

Introduction

1.1 The environmental remit

We were invited, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the tax system and specifically to investigate “fiscal measures to protect and enhance the environment including the introduction of a carbon tax”. We were also asked to have regard to the commitment in the Programme for Government “to introduce measures to further lower carbon emissions and to phase in on a revenue neutral basis appropriate fiscal measures including a carbon levy over the lifetime of the Government”.

The Minister for Finance indicated in the October 2008 Budget that our Report would assist the Government in assessing how a carbon levy might best be structured and implemented fairly and consistently in Budget 2010.

Our environmental remit extends further than simply investigating the carbon tax proposal. We have also examined other fiscal measures aimed at protecting the environment.

The environmental agenda also presents opportunities for Ireland and we conclude this Part with an overview of the ‘Green Economy’.

Section 2:

Overview of environmental measures and issues

2.1 Environmental policy instruments

Markets are a means of reflecting scarcity; if demand for oil rises sharply and supply is constrained, prices rise and we are incentivised to cut back our consumption. However, the market fails to adequately protect environmental endowments – air, the capacity to absorb greenhouse gases, water, wildlife, landscapes – in part because there is no price signal telling us that they are getting scarce and should be used sparingly. Therefore, we have significantly depleted the capacity of the earth’s atmosphere to absorb greenhouse gases without serious risk of major climatic disturbance, with no feedback about pending scarcity, and little understanding of the volumes of greenhouse gases we emit, individually or collectively.

The solution proposed by economists is to repair the market failure by either imposing an environmental tax on emissions, or by capping emissions and allocating allowances to the emitters (such that the total allocation does not exceed the cap), and allowing them to trade on condition that the allowances they hold are sufficient to ‘cover’ their emissions. In either case, polluters are faced with a price per unit of pollution emitted that reflects the scarcity of the environment, and provides a continuing financial incentive to reduce emissions. This approach is favoured because:

- It is economically efficient – the response is left up to the polluters, and they will choose the least cost mix of responses
- It encourages innovation – there is a payoff to developing better and less expensive ways

to reduce emissions, and

- It is fair in the sense that those who choose to pollute most, pay most

In the case of environmental taxes, there may be a further benefit, in that the revenues can be used to achieve some combination of reduction in other taxes, improvement in the situation of the less well off, or more expenditure on environmentally beneficial activities.¹

There is a range of other market interventions open to governments to help influence public behaviour where the environment is concerned - see Box 9.1.

Box 9.1: Other types of market-related instruments

- **Direct and indirect expenditures:** Subsidies, grants and loans for environmental improvements; also loans at low rates, tax breaks (such as capital allowances for eco-friendly investments) and tax credits
- **Enforcement incentives:** Fines for non-compliance with environmental regulations or performance bonds payable by polluters/users, which are refunded when an environmental standard is met
- **User charges:** Charges for water supply or for waste collection, or fees for dumping material at landfills. User charges may be aimed at financing the cost of treatment or disposal that is associated with the consumption of the product
- **Product taxes or levies:** These have the effect of reducing use of products which diminish environmental quality. Examples from Ireland include the plastic bags levy and the excise duty on petrol and diesel

2.2 Relevant principles in the application of environmental taxation

Environmental taxes to take account of pollution costs

The rationale behind environmental taxes is that the additional economic cost they impose per additional unit emitted will act as an incentive to the emitters to reduce their emissions and associated environmental impacts.

Ideally, the additional economic cost will cover the external environmental costs associated with the activity, so that such costs are not fully carried over to third parties, but borne by the producers or consumers concerned. With a well-designed tax, the price reflects the costs the pollution in question imposes on society.

Environmental charges and taxes give effect to the polluter-pays principle. This was first recommended as a 'guiding principle' by the OECD in 1972, and then incorporated into the EU Treaty (Article 174). Its import is that the individuals and companies responsible for creating the pollution pay the relevant costs of their activities.

The United Nations glossary of environmental statistics (1997) describes it thus:

"The polluter-pays principle is the principle according to which the polluter should bear the cost of measures to reduce pollution according to the extent of either the damage done to society or the exceeding of an acceptable level (standard) of pollution."

¹ See: OECD Environment Directorate, 2006. The Political Economy of Environmentally Related Taxes, Paris, for a review of experience in the application of environmental taxes in OECD countries.

Principles underpinning the environmental taxes agenda

We adopted a number of guiding principles to set the context of our work. These included our core principles of taxation – equity, simplicity, tax neutrality and flexibility – as well as operational principles that the approach adopted would be pragmatic and evidence-based. We agreed two additional principles in relation to the environmental agenda:

- Polluter pays
- Revenue neutrality

In practice, these principles ensure that any measures proposed by us on the environmental front will be well-targeted and proportionate. The need to take into account competitiveness issues and distributional effects – in other words, the impact on different sectors of the economy – is also noted.

A targeted, proportionate measure is one which addresses the problem that needs to be addressed. For example, if the demand for a product does not respond well to price changes (i.e. is ‘inelastic’ because, for example, consumers may not have alternative or substitute products), the imposition of an environmental tax is unlikely to have much effect on demand or production. Also, if the tax represents only a small proportion of the price, the effect may not alter behaviour. However, there is typically a distinction between the response in the short run (less than one year) and the impact on behaviour in the medium to long term – a negligible response in the short-term can often develop into a substantial one in the long-term. (See for example, Sterner (2007)².)

International competitiveness issues arise where, for example, an environmental tax in Ireland would lead to companies moving production to countries with less stringent regimes. The result would be a fall in investment and employment opportunities in Ireland, because we adopted higher environmental standards. At the same time, there would be no reduction in global pollution because the environmentally-damaging activity is relocated to an area with more lenient regulatory or taxation regimes.

While targeted exemptions to address such problems reduce the effectiveness of the tax, they may be necessary to support economic activity and employment opportunities.

Distributional effects are also important. Certain environmental taxes – such as energy taxes – have a disproportionate impact on lower-income households who spend a relatively greater proportion of disposable income on fuel. If measures are not taken to compensate such households, there may be a widening of inequalities in the distribution of income.

2.3 How should environmental tax revenues be used?

Rebalancing tax burdens

Environmental fiscal measures may be seen as serving a dual purpose. They provide economic incentives to protect the environment, and in addition a source of revenue to alleviate actual or future tax burdens in other parts of the tax system. The aim of an environmental tax measure may be to improve economic efficiency or contribute to economic growth – for example, by funding cuts in social insurance payments. Alternatively, they could be used to address social issues – funding tax cuts or social welfare increases for lower income households and/or to subsidise further action on emissions reduction. (We refer to the overall effects of carbon tax on vulnerable households in Section 5.)

2 Sterner, T. ‘Fuel Taxes: An important instrument for climate policy’, Energy Policy Volume 35, issue 6 June 2007 pp 3194-3202.

Tax-shifting policies, under which environmental tax revenues have been used to reduce other taxes, have been used in a number of countries.

A broad programme of environmental tax reform would shift the tax burden from 'goods' such as employment, to 'bads' such as pollution. A number of submissions to us suggested that support for environmental taxes increases if there is a clear idea of where the revenue is going. The argument here is that there is a tendency amongst industry and consumers to regard environmental taxes as a form of income generation for government, rather than an environmental tool. However, if the revenues are spent on, for example, environmental activities, it may negate this argument and increase public acceptability for the tax.

2.4 International context

Terminology: taxes, charges or levies?

The OECD defines environmentally-related taxes as any payments to the general government budget, where the benefits provided by government to taxpayers are not normally in proportion to their payments. In other words, there is no specific return to the taxpayer.

It defines any compulsory payments to the government that are levied more or less in proportion to the environmentally-related service provided – such as the amount of waste collected – as fees or charges. In other words, payments are made for specific services.

In either case, the tax base is deemed to be of particular environmental relevance – for example, energy, transport, waste, measured or estimated emissions and natural resources. Frequently, the revenue generated by fees or charges is earmarked for environmental funds, while revenue from taxes tends to go to general budget. The term 'levy' is used by the OECD to cover both taxes and fees or charges. Actual use of the terms 'tax' and 'charge' in practice do not always reflect the OECD's analytical distinction.

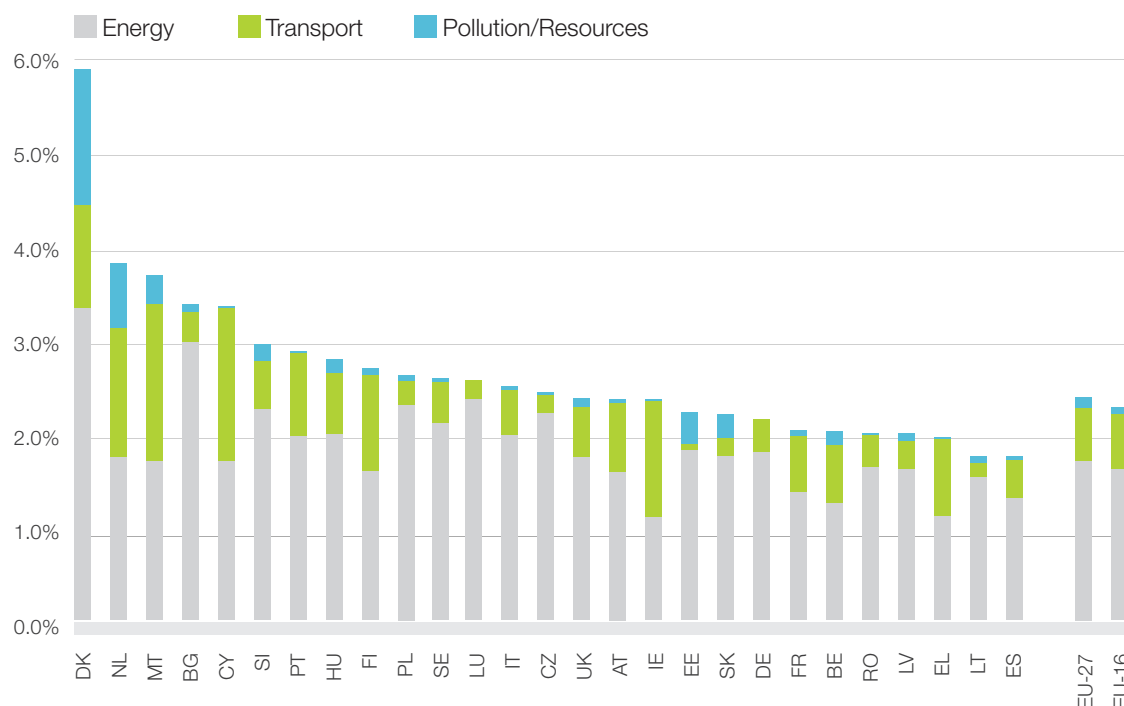
OECD environmental database

The development of consistent definitions for environmental measures allows for comparisons between countries. In co-operation with the EU Commission, the OECD and the European Environment Agency have developed a database on environmental policy instruments. This covers both market-based instruments (environmental taxes, fees and charges, environmentally-related subsidies, tradable permit systems, deposit-refund systems) and voluntary approaches that are in operation in OECD countries (which includes EU Member States and non-EU members of the European Economic Area (EEA)).

The database for 2006 showed some 375 entries for environmentally-related taxes in OECD member countries. There were a further 250 environmentally-related fees and charges. Energy products (150), motor vehicles (125) and various forms of waste (50) accounted for most of the taxes, with the balance in numbers made up by a huge range of product and other taxes, including batteries tax, beverage containers tax, tax on aircraft noise, tax on groundwater extraction, pesticides tax and tyres tax. In revenue terms, taxes on auto-fuels and vehicles account for some 90% of environmentally-related revenues across all OECD countries.

The environmental tax-to-GDP ratio for EU Member States for 2007, broken down by type of tax (energy, transport, pollution/resources), is shown in Figure 9.1. It can be seen that most countries (including Ireland) fall in the band from 2% to 3%. Environmental tax revenues exceed 3.5% of GDP in Denmark, the Netherlands and Malta. While energy taxes are predominant in most Member States, transport taxes account for about half of environmental taxes in Ireland, Cyprus and Malta.

Fig. 9.1: Environmental tax revenues as % GDP 2007, EU-27



Source: Taxation Trends in the European Union – EU Commission (2009) available from: http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2009/2009_full_text_en.pdf

2.5 Environmental tax revenues

The relative success of environmental policy cannot be measured in terms of tax yield, as a measure that is comparatively minor in revenue terms may be very important in environmental terms.

More generally, interpreting revenues from environmentally-related taxes can be difficult.

For example:

- The proportionate breakdown between environmental and other taxes depends on the level of the traditional taxes in a country
- High environmental tax revenues may be transitory, if the new taxes trigger large changes in behaviour and result in the erosion of the tax base (as producers or consumers adapt in the longer run). Revenue sustainability depends on the availability of substitutes, or the ability of consumers and businesses to change their behaviour
- Low environmental tax revenues may be attributed to the tax being set at too low a level. On the other hand, they may be attributed to high taxes and a low base of pollution
- The issue may be complicated by consumers travelling to low tax jurisdictions to buy products. Thus, a country with low fuel rates may have high fuel revenues because of the numbers of foreigners going there to fill their tanks

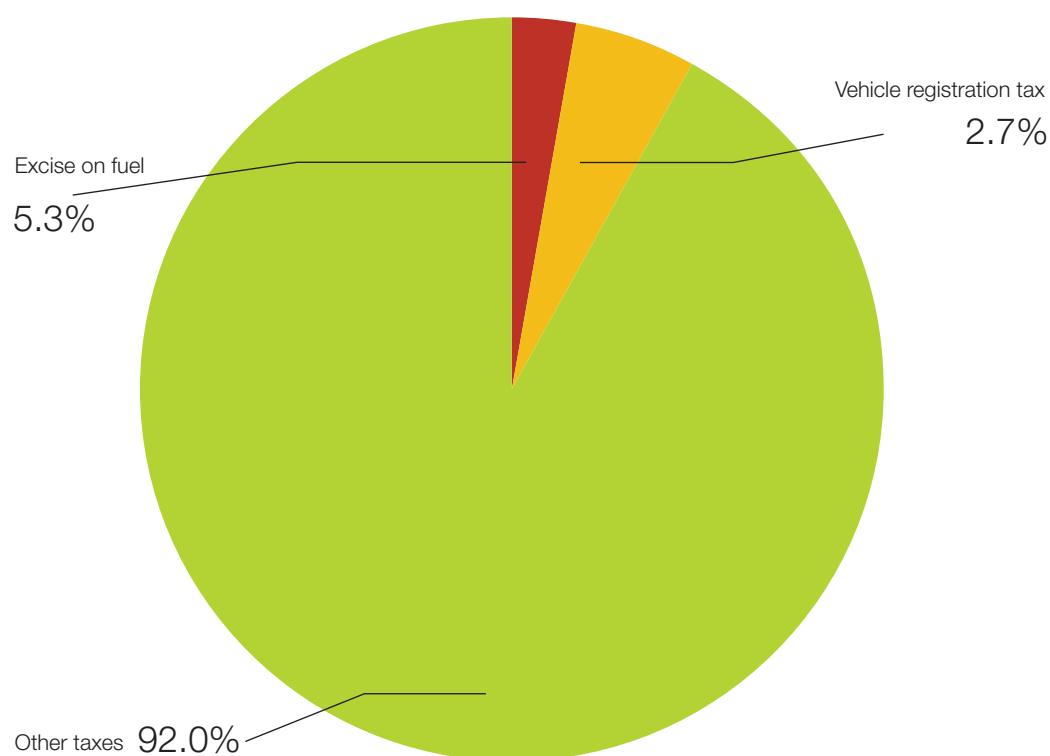
2.6 Environmental fiscal measures in Ireland

Fuel and motor taxes

In common with most countries, Ireland has had taxes that have had an environmental impact long before we ever had taxes established as an instrument in environmental policy. Also in common with most countries, VAT and excise duties on motor fuels and on vehicles are the primary 'environmentally-related' taxes in use³.

In 2008, total excise receipts were €5.6 billion (14% of total tax revenue). Excise from fuel products alone accounted for approximately €2.17 billion, and vehicle registration tax (VRT) came to €1.1 billion. Excise duties on fuel and vehicle registration tax comprised some 8% of total receipts in 2008.

Fig 9.2: Excise on fuel, VRT as % total revenue, Ireland 2008



Source: The Revenue Commissioners - Annual Report 2008

The "rebalancing" of vehicle registration tax (VRT) began in Finance Act 2008, when a tax based on emissions rather than engine size was introduced. Motor tax was also rebalanced. In addition, changes were made to the capital allowances and leasing regime for business cars, to link the availability of relief to CO₂ emission levels. The rebalancing process was extended in the Finance (No. 2) Act 2008 to provide for a new CO₂ emissions-based system for calculating benefit-in-kind (BIK) in respect of company cars provided for employees⁴.

³ Using the OECD definition of the term, that the tax base is of particular environmental relevance – see section 2.4 in the text.

⁴ The provision is subject to Commencement Order; this has not been signed at time of writing.

Plastic bags

Tax measures with specific environmental objectives have come to feature more strongly in Ireland in recent years. The environmental levy – or so called ‘plastic bag tax’ – is a good example of this.

Box 9.2: The plastic bag levy

- Introduced in March 2002 at 15 cent per bag
- Charge applies at the point of sale: customers pay the full amount, which is itemised on the receipt
- Retailers make quarterly returns and payments to the Revenue Commissioners by direct debit. Administration costs are low because the system is integrated with VAT returns
- Plastic bag levy revenues (approximately €120 million up to end-2008) are earmarked for the ‘environmental fund’ and support waste management, litter and other environmental initiatives
- Aim was to encourage the use of reusable bags. The levy had an immediate effect on consumer behaviour, with an estimated overnight fall in consumption of bags, from 328 per head to 21 per head
- Income from the levy increased during the course of 2006, suggesting that plastic bag usage rose to 31 bags per capita. Accordingly, the price was also increased
- The levy was raised to 22 cent per bag from July 2007

Tax reliefs and incentives

Some environmentally-related reliefs and incentives have already been introduced to the Irish tax system.

For example, policy support mechanisms for renewable energy in Ireland include the following measures:

- The biofuels excise relief scheme, introduced in November 2006 (see Box 9.3)
- Tax commitments in the Department of the Environment, Heritage and Local Government’s National Climate Change Strategy (2007 - 2012) include:
 - Extending the qualifying period for corporate tax relief for corporate equity investments in certain renewable energy generation projects, and
 - Extending the Business Expansion Scheme and the Seed Capital Scheme, both of which can be used for investment in companies carrying on renewable energy generation and recycling

Other measures include:

- A scheme of accelerated capital allowances for energy-saving plant and machinery (see section 4.3 of this Part)
- Allowances and credits issued under emissions trading schemes can now be treated in a tax neutral manner for securitisation purposes

Box 9.3: The biofuels excise relief scheme

- A €200 million excise relief scheme for biofuels was introduced in Budget 2006
- The aim is to reach a 2% target for biofuels penetration of the transport fuels market and CO₂ savings of over 250,000 tonnes per annum
- Four types of biofuels are supported under the scheme:
 - Bio diesel made from pure plant oil, used cooking oil and tallow, blended with fossil diesel and sold at regular diesel pumps
 - Bio diesel in higher blends of up to 100% in specific fleets of vehicles whose engine warranties cover these blends
 - Bio ethanol made from wheat, barley, whey and other feedstock, blended with petrol and sold at regular petrol pumps
 - Pure plant oil made from the oilseed rape crop and used in modified diesel engines
- Sixteen projects have been selected through the application process for excise relief; reliefs are awarded by the Minister for Finance in consultation with the Minister for Communications, Energy and Natural Resources
- The successful projects cover a broad range of business sectors including renewable energy companies, oil companies, recycling companies and food and farming sector businesses

Section 3:

Carbon tax

3.1 Context – the climate change challenge

The introduction of a carbon tax requires a completely new tax charge and structure. While the primary focus was on the form the tax should take (in accordance with our terms of reference), we were also cognisant of the fact that the scale of the tax would have policy implications for other aspects of our terms of reference – such as supporting economic activity and competitiveness.

The importance of reducing greenhouse gases⁵ to curb climate change is now well documented. Six groups of greenhouse gases have been identified as contributing most to global warming:

- Carbon dioxide (CO₂),
- Methane (CH₄),
- Nitrous oxide (N₂O),
- Hydrofluorocarbons (HFCs),
- Perfluorocarbons (PFCs), and
- Sulphur hexafluoride (SF₆).

As emissions from all six sources may be converted to carbon equivalent measures, a carbon tax may apply to emissions from any of the greenhouse gases.

5

Greenhouse gases are gases in the atmosphere contributing to the greenhouse effect (i.e. the process by which the atmosphere captures and recycles energy emitted by the earth's surface).

Carbon tax in the EU

There is wide agreement that tackling climate change requires that there be a credible long-term stable price on emitting carbon. For some time, the EU has been in favour of a co-ordinated carbon energy tax to reduce emissions in an effort to combat global warming. It put forward a proposal in 1991 for a tax that was based both on carbon emissions and on the energy content of fuels⁶. The proposal contained certain exemptions for energy intensive industries, and other measures to even out the disparities between Member States in terms of their dependence on different energy sources.

While there is still no European-wide carbon tax, several EU Member States introduced carbon/energy type taxes in the 1990s, including Sweden (1990), Denmark (1992), the Netherlands (1996), Finland (1997), Germany (1998) and the UK (1999).

There is now an EU-wide Energy Tax Directive (ETD), which sets out the current framework for taxing energy products across the Community. We also took account of this in our deliberations. The Directive, which came into force in 2004, widened the scope of the EU's minimum rate system for energy products, previously limited to mineral oils⁷, to all energy products including coal, natural gas and electricity. Peat is exempt. The current position in Ireland is:

- Oil, auto fuel and LPG are taxed at various rates per 1,000 litres
- An exemption (derogation) applies for natural gas; broadly speaking, this expires in 2013, or when natural gas reaches 25% of energy consumption in Ireland, if that comes sooner
- In accordance with the ETD, coal has been taxed since 2005, but Ireland availed of several exemptions from this tax. (The exemptions include coal for domestic use, for electricity generation, and for use in agriculture/forestry; also coal used by charities)
- An excise duty on electricity – 'electricity tax' – was introduced from October 2008. (There are a number of exemptions, including supplies to domestic households, electricity generated from renewable sources, and electricity produced from eco-friendly combined heat and power generation)

A proposal to amend the ETD was due to be published by the EU Commission before the end of 2008; its timescale is now uncertain. This may include the proposal that each tax rate would have separate energy and carbon elements.

Kyoto Protocol and emissions trading

The Kyoto Protocol is a protocol to the UN Framework Convention on Climate Change (1992), which was signed by participating countries in December 1997, and committed them to agree to specific reductions in greenhouse gas emissions in the period 2008-2012. The Protocol was ratified in February 2005 and approximately 175 countries are signatories. The EU signed up to the Kyoto protocol in addition to the individual Member States. The 15 countries that were Member States of the EU in 1990 were given a collective target for 2008-2012 of minus 8% over 1990 emission levels. Under the EU burden-sharing agreement, Ireland's allocation within this amounts to plus 13% over our 1990 emissions levels.

6 A broad-based tax on all energy sources (and not just the CO₂ content in fossil fuels) does not lead to maximum reductions in CO₂ emissions (maximum abatement), because it ignores the relationship between the demands for fossil and non-fossil fuels (i.e. cross-price elasticities). A pure carbon tax would, on the other hand, increase the price of certain fuels only, leading (in theory at least) to an increase in demand for non-carbon fuel substitutes.

7 Petrol, diesel, kerosene, LPG, heavy fuel oil.

Emissions trading – sometimes called ‘cap and trade’ – was one of a number of market mechanisms agreed to help countries achieve their Kyoto targets. The EU has channelled its efforts into creating a trading system since Kyoto. The EU Emissions Trading Scheme (EU ETS) came into operation on 1 January 2005 and key elements are set out in Box 9.4.

Box 9.4: EU emissions trading scheme (EU ETS)

- The EU ETS came into operation on 1 January 2005 and operated on a pilot basis across the EU (with no binding targets) until 31 December 2007 (phase 1)
- Phase 2 runs from 2008 to 2012, which coincides with the first Kyoto commitment period, and has binding targets for each Member State. Some of the target – in Ireland’s case, about 30% of emissions – is met under the trading scheme. (Typically, approx. 50% of emissions in other Member States are covered under the ETS; Ireland’s figure is lower because of our high proportion of emissions from agriculture, which falls outside the remit of the ETS)
- Under the EU ETS, each Member State has a cap on CO₂ emissions for all installations covered by the scheme; each installation gets an allowance (from its national regulatory authority) for a given period
- Four categories of activity are covered – energy activities; iron, steel and metal ore production/processing (ferrous metals) activities; cement, glass and ceramics production (mineral industry) activities; and timber, paper, board production activities. In each case, the ETS covers installations where the level of activity is above certain specified thresholds
- About 70 companies in Ireland are in the ETS, operating in sectors covering power generation, large boilers, cement, lime, glass, ceramics, oil refining and paper mills
- The principle behind the trading scheme is as follows:
 - The polluters must hold sufficient allowances at the end of the period to ‘cover’ their emissions for the period
 - If they emit more than their allowances, they must buy allowances from those who haven’t reached their threshold
 - These transactions produce a price per unit of pollution. It provides an incentive to polluters to reduce emissions (and sell their surplus allowances)
- Emissions must be monitored and reported in accordance with agreed guidelines that apply

EU energy and climate change package of December 2008⁸

In December 2008, the European Union agreed a set of legally binding obligations for the Member States. In regard to the EU ETS, the trading period has been extended to 2020, and the overall EU cap on emissions has been reduced by 21% from the 2005 base. For the nontrading sectors (agriculture, transport, residential and commercial, light industry, waste) each Member State has been given a legally binding cap. Ireland’s legally binding cap is a 20% reduction from a 2005 base.

3.2 Current state of play in Ireland

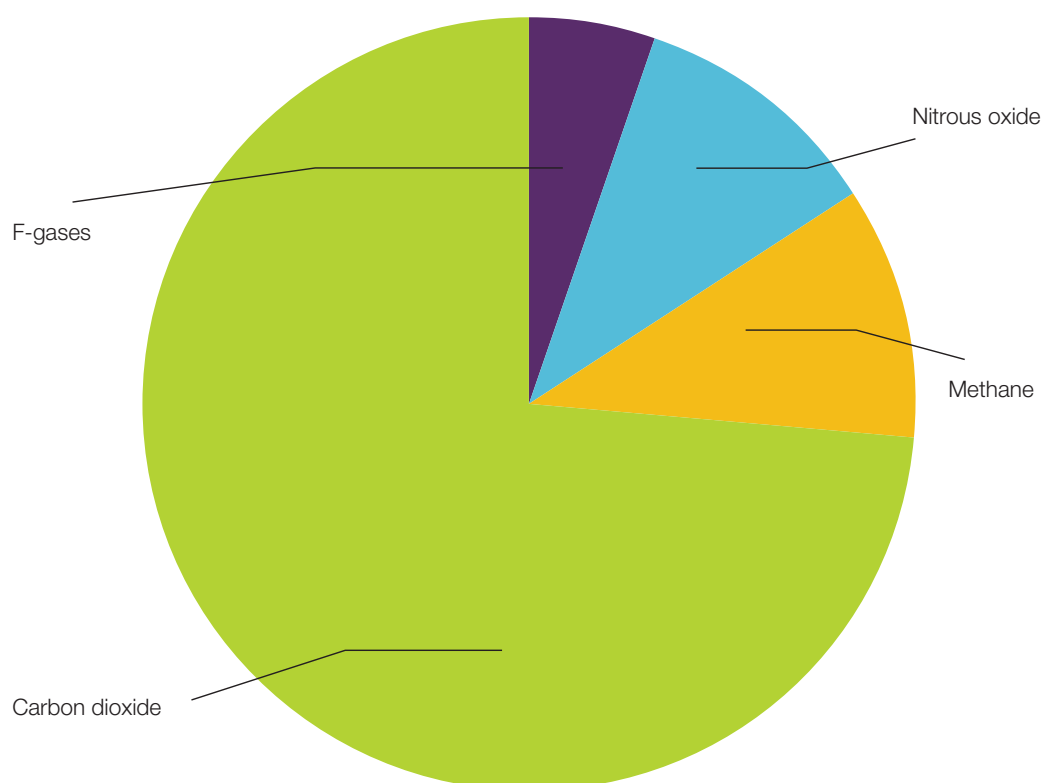
The following Table and Chart show a breakdown of total greenhouse gas emissions for Ireland for 2007.

Table 9.1: Emissions in 2007, Ireland

Gas	Emissions Gg CO ₂ equivalent	
Carbon dioxide	46,480	68.13%
Methane	12,963	19.00%
Nitrous oxide	8,076	11.84%
F-gases (HFCs, PFCs, SF ₆)	701	1.03%
Total	68,220	100%

Source: Environmental Protection Agency (EPA), National Inventory Report 2009. "Table 2.1- Greenhouse Gas Emissions 1990 – 2007", Page 26 (figures include net CO₂ from activities related to land-use, land-change and forestry (LULUCF)). Note: Gg = 1,000 tonnes.

Fig 9.3: % Breakdown of emissions 2007, Ireland



Source: Derived from the figures in Table 9.1

Targets up to 2012

Ireland's greenhouse gas emissions were 55.6 million tonnes in 1990⁹. Our EU commitments allow for an annual average emissions level of 62.8 million tonnes for 2008–2012 (i.e. not more than a 13% increase on our 1990 total). Our annual average actual emissions were about 7 million tonnes over the baseline in 2005 and in 2006 – or 25% over the 1990 total for each of these years.

9

This is an agreed figure which was calculated using CO₂, N₂O and CH₄ emissions for 1990 and F-gas emissions for 1995.

The deterioration in the economic outlook since 2008 has meant that projected outturns for future emissions are less pessimistic than previous estimates. In fact, emissions from sectors covered by the emissions trading scheme are now projected to be less than the amount allocated in the National Allocation Plan 2008-2012 (see below). As Table 9.2 shows, the latest projections suggest that Ireland will come in below target in 2012.

Table 9.2: Projected annual emissions to 2012 and distance to Kyoto target (62.8 MtCO₂ equivalent)

MtCO ₂ equivalent	With measures (WM)		With additional measures (WAM)		Economic shock plus WAM	
	Projected emissions	Distance to limit	Projected emissions	Distance to limit	Projected emissions	Distance to limit
2008 - 2012	65.4	2.5	61.8	-1.0	58.4	-4.5
of which:						
ETS	19.6		17.7		16.6	
Non-ETS	45.8		44.2		41.8 to 42.3	

Source: Environmental Protection Agency – Ireland's Greenhouse Gas Emissions Projections 2008 - 2020 (March 2009) – Table 3 on page 15

- Numbers do not sum due to rounding
- With measures means emissions forecasts are based on policies in place at end 2007. With additional measures means forecasts incorporate planned energy saving policies. Economic shock means forecasts incorporate up to date recession data. See text below for more detail on the three scenarios

Summary details on our carbon commitments to 2012 are provided in Box 9.5.

Box 9.5: Ireland's carbon commitments to 2012

- 1990 greenhouse gas emissions level = 55.6 million tonnes
- 2008-2012 targets agreed under EU/Kyoto = 62.8 million tonnes (annual average) or 13% over 1990 level
- 2006 emissions = 69.76 million tonnes, or 25.5% above the 1990 level
- Average annual emissions = 25% above the baseline level
- Exceeding the target comes at a cost to the Exchequer. The excess requires extra permits to be purchased from other countries, the cost depending on price per tonne. The National Treasury Management Agency (NTMA) was established as the purchasing authority for the State under the Carbon Fund Act 2007
- Ireland's National Allocation Plan 2008 - 2012 (drawn up by the EPA and approved by the EU in February 2008) allocates about 30% of Ireland's projected emissions for the period to installations covered under the EU emissions trading scheme. Under the National Allocation Plan, emissions amounting to 22.3 million tonnes of CO₂ per annum are assigned to the ETS sector
- The remaining 70% of Ireland's greenhouse gas emissions are accounted for by the non-trading sectors – principally agriculture, transport and residential

All sectors have a role to play in reducing emissions. The most extreme difficulties arise if the focus is on one sector. The most appropriate course is for emissions reductions to occur up to the point where the cost per 'tonne of carbon dioxide reduced' costs the same everywhere. In this way the nation does not end up paying for expensive reductions while cheaper reductions in other areas are left unexploited.

Obligations after 2012

Our terms of reference require us to take a medium to long-term strategic perspective. As noted above, the EU energy and climate change package of December 2008 requires demanding emissions-reduction targets for sectors outside the emissions trading scheme (the non-trading sectors). Ireland's target requires us to reduce emissions by some 20% over baseline 2005 levels. (Under the climate change package, a single EU-wide cap has been agreed for sectors covered by the EU Emissions Trading Scheme. This means that Ireland does not have any specific national emissions target for emissions from our ETS installations by 2020. Our 20% target is for the non-ETS sectors.)

Projections for Ireland

The Environmental Protection Agency (EPA) has produced greenhouse gas emission projections under two scenarios for each key emission sector up to 2020. The scenarios, which depend on policy developments, are:

- With measures (this is a baseline energy forecast, which incorporates the estimated impact of policies in place by end-2007), and
- With additional measures (this is a more optimistic scenario, which incorporates planned measures in the Energy White Paper and National Energy Efficiency Action Plan)

The EPA projections are underpinned by energy forecasts produced by Sustainable Energy Ireland (SEI), which are based on the Credit Crunch scenario from the ESRI's Medium-Term Review 2008-2015, updated to take account of the Autumn 2008 Quarterly Economic Commentary. An *economic shock* analysis was carried out to take account of more recent information on the depth of the recession.

Table 9.3 following shows projected emissions for 2020 for the non-ETS sector, using the additional measures plus *economic shock* scenarios. Emissions in the base year of 2005 from the non-trading sectors were 48.3 million tonnes of CO₂ equivalent. The obligation to reduce these emissions by 20% amounts to 37.9 million tonnes of CO₂e by 2020¹⁰.

10

In the event that a global agreement is reached at the UN Framework Convention on Climate Change (UNFCCC) in Copenhagen in December 2009, the reduction obligation may be increased from 20% to 30%.

Table 9.3: Ireland's emissions projections for the non-ETS sectors to 2020

Non-trading Sectors	2005	2020 (With Additional Measures) and Economic Shock
	MtCO ₂ equivalent	MtCO ₂ equivalent
Agriculture (A)	19.6	17.8
Residential (R)	7.4	6.6
Transport (T)	13.0	16.0
Waste (W)	1.8	1.4
Total	41.8	41.8
Other (commercial and light industry)	6.5	3.1
Grand total	48.3	44.9

Source: Ireland's Greenhouse Gas Emission Projections 2008-2020, EPA, March 2009, p. 17 and 19.

We note that, even incorporating the impacts of the economic shock, emissions are projected to exceed the obligation by 7 million tonnes of CO₂ equivalent by 2020 (i.e. 44.9 MtCO₂e minus 37.9 MtCO₂e). However, Ireland is allowed to net out carbon sequestered by afforestation, and this is expected to fall in the range of 2.2 to 4.4 million tonnes, so the net overshoot will be in the range of 4.8 to 2.6 million tonnes.

In terms of impact on emissions, it will be the effectiveness of a carbon tax, in combination with other policies in reducing emissions from the residential, transport, and commercial and light industry sectors, that will be of most policy relevance as regards climate change. We now consider these issues. The following two sections examine the imposition of a carbon tax to limit carbon dioxide emissions (section 3.3) and the other greenhouse gas emissions (section 3.4). Section 4 examines other fiscal measures.

3.3 Taxing carbon dioxide emissions

The combustion of fossil fuels¹¹ is the largest source of carbon dioxide (CO₂) emissions globally. CO₂ emissions also arise from certain industrial processes and product uses, such as cement production, mineral production and the use of petroleum-based products for purposes other than energy production (such as in plastics and solvents).

Table 9.1 indicates that Ireland's carbon dioxide emissions in 2007 amounted to over 68% of total greenhouse gas emissions. These came mainly from energy, manufacturing and transport.

The rationale behind a carbon tax on fuel is to change the relative price of fuels based on CO₂ emissions, in order to change consumption patterns, encourage fuel efficiency and lead to an improvement in environmental quality. A carbon tax is based on the carbon content of the fuel being consumed. If the tax works as intended, consumers make the switch to alternative energy products, and there is a permanent incentive to reduce emissions at the place of consumption.

11 Fossil fuels are hydrocarbon deposits derived from living matter that build up underground over geological periods. They can be liquid (oil), solid (coal, peat) or gaseous (natural gas).

Our terms of reference in relation to carbon tax were quite specific. We were asked to have regard to the commitment in the Programme for Government to phase in, on a revenue neutral basis, a carbon levy over the lifetime of the Government. We were asked to commence work immediately in the area of the carbon tax, because it required a new tax charge and structure. We were reminded, in the 2008 October Budget, that our Report would assist the Government in assessing the structure and implementation of a carbon levy in Budget 2010.

We present our recommendation on carbon tax in the context of the above.

Recommendation 9.1

A carbon tax on fossil fuels should be introduced.

Costings

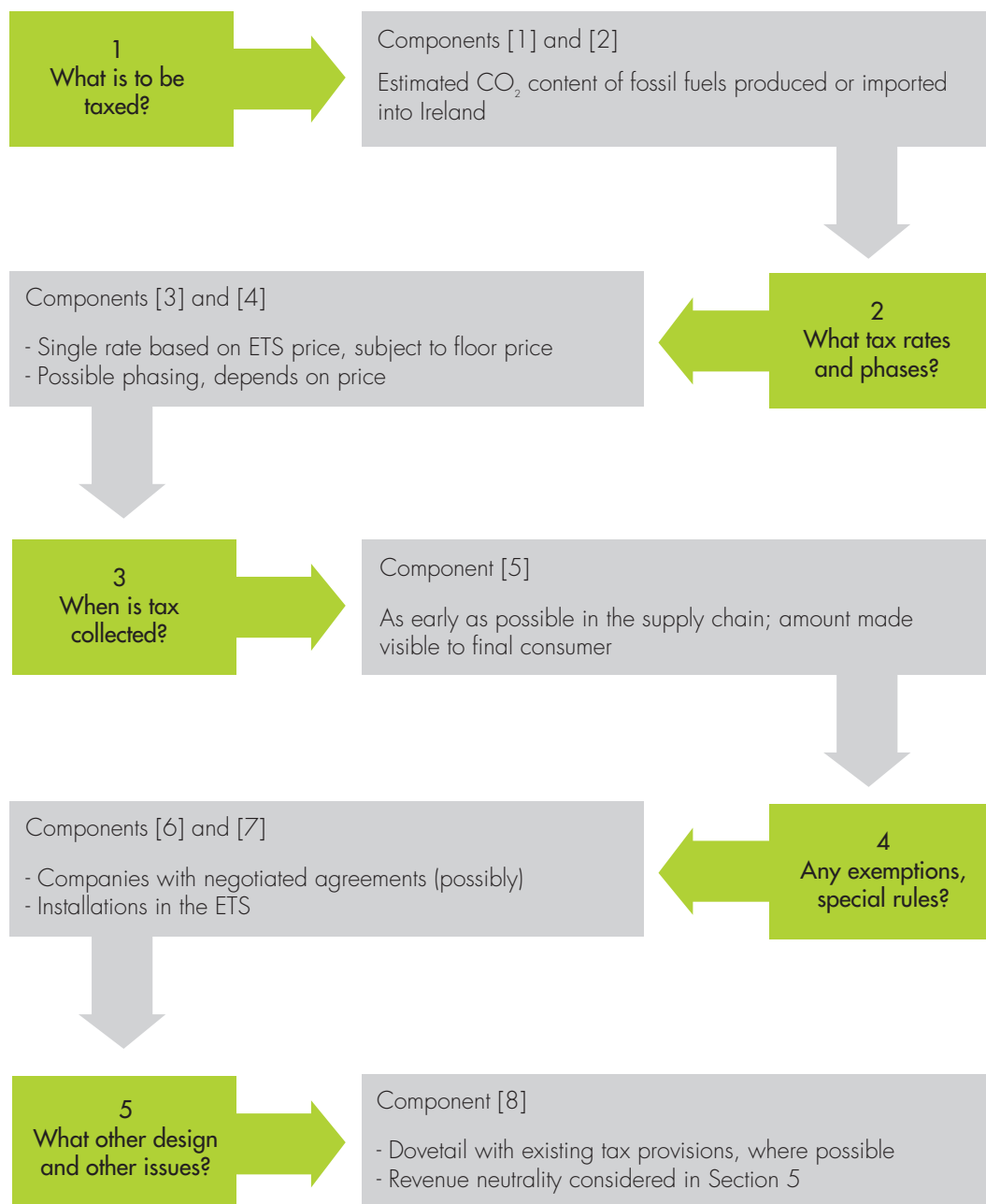
Estimates from the ESRI suggest that a carbon tax on the lines we propose of €20 per tonne could raise revenue of some €480 million in 2010 rising to €500 million in 2012¹². Obviously the revenue raised would depend on the level of the tax (which in turn is largely dependent on the ETS price for carbon permits and the floor price that is set). We also note that the ESRI estimate does not take account of exemptions or special rules that may apply – for example, our detailed proposal recommends that businesses with approved, negotiated energy agreements should be accommodated under the carbon tax design.

12 See Table B1 and Appendix 2 of "Recovery scenarios for Ireland" Bergin, A., Conefrey, T., Fitz Gerald, J. and Kearney, I. ESRI Research Series No. 7 May 2009.

The carbon tax proposal in detail

The diagram at Figure 9.4 gives an overall picture of the carbon tax scheme we developed for fossil fuels.

Fig 9.4: Main elements of the carbon tax on energy proposal



Our recommendations in relation to each of the carbon tax components are summarised below in Box 9.6. The rationale behind each component of the tax – including options that were considered – is outlined in the following paragraphs.

Box 9.6: Components of the carbon tax

- [1] Carbon tax should be charged on a standardised measure of the carbon dioxide content of the energy product; the measurement factors that are used should accord with international norms.
- [2] The tax should apply to energy products released for consumption in Ireland.
- [3] The tax rate should approximate the permit price under the EU ETS. This should be established annually on a recognised market place for trading carbon credits. A floor price, below which the tax should not fall, is also appropriate.
- [4] Any phasing in of the tax rate should depend on the scale of the price.
- [5] The tax should be collected at the earliest practical point of supply. It should be clearly visible at the point of final consumption.
- [6] In general, there should be no preferential rates of carbon tax, although certain exceptions may apply in relation to businesses with legally binding negotiated agreements to reduce emissions.
- [7] Carbon tax should not apply to EU ETS participants, nor should tax be imposed at this time on such participants in respect of the gains they made from the free allocation of permits.
- [8] Administration rules for the new carbon tax should fit in with existing tax provisions wherever practicable.

Component [1]: The tax charge

Carbon dioxide emissions from peat, coal, oil, auto fuel, LPG and natural gas will be covered by the tax. Different fossil fuels produce different amounts of CO₂. The internationally agreed standard for comparing the amounts of CO₂ emitted by the different fuels is called the 'tonne of oil equivalent' (TOE)¹³, which indicates the amount of emissions that are expected to be produced when the fuel is used. It is generally accepted that CO₂ content is a very good proxy for emissions.

Emissions on the basis of this standardised measure for selected fuels are as follows:

Table 9.4: Emissions factors for fossil fuels

Fossil Fuel	Tonnes of CO ₂ emitted (per TOE)
Peat - briquettes	4.14
Coal	3.961
Fuel oil	3.182
Diesel	3.069
Petrol	2.927
LPG	2.667
Natural gas	2.3

Source: http://www.sei.ie/Publications/Statistics_Publications/Emission_Factors/

¹³ This is the amount of energy produced by burning one tonne of crude oil. It is defined by the International Energy Agency (IEA)/OECD as being equal to 41.868GJ.

The tax is applied per tonne of CO₂ emitted, which means that fuels generating the greatest amount of carbon are taxed proportionately more than cleaner fuels. For example, a rate of €20 would mean tax per TOE (excluding VAT) of €82.80 (€20 × 4.14) for peat and €46 (€20 × 2.3) for natural gas.

The figures in Table 9.4 are indicative only; there are small variations in values quoted by different sources. It is not our function to set exact emissions factors for the purposes of the carbon tax. We recommend that, as a general principle, agreed EU measures – such as the framework used under the EU ETS – should be adopted.¹⁴ We are aware that the proposed amendments to the Energy Tax Directive may also clarify emissions factors in relation to the different energy products.

We considered three alternative approaches to using a standardised measure of CO₂ content:

- The first of these was to have an *ad valorem* tax, based on the value of product sold. This was rejected, because such a measure is not linked to carbon content. We agreed that defining a tax base in specific terms is the appropriate way to capture the negative externalities, because it is the physical quantity of fuel used to produce the energy that is linked to the emissions, not the pre-tax price of the fuel. Submissions also suggested that the tax should be a monetary amount (rather than a percentage) in order to provide a stable price signal to industry. A tax based on the value of the product sold would also not be in accordance with the Energy Tax Directive
- The second alternative was to tax directly measured actual emissions. While this would give better linkage to the pollution source, we did not regard it as practical, especially when there are a huge number of separate emissions sources
- The third option involved taxing the excess CO₂ produced relative to natural gas or some other standard, in order to encourage fuel switching. While this had merit from an environmental point of view, we rejected it on the grounds that it was overly complex, favoured certain sectors over others and was not in line with the system used in the EU Emissions Trading Scheme

Recommendation 9.1.1

The carbon tax should be based on a standardised measure of CO₂ content of the energy product. Measurement factors used should accord with international norms.

Component [2]: The products covered

We propose that the tax would be levied on domestic and imported processed fuels. It seems logical that exporters of emitting products would be exempt, if the emissions occur outside Ireland; and importers of emitting products would be taxable, if the emissions occur in Ireland.

The Revenue Commissioners have indicated that, as an excise duty, carbon tax would be charged when products are released for consumption in Ireland and would not, therefore, apply to exports.

Recommendation 9.1.2

The carbon tax should apply to energy products released for consumption in Ireland.

¹⁴ This suggests that more detailed emissions factors may be used in practice. For example, separate emissions factors are used for kerosene and gas oil under the EU ETS, while emissions factors for certain fuels (such as peat) depend on the product's physical source and are site specific.

Component [3]: The carbon price

The tax should, subject to a minimum level, be set at the level equal to the carbon price for emissions trading under the EU ETS – that is, the international price of emissions. In broad terms, a uniform carbon price is both logical and equitable – trading and non-trading sectors are treated the same, and the abatement costs (per tonne of CO₂ reduced) are the same for persons paying carbon tax or buying carbon credits. A floor price is also appropriate, as indicated below.

Under emissions trading, EU ETS permit prices adjust in line with demand and supply. Because the actual permit price changes daily and may fluctuate significantly (unlike tax rates, which are generally changed as part of the annual budget cycle), we propose that the tax rate would be linked to the carbon price in the futures market for the next calendar year. A frequently changing rate would cause uncertainty for business, would be less efficient and would create compliance and administration costs.

A number of submissions to us agreed with this broad approach. In addition, the National Competitiveness Council suggested that the tax should be introduced at a low rate and ramped up to match the ETS carbon price. The Environmental Protection Agency made the point that distortions would be created if the carbon tax and ETS allowance price differed substantially in the long term, as businesses would focus on reducing tax rather than emissions.

We considered two alternative approaches to the tax level. One was that a punitive rate to meet emissions reduction targets should be set. The other was that the rate should reflect all the costs that were involved. We rejected these options. The carbon tax is a visible, concrete move in the right direction towards implementing Ireland's climate change obligations. Its purpose is not to achieve a given level of emissions reductions. Some estimates suggest that a carbon tax of over €180 per tonne would be needed to achieve a reduction of 20% in energy-related CO₂ emissions from non-ETS sectors (by 2020, over 2005 levels).

The need for a floor price

ETS permit prices have been quite volatile. As an illustration, the futures price for December 2009 was close to €20 in November 2008. It had fallen to around €12 by January 2009, and was as low as €8 in February 2009. It had risen close to €15 by June 2009.

A floor price for carbon would be appropriate. We suggest that a rate of €20 might be reasonable in meeting the objectives of a carbon tax as outlined above; in any event the floor price should be monitored to ensure it remains effective. The advantages of a floor price include certainty and revenue yield. Our general philosophy - that taxes should not be too cyclical - is dealt with in some detail in Part 4 of our Report. In addition, it may be noted that if the carbon price was really low, then not only would transaction and collection costs be disproportionately high, but also the effect on behaviour could be negligible. This is not in keeping with the purpose of the carbon tax.

For illustrative purposes, domestic fuel price increases resulting from a carbon tax of €20 per tonne of CO₂ in the first quarter of 2009 are shown in Table 9.5.

Table 9.5: Retail price increases from carbon tax of €20 per tonne CO₂, 2009

Fuel	Price including existing tax €	Price including existing tax plus carbon tax €	Price increase Carbon tax €20 per tonne CO ₂	
			€	%
Premium unleaded gasoline 95 RON (litre)	0.986	1.033	0.047	4.8%
Auto diesel - non commercial user (litre)	0.975	1.029	0.054	5.5%
Natural gas - household (kWh)	0.0643	0.0684	0.004	6.4%
Light fuel oil - household (1,000 litres)	610.17	663.84	53.67	8.8%
Briquettes (bale)*	3.85	4.33	0.48	12.5%
Premium domestic coal (tonne)*	405.00	461.32	56.32	13.9%

* Price at 1 April 2009

Source: ESRI (July 2009)

Recommendation 9.1.3

- The tax rate should approximate the ETS price of carbon.
- The price should be established annually, on a recognised market place for trading carbon credits.
- A floor price for carbon should be set.

Component [4]: Possible phase in of tax rate

We are asked in our terms of reference to have regard to the commitment in the Programme for Government requiring that a carbon levy would be phased in on a revenue neutral basis. A number of submissions to us suggested that the tax should be *phased in* to allow consumers time to adjust. This might involve, for example, identifying alternative energy sources, or putting systems in place to account for the tax.

We considered a number of options in relation to phase in. The possibility of a carbon tax has been well publicised. If the tax were to be phased in, we concluded that a two-year period provided an appropriate balance between (a) offering an incentive to reduce emissions/switch fuels and (b) giving time to consumers to adapt/innovate/reduce the impact of the tax. The Revenue Commissioners indicated to us that a two-year time scale seemed reasonable in principle to prepare administratively and legislatively for the tax.

The practical value of phasing in a tax which will not have an appreciable impact on prices is questionable. It was shown in Table 9.5 that a carbon tax of €20 per tonne of CO₂ emitted would, for example, add five cent to the cost of a litre of petrol, on the prices given in the table. We suggest that 'time to adjust' is not necessary in this case. On the other hand, if the international price of carbon increased substantially, a gradual phase in period – perhaps longer than two years, would be appropriate.

Phase in periods for certain sectors (e.g. consumers but not business, or vice versa) was also considered, but we decided it would be too complex administratively. We concluded that, if the

impact of the tax on prices is insignificant, and if adequate safeguards are in place to deal with fuel poverty, then a phase in of the tax is not necessary.

Recommendation 9.1.4

Any phasing in of the tax rate should depend on the scale of the price.

Component [5]: Collection of the tax

We recommend that the carbon tax is imposed when the fuel goes into the market (as opposed to when it is sold to final consumers). This minimises the number of tax collection points, because taxpayers are limited to 'upstream' suppliers and producers. Discussions with the Revenue Commissioners confirm that such a system allows for alignment with existing excise duties, which is straightforward and cost effective.¹⁵

For example, if the carbon tax is imposed at the same time as mineral oil excise duty, it can be collected simultaneously, leading to administrative efficiencies. New collection arrangements will need to be put into place for fuels – peat and natural gas – which are not subject to excise duties.

Collecting the tax with excise duty upstream makes it less transparent, since it would be linked to another tax. This means that there is not an immediately apparent link between the tax and the amount of pollution caused. Accordingly, an important part of our proposal is that the carbon tax component should be made clearly visible at the point of final consumption. It is important to promote the idea that the carbon tax is not 'just another tax', but is designed to change behaviour.

Other evidence supports this proposition. For example, the initial proposals for a plastic bag levy was that it be imposed upstream, and absorbed by the retail outlets, which would, it was presumed, adjust. But the decision was made to shift the incidence downstream to the shopper, so as to make the link directly between plastic bag usage, environmental impact and consumer behaviour.

A drawback to an upstream approach is that small distributors/suppliers with slow stock turnover (for example, anthracite), who have to pay the tax upfront before collecting it from customers, may be particularly hit by cash flow issues. We propose that these be accommodated if practicable.

Recommendation 9.1.5

- The carbon tax should be collected at the earliest practical point of supply and linked into the existing mineral oils tax system where appropriate.
- The carbon tax should be clearly visible at the point of final consumption to ensure it is not seen as 'just another tax'.
- Working capital problems caused to small distributors/suppliers with slow stock turnover by the imposition of a tax at the earliest point of supply should be accommodated where practicable.

Component [6]: Possible preferential tax rates

Subject to the caveat below about negotiated agreements, our recommended default rule is that there will be one carbon tax rate, with no difference between sectors of the economy. Such a system is easy to understand and administer. Claims that some sectors are being favoured or unfairly treated are avoided.

¹⁵ We have been advised that, under the EU Energy Tax Directive, natural gas must be taxed at the time of supply to the consumer. We understand that this is the most efficient and accountable method of taxation for that particular fuel.

We considered having a sliding scale of rates. While this would mean that particular problems faced by certain sectors could be addressed, by its nature such a system could become extremely complex. Questions such as fair treatment, the extent of exemptions, levels of proof needed to qualify for special rates all arise. The pressure to exempt sectors would probably be intense. In addition, if the rate for a 'preferential' sector was too low, there may be no change in behaviour, putting the burden of meeting Ireland's emissions reduction targets on other sectors.

Notwithstanding the default rule, the carbon tax design should allow for the possibility that companies with legally binding action-based and/or target-based emissions reduction agreements with Sustainable Energy Ireland (SEI) could be accommodated. There is some evidence to suggest that negotiated energy agreements (NEAs) are an effective method of reducing emissions – they have been used successfully in Denmark, for example. In addition, documentation from SEI indicates that emissions reductions double when there are binding negotiated agreements in place¹⁶.

Negotiated agreements address concerns about competitiveness. They recognise the fact that individual businesses have different emissions profiles and input combinations and are affected in different ways by carbon tax. A number of submissions also supported exemptions for firms participating in agreement schemes.

The Energy Tax Directive (see section 3.1) includes provisions for optional tax relief for, among other things, fuels used by companies undertaking energy efficiency measures. The proposed exemption from carbon tax for companies with NEAs appears to be in conformity with this. We recommend that any exemptions that may arise from restructuring of the Energy Tax Directive in the future should also be taken into account, as they may need to be dovetailed with the carbon tax.

The mechanism for accommodating companies with negotiated agreements might involve exemptions, special rates, or rebates. Precise details on these mechanisms are outside the scope of the design. We suggest that the scope of the reliefs which might be granted should be framed in the context of measures agreed under the Energy Tax Directive, in order to protect Ireland's competitiveness.

Recommendation 9.1.6

- In general, there should not be preferential rates of carbon tax.
- Binding action-based and/or target-based monitored agreements to reduce emissions should be accommodated under the carbon tax design.

Component [7]: Treatment of EU ETS participants

The EU ETS covers over 100 installations (70 companies) in Ireland. We propose that EU ETS participants would not be liable for the additional carbon tax, since such companies are already facing a price for carbon which incentivises adopting abatement measures to reduce emissions and/or purchasing emissions allowances. Imposing a carbon tax on Irish ETS participants may create an incentive for Irish companies to reduce emissions/fuel switch even further (at the cost of increased prices). However, the net effect on EU emissions would be zero, because the EU ETS places a cap on total EU emissions. The system involves surplus permits being sold on to a purchaser who can then emit instead. This total is not affected by a carbon tax in Ireland.

16 See, for example: http://www.sei.ie/Publications/Your_Business_Publications/Energy_Agreements/Pilotexecsumm.pdf for summary details on a pilot scheme run by SEI in 2003.

The distribution of emissions across Member States would be affected however (as Irish ETS companies subject to a carbon tax would reduce emissions and buy fewer permits).

Several submissions to us also expressed the view that ETS companies should not have to pay carbon tax. In addition, the Energy Tax Directive allows for tax relief for energy products used by companies involved in the emissions trading scheme.

The precise details on how such installations might be exempted in practice are an administrative matter – the Revenue Commissioners have indicated that the tax warehouse system and/or operating a refund scheme for all ETS companies would be feasible.¹⁷

Tax treatment of permits allocated to ETS participants

Companies involved in emissions trading were given a free allocation of permits for the 2008 to 2012 trading period. The argument was put to us that this free allocation should be taxed because it amounted to a subsidy to ETS participants. Another argument for taxing free permits is the fact that a polluting ETS company may trade its permits in an economic downturn (because production, and hence emissions, have decreased), whereas a ‘green’ competitor company outside the ETS does not have such a source of profits.

The dominant holder of allowances is the power sector¹⁸. With the emergence of the all-island electricity market, generators in the market post-2008 are expected, as a condition of their generation licences, to bid into the all-island wholesale market at prices that fully factor in their short-run marginal costs for each half-hourly dispatch period.

Such costs explicitly include the full opportunity cost¹⁹ of the permits for each half-hour period²⁰, a provision which did not apply during the pilot (2005-07) phase. Thus we would expect in fully competitive markets that the value of allowances will be included in the price consumers pay for their electricity. If allowances are granted for free, this means that generators accrue a windfall gain. It was this consideration that led countries such as Germany and the UK to auction up to 10% of the allowances in the 2008-12 period, so as to claw back some of this gain.

If pass through were operating in Ireland, it has been estimated that the value of the gain would be in the range of €400 to €600 million over the period.²¹ However, there are particularities in the Irish situation, including:

- The fact that the major incumbent – ESB – is State owned, and some of the gain is captured by the shareholder
- Retail electricity prices are still influenced by regulation
- The Government is attempting to encourage new entrants, and a windfall tax would not be helpful in this context, and

17 A tax warehouse is an approved premises where excisable products (or in this case, fuel subject to carbon tax) may be produced and stored under ‘duty suspension’ arrangements, whereby tax is not payable.

18 The other major beneficiary of free allowances is the cement sector. However, market conditions are such that competitive pressures are likely to inhibit the potential for pass through of the value of allowances.

19 ‘Opportunity cost’ is the value foregone in using an asset and is independent of whether one paid for it or not. Although emitters get these valuable allowances for free, they will still recognise their full value as they make decisions.

20 See: *All Island Project – the Bidding Code of Practice – A Response and Decision Paper* AIP-SEM 07-430, 30 July 2007.

21 See: Ryan, Lisa, Convery, Frank and Casserly, Noel, 2008. ‘Mobilising Market-based Instruments for Climate Change in Ireland’ *Budget Perspectives* 2009. Editor Tim Callan, ESRI, 2008.

- There is a Government decision for the ESB to be a leader in the development of the 'green economy' including the areas of smart meters, smart networks, electric vehicles, wind energy, home insulation and green technology, all of which require capital

Given this wider energy policy framework, it did not appear sensible to us to proceed with a recommendation that the gain from these permits would be taxed at this time. A further consideration is the fact that all of the power sector participants will be buying their permits at auction from 2013, when the amended Emissions Trading Scheme comes into operation²² and this revenue will accrue to the Irish Exchequer. We conclude that the tax treatment of permits that are given free to participants in the ETS is a complex, technical issue. While we accept that in principle, such permits should be taxed in order to capture the gain to the beneficiaries, we do not recommend such a course at this time. It may, however, be appropriate in the future.

Recommendation 9.1.7

- Carbon tax should not apply to ETS participants.
- Tax should not be imposed at this time on ETS participants in order to capture the gains they made from the free allocation of permits; the issue should be monitored and taxation may be appropriate in the future.

Component [8]: Administration rules

We propose in component [5] that the new carbon tax would be aligned with the existing mineral oil tax provisions in terms of point of charge and collection procedures. We also recommend that the legislative framework – including the rules for filing of returns by persons liable, for making payments, for interest, for determining when exactly a supply is made, and for appeals – should follow existing provisions in the tax code where possible.

Some new administrative rules may also be needed – for example, it might be decided that a minimum liability threshold should apply before the tax on carbon arises. In practice, this would mean that suppliers would not have to register and file returns unless some pre-determined tax liability amount was reached. While this allows for the fact that administrative and compliance costs in the case of some very small suppliers may limit the cost effectiveness of the tax, we recognise that there may be monitoring and control issues – enforcement, setting the threshold amount, and so on. We do not object in principle to the setting of threshold amounts.

Recommendation 9.1.8

Administrative rules for the carbon tax should fit in with existing tax provisions where practicable.

3.4 Other greenhouse gases

Greenhouse gases other than CO₂ account for approximately 32% of Ireland's total emissions (2007 figures), and are much more harmful to the environment than carbon dioxide. Tax initiatives which lead to emissions reductions in these gases, which cover methane, nitrous oxide and the three F-gases, would contribute to meeting Ireland's international climate change commitments, and our terms of reference on fiscal measures to protect the environment.

²² The power sector will be subject to auction immediately. Full auctioning of permits has been delayed for other sectors, following agreements at EU level in December 2008. Also see 'Obligations after 2012' in section 3.2 of this Part.

Summary statistics in relation to each of the gases are provided in the following table:

Table 9.6: Other greenhouse gases in Ireland, 2007

Gas	Main sources	Global warming potential*	% total emissions	Potential Yield €m**
CH ₄ (methane)	Agriculture, waste.	21	19%	250
N ₂ O (nitrous oxide)	Agriculture, energy.	310	12%	150
HFCs group (F-gas)	Fire extinguishers, semiconductor manufacture, refrigeration and air conditioning equipment, foam blowing, aerosols/metered dose inhalers.	From 140 to 11,700	1%	19
PFCs group (F-gas)	Semiconductor manufacture.	From 6,500 to 9,200		
SF ₆ (F-gas)	Semiconductor manufacture, electrical equipment, medical applications, sporting goods, double-glazed windows.	23,900		

Sources: Environmental Protection Agency (EPA) National Inventory Report 2009; Economic and Social Research Institute (ESRI).

* Global warming potential is one of the measures that can be used to compare the potency of gases relative to carbon dioxide (which has a GWP of 1).

** ESRI estimates of potential yield are based on a tax of €20 per tonne of CO₂ equivalent and are taken from 'A carbon tax for Ireland' 23 May 2008. Tol, R., Callan, T., Conefrey, T., Fitzgerald, J., Lyons, S., Malaguzzi Valeri, L. and Scott, S.

The submissions to us and discussions held with interested bodies were mixed on the question of whether other greenhouse gases should be taxed. On the one hand, there was support for the view that the carbon tax should apply to all six greenhouse gases as part of a coherent climate change policy. On the other hand, concern was expressed about whether taxing these gases would bring Ireland into uncharted waters, and damage our competitive position, since other jurisdictions did not, in general, impose such taxes.

An overview of our analysis of the taxation of these gases is presented in Box 9.7.

*Box 9.7: Pros and cons of taxing other greenhouse gases in Ireland***Case for a tax:**

- The relative contribution of methane (approx. 19%) and nitrous oxide (approx 12%) to total emissions suggests that these gases are too important to ignore in terms of meeting Ireland's emissions reductions targets. Also, methane contributes over 40% of emissions in the non-trading sector, where the potential application of a tax is most relevant and salient
- A tax would give the right signal at EU level and show Ireland's commitment to climate change
- Significant potential revenue yield in the case of taxing methane (€250 million) and nitrous oxide (€150 million) – see Table 9.6
- Treating all greenhouse gases the same is more equitable and does not place Ireland's emissions reduction burden on certain sectors only
- HFCs, PFCs and SF₆ are growing fast and are very potent

Case against a tax:

- Principle of synchronisation with the EU ETS – agricultural emissions are not currently capable of being accurately monitored, reported and verified
- International competitiveness issues and the uncertain effects on the Irish economy: such taxes would put Ireland at a disadvantage in relation to other countries and lead to businesses relocating
- Greenhouse gas leakage: such taxes could result in herd cuts in agriculture, and encourage businesses to move abroad without achieving any overall emissions reductions, because the activity continues to be carried out elsewhere
- The level of food consumption in Ireland would not be influenced by the tax; thus the decline in food production in Ireland would be replaced by food produced elsewhere in the world, resulting in no overall reduction in emissions and adding further emissions from additional transportation
- Alternative technologies and feeding systems to reduce greenhouse gas emissions from agriculture are currently being developed
- There are already a number of EU regulations on the control of the F-gases. Support for EU-level focus on non-tax measures – prohibition, regulation and technological change – could better signal Ireland's commitment to international climate change policy
- The low potential tax yield (about €20 million) and effect on emissions for the F-gases does not warrant a tax

We examined proposed amendments to the EU Emissions Trading Scheme in the context of the other gases. The existing scheme covers certain CO₂ emissions only. Post-2012 it is intended that the scheme will also cover:

- CO₂ emissions from petrochemicals, ammonia and aluminium
- N₂O emissions arising from the production of nitric, glyoxalic and adipic acid, and
- PFCs from the aluminium sector

The EU Commission indicates that the inclusion of these sectors and gases is feasible because they can each be measured with sufficient accuracy. Specifically, the proposal to amend the Directive states that:

“The emissions trading scheme should only be extended to emissions which are capable of being monitored, reported and verified with the same level of accuracy as applies under the monitoring, reporting and verification requirements currently applicable under the Directive. This ... is not the case for emissions from agriculture or forestry.”

It was noted in Component [1] of the carbon tax proposal that we agreed, as a general principle, that emissions factors used under the EU ETS should also be used for measurement purposes for the carbon tax on fossil fuels. We also adopted the principle that our carbon tax proposal should be in symmetry, as far as possible, with the EU ETS in terms of coverage.

We concluded that a carbon tax should not be imposed in respect of methane and nitrous oxide emissions from agriculture. This is in keeping with the principle that the carbon tax proposal should synchronise where appropriate with the EU ETS; such emissions are excluded from the EU ETS because they cannot be accurately monitored, reported and verified. This course is being proposed for reasons of practicality. The Commission is strongly of the view that, on environmental grounds, it is undesirable in principle to exempt a sector that is a very substantial contributor to emissions. If the monitoring, reporting, verification situation were to improve to the point that inclusion was feasible, the issue should be reconsidered.

We also decided against taxing the F-gases. Our examination of the F-gases indicated that the trend across Europe in relation to consumption and emissions reduction has focused on prohibitions, regulation and technological change, rather than taxation.

Our remit in relation to carbon tax includes examining how best the tax system can support economic activity and increase employment. Ireland is a small open economy. We concluded that imposing a tax on the industries affected, particularly when other countries did not have similar measures, would not be prudent - the tax take would be insignificant, and the damage to the economy could be high, if such businesses chose to relocate to other jurisdictions. The preferred approach is to conclude voluntary agreements with business, and to foster producer initiatives and negotiated agreements.

Recommendation 9.2

Research into measures to reduce agricultural emissions – such as alternative technologies and feeding systems – should continue and be intensified.

Recommendation 9.3

If methane and nitrous oxide emissions from agriculture become capable of being monitored, reported and verified with sufficient accuracy, their exclusion from the carbon tax should be reconsidered.

Section 4:

Other environmental taxes/fiscal measures

4.1 Introduction

The targeting of greenhouse gas emissions via a carbon tax is just one element of our remit. Our terms of reference cover fiscal measures to protect and enhance the environment generally. In this section, we examine measures that might be taken to counteract environmentally-damaging products other than carbon, and to promote energy efficiency and environmentally clean means of transport.

Market pricing mechanisms in relation to water and waste water services, and to the control of waste, are two other significant areas in the context of maintaining a sustainable environment. We analysed these factors as part of our remit to examine the future financing of local government.

Full details of our findings and recommendations on water, waste water and the control of waste are in Part 11 of our Report.

4.2 Environmental product taxes

The purpose of taxing environmentally damaging products (such as batteries, tyres or excess packaging) is to provide an economic incentive to reduce their production or consumption. The 'plastic bag tax' is an example of a highly successful product tax in Ireland (see Box 9.2).

The definition of environmental product tax is potentially very wide. It could include, for example, the tax on carbon in fuels already proposed, as this is a tax on a product that could be deemed damaging to the environment. We based our analysis on the categorisation adopted by the European Environmental Agency (EEA). The EEA lists the following items under the 'products' category in its 2006 report on market based instruments for environmental policy²³:

Tyres, beverage containers, packaging, bags, pesticides, CFCs, batteries, light bulbs, PVC/phthalates, lubrication oil, fertilisers, paper/board and solvents.

We developed a set of general criteria under which product taxes might be imposed. These were formulated according to the relevant principles set out in section 2.2 and are presented in Box 9.8.

Box 9.8: Criteria in relation to the imposition of environmental product taxes

Product taxes should only be imposed if:

- Voluntary agreements, underpinned by regulation where appropriate, have been unsuccessful or have not been applied*
- The tax is likely to be environmentally effective: the user has an alternative to the pollutant; the tax is expected to change behaviour, and there is a measurable behavioural response
- The administrative burden is not excessive
- The collection costs are not excessive in relation to the expected yield

** For example, in the case of packaging, there are no voluntary agreements in place that cover the generation of waste in the first instance.*

23 The other EEA categories are air/energy (which includes carbon taxes), transport, water, waste, noise and resources (raw materials).

Proposals in relation to environmental product taxes did not feature significantly in either the submissions we received or the discussions we held with relevant bodies on environmental issues. There was some support for the imposition of economic disincentives on the producers and distributors of unnecessary packaging. It was also suggested to us that it was important that retailers were not faced with the daily administration of a multitude of different environmental levies or charges. The efficacy of non-tax environmental policy instruments – such as information campaigns and voluntary agreements – also came up during the consultation process.

We examined a number of programmes in this area. Examples of our findings include the following:

- Successful industry-led initiatives have been introduced for packaging – where rates of recovery and recycling significantly exceed EU targets – and tyres. There is no fiscal, voluntary or other policy designed to reduce the creation and use of packaging. A prominent scheme is the implementation on the basis of producer responsibility of the Waste Electrical and Electronic Equipment (WEEE) Directive, whereby at time of purchase, consumers are separately charged the environmental management costs of final disposal, and these contributions to the producer recycling fund are used to safely recycle or dispose of such equipment
- There are also schemes for end-of-life vehicles (typically, passenger cars or light commercial vans that the registered owner wishes to dispose of); farm plastic waste; and (since September 2008) batteries. In most cases, these recycling schemes are underpinned by EU Directives and domestic legislation
- The Department of the Environment, Heritage and Local Government has concluded a negotiated agreement with the chewing gum industry, covering initiatives over the period 2007–2009. This includes information campaigns and an R&D grant funded by the industry. That Department has also agreed a protocol with the Irish Banking Federation (IBF), acting on behalf of retail banking groups with ATM networks, to tackle litter caused by ATM advice slips. The Department is also undertaking negotiations with the take-away sector to deal with fast food packaging
- In addition, there is a wide range of EU legislation, which has been transposed into Irish law, that addresses issues such as chemical and pesticide management, water and air quality and the protection of waters against pollution caused by nitrates from agriculture²⁴

Environmental product taxes may not always be the most appropriate answer to an environmental problem. Regulation and/or voluntary initiatives may be more appropriate options, and this is the way that environmental policy vis-à-vis products is developing in Ireland. In the light of the criteria outlined at Box 9.8 and the analysis undertaken on this issue, we do not recommend that new product taxes be introduced at this stage. Our preferred approach is the agreement of voluntary initiatives in the first instance. However, if the agreements approach now evolving proves in some instances to be ineffective – for example, if there is no change in behaviour after a suitable time period has elapsed – then a tax should be considered.

Recommendation 9.4

- Environmental product taxes should be considered where voluntary initiatives are unsuccessful.
- If such taxes are to be considered, the criteria developed by us (see Box 9.8) should be met.

24

For example, implementation of the Nitrates Directive in Ireland has included monitoring of waters by local authorities and the EPA, the development of a code of practice to protect water from pollution by nitrates, a range of actions to support good agricultural practice (for example, farm inspections by local authorities; grant assistance to farmers under the Farm Waste Management Scheme, Rural Environment Protection Scheme (REPS) and advisory schemes; EU-supported investment in farm waste management facilities) and the development of a nitrates action programme and regulations.

4.3 Energy efficiency

There is a large body of evidence to suggest that investment in energy efficiency is a cost effective way of reducing carbon emissions and improving the environment. The EU Commission's Action Plan for Energy Efficiency (2006) indicates that realising the Community's savings potential is a key element in EU energy policy, and

"... is by far the most effective way concurrently to improve security of energy supply, reduce carbon emissions, foster competitiveness and stimulate the development of a large leading-edge market for energy-efficient technologies and products".

The Action Plan suggests that the adoption of cost effective energy-saving measures would enable the EU to cut its energy use by over 20% by 2020. This includes reductions in CO₂ emissions of some 780 million tonnes (over 2005 baseline levels), which is more than twice the reductions needed by 2012 under the Kyoto Protocol. The Plan points out that the estimated savings would more than compensate for the additional investment expenditure in more efficient and innovative technologies. The EU Commission's estimates for full energy-saving potential by sector are summarised in Table 9.7. The largest potentials lie in residential households and commercial buildings – retrofitted wall and roof insulation (housing); improved energy management systems (commercial buildings); motors, fans and light (manufacturing) are noted as offering significant energy-saving opportunities. Savings in the transport sector include the impact of shifting to other traffic modes.

Table 9.7: Estimates for full energy saving potential, EU-25 by end-use sectors

Sector	Energy consumption (Mtoe) 2005	Energy consumption (Mtoe) 2020 business as usual	Energy savings potential 2020	
			(Mtoe)	%
Households (residential)	280	338	91	27%
Commercial buildings	157	211	63	30%
Transport	332	405	105	26%
Manufacturing industry	297	382	95	25%

Source: European Commission, 2005

Mtoe = million tonnes of oil equivalent. Energy savings potential for 2020 includes savings due to price effects, structural changes, natural replacement of technology and measures already in place.

Fiscal measures consist of changes to the tax base, tax rates or tax rules. In the context of energy saving this involves, for example:

- Tax breaks (such as incentives to encourage businesses to buy machinery that is more energy-efficient; tax credits for householders who insulate their homes), and
- Differentiation of tax rates (such as lower rates of tax in respect of purchases of greener houses or environmentally friendlier goods)

The Government's *Energy Efficiency Action Plan* was issued in May 2009, and reflects in Ireland the opportunities available at EU level.²⁵ Energy efficiency opportunities (in terms of reduction in energy use and carbon emissions) are identified for different sectors. Those that are of possible relevance in regard to tax intervention (regulation interventions are excluded) are shown in Table 9.8.

Table 9.8: Energy efficiency opportunities

Sector	Energy reduction in GWh	KtCO ₂ reduced
Business and Public Sectors		
SEI large energy agreements	4070	887
SEI small business supports	565	141
Renewable heat deployment	410	92
Accelerated capital allowances for energy efficient equipment	800	143
Residential		
Warmer homes (lower income households)	170	42
Home energy saving scheme (retrofit)	600	157
Greener homes (renewable)	265	64
Lighting	1200	210
Efficient boiler standard	2400	585
Transport		
Improved fuel economy of private car	1530	412
Electric vehicle deployment	955	350
VRT/motor tax changes	200	54
E working	150	40
Energy Supply		
Winter peak demand reduction	55	10

Source: Energy Efficiency Action Plan, Department of Communications, Energy and Natural Resources, May 2009, pp10-11
 GWh is a unit of electrical energy equal to a gigawatt hour (109 watt hours).
 KtCO₂ is 1,000 tonnes of CO₂.

In addition to the above, it is estimated that there are huge opportunities in the existing housing stock for retrofit intervention, comprising (number of units shown in brackets) attic insulation (500,000), cavity wall (62,000) and wall-lining (120,000) which would yield energy savings of 2,690 GWh per year, contributing over 8% of the 32,000 GWh reduction that Ireland is legally obliged to achieve by 2020.

Energy efficiency was a topic that featured strongly in our consultation process. We considered it to be a priority area for examination, as the ratio of benefit-to-cost was very high. We examined accelerated capital allowances for 'green' business equipment, favourable VAT rates for environmentally friendly goods, and mandatory energy reduction programmes for business.

Energy-efficient equipment in business

A scheme of accelerated capital allowances for companies purchasing certain 'green' equipment was introduced in the Finance Act 2008 and expanded in the Finance (No. 2) Act 2008. Eligible companies under the scheme are entitled to claim a 100% write-off of the cost of acquiring the energy-efficient equipment in the year in which the expenditure is incurred, compared with a 12.5% write-off over eight years, which is the normal rule for plant and machinery. Box 9.9 provides summary details.

Box 9.9: Accelerated capital allowances (ACA) for energy-efficient equipment

Product taxes should only be imposed if:

- Introduced in Finance Act 2008 for certain energy-efficient equipment bought by companies for use in their trade
- Applies to new equipment which:
 - Belongs to a category of technology defined in the legislation
 - Is on a list approved by the Minister for Communications, Energy and Natural Resources and maintained by Sustainable Energy Ireland
- Three categories introduced in Finance Act 2008 - motors & drives; lighting; building energy management systems. Four additional categories introduced in Finance (No. 2) Act 2008 – data server systems (ICT); heating and electricity provision; heating, ventilation and air conditioning systems; electric and alternative fuel vehicles
- Certain minimum expenditure limits apply for each category
- Scheme applies to equipment bought up to the end of 2010

We examined the accelerated capital allowances (ACA) scheme as part of our review of tax expenditures. We concluded that the measure should continue for its current term, and that it should be evaluated in accordance with our criteria for tax expenditures before any extensions are considered. See Part 8 of our Report for details.

We examined similar schemes in operation in the UK (since 2001) and in the Netherlands (since 1991). Under the Dutch provisions, the equipment or asset must not be in common use (where 'common use' is defined as having a market penetration of 30% or over), in order to provide an incentive for the development of new technology. An evaluation undertaken in the Netherlands in 2005 indicates that about 60% of the technologies on the list had been sponsored by the Government in an earlier phase of development under an R&D programme. This suggests that the accelerated depreciation scheme complements the R&D programme by encouraging the shift to new technology.

A limitation of the existing ACA provision in Ireland is that it does not encourage innovation and associated enterprise and job creation – only technologies from an approved list qualify. As the R&D programme focused on energy supply and energy efficiency develops, we recommend that the Dutch model of differentially favouring innovation should be seriously considered.

Differential VAT rates for "green" goods and services

A commitment to examine the reduction of VAT on certain environmental goods and services was included in the Programme for Government and was examined as part of our analysis of energy

efficiency. This would involve moving items that are currently standard-rated (now 21.5%) down to the 13.5% category. A lowering of the rate on 'green' items is not possible under existing rules²⁶. However, a proposal to examine amendments to the EU VAT Directive in order to reduce VAT on environmentally friendly goods (such as energy-efficient light bulbs and insulation materials) was instigated by France and the UK in March 2008. We recommend that Ireland should support this initiative at EU level.

Mandatory energy reduction programmes for business

Fiscal incentives to increase energy-saving measures in businesses have been implemented successfully in Europe. We note in component [6] of our carbon tax proposal that negotiated energy agreements have been successful in reducing emissions²⁷. We propose that businesses should be accommodated under the carbon tax scheme if they participate in an approved mandatory energy reduction scheme, based on Sustainable Energy Ireland's Energy Agreements Programme²⁸.

Tax is just one of several policy instruments used to promote energy efficiency. Non-fiscal measures include:

- Regulation (there is a comprehensive body of EU legislation on improving energy efficiency in products, buildings and services²⁹)
- Information campaigns to improve energy awareness
- Financial incentives in the form of loans and grants to promote the purchase of green products

We conclude that, in relation to energy efficiency, non-fiscal measures including the direct expenditure route are more appropriate in many cases. We do, however, propose the development of the accelerated capital allowance scheme, amendments to the VAT regime, and accommodation of non-ETS businesses, as indicated below.

Recommendation 9.5

Continue the Accelerated Capital Allowance for energy-efficient equipment scheme for its current term; evaluate the potential for expanding the scheme to incentivise innovation (based, for example, on the Dutch model).

Recommendation 9.6

Ireland should support amendments to the EU VAT Directive that would allow the implementation of lower VAT rates for energy-efficient goods and services.

Recommendation 9.7

Businesses that are not in the emissions trading scheme should be given a rebate on their carbon tax payments if they participate in an approved mandatory energy reduction programme.

26 There are two aspects. One, there is no scope under EU law to differentiate according to the environmental impact of a particular good or service - which means, for example that energy-efficient fridges can not have a lower rate than other fridges. Two, only goods and services listed in Annex III of the EU VAT Directive can have the reduced rate applied to them, which in practical terms means that the scope for change is restricted.

27 To take another example, under the UK climate change levy provisions companies were allowed an 80% reduction in their payment provided they entered an agreement to meet negotiated emissions reduction targets.

28 See: http://www.sei.ie/Your_Business/Energy_Agreements/ for details.

29 Examples include the Eco-Design Directive, the Labeling Directive, the Energy Star Regulation, the Directive on Energy End-Use Efficiency and Energy Services and the Energy Performance of Buildings Directive.

4.4 Transport

Transport-related greenhouse gas emissions are one of the fastest growing sectors outside the emissions trading scheme. Significant improvements have been made since the 1990s in relation to fuel efficiency, resulting in substantial reductions in average emissions per car – from 3.70 tonnes of CO₂ in 1990 to 3.44 tonnes in 2005 (industry estimates). However, these reductions have been more than offset by the growth in the fleet over the same period.

Any sustainable developments in transport require measures to influence and change personal travel behaviour. This is recognised in the Government's Transport Policy for Ireland 2009 – 2020³⁰, which proposes the following in relation to taxation:

"In the context of the Commission on Taxation Report due in 2009 we will consider the application of fiscal measures aimed at reducing car use and achieving a shift to alternative modes of transport, which will ease congestion, reduce further transport emissions and take into account economic competitiveness and social inclusion. Where necessary, we will carry out research to ensure effectiveness of this action."

Our analysis of fiscal measures in the transport sector was undertaken against the backdrop of the Transport Policy, which covers the period up to 2020. We support the introduction of fiscal measures aimed at reducing car use, as indicated above.

Existing transport taxation system

Currently, the tax treatment of motor transport comprises:

- a) Once off purchase tax: vehicle registration tax (VRT)
- b) Annual charge: motor tax, regardless of usage level
- c) Usage charge: auto fuel taxes, comprising excise duty and VAT
- d) Fiscal measures to encourage more environmentally friendly travel

Existing system – (a) VRT on car purchase

Vehicle registration tax (VRT) applies to new and used imported vehicles. Vehicles must be registered before they can be licensed for road tax purposes. The 'rebalancing' of VRT, under which the basis for assessing the tax is more aligned with CO₂ emissions, was introduced with effect from July 2008. Similar environmentally-friendly changes were introduced for motor tax and for business cars (capital allowances and leasing expenses). Summary details are shown in Box 9.10

Box 9.10: Rebalancing of motor charges to take account of CO₂ emissions

1. **Old system:** Tax based on engine size.
 - Main VRT categories (A1 = Cars up to 1,400cc, tax 22.5% of Open Market Selling Price; A2 = Cars 1,401 to 1,900cc, tax 25% of OMSP; A3 = Cars over 1,900cc, tax 30% of OMSP).
 - There was a minimum VRT tax of €315 on passenger cars. 50% VRT reduction for hybrid-electric and flexi-fuelled bio-ethanol mix vehicles.
2. **New system:** Tax based on emissions.

Band	2007	2007	2007	2007	2007
A	Up to and including 120g CO ₂ per km	14%	€100	At CVT*	At CVT
B	More than 120 – 140g	16%	€150		
C	More than 140 – 155g	20%	€290		
D	More than 155 – 170g	24%	€430	Lower of 50% CVT or car cost	50% of amount available pre July 08
E	More than 170 – 190g	28%	€600		
F	More than 190 – 225g	32%	€1,000	Do not qualify	Do not qualify
G	More than 225g	36%	€2,000		

* CVT = car value threshold, currently €24,000.

- A CO₂ emissions labelling system for cars, similar to the energy efficiency labels for white goods, underpins the new rules
- Hybrid electric and flexible fuel cars get relief of up to €2,500 on the VRT payable under the new system
- Electric cars and motor cycles have been exempted from VRT from 1 January 2008; exemption expires end-2010
- Electric cycles are exempt from VRT (as they are exempt from registration)

Existing system – (b) Annual motor tax

Motor tax rates have also been rebalanced, to align them with the emissions rating of the vehicle (see Box 9.10).

Cars under the pre-July 2008 motor tax system continue to be taxed based on engine size (cc). New cars registered from July 2008 are taxed based on CO₂ emissions level. New low CO₂ emitting cars purchased in the first six months of 2008 were switched to the CO₂ system on first renewal of motor tax after 1 July 2008. (Motor tax receipts are paid into the Local Government Fund, as opposed to the Exchequer.)

Existing system – (c) Auto fuel taxes

The cost implications of changing excise duty rates and the effects on the consumer price index (CPI) have been estimated as follows:

Table 9.9: Yield and CPI effects of changing excise rates

Cost of Increases (VAT inclusive)	1 cent	2 cent	3 cent	4 cent	5 cent	10 cent
Petrol: Cost €m	18.9m	37.4m	55.7m	74.1m	92.3m	182.7m
CPI (%)	.024	.047	.071	.094	.118	.236
Diesel: Cost €m	19.7m	39.4m	58.9m	78.4m	97.8m	193.5m
CPI (%)	.007	.013	.020	.026	.033	.065

Source – Department of Finance post Supplementary Budget 2009 figures

Excise duty and VAT amount to well over 50% of the Irish retail price of petrol and diesel. Excise duty is a specific tax (i.e. a rate per unit). This means that, as the price increases over time, the percentage of the price accounted for by excise duty will fall. VAT is an ad valorem tax (i.e. applied according to the value of the product). VAT is applied to the final pre-VAT price. This means that VAT receipts increase as prices increase, even if there is no change in rate. Ireland has low excise rates relative to our main trading partners, particularly the UK. Differences in tax rates between here and Northern Ireland may induce cross-border fuel tourism but this depends also on the euro-sterling exchange rate.

At 1 January 2009, our excise rates for diesel (€368.05 per 1,000 litres) and petrol (€508.79 per 1,000 litres) were about average across the EU – see Table 3.10 in Part 3 of our Report.

Table 9.10 shows the price and excise duty differentials between Ireland and Northern Ireland for petrol and auto diesel, using results from a cross border survey of June 2009.

Table 9.10: Cross border comparison – motor fuel (rates in €) June 2009

	ROI Price	ROI Excise	N.I. Price	N.I. Excise	Price Differential	Excise Differential
Petrol (litre)	1.21	0.51	1.28	0.64	-0.07	-0.13
Auto-diesel (litre)	1.07	0.41*	1.24	0.64	-0.17	-0.23

Source – Cross Border Price Survey 24 June 2009 – the Revenue Commissioners

* The diesel rate increased from €368.05 to €409.20 per 1,000 litres in Budget 2009.

Existing system – (d) Tax measures to promote environmentally friendlier travel

In addition to the rebalancing of VRT and motor taxes, there are a number of other provisions in the tax code in relation to the promotion of environmentally friendlier forms of transport and travel. Box 9.11 provides summary details.

Box 9.11: Other tax measures to promote environmentally friendly travel

- Tax incentives for alternative modes of transport:
 - The 'TaxSaver Commuter' ticket scheme (1999) under which employees receive bus or rail tickets either as part of their salary package, or in lieu of an annual bonus. Savings arise because tickets are not subject to tax or PRSI.
 - The tax incentive to promote cycling to work (2009), under which the provision of bicycles by employers to employees for this purpose is treated as a tax exempt benefit-in-kind.
- The excise relief scheme for biofuels (2006): This is aimed at reaching a 2% target for biofuels penetration of the transport fuels market (and CO₂ savings of over 250,000 tonnes per annum; details are in Box 9.3)
- Favourable VRT treatment: VRT exemption for electric cars and bicycles and reliefs from VRT of up to €2,500 for hybrid electric and flexible fuel cars (details are in Box 9.10)
- Workplace parking levies: Measure introduced in Finance (No. 2) Act 2008 involves a charge on free workplace parking. A charge of €200 per annum applies in the main urban areas to employees who use car parking facilities provided by their employer.

Proposed transport taxation system

We propose restructuring the tax treatment of motor transport so that VRT on cars purchased is phased out over time, and tax on registration is replaced by a tax on motor usage. This would comprise (a) increased fuel charges (including the carbon tax on emissions) and (b) road pricing. We also support targeted measures aimed at reducing usage of environmentally-damaging cars, and recommend that consideration should be given to the introduction of a new VRT scrappage scheme in this context. We do not propose any further changes to motor tax.

Proposed system – (a) abolition of VRT over 10 years

Linking CO₂ pollution costs more closely to the actual creation of the pollution (i.e. car usage rather than car purchase, as is the case with VRT) is a fairer and more effective means of reducing CO₂ emission levels. It means that revenue is raised from persons actually using the transport infrastructure and energy supplies. The EU published a proposal for a Directive in 2005, supporting the gradual abolition of registration taxes (VRT) in favour of circulation taxes (fuel taxes) with a CO₂ element. It was contended, among other things, that the wide range of different systems across Member States impeded the proper functioning of the internal market. However, opposition from Member States (including Ireland) has meant that this proposal has not progressed.

In Ireland, it has been estimated that the impact of switching from VRT to increased excise on fuels (petrol and auto diesel) would require price increases of over 30 cent per litre (VAT inclusive) in order to maintain tax yield.

The CPI implications (excise duty would be immediately passed on to customers) and concerns about transport costs (increased excise on fuel would favour those that have low car mileage and transport companies operating in regions where fuel costs are lower) were among the reasons for Ireland's opposition to the proposal.

Our analysis of the issue indicated further problems with changing the system:

- Competitiveness issues with the freight industry, where fuel usage was higher (and where increased efficiencies were seriously needed)
- There was no easy way to deal with the existing fleet, on which VRT would already have been paid, but the changeover would still result in much higher fuel prices
- The prospect of 'reverse fuel tourism', where higher prices in the Republic might encourage motorists to purchase fuel in Northern Ireland, which would result in a loss of tax to the Exchequer
- Adverse impact on rural dwellers who do not have alternative means of transport available to them

Nonetheless, we consider that the VRT system does not properly deal with the ongoing demands on the transport system and that it should, over time, be replaced by taxes on usage. We suggest that a changeover period of 10 years would minimise the problems in relation to the existing fleet of tax-paid vehicles. It would also allow for a more gradual increase in the price of fuel, to preserve tax yield - in this context, we note that there would be a significantly reduced tax return for used car registration in the final years of the phasing.

The competitive impact on the haulage sector is an issue, and some industry specific scheme may be required to address this³¹.

The two elements of usage taxes are fuel taxes and road pricing (which could include congestion charges).

Proposed system – (b) increases in fuel taxes

As noted above, increases in excise duty (and therefore, VAT receipts) would be needed to preserve the tax take if VRT were phased out. In addition, it is proposed in section 3.3 that a carbon tax on fuels should be introduced. Table 9.5 indicates that a carbon tax of €20 per tonne CO₂ would increase the price of petrol by five cents.

Definitive research in the area of excise duties on transport indicates that, in the long run, fuel demand is highly responsive to price changes. For example, Sterner (2007)³² indicates that:

- A 10% increase in fuel prices will lead to a decrease in demand for fuel (and thus carbon emissions) by 7 – 8%
- The adjustment process may take more than 10 years to materialise (response to price is very low in the short-run)

Proposed system – (c) road pricing/congestion charges

Box 9.12 summarises the key elements of road pricing and congestion charges schemes.

The national climate change strategy 2007–2012 indicates that consideration will be given to the introduction of fiscal measures to reduce demand for transport once adequate supply-side infrastructure – such as electronic tolls, for example – is in place. Other complementary instruments to increase the effectiveness of fiscal measures to reduce car use include adequate parking controls and traffic management systems, as well as the availability of alternatives, such as reliable and frequent public transport.

31 Vehicles, of course, would still have to be registered under the new system. The question of whether it might be more appropriate for a body other than the Revenue Commissioners to undertake this function (as there would not be a tax charge) is a matter that would need to be considered.

32 Sterner, T. op. cit.

The introduction of road pricing as part of a strategy to reduce car use was also raised as part of the consultation process. The arguments made were that distance-based road charges, which would vary according to emissions, geographical location and time of day, would encourage the purchase of more fuel-efficient vehicles, as well as reduced car usage. Simple design and early stakeholder buy-in (to reduce resistance) and early preparatory work – including a feasibility study of a national road pricing scheme – are recommended in the main proposal submitted to us on this³³.

Box 9.12: Road pricing and congestion charges

- **Road pricing:** Purpose is to provide incentives to road users to use road capacity more efficiently. Fees (price per kilometre) can be levied according to factors such as time of day, location, distance travelled, real time congestion or vehicle type. Experience in other countries suggests that a long lead-in time, with extensive consultation, is key to the successful implementation of road pricing
- **Congestion charges:** Cordon charges or area licences are used to promote the shift from personal car transport in selected areas. Schemes in London and Stockholm have been successful. The London charge reduced congestion by 30% and traffic levels by 18% when it was introduced. The Stockholm charge reduced weekday traffic by 22% and emissions by 12%. Adequate preparation and the availability of public transport alternatives are generally seen as key issues in relation to the success of congestion charge initiatives

Fiscal incentives to reduce emissions – scrappage scheme

It was suggested to us during the consultation process that an environmentally-focused VRT scrappage scheme, under which incentives would be given to motorists who traded-in cars that are over 10 years old against low emissions new cars, would help to reduce CO₂ emissions from cars in use on our roads.

While we suggest that benefits of a car scrappage scheme are greatest in countries with a car manufacturing industry, we conclude that such a scheme may have some merit. Any scrappage scheme should be time-bound and carefully targeted. It should focus on promoting the use of environmentally friendly vehicles. For example, a scheme focussed on encouraging a switch to very low carbon emitting vehicles (such as electric, hybrid electric and flexible fuel vehicles) may be appropriate at some stage in the future.

Conclusions on transport

We support targeted fiscal measures aimed at reducing car use. Such measures should only be implemented where alternatives are available. We also support fiscal measures that help the environment by leading to the purchase of newer, cleaner cars. We welcome the rebalancing of motor charges to take account of CO₂ emissions, because it provides a clear incentive to motorists to make environmentally friendlier car purchasing choices.

33 Some detail on road charging as it could be applied in Ireland, based on the Dutch model, is provided in: http://www.comharsdc.ie/_files/Comhar%20STIAP%20report.pdf

Recommendation 9.8

The VRT system should be replaced by a system based on car usage, in the longer term. Such a system should be introduced over a 10-year period in order to minimise adverse impacts (in relation, for example, to the existing fleet of tax-paid vehicles).

Recommendation 9.9

A focussed scrappage scheme, targeted at encouraging a switch to the purchase of electric and very low carbon emitting vehicles, should be considered.

Section 5:

Revenue neutrality and carbon tax

5.1 Introduction

Our terms of reference indicate an intention that environmental measures should be revenue neutral. In particular, we are asked to have regard to the commitment in the Programme for Government

“to introduce measures to further lower carbon emissions and to phase in on a revenue neutral basis appropriate fiscal measures including a carbon levy over the lifetime of the Government...”

From an Exchequer point of view, revenue neutrality is generally taken to mean that there is no overall increase or decrease in Exchequer receipts because of the measure. We agree with this approach. We consider that our carbon tax proposal, outlined in Section 3, should not lead to an increase in the overall burden of taxation. In other words, the net Exchequer position should be the same after the carbon tax is introduced as it was before.

A number of the submissions that we received referred to revenue neutrality, predominantly in the context of environmental taxes. Some of the suggestions covered using carbon revenues to ‘fund’ reductions in other taxes. Other submissions covered earmarking revenues for environmentally-related spending. The importance of using carbon tax revenues to combat fuel poverty, so that those on low incomes are compensated for the increase in fuel prices that would result from a carbon tax, featured strongly, and we consider this to be a priority area.

5.2 Use of the carbon tax revenue

We recommend that carbon tax revenue should be used, in the first instance, to combat fuel poverty. The overall effects of the carbon tax on vulnerable households should be appraised to ensure that such households (urban and rural) are cushioned from the effects of the tax.

We suggest that measures to address fuel poverty should be biased towards schemes that target energy efficiency. It is important that the incentive created by the carbon tax to reduce emissions is not negated, so measures that preserve the incentive of the tax to change polluting behaviour are generally preferable. We accept that in some cases, however, direct monetary transfers through the social welfare system may be appropriate.

The combating of fuel poverty will improve living conditions for the most vulnerable sectors of society. Reduced greenhouse gas emissions and employment opportunities (through, for example, energy efficiency measures for social housing and low-income private households) are additional benefits.

The recycling of carbon tax revenues to fund energy efficiency incentives for businesses and households featured strongly in the consultation process. We also consider that this would be an appropriate use of carbon tax revenues. Suggestions that were made to us include:

- Funding of loans at favourable rates to business to finance investment in energy-saving products. (Along the lines, for example, of the scheme run by the Carbon Trust in the UK, which offers interest-free loans repayable over four years to enterprises which have been trading for at least 12 months to help them to replace or upgrade their equipment), and
- Grants to householders towards expenditure on insulation and other energy-saving measures

It is important that the competitive effects on energy-intensive businesses of the proposals in this Part of our Report are taken into account; carbon tax revenues might also be used for this purpose. At a more general level, the availability of carbon tax revenues to fund the lowering of direct taxes to improve competitiveness and lessen the labour tax wedge is a valuable policy tool.

We conclude this Section by emphasising that revenue neutrality is not an 'optional extra' in relation to carbon tax and recycling should address fuel poverty in the first instance. Competitiveness issues are also very important; carbon tax revenues should also be used to address this. In all cases, the uses to which the revenue is put should be transparent and open to scrutiny.

Section 6: The green economy

6.1 Introduction

The climate change challenge for Ireland is outlined in Section 3. The environmental agenda poses risks, but also creates business opportunities for Ireland. The green collar jobs and growth agenda, or 'green new deal' has gained considerable momentum in the time we were in session. A number of countries have already developed initiatives that are very large in ambition and scope – notably China, South Korea and the United States³⁴. The European Economic Recovery Programme focuses on investment in energy infrastructure, energy efficiency in buildings and research and development (green cars and energy efficiency in buildings).

The Green New Deal economy has two distinct strands:

- Conventional investment that uses proven existing technologies to generate jobs and improve economic, financial environmental and social performance – investment in energy conservation for the relatively deprived is characteristic of this strand
- Innovation that allows better and cheaper ways of generating employment, reducing pressure on the environment, and supporting social objectives. Hybrid cars and cheaper and more effective ways of insulating homes are examples

34 In China and South Korea, the focus is on conservation (low carbon vehicles, renewable and clean energy and recycling); quality of life (green neighbourhoods and housing); environmental protection (including flood defence); and infrastructure (IT and green transport networks). In the USA, the American Recovery and Reinvestment Act 2009 (ARRA) provides \$94 billion for low carbon power (mainly renewables), \$27.5 billion for energy efficiency in buildings, \$4 billion for low carbon vehicles, around \$10 billion for rail and \$11 billion to upgrade the electricity grid.

Sustainable growth in the future depends on securing niches in the second of these strands. The move towards taxing 'bads' – pollution and environmental degradation – reflects the reality that not pricing the use of scarce environmental endowments is an expression of market failure; it also creates a demand for alternative products and technologies and creates an incentive to improve efficiency and innovation.

6.2 Opportunities for Ireland

An indication of what the opportunities for Ireland might be is given in a 2008 report by Forfás and InterTradelreland on Ireland's Environmental Goods and Services (EGS) sector³⁵. Key findings from the report are contained in Box 9.13.

Box 9.13: Some key findings from Forfás/InterTradelreland study, October 2008

- Globally, investment has been increasing dramatically in the EGS* sector in recent years – it was the fourth largest venture capital investment category in North America in the first quarter of 2008
- Value of the EGS sector in the Republic is conservatively estimated at €2.8 billion, with Northern Ireland accounting for an additional €780 million
- In Ireland, the sector is made up of a small number of major players with a high proportion of SMEs. The drivers seen to be facilitating growth are listed as:
 - Compliance with EU environmental legislation
 - Rising energy costs, climate change considerations, green consumerism
 - Increasing public investment in environmental services/infrastructure
 - Increasing investment in energy and environmentally-related R&D, and
 - Green public procurement
- A targeted approach focussing on five key areas with the greatest growth potential is suggested, in the light of the drivers, international trends and research on the existing enterprise base. The areas are:
 - Renewable energies
 - Efficient energy use/management
 - Waste management, recovery, recycling
 - Water and wastewater treatment, and
 - Environmental consultancy services

** The OECD broadly defines the EGS sector as follows: The environmental goods and services industry consists of activities which produce goods and services to measure, prevent, limit, minimise or correct environmental damage to water, air or soil, as well as problems related to waste, noise and eco systems. This includes cleaner technologies, products and services that reduce environmental risk and minimise pollution and resource use.*

6.3 Conclusions for Ireland

We recognise that the environmental goods and services sector has been identified as a growth area of the economy. Fiscal measures – not least the improvements identified in this Report – have a role to play in this. The implementation of our portfolio of recommendations, including – carbon tax, metered water charges, waste charges, road charges, not taking gains from EU ETS

35 "Environmental Goods and Services Sector on the Island of Ireland – Enterprise Opportunities and Policy Implications" InterTradelreland and Forfás, October 2008.

allowances, accelerated capital allowances for energy efficient equipment, favourable VAT rates for environmental goods and the offset of R&D tax credits against employer PRSI costs – are key to Ireland's prospects of success in this emerging world.

Our measures provide a context and set of incentives that, if implemented, will encourage and facilitate improved environmental performance and will also provide a basis for both conventional business using existing technologies, and for knowledge-led enterprise built on innovation.

Our recommendations of most relevance to the green economy agenda are brought together in Table 9.11.

Table 9.11 relevant to the green economy

Measure	Comments
Carbon tax <i>Recommendation 9.1 in this Part</i>	This signals that there is an immediate cash flow to be generated by those who can reduce emissions. It is the essential pre-requisite for both strand 1 (conventional investment) and strand 2 (innovation) that we mention in section 6.1. It will enhance the justification for business investment in energy-efficiency and renewable energies.
Metered water charges <i>Recommendations 11.13 to 11.21 in Part 11, Local Government Financing</i>	This provides a number of benefits: • It encourages water conservation, which prevents or delays the costs and ecological and other disruptions of major supply schemes such as the transfer of water from the Shannon to Dublin • It reduces the waste of water that has been very expensively captured, stored, treated and transferred to consumers • It creates a business in the development and provision of water saving technologies and techniques • It is equitable – those who consume least do not subsidise those who consume most
Charges for final disposal of domestic and industrial waste <i>Recommendations 11.22 and 11.23 in Part 11, Local Government Financing</i>	These create the context where reduction in waste, recycling and re-use are all enabled and become more commercial.
Phase out of VRT and replacement by charges <i>Recommendation 9.8 in this Part</i>	The big payoffs to this approach are the reduction in congestion, the associated benefits of hugely improved traffic flow for buses and public transport, and the strong incentive to use very efficient, low environmental impact transport (personal car, walking, cycling, or public transport). The green business opportunities come from the enhanced attractiveness of investment in low impact alternatives, the improved mobility of labour, and the enhancement of quality of life for residents and visitors.

Conclusion not to tax the gains resulting from the free allocation of allowances in the EU ETS over the 2010-2012 <i>Recommendation 9.1.7 of the carbon tax – Section 3 of this Part</i>	Our analysis of carbon tax included possible taxation of gains from the free allocation of allowances in the EU Emissions Trading Scheme (EU ETS) over 2010-2012. We decided against this course of action. This decision will contribute to funding the transformation of the ESB into a zero emissions company, the renewal of the grid and the time of day metering of electricity. The business opportunities will include rapid expansion of renewables and energy efficiency technologies.
Accelerated capital allowances for energy-efficient equipment <i>Recommendation 9.5 of this Part</i>	The ACA scheme in itself is likely to stimulate demand for more energy efficient equipment. As such, it will improve energy and environmental performance, but is unlikely to stimulate new enterprise, because it only applies to existing technologies. Our recommendation on the expansion of the scheme to incentivise innovation would help overcome this limitation.
Supporting favourable VAT rates for environmentally friendly goods <i>Recommendation 9.6 of this Part</i>	If enacted by the EU, this will stimulate demand for goods that fit this description, and encourage substitution away from the alternatives. The extent to which this creates business and employment in Ireland depends on the extent to which entrepreneurs can respond and innovate to meet the new opportunities.
Option for companies to offset the R&D tax credit 'above the line' <i>Recommendation 7.20 in Part 7, Supporting Economic Activity</i>	Allowing companies to elect to offset the R&D tax credit against their employer PRSI costs will help the innovation-led economy of the future. We note also that the measures we propose to support business generally in Part 7 – such as the removal of tax barriers and help for new enterprise – will also have a role in developing the green economy.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 10

TAX INCENTIVES FOR RETIREMENT SAVINGS



Part 10:

Tax incentives for Retirement Savings — *consider how the tax system can encourage long term savings to meet the needs of retirement*

Section 1 is an introduction.

Section 2 describes the general context.

Section 3 summarises the tax treatment of the supplementary pension provision.

Section 4 sets out criteria to encourage long-term savings to meet the needs of retirement

Section 5 contains our review of options for tax relief.

Section 6 describes a new retirement savings scheme.

Section 7 contains a summary of our overall recommendations.

Section 8 deals with other issues related to the tax treatment of retirement provision.

Appendices 1 and 2 contain supplementary information.

Our recommendations in this Part are as follows:

10.1	The regime for non-funded pensions should be examined to identify the implicit tax cost to the Exchequer in the context of an equitable distribution of the tax expenditure on pensions.
10.2	The current tax relief for personal retirement provision should in the medium to long-term be replaced by a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer.
10.3	The matching contribution approach should be accompanied by a kick-start provision involving a contribution of €1 for each €1 contributed by the taxpayer in the first, say, five years of pension provision by an individual.
10.4	The matching contribution should apply where an individual has relevant earnings including where, because of the level of his or her earnings, the individual is not liable to tax.
10.5	A soft-mandatory approach could make a significant contribution to increasing pension coverage and should be considered.
10.6	An employee's payslip should show the amounts contributed by the Exchequer to the employee's retirement savings.
10.7	A retirement savings scheme along the lines of the former SSIA scheme, that is easily understood and which involves an Exchequer contribution, should be introduced – the scheme is outlined in Box 10.16 of Part 10.
10.8	- As the annual earnings limit does not apply to employer contributions, there is a need to retain the standard fund threshold. - There should be a correlation between the annual earnings limit and the standard fund threshold, and the reduction in the annual earnings limit suggests that there should be a corresponding reduction in the standard fund threshold.
10.9	A lump sum taken on retirement should be liable to tax as follows: - An amount of up to €200,000 should be tax free. - The balance of the lump sum should be subject to tax at the standard rate of income tax.
10.10	The current tax relief rules should be reviewed to ensure that contributions and remuneration levels cannot be manipulated close to retirement to allow individuals to take advantage of unintended and inappropriate benefits.
10.11	Age-related limits on the amount of an individual's relevant earnings should continue.
10.12	The flexibility of an ARF should be extended to defined contribution occupational pension schemes.
10.13	Anomalies in the treatment of different retirement arrangements should be eliminated as far as possible.
10.14	The various ages specified in the legislation governing the time at which benefits may commence should be reviewed and conformed.

Section 1:

Introduction

1.1 The pensions remit

As part of our terms of reference, we were asked to consider how best the tax system can encourage long-term savings to meet the needs of retirement. Our examination is conducted within the context of the overall pensions system in Ireland, which is the subject of the Green Paper on Pensions¹, and two of our terms of reference in particular:

- Consider how best the tax system can encourage long term savings to meet the needs of retirement
- Review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of any which are unjustifiable on cost/benefit grounds

1.2 Saving for retirement

A State pension is provided through the social welfare system. The pension is intended to provide an adequate basic standard of living in retirement. In many cases the State pension is supplemented by private pension arrangements, generally through occupational pension schemes and personal pension plans, which are regulated by the State and are afforded support through the tax system.

Some people save to meet their retirement needs in other ways, for example through personal investments including real property. Home ownership can also be regarded as a part of the provision for retirement. The tax system affords relief on some, but not all, of these other savings mechanisms. People who are not high-rate taxpayers are less likely to avail of such savings mechanisms to accumulate assets.

1.3 Coverage and adequacy

The gap in coverage – whereby some individuals have limited capacity to save for retirement (or choose not to do so), and instead rely on the State pension to meet all of their needs – forms a backdrop to our deliberations. A key consideration in our examination of this issue is our changing demographics. By 2061, Ireland will move from an old-age dependency ratio of six people of working age to every one person aged 65 or over, to a ratio of 2:1 – in other words, just two people of working age to every one person aged 65 or over.

Unless there is more personal saving for retirement in the meantime, there is likely to be a significant gap in coverage. Various studies² have identified the gaps in pension coverage. We consider how best the tax system can contribute to closing those gaps by encouraging long-term savings to meet the needs of retirement.

Much work has already been done to identify the range of policy issues that need to be addressed and these are set out in the Green Paper on Pensions (2007). Section 7 of the Green Paper raises a number of options and poses a number of questions on incentives to encourage savings for retirement. We considered these and other options.

¹ Green Paper on Pensions (2007)

² OECD Economic Surveys: Ireland 2008 / Green Paper on Pension (2007) Section 3

There is no agreed methodology for measuring progress, nor is there any reliable means of gathering information in relation to the adequacy of retirement provision. However, the National Pensions Review found that there were a number of sources of data which might show a reasonable picture of the situation. The targets and adequacy of the National Pensions Review are set out in Box 10.1.

1.4 Market conditions

We share the general concern that a significant number of people in Ireland are not making adequate provision for their retirement. Our analysis and conclusions in this Part are informed by that concern. As regards our remit to consider the role of the tax system in encouraging people to make such provision, we are clear that the tax system alone will not address the problem – although it is now, and can continue to be, a part of the solution. There are also a number of equity issues in regard to the tax treatment of retirement savings and we took these into account.

We were mindful, in our deliberations, of the realities that the changed economic climate and the recent performance of pension funds is not making it easy for individuals to decide to invest in pension arrangements. In this Part of our Report, therefore, we are putting forward a model through which the tax system could make a contribution to encouraging people to save for their retirement and which addresses the equity principle.

One aspect of the model we present, that of giving a matching contribution, is appropriate to a more stable economic and retirement savings environment than exists at the time of publication of our Report. It is presented as a model for the medium to long term and as a contribution to the wider debate. A comprehensive examination of a range and mix of options and which is needed as a matter of urgency. The Green Paper on Pensions (and the impending White Paper) provides a timely framework for that debate.

Section 2:

General context relating to retirement provision

2.1 National pension policy initiative

In 1998, the National Pensions Policy Initiative (NPPI) was published by the Pensions Board in conjunction with the Department of Social and Family Affairs. The NPPI set targets in relation to pension coverage and adequacy. These are set out in Box 10.1.

Box 10.1: NPPI targets

- The Board has come to a judgement that it would be reasonable to measure adequacy of gross retirement income from all sources (including lump sums and gratuities and other accumulated assets) against a benchmark of 50% of gross pre-retirement income subject to a minimum of 34% of average industrial earnings together with any associated adult dependant's allowance
- In summary, the Board considers that comprehensive achievement of an adequate level of income over a lifetime would involve an ultimate goal of some 70% of the total workforce over age 30 making, or having, supplementary pension provision. However, it will clearly take many years to reach that goal

The targets were reviewed in the National Pensions Review (NPR), which was published by the Pensions Board in October 2005. The view taken in the NPR was that the NPPI coverage and adequacy targets would not be met without some change to the existing voluntary pension system.

2.2 Towards 2016

In the Social Partnership agreement, Towards 2016, the parties agreed that all retired people should have adequate incomes; that the level of coverage of occupational pension schemes should be increased; and that the social partners would co-operate to promote improvements in the coverage of pension schemes towards the agreed NPPI target of 70% of the total workforce over age 30.

2.3 Programme for Government (2007-2012)

The Programme for Government 2007-2012 includes commitments relating to pension provision. These are set out in Box 10.2.

Box 10.2: Programme for Government 2007-2012

- Increase the basic State pension by around 50% to at least €300 per week by 2012
- Seek to develop imaginative proposals in the context of the Green Paper, and in consultation with the social partners, to provide an SSIA-type scheme in an effort to make supplementary pension provision more attractive to those on low incomes
- Aim to secure the target of at least 50% of pre-retirement earnings from all sources, including social welfare supports, private and occupational pensions, and savings and investments
- Remove anomalies identified in the pension system
- Ensure women are treated fairly in pension provision

2.4 The current arrangements regarding pension provision

The current arrangements regarding pension provisions are made up of two pillars. These are as follows:

The first pillar

The State pension comprises: a contributory pension for those who satisfy the PRSI contribution conditions, and a non-contributory pension, which is subject to a means test, for those who do not qualify for a contributory pension³. The State pension is intended to meet basic living needs.

The second pillar

This involves private pension arrangements intended to supplement the State pension. Supplementary provision is not mandatory. People are assisted through the tax system to make supplementary pension provision. Supplementary pension provision includes:

³ State pensions (transition) can be claimed at age 65 if the person is retired from full-time employment and satisfies social insurance contribution conditions. The State pension (contributory) can be claimed at age 66 or over, once social insurance contribution conditions are satisfied. The State pension (non-contributory) is a means-tested payment for people aged 66 or over who do not qualify for the State pension (contributory) based on their social insurance record.

- Occupational pension schemes: Provided in the public and private sectors, generally on a voluntary basis, by employers for their employees. Funded either jointly by employers and employees, or by the employer alone
- Personal pension schemes: Consist of retirement annuity contracts (RACs) (used mainly by the self-employed) and personal retirement savings accounts (PRSAs). They are voluntary⁴.

2.5 Occupational pension schemes

There are a number of types of occupational pension schemes as follows:

Defined benefit schemes

In the past⁵, the most common form of occupational pension scheme was a defined benefit scheme. Under this type of scheme, the pension and other benefits to be paid to members and their dependants are specified in the scheme rules, and are generally linked to final salary. The employer carries the investment and longevity risks⁶.

Defined contribution schemes

Another type of occupational scheme, the defined contribution scheme, is becoming more widely used. Under these schemes, the individual member's benefit is determined solely by reference to the contributions paid into the scheme, and the investment return earned on those contributions. The value of the pension at retirement depends on fund performance and interest rates at the time a pension annuity is purchased. In these schemes, the member bears the risk of investment performance by the fund.

Hybrid schemes⁷

Some more recent schemes combine elements of both the defined benefit and defined contribution approaches. A hybrid scheme is one that is neither a full defined benefit nor a full defined contribution scheme, but has some of the characteristics of each. In hybrid schemes, the risk is shared between the employer and the employee.

Table 10.1 sets out the numbers of schemes in each category.

4 In the sense that there is generally no obligation on individuals to effect any form of pension arrangements for themselves, or on employers to provide pension benefits for their employees (employers are obliged to offer a PRSA facility to their employees but are not obliged to contribute).

5 In substance, there have been no new defined benefit schemes. According to the Pensions Board, the registration of 237 new defined benefit schemes with the Board in 2008 should be seen in the context of 285 deregistrations in that year. Almost all of the new schemes were restructurings. The balance were schemes that had previously failed to register.

6 There is an overriding risk of the employer being unable to fund the scheme adequately due to solvency issues.

7 Examples of hybrid schemes would include: "career average" schemes, where the benefit offered is based on the average earnings throughout the member's entire career and "combination" schemes, where defined benefit applies to the first portion of a person's earnings and defined contribution applies to earnings above that portion.

Table 10.1 – Occupational pension schemes December 2008

Scheme size	Defined benefit		Defined contribution	
	No. of schemes	No. of members	No. of schemes	No. of members
Non group	29	29	68,504	68,504
1 to 50	749	12,660	21,330	89,277
51 to 99	156	11,511	332	22,952
100 to 500	230	53,097	222	41,338
501 to 1000	48	33,261	19	13,422
1001 +	59	469,364	17	36,704
Total	1,271	579,922	90,424	272,197

Source: The Pensions Board Annual Report and Accounts 2008

Note: Excludes AVC only, Death Benefit only, frozen schemes and schemes in wind-up. Hybrid schemes are not registered as a separate category.

2.6 Personal pension arrangements

Personal pension arrangements consist of RACs used by the self-employed and PRSAs. These contracts and accounts are similar to defined contribution pension schemes in so far as the investment risk lies solely with the individual who takes out the contract or account. Details are as follows:

Retirement annuity contracts (RACs)

An RAC is the formal name for what is normally called a personal pension. An RAC is a type of insurance contract approved by the Revenue Commissioners. The value of the ultimate benefits payable from the contract depends on the level of contributions paid, the investment return achieved, and the cost of buying the benefits. The total number of RACs is approximately 200,000⁸.

Personal retirement savings accounts (PRSAs)

PRSAs were introduced in 2002 as a flexible and portable pension product that can be used by everyone - employees, self-employed or unemployed. They are divided into standard and non-standard products. A PRSA is a long-term personal retirement account that enables a holder to save for retirement in a flexible manner. It is a contract between the account holder and a PRSA provider in the form of an investment account.

Like an RAC, the value of the ultimate benefits payable from the account depends on the level of contributions paid, the investment return achieved and the cost of buying the benefits. PRSAs are mainly vehicles for retirement savings for those who are not members of occupational pension schemes or those who make additional voluntary contributions (AVCs). Employers who do not provide an occupational pension scheme must provide access to a PRSA for their employees. Table 10.2 sets out the take-up of PRSAs since 2003.

Table 10.2 - Cumulative take up of PRSAs since 2003

Year	2003	2004	2005	2006	2007	2008
Standard Product	14,686	36,557	53,001	72,761	100,229	119,436
Non Standard Product	4,336	9,700	15,256	22,284	30,480	36,196
Total	19,022	46,257	68,257	95,045	130,709	155,632

Source: The Pensions Board Annual Report and Accounts 2008

Note: A standard PRSA is a contract that has a maximum administration charge of 5% on the contributions paid and 1% per annum on the assets under management. Investments are only allowed in pooled funds which include unit trusts and life company unit funds.

A non-standard PRSA is a contract that does not have maximum limits on charges and/or allows investments in funds other than pooled funds

2.7 Demographic considerations

Ireland's dependency ratio is six people of working age for every one person aged 65 or over. This dependency ratio is set to change dramatically in the coming decades:

- The overall size of the population is projected to reach approximately 6.5 million by 2050⁹
- The population share of those aged 65 and over is expected to more than double between now and 2050, from 11% to 28%. It is also likely that people will live longer
- In contrast, the population share of those of working age is projected to gradually decline during this period, from 69% to 57%
- The upward trend in the old-age dependency ratio implies that Ireland will move from having six people of working age for every older person, to two working for every one in retirement by 2050¹⁰

Because of these demographic considerations, the burden of providing the State pension in the longer term will increase, as lesser numbers of people will be working to support a greater number in retirement.

It is critical that provision is made for this eventuality. Individuals must be encouraged to make immediate and more adequate provision for their retirement. The available options include:

- Joining an occupational pension scheme, taking out a PRSA or entering into an RAC, all of which attract tax relief
- Accumulating other savings such as deposits, shares, bonds, fund investment, investment in property or in a business. While not all such savings are tax relieved, they could nonetheless contribute towards an adequate income in old age¹¹. These assets can, of course, be accessed at retirement, if they still exist, but they are not linked specifically to retirement because they can equally be accessed and used at an earlier stage. Consequently, they are not given further consideration here

⁹ Source Department of Finance projections based on CSO data.

¹⁰ Green Paper on Pensions Paragraph 3.4.

¹¹ Home ownership also makes a contribution to retirement provision. A retired person who owns his or her own home, and whose mortgage has been repaid, will not have to incur the expense of providing a home. In addition, a person may be in a position to release some equity from his or her home. The tax system does not provide relief for home ownership in the context of provision for retirement. However, there are provisions within the tax system that support home ownership.

2.8 Gaps in retirement savings coverage

NPPI targets

The NPPI set out targets for first and second pillar pension coverage and adequacy. As Table 10.3 shows, progress has been slow in meeting the NPPI target for second pillar pension coverage of 70% of those in work aged between 30 and 65. That said, coverage has increased in recent years, and in 2008 stood at 61% of the target age group. Coverage under the private pension system has been measured at various points over the past decade.

Table 10.3 - Progress since 2002 towards NPPI supplementary pension coverage targets

		2002 CSO survey	2008 CSO survey	NPPI 2003	NPPI target ¹²
Pension coverage – all workforce		51%	54%	53%	60%
Pension coverage	Aged less than 30	36%	37%	34%	35%
	30 to 65	58%	61%	62%	70%
Pension coverage	Men	56%	56%	54%	59%
	Women	45%	50%	51%	61%
Pension coverage	Self-employed	44%	46%	36%	44%
	Employees	53%	56%	58%	64%

Source: National Pensions Review (2005). This table refers only to coverage and not to adequacy

While the above table illustrates that progress has been made towards reaching the NPPI targets, it is estimated that approximately one million people in the workforce still have no supplementary pension provision. Although there are differences between the CSO and NPPI figures, there remains a considerable gap between the 70% target and the 61% achieved.

2.9 Sectoral position

Annual surveys and updates¹³ undertaken by the CSO between 2002 and 2008 provide estimated breakdowns of pension coverage by economic sector, hours of work, occupation and company size. The broad patterns arising over that period are shown in Box 10.3.

¹² To be achieved in the period after 2013.

¹³ CSO Quarterly National Household Survey: Pensions Module

Box 10.3: Patterns in pension coverage 2002-2008

- The sectors that had below-average coverage in 2002 showed similar patterns in 2008. The agriculture, construction, wholesale, retail and hotel and restaurant sectors are below the average occupational coverage level for employees, which is 56%. The self-employed (46%) show less variation by sector
- Part-time workers have lower than average coverage levels, as do employees of small companies
- Higher professional and technical occupations report higher than average coverage
- The public service pension schemes provide benefits on retirement for staff in the civil service, local authorities, Garda Síochána, the defence forces, the health and education sectors and in non-commercial State bodies. Employee coverage is close to 100% across the public service, with most new recruits, including atypical and part-time workers, becoming members of schemes¹⁴. This would suggest that coverage is lower in the private sector than the data in Table 10.3 would suggest, given that it is based on averages

2.10 Factors that contribute to less than adequate supplementary pension coverage

The reasons people do not save for retirement, despite the tax reliefs available, include some of the factors set out in Box 10.4, based on data compiled by the CSO¹⁵.

Box 10.4: Reasons why people do not save for retirement

- Never got around to organising a pension (32.5%)
- Cannot afford a pension (26.9%)
- No scheme available through work (8.4%)
- Other income source adequate (5%)
- Do not understand pensions (3.4%)
- Spouse's or partner's pension is sufficient (2.6%)
- Unable to access pension prior to retirement (0.9%)
- Other reason/do not know (20.3%)

Our consultation process revealed a number of other reasons that may contribute to less-than-adequate supplementary pension coverage. These include:

- Complexity
- Lack of transparency
- Lower income groups given lower level of tax relief on contributions
- Perceived lack of value of investment products
- Expectation that spouse's or partner's retirement income will be the main income source
- Lack of a consistent level of income
- Breaks in income
- Fund administration costs

¹⁴ This excludes commercial semi-State bodies. In addition, pension survey data is not broken down in such a way that would provide for a comparison between public and private sectors.

¹⁵ Quarterly National Household Budget Survey, December 2006

2.11 Gaps in adequacy of pension contributions

The National Pensions Review (2005) highlighted the difficulties involved in assessing the adequacy of pension contributions. There is no agreed methodology for measuring progress, nor is there any reliable means of gathering survey information in relation to the adequacy of contributions. However, the National Pensions Review found that there were a number of sources of data which, taken together, allowed it to build a reasonable picture of typical supplementary pension provision. The main findings are set out in Box 10.5.

Box 10.5: Findings of National Pensions Review (2005) on adequacy

- The majority of private sector defined benefit schemes will provide benefits greater than the NPPI target at retirement, for those who have spent most of their working life in the scheme. However, most people in the private sector do not remain with the same employer throughout their working lives
- The great majority of defined contribution scheme members are unlikely to have a retirement income equal to, or greater than, the NPPI target, irrespective of the length of time they are members of the scheme
- Additional voluntary contributions (AVCs) are increasingly likely as scheme members approach retirement. However, the typical contribution rate is unlikely to provide NPPI target benefits
- It is difficult to draw conclusions about adequacy from PRSA and RAC data, because of the lack of income data in the latter case, and because savers may have multiple contracts
- Inflation can erode the value of the benefits in retirement surprisingly quickly. For instance, over the 10 years to 2004, a period that would be considered to be one of comparatively low inflation, a pension of a fixed amount would have lost one quarter of its real value

Since the NPR was published, the position has been further exacerbated by the fall in value of pension assets. Ongoing volatility in world financial markets continues to be a source of serious concern for pension savings, many of which have suffered significant investment losses since 2007. It has been estimated by the Pensions Board that approximately 90% of all defined benefit schemes are underfunded and will not meet the requirements of the minimum funding standard. The unprecedented fall in the capital markets affects all forms of private pension provision, and will make achieving NPPI targets more difficult.

We are of the view that income adequacy in retirement can be improved by a package of measures that would encourage people to begin saving early and allow them to continue the saving habit during breaks in their career, in moving from one employment to another, or in switching to self-employment.

Section 3:

Current tax treatment of supplementary pension provision

3.1 Introduction

Individuals are encouraged to supplement the State pension with private pension arrangements through tax relief on private pension provision. Just over half of those in employment belong to a

voluntary private pension scheme – see Table 10.3.

Support for supplementary pension provision in the tax system usually involves the deductibility for income tax purposes of contributions made to supplementary pension arrangements¹⁶. The income tax relief (subject to rules regarding caps and limits) is set out in Box 10.6.

Box 10.6: Relief for pension contributions

- Contributions made by employees under an approved occupational scheme are deductible for income tax purposes
- Contributions made by the employer to an approved occupational scheme are not charged to tax as a benefit-in-kind
- Payments made to a PRSA are deductible for income tax purposes
- Premiums paid under an RAC are deductible for income tax purposes

The Public Service Pension Levy is an amount deducted from the remuneration of public servants. All such amounts are deducted in calculating taxable income¹⁷.

In addition to the tax reliefs outlined in Box 10.6, income and gains generated by the investments held by the schemes are exempt from tax. Benefits payable on retirement are taxable, subject to an entitlement to take a tax-free lump sum.

For individuals in funded pension schemes, the overall aggregate earnings limit on tax relieved contributions for the purposes of calculating relief is €150,000 in 2009 (reduced from €275,239 in 2008). There is also a limit on the capital value of tax relieved pension benefits that an individual can draw down. This limit, known as the standard fund threshold is €5,418,085 for 2009 (unchanged from 2008).

The main features of the tax treatment of each arrangement available for supplementary retirement savings are described below and further information on each of these products is set out in Appendix 1.

From the description of the main rules and tax reliefs available, it is clear that there are anomalies in the tax treatment of the various arrangements. These are discussed in section 8 of this Part.

3.2 Occupational pension schemes

Contributions made by employees

Contributions made by employees are deductible for income tax and PRSI¹⁸ (including health contribution levy but excluding the income levy) purposes and tax relief is applied at the individual's marginal income tax rate. The amount of employee contributions that can be tax-relieved is limited to an age-related percentage amount of the employee's remuneration as follows:

¹⁶ There is no relief from the income levy in respect of supplementary pension provision

¹⁷ Financial Emergency Measures in the Public Interest Act 2009

¹⁸ The pension contribution takes place before income is taxed or subjected to PRSI. Consequently, an employee is not liable for PRSI or tax on the contribution and the employer is not obliged to pay employer's PRSI on that element of the employee's pay. The contribution is therefore not liable to:

- Employee tax (this can be at 41%, 20% or partly at each rate depending on the employee's income level)
- 8% employee PRSI (4% PRSI and 4% health contribution levy), and
- 10.75% employer PRSI

The relief would be reduced by 8% in the case of contributions made by an employee earning below €18,304 and by 3% in the case of an employee earning above €75,036 as these employees do not pay PRSI on such income but the health contribution levy is 5%. For illustrative purposes, we adopted a rate of 8% for PRSI (which includes the health levy).

Age Limit	% of Remuneration
Under 30	15
30-39	20
40-49	25
50-54	30 ¹⁹
55-59	35
60 and over	40

Tax relievable contributions are subject to an earnings cap of €150,000 per annum, with the result that the maximum annual tax relieved employee contribution is limited to €60,000 – i.e. €150,000 x 40% for an employee aged 60 or over. A contribution not allowed in one year may be carried forward and relief is allowed in subsequent years subject to the annual limit.

Additional voluntary contributions (AVCs)

Employees may make additional voluntary contributions (AVCs) into occupational pension schemes or PRSAs. AVCs are used to improve benefits over and above those provided by the scheme, while staying within limits set by the Revenue Commissioners. They are deductible for income tax and PRSI (excluding the income levy) purposes, and are tax relieved at the marginal income tax rate. The age-related percentage limits and earnings cap outlined above in relation to occupational schemes apply to aggregate employee contributions, including AVCs.

Contributions by employers

Contributions by employers into an employee's pension fund are not²⁰ charged as a benefit-in-kind on the employee. The age-related and earnings-related limits on tax relief for employee pension contributions do not impose a restriction on the level of employer contributions. The main control²¹ on employer contributions is the statutory rule which limits the size of the tax-relieved fund to one capable of providing a pension of two-thirds of final remuneration, subject to the overall standard fund threshold limit of €5,418,085.

Employer contributions are deductible in computing the income for tax purposes of the employer's business.

Investment income and capital gains of the pension scheme

Neither income tax nor capital gains tax is payable on any increase in value of a pension fund.

3.3 Personal pension arrangements - retirement annuity contracts

Contributions

Contributions to retirement annuity contracts are premiums payable on insurance policies taken out by an individual. All contributions are paid by the individuals. As with occupational pension schemes, contributions are deductible for income tax purposes and are tax relieved at the

¹⁹ The 30% earnings limit applies, irrespective of age, to specified sportspersons.

²⁰ Section 778(5) TCA.

²¹ The manner in which this rule is applied is elaborated in guidance notes issued by the Revenue Commissioners following consultation with the Society of Actuaries in Ireland.

individual's marginal income tax rate. Tax-relieved contributions are subject to the same age-related percentage limits, annual earnings cap, rules for carry forward of unused contributions and overall standard fund threshold limits as apply to occupational pension schemes. No benefit limits apply in the case of retirement annuity contracts.

Investment income and capital gains

Neither income tax nor capital gains tax is payable on any increase in value of an RAC.

3.4 Personal retirement savings accounts (PRSAs)

A PRSA is a contract between an individual and an authorised PRSA provider. It is a defined contribution arrangement. Employees and the self-employed, homemakers, carers and the unemployed – in fact every adult under age 75 can avail of a PRSA. There is no requirement to have taxable earnings in order to pay PRSA contributions. Tax relief is available for contributions of up to €1,525 per annum even if this exceeds the normal age-related income-based limit.

Contributions

Contributions to PRSAs are deductible for income tax and PRSI purposes²² (excluding the income levy) and are tax-relieved at the marginal income tax rate. Tax-relieved contributions are subject to the same age-related percentage limits, annual earnings cap, rules for carry forward of unused contributions and overall standard fund threshold limits as apply to occupational pension schemes. No benefit limits apply in the case of PRSAs.

Employers may also contribute but, in contrast with the position for occupational pension schemes, these contributions are treated as benefits-in-kind. They are also included within the age-related percentage limits and within the overall €150,000 earnings cap, for the purposes of tax relief. However, the employee is entitled to relief on the employer contribution as if it were a personal contribution. If combined employer and employee contributions exceed the limits, an unrelieved benefit-in-kind charge applies to the excess.

Investment income and capital gains of a PRSA

Neither income tax nor capital gains tax is payable on any increase in value of a PRSA.

Section 4: **Criteria to encourage long-term savings to meet the needs of retirement**

4.1 Context

This Section sets out the main issues that we took into account in considering the support given to retirement savings through the tax system, and how best the system can encourage long-term savings for retirement.

4.2 Principles

We established criteria against which any measure to incentivise long-term savings for retirement could be measured. These are set out in Box 10.7.

²² But contributions are not deductible for PRSI purposes (see Section 8) in the case of PRSAs taken out by the self-employed.

Box 10.7: Criteria for incentives to encourage long-term savings for retirement

Measures to incentivise savings for retirement should:

- Target the 'gap in coverage', i.e. those with low- to middle-incomes who are unlikely to have supplementary pension coverage
- Improve coverage for women and those with intermittent employment patterns
- Give relief in a way that concentrates the benefits on those with low- to middle-incomes
- Be sufficiently attractive to encourage such earners to participate
- Be fiscally sustainable for the Exchequer
- Not impose an excessive cost on participants
- Not impose an unreasonable administrative burden on employers, contributors or the State
- Avoid complexity, and be as simple and transparent as possible
- Not adversely impact on existing occupational pension arrangements

4.3 Equity in support given through the tax system to retirement saving

The tax system²³ gives the greatest level of support to pension provision by those with the highest levels of income, while those most in need get the least support. This is because in general:

- Those who can most afford to provide for retirement are given the highest level of support through the income tax system (€41 for each €100 saved)
- Those on modest incomes who pay income tax at the 20% rate get a lower level of support (€20 for each €100 saved)
- Those on low incomes who are not within the tax system get no support

It is not consistent with our guiding principle of equity that the tax relief for contributions by individuals to fund their pensions is given at differing rates and gives least support to those with the lowest income. We make recommendations later in this Part to equalise the tax relief for all contributions. However, it is important to be clear that in addressing this issue, we are only dealing with a limited aspect of equity i.e. considering how tax relief can be given in a fairer way in respect of contributions made by individuals.

Clearly, contributions are also made by employers and these also have an Exchequer cost. In the case of funded schemes, contributions have a tax cost in that the individual is not taxed on the contributions made by the employer to the pension fund. In the case of non-funded schemes (i.e. the employer does not contribute to a fund, but pays the pension out of its income during the employee's retirement), which are mainly in the public sector, there is no contribution and therefore no tax cost while the employee accrues the entitlement to the pension, but the employer incurs a liability to make a pension payment in the future.

In all cases, the individual receives a pension which has an explicit or implicit tax cost to the Exchequer. Therefore, in addressing the inequitable treatment of employee contributions, we are only dealing with one aspect of the Exchequer cost of pensions. We address the issue of employer funding to a certain extent through recommendations for a reduction in the standard fund threshold limit and prevention of manipulation of contributions or remuneration levels close to retirement.

However, we believe that the regime for non-funded pensions should be examined to identify the

²³

This is apart from PRSI relief.

implicit tax cost to the Exchequer in the context of an equitable distribution of the tax expenditure on pensions.

Recommendation 10.1

The regime for non-funded pensions should be examined to identify the implicit tax cost to the Exchequer in the context of an equitable distribution of the tax expenditure on pensions.

4.4 Tax deferral

Where a pension fund is drawn down in retirement, it is subject to tax. On this basis, some submissions to us argued that tax relief in respect of pension contributions is not in fact 'tax relief', but is 'tax deferral'. The tax treatment of pension provision is as follows:

- Contributions to approved occupational pension funds, PRSAs and RACs are tax deductible. In effect the income used to make the contribution is **exempt**
- Income and gains arising to the fund are **exempt**
- Draw downs from the fund are **taxable** (subject to a once-off tax free lump sum)

This treatment of exempt/exempt/taxable (or EET) is the norm in the EU.

Apart from the tax-free lump sum aspect, the argument regarding 'tax deferral' is as follows: income put into a fund to finance retirement provision is exempt from tax, as is any capital growth. In the absence of special rules, those amounts would be liable to tax. But when this money is drawn down in the form of a pension, it is income which is subject to tax. In this sense, pension provision can be regarded as tax deferral.

This is, of course, subject to some qualifications:

- The lump sum is tax free
- In many cases, the pension contributions are relieved at the higher rate of tax while the pension draw-down is taxed at a lower rate²⁴
- Where the pension is below the income exemption limits, no tax is payable
- There is a significant delay between the granting of tax relief and taxation of the drawdown
- Where the person is entitled to use an approved retirement fund (ARF) (see section 8.5 of this Part), any amount remaining in the fund (after any deemed distributions) is not taxable until the death of the individual, and then can be transferred to an ARF of the deceased's spouse without tax on the transfer
- Overall tax levels may increase or decrease over time

Should a recommendation to equalise State support for retirement provision by taxpayers liable to tax at different rates be adopted, the extent to which tax is deferred may change. Those on lower incomes may generally be granted tax relief at a rate greater than that which will apply to their pension. However, a proportion of high earners may find that a pension, based on 50% of pre-retirement income, may be taxable at a higher rate than the rate of support applied to their funding contribution.

4.5 Improving provision for retirement – compel or encourage?

²⁴ In the case of a person who makes very high retirement provision, there is likely to be a closer match between the rate of tax relief and the rate of tax on draw down.

There are a number of approaches that can be taken to pension reform. Reforms can be based on a voluntary system, a mandatory system or a soft-mandatory system, as set out in Box 10.8.

Box 10.8: Approaches to pension reform

- A **voluntary system** involves encouraging long-term savings for retirement by way of tax incentives or direct contributions by the State to a pension arrangement
- A **mandatory system** requires a person to make contributions to a pension fund either through a social insurance system or mandatory private savings. It could be said that Ireland already has a mandatory occupational pension system, namely the contributory State pension funded through PRSI. One approach to pension reform would be to consider changes to that system. Another approach would be to allow the PRSI scheme to operate in parallel with a supplementary scheme which is itself mandatory
- A **soft-mandatory approach** to pension reform involves the mandatory introduction of a pension scheme by an employer and automatic enrolment of employees in the scheme, but with an option given to an employee to opt-out of the scheme after a period (this is the 'soft' aspect)

Our terms of reference in relation to retirement savings are that we should consider how best the tax system can *encourage* long-term savings for retirement. The question of whether pension provision should be mandatory is essentially a pension matter. On this basis, we focussed on how the tax system could encourage long-term savings in accordance with our terms of reference. Changes to the tax system may not on their own be capable of addressing the gaps in pension coverage and adequacy.

4.6 Mandatory approach: Pensions Board proposal

In its report entitled *Special Savings for Retirement* (2006), the Pensions Board suggested a 'hybrid' model involving retaining the State pension and having a mandatory supplementary pension system. The proposal applies to all those at work who are not making supplementary provision and envisages increasing the State pension to 40% of gross average industrial earnings (GAIE) and having a mandatory supplementary system with the features set out in Box 10.9.

Box 10.9: Features of Pensions Board hybrid model

Eligibility	All employees and self-employed
Eligible income	All earned income between 125% and 500% of the increased State pension (between approximately €15,000 and €60,000 as at June 2006)
Benefit type	Defined contribution
Contribution rate	15% of eligible income
Exchequer contribution	5% (included in the 15% above). This would be in lieu of any employer and employee PRSI relief and of any employee tax relief on contributions ²⁵

²⁵ The pension contribution is deducted before income is taxed. Therefore, an employee is not liable to PRSI or tax on the contribution and the employer is not obliged to pay PRSI on the contribution element of the employee's pay. Therefore the contribution element is not liable to 41% tax, 8% employee PRSI and 10.75% employer PRSI.

We consider that, because the proposed scheme is mandatory, it is not within our terms of reference and we do not examine it further. We believe that the approach is one that should be investigated as part of the Pensions Green Paper process. The proposal has some interesting characteristics and these are taken into account later in this Part.

4.7 International pension reform

Reforming pension systems is one of the biggest challenges facing most countries. Much has been done since the early 1990s across the OECD in an attempt to ensure the long-term viability of pension systems. There have been reforms in the UK which, like Ireland, has a long history of private pension coverage. In broad terms, the pension reform in other countries can be categorised as set out in Box 10.10.

Box 10.10: Pension reform in other countries

Mandatory private pensions as a substitute for part of public provision	South America, Eastern Europe, Central Asia and Sweden
Mandatory private pensions in addition to public pensions	Australia, Hong Kong, Italy, Norway and South Africa
Soft mandatory pensions in addition to public pensions	New Zealand
Cuts in public pension to leave a greater role for the private sector	Germany and Japan

Annex 13 sets out how some of the above countries have reformed their pension systems in response to the specific challenges they faced. These challenges included amending State provision to ensure long-term sustainability in the face of demographic change and encouraging long-term savings for retirement, by using mandatory or soft-mandatory systems.

4.8 The role of the tax system

The tax system already offers incentives to encourage retirement provision, by allowing contributions to occupational pension schemes, PRSAs and RACs to be deducted in calculating taxable income. While these incentives are widely used, there remains a gap in retirement savings coverage, particularly in the case of those with low to middle incomes.

An analysis of the 2004/2005 Household Budget Survey data shows that while middle to high-income individuals and households invest in private pensions, this is not the case to the same extent for low-income earners. Evidence from the UK suggests that although low- to middle-income individuals save, “they are not strongly influenced by the availability of tax relief”²⁶. The reason for this is that the benefits of tax relief are not as great for low-earners, who do not pay as much tax as high-earners. In addition to this, individuals with incomes below the taxable limits do not have any tax incentive to invest in pensions.

Whether an incentive can be introduced in the tax system that will encourage those who have not responded to existing tax incentives to begin to save for retirement is unclear. The Indecon Review of Potential Options to Encourage Increased Pension Coverage, which was prepared

26 Understanding Small Savers: Whyley and Kempson 2000.

in the context of the National Pensions Review, refers to the lack of evidence to suggest that tax incentives increase the overall level of savings. It cites the difficulties with understanding the benefits of pension arrangements, particularly in the case of those with low income. Factors contributing to this include:

- Tax incentives are complex and can be difficult to understand
- Low- to middle-income groups (who are traditionally low savers) pay lower rates of tax and so gain less from reduced tax liabilities
- The amount that people want to save is determined by a range of factors not linked to tax relief or rates of return, such as income and affordability

On the other hand, the ESRI Report *Pension Policy: New Evidence on Key Issues*²⁷, poses the question as to why participation is so low among low earners. It points to research which suggests that poor families will save if presented with financial incentives to do so.

This suggests that an explanation for low participation may be that tax incentives for retirement are less effective in low-income households. Tax deferral means little to people whose tax rate is low or zero. Where income is too low to allow for any savings, it is unlikely that they would respond to any incentive to start saving for retirement. In such a case the tax system will not provide a solution. Instead, retirement provision will need to be addressed through other support mechanisms.

In some cases, it may be that inertia rather than affordability is the reason for a person not having started to save for retirement and a soft-mandatory approach may be appropriate. This is developed in Section 5.

Tax incentives are offered in many countries to encourage retirement provision. The OECD Economic Survey of Ireland (2008, p.90) highlights international experience which suggests that tax incentives are likely to be more effective at raising savings if they are targeted at low- and middle-income earners, and if they are designed so that the incentives are easy to understand. It also points out experience in Australia, Canada and the United States which shows that households respond well to incentives presented as matching contributions from the government for each amount paid into retirement savings accounts. From this, it concludes that the high take up of special savings incentive accounts (SSIAs) by households in Ireland indicates they might respond to a system of matching contributions. But it goes on to say that it is unlikely that the same take up rate could be achieved for retirement accounts as for SSIs, because pension funds must be committed for much longer periods.

We examine a number of approaches that might help to encourage more long-term saving for retirement and propose a combination of tax measures that, taken together, may contribute to addressing the issue. The focus of any new reliefs should be on those who are not currently saving for their retirement and on those who are not saving enough. Care is needed so as not to discourage those with existing savings for retirement from continuing to save. If any change were to encourage people to move from dedicated savings for retirement, which are inaccessible until retirement, to general savings which can be accessed at any time, the risk is that such savings would be drawn down before retirement. This could result in a fall in adequacy of retirement savings.

27 T. Callan, C. Keane, J.R. Walsh (2009) *Pension Policy: New Evidence on Key Issues*, Dublin: The Economic and Social Research Institute. Page 6.

Existing pension arrangements have been successful in attracting significant amounts of retirement savings. This success can be built on by the removal of anomalies in current tax treatment. Having a more consistent tax treatment of such arrangements should make the decision on which product to use a simpler one for taxpayers. Industry and regulators also have an important role to play in making pension and retirement products simple and understandable, and in actively marketing them.

Under the tax heading, there are two possible approaches:

- The first is for the Exchequer to grant tax relief for contributions along the lines of the current system. However, modifications to the system could encourage those most in need of retirement savings to save. This may involve giving increased tax relief to those on lower income levels. Such an approach should help low-paid workers, subject to them being in a position to avail of the relief. It would not help those outside the tax net. It may be possible to meet some or all of the extra costs involved by lowering the level of support for retirement savings given to those on higher levels of income
- The second is for the Exchequer to make a direct contribution to supplement what a person puts into retirement savings. This could involve putting in place a system to replace the existing tax relief system with respect to future pension contributions, or it could be something that supplements the existing tax relief system. This would help those outside of the tax net as well as low-paid employees - again subject to them being in a position to avail of the scheme

Section 5: Review of options for tax relief

5.1 Introduction

This Section sets out the options for reform that we examined. We looked at how equity might be improved and retirement savings encouraged while still providing an incentive for those liable to tax at the higher rate of income tax. The options we examined are:

- Relief for all at the higher rate
- A 'stepped' approach
- Relief for all at the higher rate for a short period only to kick-start retirement savings
- A matching Exchequer contribution combined with a kick-start approach

While the first three options have merit, we do not recommend them. We are recommending the option of a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer. This would improve equity in that the same level of State support would apply to all and should encourage retirement savings by those on lower income levels. This, combined with a kick-start approach, is our recommended option. We asked the Department of Finance to cost these options – details of the Department's costings are in Appendix 2.

5.2 Option 1: Tax Relief for all retirement provision at the higher rate

5.2.1 Overview

This is the proposal in the Green Paper on Pensions (and originally proposed as one alternative in the National Pensions Review 2005) that all contributions towards supplementary retirement provision should qualify for tax relief at the higher rate. Under current rules, such contributions are deducted in calculating an individual's taxable income. The effect of this is that individuals liable to tax at the higher rate benefit most as income, which would otherwise be taxed at the higher rate, is sheltered from tax by the contribution. In the same way, individuals who are liable to tax at the standard rate get a smaller tax benefit²⁸. Individuals who are not liable to tax get no benefit under the tax system. This system of giving relief is regressive.

The Green Paper proposal is that, in the case of all forms of supplementary pension provision (other than PRSAs²⁹), tax relief for all personal contributions should be given at the higher rate.

The proposal refers to personal supplementary pension contributions. It does not cover contributions made by an employer on behalf of an employee.

The proposal seeks to incentivise individuals with low- to middle-income to start a pension³⁰. Many of these will not be liable to income tax at the higher rate but will either be paying tax at the standard rate or not be liable to tax at all. The proposal should act as an incentive to such individuals to make provision for their retirement. However, the reality remains that, in many cases, people may take the view that their current financial commitments make it impossible for them to save for retirement.

This option would not adversely affect those on higher levels of income who have been getting relief at the higher rate of tax because they would continue to get relief at that rate. It would improve equity between different categories of taxpayers by equalising the rate of tax on employee contributions between high and low levels of income.

5.2.2 Employer contributions

No change is envisaged to the existing treatment of employer contributions. Such contributions are not subject to tax on an employee as a benefit-in-kind. Consequently, there is a tax saving to the employee at his or her marginal rate. This would retain a degree of inequity between those taxable at the higher rate and others.

5.2.3 Limit existing tax reliefs to secure savings

The National Pensions Review recommendation for relief at the higher tax rate includes support for "a cap on incomes for pension contribution and benefit purposes but only if the derived savings are used to improve incentives for lower rate taxpayers and non-taxpayers". The details of the type

28 As the level of a person's income rises, some of their income will be exposed to the higher tax rate. Pension contributions would shelter income taxable at the highest rate of tax. In some cases, some income may be sheltered at the higher rate and some at the standard rate. Thus the effective rate of relief will be either the standard or higher rate or a combination of these rates.

29 For PRSAs the Green Paper proposes a matching contribution.

30 There is no official definition of what constitutes low to middle incomes. For our purposes, we have used as a base figure the amount of €34,000 which is broadly representative of average earnings. This is based on the figure of €32,730 for industrial earnings for 2007 contained in the CSO Earnings and Labour Costs (Table 9, page 15) publication. If we assume earnings growth of 3% for 2008 (based on the trend in the first three quarters of 2008), this gives an estimated industrial earnings figure for 2008 of €33,720 which, when rounded to the nearest €1,000, gives €34,000. Using the €34,000 guideline, it would be reasonable to assume that low income for an individual could be income up to, say, two-thirds of average earnings (i.e. €22,667), middle income could be up to, say, twice average earnings (€68,000) and high income could be income above that level.

or level of any cap are not specified. The annual earnings cap was reduced in Finance (No. 2) Act 2008 to €150,000. The Exchequer tax savings from that reduction in the cap could go some way to meet the cost of extending relief at the higher rate to all taxpayers.

Applying a cap to, or reducing the existing cap on, employee contributions, as a way to recoup some of the costs of this option might not be effective, as it could give rise to a change in behaviour by those affected.

There is a cap on employee contributions³¹, but there is no cap on the benefit-in-kind exemption for employer contributions to occupational pension schemes³². For PRSAs, the cap applies to both employer and employee contributions. If the cap on employee contributions was reduced, high-rate taxpayers might be able to avoid the measure by arranging for a reduced salary with lower employee contributions and higher employer contributions into the occupational pension scheme³³. If this happened, the cost of extending relief at the higher rate would be borne by the Exchequer.

One way of addressing this would be to introduce a cap on the exemption from the benefit-in-kind charge on employer contributions. This would make the provisions very complex for a number of reasons:

- Payments into a defined benefit pension scheme are made on a fund (rather than on a member) basis. Consequently, determining how much of any payment related to any particular member would be difficult to ascertain
- Even if it were possible to overcome this difficulty, it could give rise to problems in the case of employers who are required to make additional contributions to defined benefit pension funds that are under-funded. Unless specific exemption was to be introduced for such additional contributions, employees would pay tax on them as a benefit-in-kind

5.2.4 Soft-mandatory approach

An auto-enrolment approach could be considered under this option. This is a soft-mandatory approach to pension reform that involves the mandatory introduction of a pension scheme by an employer and automatic enrolment of employees in the scheme, but with an option given to an employee to opt-out of the scheme after a period (this is the 'soft' aspect).

5.2.5 Cost of providing tax relief at the higher rate

We asked the Department of Finance to cost this option. The Department's costings are outlined in Box 10.11.

31 Age related relevant earnings

<30 15%

Up to 40 - 20%

Up to 50 - 25%

Up to 55 - 30%

Up to 60 - 35%

>60 40%

Subject to an annual earnings cap of €150,000.

32 Subject to an overall control that a pension fund cannot exceed an amount sufficient to fund a pension of two thirds of final remuneration or €5,418,085 (the standard fund threshold), whichever is the lower.

33 Section 118B of the Taxes Consolidation Act 1997 ensures that salary sacrifice arrangements are subject to PAYE and PRSI. Tax Briefing Issue 70 specifies, as an example of such an arrangement, attempts to circumvent the limits imposed on personal contributions to pension schemes by foregoing salary and transferring the contributions from the hands of the employee to the employer.

Box 10.11: Cost of tax relief for all retirement provision at the higher rate

Additional cost for those already within the tax system and contributing to a supplementary pension (this is the 'deadweight' cost)	€91m
Additional cost if higher rate attracted more into supplementary pension schemes	€75m
Total	€166m
Additional cost if auto-enrolment were to apply ³⁴	€590m
Total	€756m

5.2.6 Advantages and disadvantages — relief for all retirement provision at the higher rate

The advantages of this option are that it equalises State support, encourages increased coverage in target groups without adversely impacting on existing contributors and builds on existing (and familiar) tax relief structures. It also meets the objective of maintaining employer involvement which is considered an important component in encouraging pension coverage. However, the disadvantages include overall cost (particularly if a soft-mandatory approach is adopted), possible deadweight cost and a lack of appeal to individuals outside the tax system. It might also cause employers to reduce their pension contributions for employees taxable at the standard rate, since employee contributions at the higher rate would be more tax efficient.

5.2.7 Conclusion

We see considerable merit in the option whereby relief for all retirement contributions would be granted at the higher rate. It could act as a strong incentive to those on lower levels of income, who have not been providing for their retirement to begin to do so. In addition, it would not disincentivise those on higher levels of income, who have been getting relief at the higher rate of tax, because they would continue to get relief at that rate. It would also improve equity as between the different categories of taxpayers.

However, we have concerns about the costs of this approach, particularly the costs of auto-enrolment. There are also deadweight costs associated with it. We took the view that this is likely to be the most costly of the options we considered.

On balance, we do not recommend this approach because of the potential cost of auto-enrolment.

5.3 Option 2: Stepped Approach

5.3.1 Overview

This section sets out another approach that could incentivise people to save for retirement. The approach is designed to maximise the incentive to save for retirement among those on low to middle incomes, who might otherwise get no tax relief, or only get relief at the standard rate. It does so by giving them tax relief at the higher rate of income tax.

It involves dividing retirement provision in any year into tranches. For the first tranche of contributions, tax relief would be given at the higher rate. For the next tranche of contributions, relief would be

³⁴ This is the excess of the additional cost of auto-enrolment (€665m) over the cost of those attracted to save for retirement in the absence of auto-enrolment (€75m).

given at the standard rate. Above a level where it is considered that an incentive may not be justified, no tax relief would be given.

Those with higher incomes who currently receive relief for retirement provision at the higher rate would get less relief once the amount of their pension contribution exceeds the first tranche.

Unless new rules on employer contributions are implemented, a degree of unequal treatment would result. This is because those taxable at the higher rate would be in the best position to take advantage of the benefit-in-kind exemption.

5.3.2 Advantages and disadvantages — stepped approach

The advantages of this approach are that it equalises the State support, it should increase coverage in the target group and it reduces deadweight costs. The disadvantages are that it adversely impacts on some existing contributors and it would not be possible to apply it in conjunction with a kick-start approach.

5.3.3 Conclusion

The stepped approach could not be used in the same way as the kick-start option (described below) to encourage individuals to start providing for their retirement. This is because the stepped approach ensures relief at the higher rate will be available for the first tranche of retirement provision in each year and could not be restricted to the early years of saving. We have a concern that taxpayers would not invest in pension arrangements to the extent that tax relief is available at the standard rate.

Consequently, we do not recommend the introduction of a stepped approach.

5.4 Option 3: Tax relief for all retirement provision at the higher rate for a kick-start period

5.4.1 Overview

This is a modified version of Option 1 and would allow relief at the higher rate for a limited period of, say, five years. The relief at the higher rate would only be available for retirement savings by the individual in the limited period beginning with the first year in which such retirement savings are made. We considered it because:

- It should impose a smaller Exchequer cost than Option 1
- It has the potential to incentivise individuals to begin the savings habit (particularly if it could be restricted to individuals under a certain age)

Relief would be given at the higher rate for all pension contributions in the limited period. After this period, relief for retirement savings would be given at the taxpayer's marginal rate. That could be the higher rate of income tax or the standard rate, depending on the income and circumstances of the taxpayer. In the case of a taxpayer who is not subject to the higher rate of income tax, a sudden drop in relief at the end of that period could pose problems. This could be addressed by gradually stepping down the rate of relief over a further period of, say, two to three years.

This option should act as an incentive to individuals to commence providing for retirement. Giving tax relief at the higher rate for a limited period would be a significant contribution by the State towards getting taxpayers on low to middle-incomes to begin saving for retirement. Contributions

made early in a person's working life have a longer period to grow before retirement and so can give much greater value than those made later.

5.4.2 Costs

Even though this option is time bound, there would still be a significant cost to the Exchequer. However, the deadweight costs associated with Option 1 would be reduced as the additional tax relief would only apply to those who had been contributing to pensions for less than five years. The Department of Finance was unable to cost this option as there was no relevant data on which to estimate its cost.

5.4.3 Advantages and disadvantages — kick-start period

The advantages and disadvantages of this option are similar to those for Option 1. However, a significant disadvantage is that the equality of support ceases at the end of the five-year period.

5.4.4 Conclusion

We see merit in a kick-start period whereby relief for retirement contributions would be granted at the higher rate for a defined period. The option is focused on those who have not yet commenced saving for retirement and the time constraints should serve as an incentive to begin doing so. Limiting the relief to a specific period of time would also reduce the Exchequer cost of the proposal. However, the fact that the equal treatment of taxpayers would cease at the end of that period is unsatisfactory.

We do not recommend this approach in the context of relief at the higher rate. However, we recognise that a kick-start is likely to have a strong incentive effect and it is further considered in conjunction with the matching Exchequer contribution approach outlined in Option 4 below.

5.5 Option 4 — A matching Exchequer contribution

5.5.1 Overview

Under this option, contributions towards supplementary retirement provision would qualify for a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer. The Exchequer contribution would be limited to the current age-related and earnings limits.

The impact of this approach is that individuals liable to tax at the higher rate would receive less Exchequer support than they do under current rules, while those liable at the standard rate would get greater support.

The matching contribution approach is a viable alternative to the options considered above, because it has the potential to incentivise those on lower levels of income, while still providing those on higher levels of income with reasonably generous support.

A matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer would incentivise individuals who are either paying tax at the standard rate or who are not liable to tax to make provision for their retirement. However, the reality remains that, in many cases, individuals in this situation may decide that, because of their other financial commitments, they cannot afford to provide for retirement.

Those with higher levels of income who, under current rules, receive relief at the higher rate for retirement provision would get less Exchequer support under this option. This could be a disincentive to save for retirement by way of pension arrangements.

5.5.2 The figures

Box 10.12 illustrates the current level of effective total Exchequer contribution made to taxpayers liable to tax at the standard and marginal rates.

Box 10.12: Current Exchequer contribution where pension contributions made

Example	Higher rate taxpayer	Standard rate taxpayer
Contribution made to a pension scheme by an employee	100	100
Employee gets -		
• tax relief of:	41	20
• relief from PRSI and the health contribution ³⁵	8	8
Employer gets PRSI relief of:	10.75	10.75
Exchequer contribution (in the form of reliefs given) is:	59.75	38.75
Savings by employee	49(41+8)	28 (20+8)
Savings by employer ³⁶	10.75	10.75
Amount in pension fund	100	100
Net cost to employee	51	72

Higher rate taxpayer

- In the case of a higher rate taxpayer, for every €100 contributed to a pension fund, the Exchequer will incur a cost of €59.75. This Exchequer cost is shared between the employee (€49) and the employer (€10.75). Thus from the point of view of the employee, for each €100 that goes into the fund, the State contributes €49, in the form of the reliefs given to the taxpayer. This is the equivalent of the State contributing €49 for every (net) €51 contributed by the taxpayer, or almost €1 for each €1 contributed by the taxpayer.

Standard rate taxpayer

- In the case of a standard rate taxpayer, for every €100 contributed to a pension fund, the Exchequer will incur a cost of €38.75. This Exchequer cost is shared between the employee (€28) and the employer (€10.75). Thus from the point of view of the employee, for each €100 that goes into the fund, the State contributes €28 in the form of the reliefs given to the taxpayer. This is the equivalent of the State contributing €28 for every (net) €72 contributed by the taxpayer, or roughly €1 for each €2.50 contributed by the taxpayer.

5.5.3 A matching contribution

We propose that, instead of the State contributing €1 for each €1 contributed by a high rate taxpayer and €1 for each €2.50 contributed by the standard rate taxpayer, it would make a matching contribution of €1 for each €1.60 contributed by the taxpayer in all cases. If this approach were to be adopted, the same level of State support would apply to all contributions.

³⁵ PRSI relief does not arise in all cases due to the employee PRSI ceiling of €75,036 – see footnote 28.

³⁶ If a matching Exchequer contribution applies, there will not be any employer PRSI relief

It would be difficult to give such support through the tax system under the net pay arrangement. We propose that it be given at source. Tax relief is given at source for mortgage interest and for medical insurance and it works well. It is operated by the service provider and is transparent. The Revenue Commissioners consider it feasible to give support in this way in the case of retirement provision but indicate that it would require a significant lead-in period to adapt to the new approach. It would mean that a person wishing to contribute €100 to his or her pension scheme would pay €62 to the pension scheme and the pension scheme would collect the €38 Exchequer contribution from the Revenue Commissioners.

5.5.4 Impact of moving to a matching Exchequer contribution

Box 10.13 shows the position of a higher rate taxpayer and a standard rate taxpayer under current arrangements and under the proposed arrangements.

Box 10.13: Comparison of current and proposed arrangements

	Current arrangements		
	High rate taxpayer	Standard rate taxpayer	Matching contribution
Contribution/amount in fund	100	100	100
Relief			
– Tax	41	20	
– PRSI, health contribution, levy	8	8	
Tax relief at source	–	–	38
Net contribution	51	72	62

5.5.5 Employer PRSI relief

A consequence of giving support by a matching contribution is that employer PRSI relief would cease to exist. That relief only arises because of the 'net pay arrangements' through which relief of pension contributions is effected. Where an employee makes contributions to a pension scheme the employer's PRSI is calculated on the remuneration net of employee pension contributions. If the employee makes a pension contribution, the employer makes a PRSI saving. If the employee makes no pension contribution, the employer makes no saving. It is arguable whether such a windfall gain should be available to an employer. Because there is no salary cap for employers' PRSI, the savings to the employer can be substantial. According to the Department of Finance, the Exchequer cost of employer PRSI relief for 2007 is estimated to be close to €185 million.

5.5.6 Impact on occupational pension schemes

In the case of occupational pension schemes, this option would standardise the Exchequer support of employee contributions. This would equalise the treatment of taxpayers and go some way towards helping to meet the Exchequer cost of providing the incentive for those on low and middle incomes.

Some inequity would remain unless corresponding changes were made to relief for employer contributions (through the benefit-in-kind exemption arrangements), because those taxed at the higher rate would benefit most from the benefit-in-kind exemption.

In addition, there could be behavioural changes in relation to new employment contracts, i.e. these could provide for less employee contributions and greater employer contributions. This is not a new issue. It is there already due to the reduction to €150,000 of the earnings related cap.

5.5.7 Impact on PRSAs and RACs

In the case of PRSAs and RACs, our proposal is that they also should get a matching Exchequer contribution rather than a deduction for tax purposes. On the basis of the above, the appropriate matching contribution would be €1 for each €1.60 contributed by the taxpayer.

The impact of the handling of an employer's contribution to a PRSA must also be considered. As is currently the case, the employer's contribution would be taxed as a benefit-in-kind at the employee's marginal rate - either the higher or standard rate depending on the employee's circumstances. The employer's contribution is effectively then an after-tax contribution by the employee and could qualify for the matching contribution.

5.5.8 Impact on those who are not liable to tax

Those who are not liable to tax because of the level of their income do not benefit from tax relief under current rules. In our view, the matching Exchequer contribution should apply to an individual who has relevant earnings, even where, because of the level of their earnings, they are not liable to tax. The matching contribution approach would not give Exchequer support to persons outside of the tax net because they have no income³⁷.

5.5.9 Exchequer costs related to this proposal

We asked the Department of Finance to cost this option. The Department's costings are set out in Box 10.14.

Box 10.14: Exchequer costs of giving relief for pension contributions at a matching contribution rate of €1 for each €1.60

Savings in respect of those already within the tax system and contributing to a supplementary pension	(€120m)
Additional cost if matching contribution attracted 10% more into supplementary pension schemes	€60m
Net savings	(€60m)
Additional cost if auto-enrolment were to apply ³⁸	€460m
Net overall cost	€400m

³⁷ This could arise in the case of individuals who stay at home for family reasons and have no income but are fully supported by, say, a spouse with a high income. On the one hand, it can be argued that such a person should be entitled to benefit. On the other, the underlying objective is to try to get people to provide for an income in retirement that is 50% of their pre-retirement income. As the person in this scenario had no pre-retirement income, an issue does not arise. The Retirement Savings Scheme in Section 6 addresses this issue.

³⁸ This is the excess of the additional cost of auto-enrolment (€520m) over the cost of those attracted to save for retirement in the absence of auto-enrolment (€60m).

5.5.10 Advantages and disadvantages — matching Exchequer contribution

The advantages of this option are that it equalises State support for retirement provision and makes it more transparent, it encourages increased coverage in the target group and it can combine effectively with a kick-start approach. A disadvantage is that it could disincentivise some existing contributors.

5.5.11 Kick-start period in conjunction with the matching contribution

The kick-start period, which was outlined in section 5.4 above, could be considered in conjunction with the matching contribution approach. This would involve:

- A matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer in respect of all retirement provision
- For the kick-start period, a matching Exchequer contribution of €1 for each €1 contributed by the taxpayer in the first, say, five years of pension provision

This would mean that a higher State contribution would be available for retirement savings in the five-year period beginning with the first year in which such retirement savings are made. After that period, the matching contribution would return to €1 for each €1.60 contributed by the taxpayer. This approach would give an incentive to all to begin providing for their retirement and encourage them to maximise provision in the first five years. This should help to embed the savings habit. The kick-start approach would be even more of an incentive to begin saving early if it could be restricted so that it only applied where the retirement savings commenced before, say, age 30³⁹. The compatibility of this with equality law would need to be examined.

We conclude that this matching Exchequer contribution option would improve equity and incentivise those with low- to middle-incomes to begin providing for their retirement. In addition, it could be combined in an effective way with a kick-start period in a manner that is equitable but also provides a strong incentive to begin retirement provision as early as possible.

Recommendation 10.2

The current tax relief for personal retirement provision should in the medium to long-term be replaced by a matching Exchequer contribution of €1 for each €1.60 contributed by the taxpayer.

Recommendation 10.3

The matching contribution approach should be accompanied by a kick-start provision involving a contribution of €1 for each €1 contributed by the taxpayer in the first, say, five years of pension provision by an individual.

Recommendation 10.4

The matching contribution should apply where an individual has relevant earnings including where, because of the level of his or her earnings, the individual is not liable to tax.

5.6 Soft-mandatory approach

An issue separate to the above options is the extent to which retirement provision could be made

39 This could apply by allowing the person concerned to apply to Revenue to commence the kick-start period at any time before age 30. This would ensure that the period would not be used up earlier when a young person, for example, may travel abroad after taking up employment.

mandatory. It would be possible to apply a soft-mandatory, or auto-enrolment, approach to any of the arrangements mentioned above. Under existing rules, employers are obliged to offer a PRSA to their employees where no employer-sponsored occupational scheme is in place. We understand that there has been a relatively small take-up by employees of this option.

Changing to a soft-mandatory approach would mean that employers would not only be compelled to offer the PRSA facility, but they would have to automatically enrol the employee in the scheme. The 'soft' aspect is that an employee would be entitled to opt out of the scheme later. The soft-mandatory approach has the advantage of using inertia in a positive way. In other words, instead of inertia having the effect of delaying a decision to start providing for retirement, the person concerned would be enrolled automatically in the system, and would have to make a decision and take action to opt out of the system. If adopted, it should have a positive impact on the number of individuals beginning the savings habit. In our view, this has the potential to increase pension coverage significantly.

There are a number of issues that would have to be considered in the case of a soft-mandatory approach. These include when an individual would be entitled to opt out of a scheme and the timing and extent of any refund of contributions made by an individual who opts out. These, however, are design features and not for consideration here.

In the event that a soft-mandatory approach was adopted, decisions would be required on a number of issues which have not been given further consideration here, including:

- Reducing the complexity of pensions so that they are more understandable and transparent
- The level of contribution that would apply on auto-enrolment
- Whether the employee only would be required to make the contribution, or whether the employer should also be obliged to contribute
- Whether an employer would be free to nominate the provider of the savings arrangement, or whether the employee would be given a choice, with a default option. If the employer were to be required to give a choice to employees, this would imply a considerable administrative burden. On the other hand, requiring an employee to take part in a scheme chosen by the employer might not be satisfactory
- Arrangements for re-enrolment at an appropriate time where an individual opts out

If a soft-mandatory approach were to be adopted, there may be a case for considering whether it would be possible to confine such an approach to individuals over say 25, subject to compatibility with equality laws. This would avoid putting an unnecessary administrative burden on employers in the case of younger employees, such as students engaging in holiday and part-time work. In addition, were a kick-start to apply, a young person in this position would then be able to avail of any kick-start option when they enter the workforce more permanently.

The question of introducing a soft-mandatory approach may be outside our terms of reference. Nevertheless, we are of the view that a soft-mandatory approach could make a significant contribution to increasing coverage and is something that should be considered.

Recommendation 10.5

A soft-mandatory approach could make a significant contribution to increasing pension coverage and should be considered.

5.7 Visibility of Exchequer contribution

Whichever of the above options is adopted, we consider that an employee's payslip should be required to show the amount contributed by the Exchequer to the employee's retirement savings. The 'net pay arrangement' which now applies is not fully transparent. A greater visibility of the State support for retirement savings is likely to increase awareness and act as an incentive to save.

Recommendation 10.6

An employee's payslip should show the amounts contributed by the Exchequer to the employee's retirement savings.

Section 6: A retirement savings scheme

6.1 Introduction

This section examines the various components of a retirement savings scheme. This is effectively a special savings incentive account (SSIA) scheme, which involves a person opening an account to accumulate funds for use in retirement. It is envisaged that such accounts would be simple and straightforward. The approach is designed to address the issues raised in the CSO findings outlined in section 2.10 and in some submissions made to us. It would also address the objective in the Programme for Government to provide an SSIA-type scheme in an effort to make supplementary pension provision more attractive to those on low incomes. The approach is proposed to run in addition to the options considered in Section 5.

6.2 The SSIA scheme

A total of 1,170,208 SSIA accounts were commenced by individuals prior to the closing date of 30 April 2002. Approximately 1,085,000 SSIA accounts matured by the end of the scheme. 26.5% of persons who opened an SSIA did not already have a pension. The CSO Quarterly National Household Survey module on SSIA accounts gives the profile of all individuals over 21 who held such accounts. The data is set out in Box 10.15.

Box 10.15: Profile of individuals who held SSIA accounts

Broad occupational group	Population in these occupational groups ('000)	No of Accounts ⁴⁰	Percentage of occupational group with an SSIA account
Managers and administrators	310.3	178.0	57.4
Professional	223.6	162.8	72.8
Associate professional and technical	165.5	104.3	63.0
Clerical and secretarial	233.4	131.4	56.3
Craft and related	256.1	88.0	34.4
Personal and protective service	190.7	63.0	33.0
Sales	146.1	51.3	35.1
Plant and machine operatives	166.6	52.2	31.3
Other	178.0	41.7	23.4
Totals	1870.3	872.8	46.7

The survey also indicated that in the fourth quarter of 2005 the average monthly contribution to SSIA accounts stood at €217.04.

6.3 Cost of the SSIA scheme

The SSIA scheme ended in May 2007 and the full payout to SSIA account holders was in the region of €14.6 billion. This payout included original investment and Exchequer top-up. The cost to the Exchequer of the SSIA scheme, net of exit tax, from 2001 to 2006, was as follows:

Year	Cost €m
2001	71
2002	433
2003	532
2004	548
2005	597
2006	439
Total	2,620

40 Note the total number of accounts here is lower than the total number of SSIA's as the profile was limited to persons over 21 years of age.

6.4 The proposed retirement savings scheme

A scheme similar to the SSIA could have a role to play in complementing other retirement provision arrangements. Some of the target group may not be covered by these other arrangements:

- Some may not be in a position to take out a PRSA, and
- Some may be reluctant to take out a PRSA because of the perceived lack of transparency and complexity of existing pension arrangements

The scheme would not be a traditional pension product but a long-term savings product. The key attractions of such a scheme are as follows:

- It would be easily understood
- The Exchequer contribution would be transparent
- It should specifically incentivise those who are not liable to tax
- It would be attractive to those who may not be working or who feel that they cannot realistically avail of the other pension products
- Investment choices would be straightforward, and
- Because of the nature of the scheme, it should require regulation of a different order to a pension product and this should be less costly

It is not expected that there would be the same level of uptake of a scheme that has a much longer time horizon than the SSIA because of the general inaccessibility of funds until retirement age. Nonetheless, we are of the view that it would be an attractive facility that should be available in parallel with traditional retirement savings products. It should encourage the savings habit from an early age and it would enable those with broken employment patterns, those who are carers, those who take career breaks and those with low to middle incomes, who may not be able to benefit from traditional pension products, to get support from the State for their long term savings for retirement. There is likely to be a deadweight cost in the proposal in that it would cover some savings that would happen in the absence of an incentive.

6.5 Operation of the scheme

The various components that would make up a retirement savings scheme are set out in Box 10.16.

Box 10.16: Components of a retirement savings scheme

- The scheme would be open to all persons over 18 years of age and up to the age of retirement⁴¹ who are tax resident in Ireland for the year in which the contribution is made⁴²
- Its characteristics would make it less attractive to those who could avail of more conventional supports, which would limit access to the scheme
- A **matching Exchequer contribution** would apply. Based on the analysis in Section 5.5.2 we consider that an Exchequer contribution of €1 for each €2 contributed by the taxpayer would be appropriate. This would give less support than is given under the existing rules to a higher rate taxpayer for pension provision, but more support than is given to a standard rate taxpayer. It would give less than is proposed under the matching contribution option in section 5.5.3
- **Exclusions.**⁴³ We take the view that the matching Exchequer contribution should not normally apply for any year in which the person concerned is in an employment which is covered by a defined benefit pension scheme
- The scheme would have a **minimum savings level** to encourage continued investment. This could be set as low as €120 per annum to facilitate continued participation in the scheme by very low income groups and those with intermittent work patterns. This is considered important to maintain the saving habit
- **The scheme would have a maximum savings level.** We believe it was important as far as possible to discourage people currently contributing to more traditional pension schemes, from taking up this long term saving option. A limit on the amount that could be saved annually could be set by reference to a percentage of average industrial earnings. If the upper limit were, say, €3,300 per annum, a matching contribution of €1 for every €2 saved would mean that the taxpayer would be permitted to save €2,200 (two-thirds of that amount) and the State would make a one-third contribution (€1,100)
- **Employer involvement.** Employers should be involved in providing access to the retirement savings scheme and offering a salary deduction facility
- **Administration costs.** Because of the simplicity of the scheme and based on the experience of the SSIA scheme, administration costs are unlikely to be significant.
- **A range of investment options to be available.** Persons opening such accounts should be given a range of options with explanations that clearly show the consequences in terms of the level of risk for each option, such as putting money on deposit, investing in shares, funds and unit trusts. A default option would apply in the event of no election being made. The National Treasury Management Agency could have a role in the operation of the scheme.

41 The lack of consistency regarding retirement age issue is discussed in section 8.6.

42 If a person reaches retirement age and does not draw down the funds, they should be entitled to continue to benefit from the scheme until they reach a certain age – the appropriate age is not a decision for us. However, once the funds are drawn down, they should cease to be entitled to any further use of the scheme.

43 There are certain cases where defined benefit arrangements could be inferior to a defined contribution arrangement and these would need to be addressed.

- **Pre-retirement access to funds.** We believe that there should be some form of pre-retirement access⁴⁴ in the case of, for example, the purchase of a house as a principal private residence or serious illness. All matching Exchequer contributions related to the amount drawn down would be repayable in the event of such access. The potential for exceptional access to funds may increase the attractiveness of the scheme.
- **Returns on the savings, apart from the Exchequer contribution, would be taxable.** No tax would arise on the amount saved or on the State contribution. However, any other growth in the funds would be taxed. This could be done as follows:
 - Tax at the standard rate could be applied to the growth in funds each year as they arise. However, taxing as-you-go in this way would be complex other than in the case of simple deposit accounts, or
 - Instead of taxing as-you-go, a slightly higher tax rate could be applied to the growth on maturity or draw-down of the funds.
 - No further tax liability would arise on draw-down of the funds.

6.6 Exchequer costs

The Department of Finance has estimated that, if there was a 20% take-up of the scheme and a maximum contribution by all who took part, the Exchequer cost would be about €520 million per annum.

6.7 Benefit to the individual

If €2,200 were contributed each year by an individual and the Exchequer contribution was €1,100, then after 40 years, the total contributions made would be €132,000 in today's terms (ignoring any return earned). This is broadly equivalent to 10 years of the State pension – or, in annuity terms, it could increase income by €6,000 per annum for life, equivalent to 50% of the State pension (assuming an annuity rate of 5%).

6.8 Conclusion

A retirement savings scheme along the lines of the former SSIA scheme has attributes that could encourage long-term savings for retirement. The public familiarity with the SSIA scheme would make it attractive – even though the delay before funds can be accessed is much greater (for most people) than was the case with the SSIA's, and it would not be possible to have a general cut-off date for the opening of an account.

The scheme has the potential to increase retirement provision, particularly in the case of those with low to middle incomes and those with broken employment patterns. However, we also believe the scheme should be open to all (other than those in an employment which is covered by a defined benefit scheme), as limiting its availability would result in considerable administrative complexity. The scheme could be focussed on the target group by limiting it to a relatively low annual amount – this could be pitched at an appropriate percentage of average industrial earnings. The possibility of some pre-retirement access to funds should make the scheme attractive to younger people.

44 The main disadvantage of allowing pre-retirement access is that it would defeat the object of the scheme which is to accumulate funds for retirement. The main advantage is that a person may be more willing to commit to an account if they feel that in given circumstances they may have some access before retirement even if it involves partial repayment of the Exchequer contribution.

Another advantage of the scheme is that there would be no taxation of the amounts contributed by the saver or the Exchequer (as distinct from the growth in the funds) on withdrawal at retirement.

The scheme would not be sufficient on its own to meet the retirement savings needs but could make a valuable contribution, in parallel with other Exchequer supports, towards retirement provision.

Recommendation 10.7

A retirement savings scheme along the lines of the former SSIA scheme, that is easily understood and which involves an Exchequer contribution, should be introduced – the scheme is outlined in Box 10.16 of Part 10.

Section 7: Summary of our overall recommendations

7.1 Introduction

This section sets out a possible overall approach designed to incentivise:

- More people to save for retirement (i.e. increased coverage)
- People to save more for retirement (i.e. improved adequacy), particularly those at the lower income levels

7.2 Rebalancing of tax incentives for retirement provisions

Our recommendations have the potential to redistribute the tax expenditures on pension provision towards those on lower and middle incomes. This is consistent with our guiding principle of equity ensuring a more equitable incidence of taxation on all in society. It also accords with our principles that our proposals should be viable and flexible and our tax system should be one which is responsive to, and capable of changing in time with, our economic environment and economic profile.

We believe that the tax system cannot be viewed as a panacea to address the gaps in retirement provision. There are other areas of public policy where this issue will have to be addressed in a comprehensive way. However, we have looked at how the tax system can best encourage long term savings for retirement with a focus on those on low- to middle-incomes, who may not be in a position to benefit as much as others from tax relief on traditional pension arrangements. Our view is that there is not an obvious single answer under the tax heading. However, we believe that the following approach should contribute to an overall policy solution.

The approach contains three elements:

- **Retirement savings scheme:** The first element concerns a new savings account, structured on the lines of the SSIA, which would run in parallel with the other elements below. It would be widely available to facilitate further retirement provision. This would particularly facilitate those with atypical employment patterns and those not in employment and would enable them to continue saving for retirement. It would also encourage younger people to start saving earlier. The scheme would operate as outlined in Section 6.

- **Tax relief for personal pension provisions**
 - **Matching Exchequer contribution:** Given that the option of relief at the higher rate for all retirement provision is likely to have an unsustainable cost, the second element is that a matching Exchequer contribution would be given in respect of all personal contributions to pension arrangements at a rate of €1 for each €1.60 contributed by the taxpayer. This should incentivise those on lower incomes to provide for their retirement by giving them a higher level of support for pension contributions than they get under existing rules. Those who currently get relief at the higher rate would get less support. This would improve the equity of the system.
 - **High rate kick-start:** The third element is the high rate kick-start option outlined in Section 5. This would give additional support to all taxpayers in respect of contributions to pension arrangements for the first five years in which they make contributions. After that, they would revert to the normal support. This approach should provide a strong incentive to begin making provision for retirement.

Section 8:

Other issues related to the tax treatment of retirement provision

8.1 Introduction

In this Section we consider a number of anomalies and issues in relation to the tax treatment of pensions.

8.2 The standard fund threshold

There are a number of limits on the tax relief for pension provision. One of these is the annual earnings limit, currently set at €150,000, on which tax relief for contributions can be based. Another is the limit on the capital value of the amount of tax relieved pension benefits that an individual can draw down. This limit, known as the standard fund threshold, is currently set at €5,418,085.

A limit on the overall size of an individual's tax relieved pension fund is appropriate and we are of the view that the standard fund threshold should remain. This is because pension contributions made by employers and benefits accrued in unfunded schemes are not subject to the annual earnings limit. If the standard fund threshold were to be removed, this would allow the annual contribution limit to be avoided by those who can switch from employee to employer pension contributions.

The standard fund threshold was introduced in 2005 and set at €5m. By 2008 it was €5,418,086. The annual earnings limit applying across all pension products was introduced with effect from December 2002 and set at €254,000. By 2008 it had been indexed to €275,239. For 2009 this limit was reduced to €150,000. We take the view that there should be a correlation between the annual earnings limit and the standard fund threshold and that any movement in the annual earnings limit should be accompanied by a corresponding movement in the level of the standard fund threshold.

Any change to the standard fund threshold would require transitional arrangements to cover, for example, those who may have already exceeded the revised threshold.

Recommendation 10.8

- As the annual earnings limit does not apply to employer contributions, there is a need to retain the standard fund threshold.
- There should be a correlation between the annual earnings limit and the standard fund threshold, and the reduction in the annual earnings limit suggests that there should be a corresponding reduction in the standard fund threshold.

8.3 Taxation of the lump sum

On retirement, an individual is entitled to take a part of his or her pension fund as a tax-free lump sum. Although the tax-free status of this lump sum is an arrangement of long standing, it is not possible to identify an objective rationale for it. The payment facilitates the transition from full pay to pension. Its tax-free status may provide an incentive to individuals to save for their retirement. On the other hand, the payment of a lump sum to some extent defeats the purpose of retirement savings, which is to provide income in retirement.

In general, we take the view that available Exchequer resources would be better used to enhance the incentives for those at entry level to retirement provision and believe that there is a case for subjecting the lump sum to some level of tax.

We accept that the prospect of some tax-free exemption of the lump sum is an additional incentive to make retirement savings. However, the level of exemption should be less than currently applies. The arrangements should be changed so that the lump sum, which is limited to 25% of the fund or 1.5 times final salary, is taxed as follows:

- A maximum €200,000 should be tax free
- The balance should be subject to tax at the standard rate of income tax

Examples:

Final salary	€50,000	€100,000	€150,000
Maximum lump sum	€75,000	€150,000	€225,000
Tax free	€75,000	€150,000	€200,000
Taxable @ standard rate	-	-	€25,000
Tax @ 20%			€5,000

Recommendation 10.9

A lump sum taken on retirement should be liable to tax as follows:

- An amount of up to €200,000 should be tax free.
- The balance of the lump sum should be subject to tax at the standard rate of income tax.

8.4 Excessive contributions close to retirement

There are a number of controls in tax law relating to occupational pension arrangements:

- The earnings limit on an individual's tax relieved contributions is €150,000
- A limit on the tax-relieved pension fund that can be created by contributions to a fund capable of providing a pension of two-thirds of final remuneration, subject to the overall standard fund threshold limit of €5,418,085, and
- The age-related percentage limit on relievable contributions

Many individuals – employees, self-employed and proprietary directors – do not fund their pension arrangements at a sufficiently early stage of their working lives. They can therefore find themselves with inadequate pension funding and a short time-frame to address the issue. As we note below, the age-related limits on allowable pension contributions implicitly recognise that individuals may need, for *bona fide* reasons, to increase their level of contribution as they approach retirement. It is important that these individuals continue to make these contributions as otherwise their pensions would not be adequate. While limits and controls allow this to happen, they are, in some cases, used in an unintended way. This occurs where individuals can influence the amount of contributions (or the question of who pays them), as well as the final salary level. For example, large amounts may be contributed to a pension scheme by the employer in the years before retirement. This arrangement would include agreeing very high levels of remuneration in the final years, in order to maximise both the amount of pension that can be paid and the tax-free lump sum.

We take the view that a system which allows such arrangements is not appropriate and we recommend that the law should be changed to prevent their use.

Recommendation 10.10

The current tax relief rules should be reviewed to ensure that contributions and remuneration levels cannot be manipulated close to retirement to allow individuals to take advantage of unintended and inappropriate benefits.

8.5 Age-related limits

We considered whether age-related limits should be abolished so that young people would have the same opportunity as older people in terms of the proportion of their earnings that could be invested in retirement savings.

Under current tax law, there are age-related limits on the amount of retirement provision that can be made by an individual. These range from 15% of the remuneration of a person who is under 30 years of age to 40% of remuneration in the case of someone who is aged 60 or over. It can be argued that a younger person should be able to make the same level of tax relieved contribution as an older person. Certainly, having a single limit would simplify the system. However, abolishing the age-related limits would have disadvantages.

If all individuals were allowed to make tax-relieved contributions of up to 40% of their remuneration irrespective of age, individuals aged under 30 should not need that level of contribution to provide adequately for their retirement. This would not be an appropriate use of Exchequer funds. On the

other hand, if all individuals were only allowed to make tax-relieved contributions of up to 15% of their remuneration irrespective of age, a person aged over 55 would not be able to adequately provide for their retirement on that level of contribution given increases in longevity over the past few decades. The age-related limits reflect the level of investment likely to be required at each stage in life to provide for retirement. Unless there are higher levels of investment, older people who were late beginning retirement provision would be likely to have inadequate savings.

Age-related limits on the amount of an individual's relevant earnings should therefore remain.

Recommendation 10.11

Age-related limits on the amount of an individual's relevant earnings should continue.

8.6 Approved retirement funds (ARFs) and approved minimum retirement funds (AMRFs)

On retirement, the funds accumulated in a PRSA or an RAC may be used to purchase an annuity, or may be transferred to an ARF net of a tax-free lump sum⁴⁵. If the option to transfer the funds to an ARF is chosen then, unless the person concerned has an income of at least €12,700 per annum for life, €63,500⁴⁶ of the funds must be used to purchase an annuity or invested in an AMRF until age 75. An AMRF is similar to an ARF but has the effect of locking away capital until the individual concerned reaches 75 years of age. Income can be withdrawn from an AMRF but the original capital cannot. ARFs and AMRFs pay no tax on investment income or gains.

Withdrawals from an ARF are subject to income tax. When an individual dies, transfers or withdrawals of the funds in an ARF are regarded for tax purposes as being taxable income of the individual in the year of death. However, this does not apply when the funds in the ARF are transferred:

- To an ARF in the name of the spouse of the deceased in which case no tax is payable
- To a child, who is 21 or under, of the deceased (but a capital acquisitions tax liability may arise), or
- To a child who is over 21, when the transfer is taxed at the standard rate of income tax as a final liability.

There is an imputed 3% distribution on the market value of ARF assets on 31 December each year, where distributions of at least that amount were not otherwise drawn down from the ARF. This rule applies where the ARF owner is 60 years of age or over for the whole of the tax year, and where an ARF is set up after 6 April 2000. It does not apply to AMRFs.

Availability of ARFs in relation to retirement products

ARFs are currently available in relation to PRSAs and RACs. Except in the case of proprietary directors and holders of AVCs, they are not available in relation to occupational pension schemes. Submissions have suggested that ARFs should be available as an alternative to annuities to members of defined contribution occupational pension schemes. The submissions do not, however, call for them to be made available in the case of defined benefit schemes. If ARFs were to be made available in the case of defined benefit occupational schemes this could put pressure on the solvency of such schemes and could damage defined benefit pension provision – there is already evidence of considerable funding issues in relation to such schemes.

⁴⁵ In the case of a PRSA, the funds can be left in the PRSA.

⁴⁶ or, if lower, the amount of funds in the PRSA or RAC after taking the tax-free lump sum.

The flexibility of an ARF should be extended to defined contribution occupational pension schemes. We based this recommendation on the view that if it is appropriate to allow an ARF to be available in relation to a PRSA and RAC, and to proprietary directors in relation to their pension funds, members of the defined contribution occupational pensions should be allowed to benefit in a similar way.

Recommendation 10.12

The flexibility of an ARF should be extended to defined contribution occupational pension schemes.

8.7 Other anomalies

A number of anomalies in the tax rules relating to private pension arrangements came to our attention. The tax rules on pension provision are complex. The differences in the tax treatment of various arrangements⁴⁷ available can make the decision as to which product is most suitable unnecessarily difficult – there are simply too many variables to be considered. Some of the differences are warranted because of the nature of the products and the person for whom they are intended. However, in some cases, it is difficult to see the rationale for the differences in treatment.

Employer contributions

If an employer pays contributions to an individual's PRSA, the employer must report it to the Revenue Commissioners as a benefit-in-kind. The employee can claim immediate tax relief on these contributions, as if he or she had paid the contributions directly. In practice, a benefit-in-kind tax charge will only arise where the total contributions paid in any one year exceed the appropriate percentage (calculated by reference to the age of the contributor) of the annual earnings limit.

In contrast, employer contributions to occupational pension schemes are not taxed as a benefit-in-kind and are not subject to the €150,000 annual income limit.

Age limits for draw-down

The rules regarding retirement age vary depending upon whether a person contributes to an occupational pension scheme, a PRSA or RAC. Each occupational pension scheme, PRSA or RAC requires approval from the Revenue Commissioners in order to avail of the special tax treatment. To be approved, conditions must be met. As regards retirement age, the conditions are as follows:

- An occupational pension scheme must provide for retirement at a specified age, which in general is not earlier than 60 and not later than 70
- A PRSA or RAC must provide for withdrawals to begin not earlier than age 60 and not later than age 75

While there are operational differences between PRSAs, RACs and occupational pension schemes, the different retirement age ranges that apply should be reviewed with the objective of having more consistency. The upper retirement age in the case of occupational pension schemes should be 75, as is the case for a PRSA or an RAC.

In addition, the various ages specified in the legislation governing the time at which benefits must begin to be taken date back to 1972, and may warrant being reviewed and conformed in the

47 Occupational pension scheme, PRSA and RAC.

light of the increases in life expectancy since then.

Level of lump sum

Different rules apply to the amount of a tax-free lump sum that can be drawn down. In the case of occupational pension schemes, an employee is entitled on retirement to a maximum lump sum of 1.5 times final salary, irrespective of whether it is a defined benefit or a defined contribution scheme. For PRSAs and RACs, the limit on the lump sum is 25% of the amount in the fund on retirement. All schemes are subject to the overall lifetime cap on lump sums of 25% of the standard fund threshold.

While some of the issues identified are not tax issues, they are conditions that affect the availability of the tax benefits. The anomalies identified in the rules relating to retirement provision arrangements contribute to the view that the system is overly complex. Where anomalies make the choice of retirement savings product difficult, the decision to begin saving may be deferred.

Recommendation 10.13

Anomalies in the treatment of different retirement arrangements should be eliminated as far as possible.

Recommendation 10.14

The various ages specified in the legislation governing the time at which benefits may commence should be reviewed and conformed.

Appendix 1

Tax Reliefs to encourage supplementary pension provision

Irish measures to support saving for retirement (Pillar two)

	Occupational pension schemes (both DB and DC)	Personal retirement savings accounts (PRSAs) ⁴⁸	Retirement annuity contracts (RACs) ⁴⁹
Tax treatment of contributions			
Legislative reference	Sections 770 – 782 TCA	Sections 787A – 787L TCA	Sections 783 – 787 TCA
Open to	Employees only	All	Self-employed and individuals in non-pensionable employment
Employee contribution	Deductible at taxpayer's marginal rate (i.e. 20% or 41% depending on the level of the taxpayer's income)		
Employer contribution	No benefit-in-kind ⁵⁰	Taxed as benefit-in-kind ⁵¹	No employer ⁵² contribution
Tax relievable contribution limits allowed as a percentage of earnings ⁵³		Age < 30 Up to 40 Up to 50 Up to 55 Up to 60 >60	Relevant earnings 15% 20% 25% 30% ⁵⁴ 35% 40%
Annual earnings limit	€150,000	€150,000	€150,000
Funding limit	2/3rds of final remuneration ⁵⁵	None	None
Fund limit	€5,418,085	€5,418,085	€5,418,085

48 Long term savings account to assist in saving for retirement. Products jointly approved by Revenue and Pensions Board.

49 A standard contract approved by Revenue which may then be marketed; primarily to the self-employed.

50 Section 772 (3)(a) TCA. The main control on the overall level of employer contribution is the statutory rule which limits the tax relieved pension fund that can be created by contributions to a fund capable of providing a pension that does not exceed two-thirds of final remuneration or a fund agreed to the standard fund threshold, whichever is lower.

51 Introduced with the PRSA legislation in 2002 but the employee is entitled to tax relief on the contribution as if it has been paid directly by himself or herself.

52 All contributions are paid by the individuals themselves.

53 In the case of occupational pension schemes these limits apply to employee contributions only. However, for PRSAs the limits apply to the aggregate of both the employee and employer contributions

54 30% earnings limit applies, irrespective of age, to specified sportspersons

55 Subject to being reduced to 50% of final remuneration where tax-free lump sum taken.

	Occupational pension schemes (both DB and DC)	Personal retirement savings accounts (PRSAs)	Retirement annuity contracts (RACs)
Tax treatment of draw-down			
Access before retirement	None		
Age at which benefits must be drawn down	Normal retirement age 60 to 70	Normal retirement age 60 to 75	
Tax-free lump sum ⁵⁶	1.5 times final salary	25% of the fund	
Requirement to purchase annuity	In some cases	Optional: Approved Retirement fund ⁵⁷ (ARF) / Approved Minimum Retirement fund ⁵⁸ (AMRF)	
Approved retirement funds/Approved minimum retirement funds			
Ability to avail of ARF/AMRF	AVCs and proprietary directors	Yes	Yes
Management of funds	Must be managed by qualifying fund manager		
Tax treatment of funds	Income and gains are exempt in the fund. Withdrawals (known as distributions) are taxed at the individual's marginal rate and are subject to PAYE ⁵⁹ Imputed distribution ⁶⁰ : An ARF is deemed to make a notional annual distribution where sufficient actual distributions are not made.		
Tax treatment of funds on death	The amount payable to the deceased individual's estate is treated as income of the deceased for the year of assessment in which he or she dies. There are some exceptions: • A transfer to an ARF in the name of the deceased's spouse is exempt • A transfer to a child of the individual under 21 is exempt, but chargeable to capital acquisitions tax • A transfer to a child of the individual over 21 is taxed at the standard rate of income tax		

56 Tax-free lump sum subject to lifetime limit of 25% of the standard fund threshold.

57 An ARF is a fund which pays no tax on its investment income or capital gains while the money is invested in it. However, if the money is withdrawn, it is subject to income tax at the individual's marginal rate.

58 An AMRF is similar to an ARF but has the effect of locking away capital until the individual reaches 75. Income can be withdrawn from an AMRF but the original capital cannot. The balance left after drawing down tax-free lump sum, or €63,000 if less has to be transferred to AMRF or used to purchase an annuity. However, an AMRF is not required if the individual is over 75, or has a pension or annuity of at least €12,700 for life.

59 But use of funds to purchase an annuity would not be taxable

60 Section 14 of Finance Act 2006 introduced a tax charge based on an "imputed distribution". The amount of the imputed distribution is 1% of the value of the assets in 2007, 2% of the value of the assets in 2008 and 3% for 2009 and subsequent years where the individual is aged 60 or over for the complete tax year.

Appendix 2

Department of Finance Costings

A: Relief for all individual pension contributions at the higher rate of income tax:

(i)	Additional Exchequer cost for those already within the tax system and contributing to a supplementary pension:	
1.	Employee contributions to Occupational Pension Schemes	
		€m
	Current cost ($€1.552\text{bn}^{61} \times 80\%^{62} \times 49\%^{63}$) + ($€1.552\text{bn} \times 20\% \times 28\%^{64}$) =	695
	Proposed cost ($€1.552\text{bn} \times 100\% \times 49\%$) =	<u>760</u>
	Extra cost:	65
2.	Individual contributions to RACs	
	Current cost: ($€1.084\text{ bn}^{65} \times 90.5\%^{66} \times 41\%^{67}$) + ($€1.084\text{ bn} \times 9.5\% \times 20\%^{67}$) =	423
	Proposed cost: ($€1.084\text{ bn} \times 100\% \times 41\%$) =	<u>444</u>
	Extra cost:	21
3.	Contributions to PRSAs	
	Current cost: ($€200\text{m}^{68} \times 88.8\%^{69} \times 49\%$) + ($€200\text{m} \times 11.2\% \times 28\%$) =	93
	Proposed cost: ($€1.084\text{ bn} \times 100\% \times 41\%$) =	<u>98</u>
	Extra cost:	5
	Total current cost =	1211
	Total proposed cost =	<u>1302</u>
	Total extra cost:	91 (say 90)

61 Employee pension contributions to Occupational Pension Schemes (OPS) for 2007 – per Revenue Commissioners P35 employer returns.

62 No breakdown of relief is available on contributions to OPS as between standard and higher rate taxpayers; relief at higher rate assumed for 80% of contributors but there is no scientific basis for this. If it was assumed that 70% of contributions were relieved at the higher rate and 30% at the standard rate, the extra cost of higher rate relief for all existing OPS members would be increased by about €30m and by a further €30m for each 10% "switch" in the assumption of the breakdown between higher and standard rate taxpayers contributing to OPS.

63 Made up of tax relief at higher rate of 41%, employee PRSI relief at 4% and health levy relief at 4%. Most employees pay PRSI at the "A" rate which also varies depending on an individual's level of income. In addition, employee PRSI does not apply to incomes above €75,036 per annum. A breakdown is not available of the PRSI contribution status of existing members of and contributors to pension schemes (or of the likely status of new members/contributors). A rate of 4% across the board has been used for the purpose of this exercise.

64 Made up of tax relief at standard rate of 20%, employee PRSI relief at 4% and health levy relief at 4%.

65 Latest RAC contribution figures from the Revenue Commissioners in respect of 2007.

66 Proportion of tax relief claimed at higher rate by contributors to RACs in respect of 2005 (latest year for which a breakdown is available); taken from info in PQ20745/08 as the proportion which the reduction in tax of higher rate taxpayers bears to the total tax reduction for RACs.

67 Contributions to RACs are almost exclusively made by self-employed individuals. PRSI and health levy relief is not available on pension premiums/contributions made by self-employed individuals operating outside of PAYE. Existing relief is confined to income tax relief. No breakdown available of contributors to PRSAs as between self-employed and PAYE taxpayers; so no adjustment made to PRSA costing.

68 Latest PRSA contribution figures from the Revenue Commissioners in respect of 2007.

69 Proportion of tax relief claimed at higher tax rate by contributors to PRSAs in respect of 2005 (latest year for which a breakdown is available) taken from info in PQ20745/08 as the proportion which the reduction in tax of higher rate taxpayers bears to the total tax reduction for PRSAs.

(ii)	Additional Exchequer cost if higher rate relief attracted more investment into supplementary pensions⁷⁰:
	Numbers in employment; 1.965m ⁷¹ X workforce not covered by pensions; 48% ⁷² X Additional take-up; 10% ⁷³ X pension contribution; €1,675 ⁷⁴ X 49% = <u>77</u> (say 75)
(iii)	Additional Exchequer cost if auto-enrolment were to apply⁷⁵
	Numbers in employment; 1.965m X workforce not covered by pensions; 48% X numbers in employment aged over 25 and under 65 years; 86% ⁷⁶ X pension contribution; €1,675 X 49% = <u>666</u> (say 665)

B: Replace tax and PRSI etc. relief for all individual pension contributions with a matching Exchequer contribution of €1 for every €1.60 of employee/personal contribution⁷⁷:

(iv)	Savings in respect of those already within the tax system and contributing to a supplementary pension:
1.	Employee contributions to Occupational Pension Schemes
	€m
	Current cost (€1.552bn X 80% X 49%) + (€1.552 bn X 20% X 28% tax rate) = 695
	Proposed cost (€1.552bn X 100% X 38.46% ¹⁷) = <u>597</u>
	Saving: 98
2.	Individual contributions to RACs
	Current cost: (€ 1.084 bn x 90.5% x 41%) + (€ 1.084 bn x 9.5% x 20%) = 423
	Proposed cost: (€1.084bn x 100% x 38.46%) = <u>417</u>
	Saving: 6
3.	Contributions to PRSAs
	Current cost: (€200m x 88.8% x 49%) + (€200m x 11.2% x 28%) = 93
	Proposed cost: (€200m x 100% x 38.46%) = <u>77</u>
	Saving: 16
	Total current cost = 1211
	Total proposed cost = <u>1091</u>
	Total savings: 120

70 As the higher rate relief remains a voluntary incentive under this option, the costing provided can only be illustrative based on assumptions on take-up. In addition, while it would take time for any incentive to take effect, the estimated cost ignores this timing effect.

71 CSO labour market data for Q1 2009.

72 Pension coverage for workers aged between 20 and 69 has varied between 52% and 55% between Q1 2002 and Q1 2008, according to CSO QNHS data. This would leave the non-coverage percentages ranging from 48% to 45%. The higher (48%) figure has been used in this exercise.

73 Take-up assumed at 10% of workforce without pension cover. Cost would increase if higher % take-up assumed.

74 Assumptions required about average income level and contribution level of contributors; income level assumed at average industrial wage - €33,500 p.a. (latest estimate of average industrial earnings for 2008) and contribution level assumed at 5%. Pension contribution and estimated costs would be higher if it were decided that the contribution level should be higher and/or that the average income of the contributor would be higher.

75 There would be behavioural and timing impacts, among other impacts, arising from the introduction of auto-enrolment. These impacts are not reflected in these costings.

76 CSO labour market data for Q1 2009.

77 Tax and PRSI etc. relief at a rate of 38.46% on pre-tax pension contributions is equivalent to providing a direct Exchequer contribution of €1 for every €1.60 of post-tax pension contribution.

(v)	Additional Exchequer cost if higher rate relief attracted more investment into supplementary pensions:
	Numbers in employment; 1.965m X workforce not covered by pensions; 48% X Additional take-up; 10% X pension contribution; €1,675 X 38.46% = <u>61</u> (say 60)
(vi)	Additional Exchequer cost if auto-enrolment were to apply
	Numbers in employment; 1.965m X workforce not covered by pensions; 48% X numbers in employment aged over 25 and under 65 years; 86% X pension contribution; €1,675 X 38.46 % = <u>522</u> (say 520)

C Auto-enrolment PRSA

Auto-enrolment has been included in the cost scenarios for higher rate relief and matching contribution set out above. In response to the specific issues and questions raised in the e-mail of 28 November 2008, the following is the position in relation to the assumptions made in providing the costings involved.

Employee opt-out and re-enrolment: No provision made for opt-out and re-enrolment.

Employees covered by scheme: Percentages of those at work aged between 25 and 64 and who have no pension coverage.

Level of employee contribution; contribution rate of 5% of earnings assumed.

Employee and Employer contribution: compulsory employee contribution only assumed. No employer contribution.

Refunds of contributions for opt-outs: no provision made.

D. Retirement Savings Scheme

Eligibility:	Anyone aged between 18 years and 64 years
	Tax resident in State for year in which contribution is made
Exclude:	All those who are covered by a Defined Benefit pension scheme in the year concerned
Employee Contribution:	Minimum saving level €120
	Maximum saving level 10% Average earnings x 2/3 ⁷⁸
Exchequer contribution:	50% of employee contribution i.e. €1 for €2
Investment Type:	Range of options available
Access to Funds:	Limited pre-retirement access to funds

The scheme provides for State contributions to a retirement savings scheme in the form of a direct pay over by the Revenue Commissioners into an individual's savings account of an amount equal to 50% of the amount contributed by the taxpayer, subject to min/max contribution level by the individual

⁷⁸ Maximum annual saving permitted under the scheme calculated at 10% (possibly too high at this level of income) of annual average industrial wage where employee contributes 2/3rds and the State 1/3rd.

Calculating maximum allowable contribution:

Average Industrial Wage = €33,000⁷⁹

€33,000 × 10% = €3,300 where employee can contribute 2/3 and State 1/3

=> MAX total savings level = €3,300

=> MIN total savings level = €180 (€120 employee + €60 State contribution)

Numbers eligible for scheme:

Population of the State aged between 18 and 64 = 2.9m⁸⁰

Total membership of Occupational Pensions = 797,370⁸¹

DB:DC = 2:1⁸² Defined Benefit number = 532,000 (531,580)

Number of people eligible to partake in the scheme 2.9m - 532,000

= 2,368,000

Estimation of Exchequer Cost based on the above figure (2,368,000):

5% Take Up = 118,400		Employee Contribution	Cost
Max Contribution	118,400 × €3,300 = €390,720,000	€260m	€130m
Min Contribution	118,400 × €180 = €21,312,000	€14m	€7m

10% Take Up = 236,800		Employee Contribution	Cost
Max Contribution	236,800 × €3,300 = €781,440,000	€521m	€260m
Min Contribution	236,800 × €180 = €42,624,000	€28m	€14m

20% Take Up = 473,600		Employee Contribution	Cost
Max Contribution	473,600 × €3,300 = €1,562,880,000	€1.04b	€521m
Min Contribution	473,600 × €180 = €85,248,000	€57	€28

⁷⁹ Average industrial wage at Q2 2008; €33,423

⁸⁰ Estimate based on CSO population figures released in August 2008.

⁸¹ Pensions Board Annual Report 2006.

⁸² Green Paper on Pensions (p.134) – ratio of DB to DC includes public sector schemes.

30% Take Up = 710,400		Employee Contribution	Cost
Max Contribution	$710,400 \times €3,300 = €2,344,320,000$	€1.56b	€783m
Min Contribution	$710,400 \times €180 = €127,872,000$	€86	€42m

47% ⁸³ Take Up = 1,112,960		Employee Contribution	Cost
Max Contribution	$1,112,960 \times €3,300 = €3,672,768,000$	€2.5b	€1.2b
Min Contribution	$1,112,960 \times €180 = €200,332,800$	€133m	€67m

The above costs are very tentatively estimated based on assumed savings contributions occurring in a full year. The estimates do not take account of the impact of withdrawals due to savers accessing funds or to the impact of any tax due on the accrued return on savings over the savings period

E. Abolition of employer PRSI relief in respect of employee pension contributions.

Latest figures from D/Social and Family Affairs indicate that the cost of employer PRSI relief on employee pension contributions is close to €185m (estimate for 2007).

83 CSO QNHS – Q4 2005. Almost 47% of those in employment had an SSIA. Unlikely that anything like this level of coverage would be achieved but costing included for illustrative purposes.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 11

FUTURE FINANCING OF LOCAL GOVERNMENT



Part 11:

Future Financing of Local Government – *consider options for the future financing of local government*

Section 1 is an introduction.

Section 2 gives the context for our review.

Section 3 outlines our review of potential taxation measures other than charges on property.

Section 4 deals with local commercial property taxation measures.

Section 5 examines the issue of an annual property tax as a source of local government funding.

Section 6 deals with the issue of development contributions.

Section 7 deals with the issue of water charges.

Section 8 deals with the issue of waste charges.

Section 9 deals with other means of financing local government.

Section 10 examines the balance of local government financing and the equalisation of funding.

Appendix 1 contains supplementary information.

Our recommendations in this Part are as follows:**Local commercial property taxation measures**

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|------|--|
| 11.1 | The revaluation initiative should be expedited to ensure that a transparent nationwide valuation system, including a cost-effective route of appeal, is in place as soon as possible. Regular revaluations should be carried out thereafter, in order to ensure that the valuation base remains up-to-date. This should be done as provided for in legislation, at intervals of not more than 10 years. |
| 11.2 | <p>The vacancy relief provisions should be amended to provide for the granting of vacancy relief by local authorities, in accordance with the following principles:</p> <ul style="list-style-type: none"> • Vacancy relief should only be granted where the following conditions are satisfied: <ul style="list-style-type: none"> – An owner/leaseholder is <i>bona fide</i> unable to obtain a suitable tenant, or – A property is vacant due to repairs or alterations being carried out on it, and – That the relief, where granted, is time-limited so as not to encourage the owner of premises to allow it to become dilapidated, and – The rate of the relief to be granted by a local authority to be within the range 50-100% for the time-limited period • Vacancy relief should be applied <i>pro-rata</i> according to the period of vacancy in any year. |
| 11.3 | The provision which states that a property must be vacant at the time of the striking of the rate by a local authority should be removed. |
| 11.4 | Permanent offshore structures should be made subject to commercial rates. |
| 11.5 | Bed and breakfast accommodation and guesthouses should be brought within the commercial rates base where there are four or more bedrooms in a dwelling house provided on an ongoing basis for overnight guest accommodation. Self-catering apartments and holiday homes provided by tourism operators should also be brought within the rates base. |
| 11.6 | Third-level and professional institutions should be part-rated to reflect the fact that they generate significant funds from their own resources and conduct commercial activity on their campuses. |
| 11.7 | Community halls should be part-rated where significant commercial activity takes place in such facilities. |
| 11.8 | Agricultural farm buildings which are owned by a body corporate should be subject to commercial rates. |
| 11.9 | All buildings or land occupied by the State should be brought fully within the commercial rates base. |

Annual property tax as a source of Local Government Funding

- | | |
|-------|--|
| 11.10 | After an appropriate period all of the revenues from an annual property tax should be used for local government financing. |
|-------|--|

11.11	The proposed annual property tax system should be established and operated as a national property tax system for a short initial period: • Its revenues should then be hypothecated for local government financing as soon as is feasible – once the tax has become established, and • By no later than the next local elections (June 2014) rate-setting powers should be devolved to local government subject to the considerations set out at section 5.3 of Part 11.
11.12	A new method of equalisation of funding, using a needs and resources model, should be developed in conjunction with the devolution of rate-setting powers to local government to reflect the changed funding base for local government.

Water charges

11.13	Measures should be put in place immediately to ensure that the costs of water services provided are fully recovered from the non-domestic sector.
11.14	Domestic water charges should be introduced as a sustainable approach to realising an acceptable conservation culture.
11.15	There should be some level of incentivisation to ensure that consumers are encouraged to install meters.
11.16	Charges should be phased in over a period of time.
11.17	The charging should commence with a flat rate charge and change to volumetric billing for consumers once meters are put in place.
11.18	A waiver scheme should be provided for low-income householders.
11.19	Water meters should be installed in all new housing units.
11.20	A public information campaign should clearly outline the rationale for water charges and the way in which they will be implemented.
11.21	Water pricing should be introduced for all water consumers by local authorities based on a consistent methodology and applying the principle of full cost recovery.

Waste charges

11.22	The polluter pays principle should continue to underpin waste charges to ensure that all consumers pay for their own waste.
11.23	The landfill levy should be increased to encourage behaviour to divert waste away from landfill and meet our obligations under EU law and a similar mechanism should be considered for other forms of final disposal.
11.24	Waivers should be available from all service providers in all local authority areas to all clients who lack an ability to pay.
11.25	We do not support the establishment of a national waiver scheme. The pricing of waste and water services should be designed to fund the cost of providing services to consumers who qualify for a waiver.

11.26	Tax relief on service charges should be abolished.
Other means of financing local government	
11.27	Following an efficiency review: • The Department of the Environment, Heritage and Local Government should develop a charging system in conjunction with local authorities to ensure a higher proportion of planning costs are recouped from planning applicants. • Consideration should be given to devolving responsibility for setting planning fees from the Minister to local authorities subject to central guidelines being developed.
11.28	There should be no deviation from the policy that housing rents are based on a person's ability to pay. Maximum rent levels should be removed to ensure that some tenants and households do not benefit disproportionately.
11.29	A review of the current differential rents scheme should be carried out to improve the sustainability and effectiveness of the scheme, as previously recommended by NESC.
11.30	The significant disparity across local authorities between rents collected on an income per housing unit basis should be addressed without delay with a view to elimination.
11.31	The Needs and Resource Model should be periodically reviewed and evaluated to ensure that the difference in the costs bases of local authorities are reflected in relevant decisions by central government on equalisation funding. The reviews should be undertaken in partnership with local authorities.
11.32	The initiatives being undertaken to improve efficiencies in local authority expenditure programmes should continue to receive a priority focus at local authority level and from central government. That priority will be assisted by the new standardised costing system which provides for greater benchmarking of local authority performance.

Section 1:

Introduction

1.1 The Local Government financing remit

We were invited to examine options for the future financing of local government. Our considerations were influenced by other aspects of our terms of reference, in particular:

- To keep the overall tax burden low, and to implement further changes to enhance the rewards of work, while increasing the fairness of the tax system
- To consider how best the tax system can support economic activity
- To promote increased employment and prosperity, while providing the resources necessary to meet the cost of public services, and other Government outlays, in the medium and long-term
- To examine the balance achieved between taxes collected on income, capital and spending

Our examination of the local government financing system in Ireland was also conducted in the context set out in the Green Paper – Stronger Local Democracy – Options for Change and the commitment in the Programme for Government to reform local government with the aim of making it more transparent and responsive to customers.

1.2 Guiding principles

Our work is informed by a number of guiding principles which are set out in Section 3 of Part 2 of our Report. An important exception to the principle of tax neutrality is that of user/polluter pays. This was relevant to our review of local government financing, particularly our examination of charges for water and waste.

In addition to these principles, we also had regard to the need for equalisation of funding between different local authority areas, and the desirability of improving local accountability - so that democratically elected representatives have appropriate responsibility for the decisions taken at local level, and are clearly accountable for those decisions.

1.3 Overview of the financing of local government

Green paper on local government

The green paper on local government states: "The need for proper funding of local government is recognised. Autonomy in fund raising increases local discretion and accountability. However, there is little consensus on how best to achieve such autonomy. This is an issue which will receive in-depth analysis in the context of the recently established Commission on Taxation, which is to consider the issue of local government financing."

The fact that there is little consensus on how autonomy for the local government sector is to be achieved is apparent from the relative absence of policy responses to the considerable number of reviews of the subject that have been carried out over recent decades. We have noted many other studies at national and European level touching on aspects of Irish local government financing. It is a policy issue that cannot be said to be understudied.

1.4 Sources of income

There are two broad sources of income for local authorities. The first is known as 'own resources', which are generated directly by local authorities. These account for over a quarter of current income. Own resource income is generated through commercial rates and from services provided by local authorities including waste charges, non-domestic water charges, housing rents, and planning fees. The second source of income is central government subvention via the Local Government Fund (LGF) general purposes grant and other Government grants and subsidies. The LGF is financed by Exchequer contributions, and the proceeds of motor taxation. In 2008, the aggregate share of local authority income sourced from central government resources was almost 45%. However, some local authorities in areas with strong economic bases, such as those in the greater Dublin region and elsewhere, are less reliant on central government funding. Others are far more dependent on central government resources.

In recent years, the financial position of many local authorities benefited significantly from construction activity in Ireland. Local authorities received over €1.7 billion in local development contributions in the period 2003 to 2006. Although this source of funding has dropped dramatically since then, reflecting the sharp downturn in construction activity, the additional industrial and commercial construction has greatly increased the base for commercial rates, particularly in some areas.

Ireland is one of the few countries which does not impose a tax on domestic property to fund local government. A form of domestic property tax – domestic rates – was in place in Ireland until 1978, and was collected and used by local authorities to fund services. Rates on agricultural property were abolished from 1983.

Subsequent efforts to provide for a property tax were ultimately reversed. A national property tax, known as Residential Property Tax, was introduced in 1983. It provided for a property tax in circumstances where the property exceeded a threshold value, and the household income exceeded a threshold amount. Because of these thresholds, it only targeted a very small proportion of residential properties. The number of assessments raised in any year was never more than just over 20,000¹. In 1996, the last full year of its operation, the yield was just under €17 million. It was a national tax and was not used for local government funding. It was abolished in 1997.

A farm tax, which was based on a concept of adjusted acreage, was introduced in 1986. It represented an amalgam of income tax and property tax elements. It was abolished the following year. The proceeds of the tax were intended to form part of the current income of local authorities. On its abolition, the Government indicated that: "farmers should be taxed on the same basis as other sectors of the community, that is, on actual income".

An international comparison of the balance between central and local sources of local government funding is difficult because of the many different models of local government with many jurisdictions having roles in areas such as the provision of education, health and social services and policing, which are not in the main provided by local government in Ireland. The absence of any local tax on domestic property in Ireland also makes comparisons less meaningful.

¹ With the exception of 1994 when a flat rate of RPT was payable

Section 2:

Context of the current review

2.1 Introduction

Local government financing has been the subject of periodic review over the past quarter of a century. The previous Commission on Taxation and NESC both reported on local government financing in 1985, and recommended that a local property tax should be introduced to improve local accountability and widen the national tax base. KPMG economic consultants reported in 1996 and concluded that a local property tax was the most feasible option for raising additional funding to finance local government. More recently, Indecon economic consultants reported in 2006 and published a number of recommendations including extending water charges to non-principal private residences; more economic charging for services generally; broadening the commercial rates base to include State properties, and expenditure rationalisation and efficiency measures. Their recommendations did not include the introduction of a local domestic property tax.

Since the abolition of domestic rates in 1978 – or more correctly, the transfer of the liability for paying domestic rates from the occupier to central government through the “domestic rates grant” – there have been a number of changes to local government financing. However, some of these changes have not endured, which highlights both the limited policy response to the recommendations of the various reviews, and the very significant political difficulties in implementing structural change to the local government financing base.

To allow local government to raise more finances from its own resources, a statutory provision was introduced in 1983² enabling local authorities to levy direct charges for services such as water and waste. Water charges for domestic users were subsequently abolished in 1997.

A central Local Government Fund (LGF), financed by the proceeds of motor tax and an Exchequer contribution, was introduced in 1999. The fund provides local authorities with discretionary resources to fund their day-to-day activities, non-national roads and for certain local government initiatives.

A Needs and Resources Model was developed in 2000 to provide for a more transparent allocation of general purposes grants to local authorities from the LGF. In addition, the Planning and Development Act 2000 opened up new sources of funding, by requiring developers to part-fund the provision of public infrastructure through development contribution schemes. That Act also enabled local authorities to acquire sites, land or houses at below market value for social and affordable housing.

2.2 Financial challenges

As the Green Paper on Local Government points out, there are significant financial challenges which will face the local government sector in the coming years. These include:

- Providing services to a growing population which is more diverse and mobile than ever before
- Implementation of the National Development Plan
- Improved environmental performance, particularly in areas such as waste management, water supply and ground water protection

- The significant additional costs of operating new water and waste-water treatment plants, as well as the cost of greater environmental compliance costs for all existing plants

2.3 A broader approach to financing local government

We examined the various existing and potential sources of local government finance. This approach is consistent with the identification in the Green Paper of some issues which should be taken into account by us in our consideration of local government financing. These include:

- whether some form of local taxation measures that are found in other jurisdictions should be introduced
- whether a local property tax should be considered as a base for local government finance
- whether further efforts should be made to secure more resources for local authorities
- how local taxation measures are balanced against the objectives of equity and balanced regional development
- how the 'polluter pays' principle should inform payment for services and the sustainable use of resources
- the role of central funding of local authorities, particularly the need to assist authorities with weaker economic bases

2.4 The financing mix of resources

Our approach had regard to the need to reach an appropriate financing mix of a local authority's own resources: that is, what balance should be struck between income generated from service charges, and from taxation measures, from both property and non-property sources. Our approach to service charges is based on the 'user/polluter pays' principle, which provides for the recovery of full economic costs of service delivery in the provision of water and waste-water services, and refuse services. We believe this approach provides the most direct link between the consumption of a service, and the payment for that service. It will also assist in bringing about the necessary societal behavioural change that is required to protect and enhance, in particular, water services in Ireland. It will make local authorities more accountable for these major arms of service delivery, which is an objective of the Green Paper.

It could also provide in the region of €500 million more per annum for local government finance from the authorities' own resources, by plugging a significant funding gap that arises from water and waste-water service provision over the next number of years. The combination of both these charges (for the domestic and non-domestic sectors) will mean a considerable increase in the amount of service charges (particularly for the domestic sector) over the amounts currently collected.

We consider that once the proposed annual property tax (APT) recommended in Part 6 of our Report becomes established as a national tax, all of its revenues should be directed to local government financing and provision made for each local authority to set its own rate. In other words, the tax would become a local property tax to be administered nationally by the Revenue Commissioners.

Section 3:

Local taxation measures other than charges on property

3.1 What is a local tax?

We believe that if local taxation measures are to be considered as a source of financing for local government, they should be consistent with the minimum requirement for what is a genuine local tax which is initiated by a local authority, at a rate which it determines, and is collected in its area of operation. Furthermore, we also consider that if local taxation measures are to make a worthwhile contribution to the financing of local government, then each measure should have the following characteristics:

- Its effects on after-tax income should be fair
- Its tax base should be widely distributed throughout all local authority areas, so that all areas might hope to receive sufficient revenue from it to make a contribution to the financing of local expenditure
- The cost of administration should be low in relation to the tax yield
- It should be capable of being levied at different rates by different local authorities

3.2 Local income tax

We recognise that a local income tax has some arguments in its favour. In particular, it would be a potentially buoyant source of revenue and would be linked directly to a person's ability to pay. However, in our view, the arguments against the introduction of a local income tax outweigh its potential benefits. This conclusion is influenced by the following:

- Locally determined income tax rates are not consistent with national employment policies
- A local income tax system would lead to considerable additional compliance costs on employers and on individual taxpayers
- There are difficulties in taxing non-PAYE income, such as investment income and dividends, which would give rise to anomalies. These could prove difficult to address in implementing an equitable local income tax system
- As an alternative to central government financing, a local income tax would not give an even distribution of income to each local authority given the varying density of population throughout Ireland. Central government would still have to transfer significant resources to provide equalisation of funding to some local authorities
- A genuinely local income tax that would possibly be levied at different rates by various local authorities could lead to some taxpayers choosing to live or work in areas where a lower tax rate applies
- It would increase the burden of tax on labour income

Conclusion

We do not recommend the introduction of a local income tax.

3.3 A poll tax/community charge

A flat-rate poll tax, also known as a community charge, was used relatively recently in the U.K. as a source of funding for local government following the abolition of a domestic rates system of local taxation³. A poll tax has no direct relationship to a person's income – rather, it is a fixed charge per individual resident (though those on lower incomes may be exempt from the tax).

We do not recommend the concept of a poll tax as an option for the future financing of local government as it has many features which are not consistent with our guiding principles. The tax is inequitable, as it is levied equally on all residents of a local authority area, resulting in well-off people paying the same amount as those on lesser incomes. It bears little relationship to ability to pay. It is a tax that is charged on all residents in a local authority area, as distinct from imposing a tax on each household. A significant section of the community may be able to avoid the tax, particularly in areas where some residents are transient.

In addition, we consider that a poll tax would not form part of a pragmatic approach to the future financing of local government for two reasons: firstly, because the proposed tax is inequitable; and secondly, we believe that it would be highly unlikely to be accepted by the public as a source of finance.

Conclusion

We do not recommend the introduction of a poll tax/community charge.

3.4 Local sales tax

Our consideration of this option for local government financing took into account the harmonisation of VAT laws across the EU. The common system of VAT, implemented through EU VAT Directives, does not allow the maintenance or introduction of taxes which have the characteristics of a turnover tax⁴. For this reason local sales taxes are not a feature of local government financing systems in the EU. In contrast, they provide significant sources of funding for state and local governments in the US and Canada.

EU legislative requirements therefore preclude us from considering an *ad valorem* sales tax, which is a tax based on the value of the product sold. In any event, the impact of such a tax on the cost base could adversely affect Ireland's competitiveness.

Conclusion

We do not recommend the introduction of a local sales tax.

3.5 A local bed tax or levy

This proposal has been put to us in a number of submissions as a financing option for local government. Such a levy or tax is a feature of local authority financing in some EU countries but it is not an *ad valorem* tax because of EU VAT rules.

The Department of Arts, Sport and Tourism outlined in its submission to us that:

³ Such taxes, i.e. a head or poll tax, were a common source of revenue for many governments until the 19th century but not since and were usually linked to a person's right to vote.

⁴ See Article 401 of the recast VAT Directive (2006/112/EC).

"We are not aware of any reason why hotels (as against any other individual enterprise sector) should be subject to a specific local tax given the very significant contribution of charges and rates already paid by the sector. Such a tax could have clear negative implications for the competitiveness of Irish tourism internationally if implemented in an isolated way without regard to competitiveness or other aspects of the tax system."

We consider that a bed tax or levy has the potential to provide a local source of revenue which would enhance accountability within local authorities. However, its revenue-raising potential is extremely limited. Unless a relatively high levy is struck, it would not provide a material source of funding for most local authorities.

Using Discover Ireland data, which indicates that there are over 88,500 rooms available in the Irish market with an occupancy rate of 60%, a levy of €1 per bed-night would indicate an overall yield of approximately €19 to €20 million per annum from accommodation services.

We are also cognisant of the fact that it would be an additional tax or levy to the applicable VAT rate of 13.5%, which would make the sector less competitive in a tourism market which needs to remain competitive.

However, in areas where a significant number of hotel rooms are available for the tourism market, there is potential for a bed levy which could be used to enhance tourism facilities in these areas. Local authorities, in co-operation with tourism partners, could explore how a voluntary funding scheme might enhance tourism facilities in these areas.

Conclusion

The introduction of a local bed tax or levy as a source of local government financing is not recommended. However, the potential for some local authority areas with tourism activity to use a bed levy to enhance tourism facilities, within a voluntary funding scheme, could be further explored.

Section 4: Local commercial property taxation measures

4.1 The commercial rates base

The commercial rates system is a local property tax over which local authorities have a considerable measure of control. Rates are levied annually, and, each local authority has exclusive rating jurisdiction within its own area. Rates are levied on the occupiers of commercial property, based on the annual letting value of the property. The valuation of such property for rating purposes is carried out by a central government agency, the Valuation Office, with a right of appeal to a Valuation Tribunal. Each year the level of the charge in a local authority area is determined by the elected council as part of the budgetary process. The annual rates charge for a commercial premises is calculated by applying the annual rate on valuation (ARV) to the valuation of the property concerned.

We believe the current system of raising local authority finance from commercial rates works reasonably well, despite an outdated basis for valuing commercial properties. It raises a considerable amount of revenue for local authorities, and represents an additional taxation

contribution from the business sector (much of which is subject to the corporation tax rate of 12.5%). We consider that it should remain in place.

A revaluation initiative is now underway which will, in time, modernise an antiquated valuation system, and provide a more transparent system for charging commercial rates. The revaluation initiative was legislated for during 2001. However, some eight years later, due in part to industrial relations issues, only a very small number of local authority areas have been fully revalued. The process needs to be expedited and should have regard to safeguards to ensure equitable treatment of rate payers and a cost effective route of appeal.

Recommendation 11.1

The revaluation initiative should be expedited to ensure that a transparent nationwide valuation system, including a cost-effective route of appeal, is in place as soon as possible. Regular revaluations should be carried out thereafter, in order to ensure that the valuation base remains up-to-date. This should be done as provided for in legislation, at intervals of not more than 10 years.

4.2 Rating vacant properties/vacancy relief

The current position is that commercial properties are rated whether they are occupied or vacant. However, sections 14 and 23 of the Local Government Act 1946 provide for a refund in certain circumstances. The legislation distinguishes between vacant premises in urban and rural areas. In practice, Dublin City Council and the other county borough councils may refund up to 50% of the total charge. Other councils may refund up to 100% of the rates charged.

The refund, known as 'vacancy relief', may only be given in the following circumstances:

- an owner/leaseholder is *bona fide* unable to obtain a suitable tenant, or
- a property is vacant due to repairs or alterations being carried out on it

To obtain the relief the property must be vacant at the time of the striking of the rate by council. This provision creates obvious anomalies where premises are vacated at other periods during the year, and cannot avail of the relief.

Our consideration of the vacancy relief provisions in place was informed by the requirement to have an equitable incidence of taxation - in so far as possible to treat all the relevant taxpayers in a similar way. We took the view that the incidence of commercial rates should be as broad as is feasible, in order to spread the burden of local taxation in a fairer way. Furthermore, we believe that changing the vacancy relief provisions could improve the efficiency of the property market by offering an incentive to bring under-utilised property back into productive use.

However, we are cognisant of the fact that a proposal to standardise vacancy relief could be criticised as causing undue hardship to owners in areas where demand for property is low, particularly in areas where there is population decline.

Commercial property markets tend to operate more efficiently where there is a critical population mass, which leads to steady commercial and business activity, and a consequent need for commercial property.

The Department of the Environment, Heritage and Local Government carried out a survey of local authorities to determine the level of vacancy relief being granted. The survey results indicated that

if vacancy relief was standardised in all areas at 50%, local authorities would save an estimated €20 million in rate refunds.

Recommendation 11.2

The vacancy relief provisions should be amended to provide for the granting of vacancy relief by local authorities, in accordance with the following principles:

- Vacancy relief should only be granted where the following conditions are satisfied:
 - An owner/leaseholder is *bona fide* unable to obtain a suitable tenant, or
 - A property is vacant due to repairs or alterations being carried out on it, and
 - That the relief, where granted, is time-limited so as not to encourage the owner of a premises to allow it to become dilapidated, and
 - The rate of the relief to be granted by a local authority to be within the range 50-100% for the time-limited period
- Vacancy relief should be applied *pro-rata* according to the period of vacancy in any year.

Recommendation 11.3

The provision which states that a property must be vacant at the time of the striking of the rate by a local authority should be removed.

4.3 Rating permanent offshore structures

We considered the question of whether permanent structures which are located offshore, such as wind-farms or other offshore electricity generating stations, should be rated. At present, owners or occupiers of such structures are not liable to pay commercial rates. In contrast, commercial rates are payable in respect of on-shore permanent structures.

The rating jurisdiction of a local authority extends to the high-water mark only. We acknowledge that there are significant issues that may need to be addressed, but consider that this area should receive some expert review so as to minimise anomalous treatment between permanent on- and off-shore structures.

The Department of the Environment, Heritage and Local Government pointed out in its submission that setting local authority boundaries beyond the high-water mark has significant practical difficulties as well as significant legal issues. Notwithstanding potential legal issues, we consider that these structures should be brought within the rates base subject to recognising existing territorial water limits. Expert consideration should be given to bringing them within the rates base of the local authority area of the nearest shoreline and the use of the high-water mark as the boundary for rating purposes should be reviewed.

Recommendation 11.4

Permanent offshore structures should be made subject to commercial rates.

4.4 Other commercial, for-profit premises which should be subject to commercial rates

Bed-and-breakfast premises, guesthouses, and self-catering accommodation provided by

tourism operators are exempt from commercial rates. We understand that Government, in the past, considered that there might be merit on equity grounds to rating B&B and self-catering accommodation, but did not proceed with such a measure in the absence of a compulsory national licensing or registration system for such premises.

We consider that any premises operating on a commercial for-profit basis should be included in the commercial rates base. It seems particularly anomalous that self-catering apartments and holiday homes that are owned or operated by hotels are not subject to a rates charge and we recommend that they be included in the rates base. However, we recognise that owners of some domestic houses may operate guest accommodation services on a seasonal basis or in support of educational purposes during school holidays, and only provide a very small number of rooms for accommodation, often for very short periods of time.

To address this issue, we suggest that a reasonable and consistent basis is provided for identifying B&Bs and guesthouses which should be rated. In essence, a B&B or guesthouse that provides four or more rooms for overnight guest accommodation should be brought within the commercial rates base⁵ by part-rating them.

Recommendation 11.5

Bed and breakfast accommodation and guesthouses should be brought within the commercial rates base where there are four or more bedrooms in a dwelling house provided on an ongoing basis for overnight guest accommodation. Self-catering apartments and holiday homes provided by tourism operators should also be brought within the rates base.

4.5 Properties currently exempt from commercial rates

Schedule 4 of the Valuation Act 2001 lists property types that are also excluded from the commercial rates base.

Property types excluded from the commercial rates base include:

- Agricultural and horticultural land and buildings
- Properties used exclusively for care or hospital or medical purposes which are publicly run and not-for-profit
- Land and buildings used for educational purposes which are publicly run and not-for-profit,
- Publicly funded museums and theatres
- Buildings occupied by charitable organizations, and
- Community halls

We consider that properties used or occupied by bodies which are not established for the purposes of making a profit, but where the body has its expenses defrayed wholly or mainly by the State, should continue to be included on the Schedule as should:

- Land and buildings used exclusively for religious worship
- Any body whose principal activity is the conservation of natural and built endowments in the State, and which is run on a not-for-profit basis

5 The Local Government (Planning and Development) Regulations 1994, specify that planning permission is required for the use of more than four bedrooms in a dwelling house as overnight guest accommodation. This provides a definition that could be used in the application of rates to properties where four or more rooms are used for overnight guest accommodation.

- Property used by a society established for the advancement of science, literature or the fine arts and which is used exclusively for that purpose and not for profit, and
- The organisations listed at part 12 of the Schedule⁶, all of which are publicly funded, are normally open to the public, and are not established and maintained for the purposes of making a profit, should remain not rateable

4.6 Broadening the rates base

Subject to the above we consider that the commercial rates base should be as broad as possible and we propose the following changes.

Educational institutions are exempt based on the fact that they have their expenses defrayed wholly or mainly by the Exchequer. Many third-level institutions and professional institutions are excluded from the rates base, despite the fact that many of them generate significant funds from their own resources, and conduct significant amounts of commercial activity on their campuses. We consider that these institutions should be partly rated⁷.

The level of part-rating should have regard to the level of commercial activity taking place on a campus. In order to support new businesses based in incubation units, whose purpose is to develop innovative and entrepreneurial business ideas which are based on research and development conducted on campus, such businesses should be exempted from part-rating for the first three or so years of activity.

A provisional estimate of funding from this source (from the Valuation Office and based on pre-2002 valuation lists) is about €10 million.

Community halls are not rateable. These are premises usually operated by bodies which are not established for the purposes of making a profit. However, we consider that such buildings should be part-rated if a significant amount of commercial activity operates from them. This proposal would put such business activity on the same footing as businesses carrying on similar activity which pay rates. The level of part-rating should have regard to the level of commercial activity taking place.

Provisions for the non-rating of agricultural land and farm building should remain, with one exception: farm buildings which are owned by a body corporate should pay commercial rates, as companies are subject to a lower rate than applies to farmers. Our rationale for this approach is that many farms owned by corporate businesses in the agri-food industry are subject to commercial rates on all other buildings occupied by them and that, for these, farm buildings should also be rated.

Recommendation 11.6

Third-level and professional institutions should be part-rated to reflect the fact that they generate significant funds from their own resources and conduct commercial activity on their campuses.

Recommendation 11.7

Community halls should be part-rated where significant commercial activity takes place in such facilities.

⁶ The National Museum of Ireland, the National Library of Ireland, the National Gallery of Ireland, the Irish Museum of Modern Art Company, the Arts Council, the Heritage Council, the National Concert Hall Company, the Chester Beatty Library, and the National Theatre Society Limited.

⁷ As was the case before the enactment of the Valuation Act 2001

Recommendation 11.8

Agricultural farm buildings which are owned by a body corporate should be subject to commercial rates.

4.7 State properties

Excluded from the commercial rates base are buildings or land occupied by government offices; the Defence Forces, the Gardaí, prisons, and constituency offices of TDs, MEPs, and Senators. HSE administrative accommodation is also deemed to be 'State occupied', and is therefore not rateable. The main rationale for including these properties in the rates base is that their exclusion reduces the size of the base in local authority areas with a high concentration of State properties. Their exclusion impacts on all local authority areas where government offices are located especially following various decentralisation initiatives.

Inclusion of such properties in the rates base would also ensure that commercial properties that are taken over by the State, such as toll bridges, remain within the base.

The State makes a contribution 'in lieu of rates' to the Local Government Fund in respect of State properties. It is not clear to us how the amount 'in lieu of rates' is calculated each year in the absence of each State property being valued for the purposes of striking a rate for the building.

This conflicts with our guiding principle of simplicity – that tax rules are easily understood, and that liability is clear.

A more transparent funding mechanism would be to have all State properties rated – as provided for in the Valuation Act 2001. This recommendation would replace the funding mechanism – the contribution 'in lieu of rates' that is in place – and would offer greater transparency and certainty in regard to this funding stream from the Exchequer to local authorities. While we recognise that the Local Government Fund would be correspondingly reduced, the proposed change is nonetheless desirable on the grounds of greater certainty and control for the local authority funding base.

The Minister for the Environment, Heritage and Local Government has made provision for the Commissioner for Valuation to include State properties in the revaluation initiative that is now underway. This will allow commercial rates to be collected in respect of them.

In the absence of precise valuations for each State-occupied building and the commercial rates charge that applies in each local authority area, it is not feasible to give a precise estimate of funds that would be generated by these rates charges for State properties. One provisional estimate⁸ is that revenues of almost €50 million could accrue to local authorities from rates on State properties.

Recommendation 11.9

All buildings or land occupied by the State should be brought fully within the commercial rates base.

Section 5:

Annual property tax as a source of local government funding

5.1 Introduction

We consider that once the proposed annual property tax (APT) becomes established as a national tax (see Part 6 of our Report), all of its revenues should be directed to local government financing and provision made for each local authority to set its own rate. In other words the tax would become a local property tax to be administered nationally by the Revenue Commissioners. We consider that the funding stream from an APT should replace the funding stream from motor tax revenues currently directed to the local government fund.

The introduction of an APT provides a unique opportunity to enhance the financing framework of local government and to improve its autonomy and accountability at a time when its scope and functions are being considered in the forthcoming White Paper on Local Government Reform.

An annual tax on residential property is a very common financing source for local and regional governments worldwide. It would be unusual that revenues from such an annual property tax on residences be used solely for central government finances.

Using revenues from a property tax, and from increased user charges (water, waste and planning services in particular) would provide greater clarity in how local services are funded and would help provide greater transparency over local services costs and how decisions on spending and resources have been made. This would help improve local accountability and provide for a more autonomous local government system. A distinction may need to be set out when implementing local government financing changes between user charges (such as for water and waste services) and an APT which would fund the wide range of other local authority expenditures.

5.2 How would using annual property tax revenues for local government financing impact on central government finances?

Replacing the motor tax revenue stream into the local government fund with a property tax revenue stream of the same dimension should not impact on central Government finances. In 2008 the motor tax stream of income amounted to €1.05 billion. Property tax revenues of the same dimension could replace this revenue stream. Any higher yield from APT could replace or part-replace the Government grants and subsidies funding (€1.272 billion in 2008) representing financing to local authorities from Government departments⁹. We note, however, that setting of the rate of APT is not a matter for the Commission.

Analysis

Advantages

- i) As set out at 5.2 above using the yield from APT could be revenue neutral for the Exchequer.
- ii) The provision of the APT yield for local government financing has the potential to provide greater clarity to the roles of central and local government and to provide an appropriate balance between local and national priorities.

- iii) Over €1 billion of local government financing comes from the proceeds of motor taxation (which is paid into the LGF). A more appropriate tax base for local government financing is one that is based on immobile assets such as property. It is consistent with the business property tax – commercial rates – which already provides 27% for financing current expenditure. We consider that the taxation of motor vehicles, and the national environmental policy underpinning that tax base (reducing carbon emissions), is more appropriate to a national taxation system the revenues from which should be directed to central government.
- iv) The necessity to improve the basis on which local authority financial planning is carried out is clear. The allocations to each local authority are only made known near year-end – at the time when each local authority finalises its budget. The Exchequer contribution to the LGF has to match the actual allocations to individual local authorities. This provides for a difficult budgetary process. The Green Paper argues that greater certainty on central government funding would be beneficial. The allocation of property tax receipts to the LGF would provide for a stable and long-term revenue stream for local government financing which would be desirable.
- v) Local government reliance on central government – 45% of its revenues come from central government – limits its capacity to improve local services. Its control over its own resource income is also constrained by central government to the degree that some of its own resource rates and charges – such as housing rents and planning fees – are controlled centrally. We consider that changes to local government structures to make it – as envisaged in the Programme for Government and the Green Paper on Local Government – ‘more transparent and more responsive to customers’ should coincide with changes to local government financing and make local government more accountable. These local government financing changes should be driven by effectiveness and efficiency and, as the Green Paper outlines, should be innovative, well-targeted, flexible and responsive to the citizen. Our proposals on water charges should allow local government to address and meet these objectives in the delivery of water services. A similar outcome should also be sought and can be achieved if property tax revenues are directed to local government financing.
- vi) The local government electoral cycle provides a very good landscape within which a local annual property tax on residential property could be constructed. The next local government elections will take place no later than June 2014. At that time, in our view, the proposed annual property tax (APT) should be well established and tested and it is appropriate that it should form part of the local government financing base before, or no later than, that time. It would represent a significant development of the degree of local autonomy currently held by local government and would form a constructive agenda for debate, at local level, in the context of the 2014 local elections. It would also ensure renewed and increased levels of accountability for all candidates at that time.

Disadvantages

- i) Central government ensures that local authorities with weaker economic bases have access to a pool of funding which helps equalise their funding position vis-à-vis local authorities with stronger economic bases. The equitable and transparent determination of the allocation of what is now the general purpose grant to local authorities is managed through a needs and resources model

developed by the Department of the Environment and Local Government in 2000.

Equalisation measures will still be required to protect the position of local authorities with higher levels of socio-economic need and low property tax raising abilities – whether from commercial rates or an annual property tax. The hypothecation of national property tax revenues to local authorities from the local government fund would permit the development of the current needs and resources model to ensure appropriate equalisation of funding. When fiscal powers are devolved to local authorities to permit them to set their own property tax rates, a new equalisation funding method will have to be developed to reflect the changed funding base. We recommend that this be addressed at or before that time.

- ii) The devolution of fiscal powers to local authorities permitting them to set their own APT rates may put pressure on central government to provide further funding to some local authorities whose APT rates are set at levels which would not permit them to meet their expenditure demands. This could potentially diminish local accountability.

5.3 The need to develop and establish the annual property tax system

We consider that there are a number of reasons why the proposed annual property tax should be established and bedded down before being devolved to local government.

- a) The focus during the first number of years of a new property tax should remain on the development of a robust and comprehensive tax base with a commensurate revenue yield. This will involve a concerted effort by the Revenue Commissioners, in particular, before the commencement of and during the operation of the first number of years of collecting the proposed tax including a nationally organised information campaign.
- b) The introduction of the proposed APT and the zero-rating of stamp duty on owner-occupied residential housing transactions (see Part 6) is central to our proposals for a newly restructured property tax system. Using some or all of the APT yield for local government financing during this period may, in our view, complicate the development of such a structural change.
- c) There is a requirement, in the short term, to bring a far greater degree of stability to the central government tax base. Certainty is one of the key characteristics of any tax system. It is important for the State – so that budgetary planning can be developed from a far less volatile tax base than has been the position over the past number of years – and for taxpayers. For the taxpayer, the development of a new tax system will mean that decisions to purchase a house – one of the most significant financial decisions that will be made by any taxpayer – will involve some different inputs into decision making.

In order to provide the greatest degree of certainty that is feasible for both taxpayers and the State it is appropriate that the new property tax system should, in the commencement and introductory period, have only one national set of rules including rate setting.

- d) One national organisation collecting and administering the tax will ensure that the cost of collection is kept to a minimum. One national set of rules which is administered by one agency nationally will also provide some clarity on how much revenue can be raised for the Exchequer. This will be an important issue in the first number of years of the operation of the proposed tax. It would also mean that a substantial set of established rules can form part of

any devolved system of rate-setting powers that may, in time, be given to local government.

- e) Before consideration is given to hypothecating revenues from APT, or devolving rate-setting powers, to local government financing, it is appropriate that all the substantial design features of the APT are put in place and bedded down for a period so that any devolution of functions to local authorities can be carried through from a solid and tested tax base. This period should cover the establishment of, and implementation of, all aspects of the property tax administration system – including appeal structures, wide-ranging payment options and the other ‘engine-parts’ necessary to a properly functioning tax administration system.
- f) It is appropriate that waiver and/or deferral schemes be fully developed and tested nationally before devolving fiscal powers to local government. Indeed we consider that waiver and/or deferral schemes should continue to be part of a centrally controlled function and be administered uniformly throughout all local authority areas after any proposed devolution of the rate-setting aspect of property tax system to local authorities.
- g) The implementation of our proposed water charging system will be a considerable challenge for local authorities over the next number of years and will also result in a considerable change to the funding base for local government financing. The imposition of water charges (estimated at about €500 per average household in 2014) and a local property tax would present a difficult, though not insurmountable, challenge for local authorities (elected representatives and management) over the next number of years, if both were to be rolled out concurrently.

5.4 Conclusions

Devolution of fiscal powers or hypothecation?

As the Green Paper points out, the ideal shape of local government would include a local government system which is less dependent on central government and that the primary way to achieve this objective is to give local authorities greater autonomy and accountability. Options for the future financing of local government being proposed by us – including increased own resources financing (by which we mean financing from local taxation measures – currently commercial rates, and user and service charges) – will help provide a basis for achieving this objective. Achieving these aims will take time and hard work and must be matched by clear democratic responsibility and accountability by local authority leaders who should have full responsibility for decision-making at local level.

After an appropriate period we consider that all of the revenues from a national property tax should be used for local government financing. However, we acknowledge that allocating fiscal powers between two layers of government (central and local) involves complex issues. The move from hypothecating central tax revenues to devolving taxing powers to local authorities is significant.

Hypothecating property tax revenues to local government financing rather than devolving fiscal powers to local government is the more appropriate approach in the short-term.

We consider that central government should influence the parameters of the overall tax burden on taxpayers. This would mean that central government would reserve powers to regulate how far local authorities can go in setting a local property tax rate. We recognise that such an approach may circumscribe the degree of autonomy and accountability that local government may have

but consider that it is a necessary approach given the number of local authorities that could set different local property tax rates. We consider a 'one step at a time approach' to be an advisable one. If powers are devolved to local authorities permitting them to set their own property tax rates these powers should be limited to rate-setting within clearly set parameters and which preclude a disproportionate variation in the local property tax base which would oblige central government to provide other sources of financing or which would put an undue burden on other "own resource income" of local authorities.

The impact of proposed changes to local government financing (that is, local annual property tax, water charges for domestic users, increased revenues from water charges from the non-domestic sector, other increased user charges and a broader commercial rates base) on the 2008 funding base will mean a significant restructuring of that funding base when all the financing options proposed are implemented – which should be no later than the end of 2014 in our view – see Table 11.8.

Recommendation 11.10

After an appropriate period all of the revenues from an annual property tax should be used for local government financing.

Recommendation 11.11

The proposed annual property tax system should be established and operated as a national property tax system for a short initial period:

- Its revenues should then be hypothecated for local government financing as soon as is feasible – once the tax has become established, and
- By no later than the next local elections (June 2014) rate-setting powers should be devolved to local government subject to the considerations set out at section 5.3 of Part 11.

Recommendation 11.12

A new method of equalisation of funding, using a needs and resources model, should be developed in conjunction with the devolution of rate-setting powers to local government to reflect the changed funding base for local government.

Section 6: Development contribution system

The development contribution system, which is a longstanding part of the planning system, was significantly revised in the Planning and Development Act 2000, in order to improve its transparency and increase the range of infrastructure that can be funded under this mechanism. Under the 2000 Act, the elected members of each planning authority must adopt a General Development Contribution scheme for their own functional area.

The development contribution system has been a successful method of enhancing local government funding, particularly since the start of this decade – see Table 11.1, which sets out the revenues raised by local authorities since the start of this decade. They total almost €3 billion, with a healthy growth pattern apparent in the period 2001 – 2007, reflecting the buoyant construction sector. Deterioration is apparent since then. These levies are therefore a very cyclical income stream. However, the income stream is

proportional to infrastructural requirements in a local authority area.

Table 11.1: Development contributions collected 2000 - 2008

Year	Development contributions collected €m
2000	110.4
2001	122.0
2002	151.0
2003	215.5
2004	337.3
2005	519.4
2006	671.1
2007	867.0
2008	382.7 est.

The development contribution system is a source of local government funding which is consistent with most, if not all, of the characteristics of a genuine local tax or levy. It is initiated by the local authority where the development takes place; the contribution is struck at a rate determined by the council (this is a reserved function of the elected representatives); it makes a worthwhile contribution to local authority financing (as is apparent from the figures in the table); it is reasonably widely distributed throughout all local authority areas – though areas with strong economic bases have fared proportionately better, due to factors like population shift and increased population density.

Given the sharp correction in the residential housing market, and the significant slowdown in the commercial property market, revenues from the scheme have declined significantly. However, this is happening at a rate more or less proportionate to the economic activity taking place in those areas.

The revenues arising from the development contribution system are specifically targeted at the provision of local public infrastructure (roads, water supply, drainage, parks and open spaces and community facilities).

Our proposed enhanced capital gains charge on development land will fall on the owner of land who is receiving an enhanced gain arising from rezoning decisions. Our proposed recurrent tax on rezoned land should incentivise the use of land that is rezoned for development. Both proposals should provide for more sustainable planning decisions in the future.

Conclusion

We consider that the development contribution system has worked reasonably well since the enhancement of the relevant provisions in 2000. The system should remain in place. However, we note that appeals against development levies are currently processed in conjunction with other aspects of the planning application. This can lead to inordinate delays and should be examined with a view to separating the process for appeals against the development contribution from other aspects of the planning application.

An enhanced capital gains charge on development land and a recurrent tax on rezoned land are recommended by us as part of our review of the taxation of property in Part 6 of our Report.

Section 7:

Water charges

7.1 Local and EU context

Water charges are imposed on the business and commercial sector by local authorities. However, local authorities do not impose water charges on domestic homes. We are almost unique among EU Member States in this regard.

The EU Water Framework Directive (WFD)¹⁰ provides for the recovery of costs for water services. Article 9.1 states that:

"Member States shall take account of the principle of recovery of the costs of water services including environmental and resource costs, having regard to the economic analysis conducted ... and in accordance in particular with the polluter pays principle".

Article 9.1 also provides for:

"an adequate contribution of the different water uses, disaggregated into at least industry, households and agriculture, to the recovery of the costs of water services .."

Article 9.4, known as the 'Irish Clause', provides that Ireland will not be in breach of the Directive by not securing 'an adequate contribution of different water uses'. This, effectively, allows Ireland not to impose water charges on domestic users. The clause was sought and obtained by Ireland following extensive debate at national level.

However, unmetered water charges were in place in almost every local authority area prior to 1997. These had been enabled by 1983 legislation designed to broaden the financing base of local authorities, following the removal of domestic rates in 1978 and agricultural rates in 1983.

7.2 The water challenge

In its submission to us, the Department of the Environment, Heritage and Local Government (DoEHLG) pointed out that the cost of providing safe and secure water services sufficient to meet future needs is increasing significantly in line with efforts to comply with EU standards on water safety.

The current system of funding domestic water services provision, by way of an unidentified element in the Local Government Fund (LGF) allocation, is becoming unsustainable.

The gap between the expenditure and income on local water services in 2007 was €394 million, based on local authority budgets. Local authorities contend that this gap is essentially the cost of domestic water services provision and that the funding available within the LGF is insufficient to cover it.

However, the €394 million shortfall may partly be accounted for by the fact that individual local authorities might not be applying full cost recovery to their non-domestic customers in setting their water charges. It also may be attributed to some non-payment of bills for water services supplied and a degree of water loss within the system.

A submission to us from the DoEHLG on water and waste water expenditure and income in all 34 water services authorities provides greater clarity on water and waste water costs. The Department

¹⁰ Directive 2000/60/EC

indicated that the methodologies used to measure the annual water supply and set waste water charges vary from authority to authority. There are also considerable differences in the cost base of each authority. Due to the lack of consistency and transparency in the systems and methodologies, and the variations in the cost base, the charges may be subject to dispute. The disparity in the 2007 and 2008 charges can be seen from the following figures for the combined charge per cubic metre for each year.

Table 11.2: Water charges 2007 and 2008

	2007	2008
Highest charge	€2.52	€2.71
Lowest charge	€0.99	€0.99
Average charge	€1.71	€2.07

The average charge for water per cubic metre in EU countries in 2007 was €3.25, but was considerably higher in countries that have full cost recovery e.g. Germany €5.09 and Denmark €5.63¹¹.

7.2.1 Cost of providing water services

The cost of providing water and waste water services is growing significantly and is placing an increasing strain on the LGF. The total current expenditure on water services has risen from over €442 million in 2004 to over €680 million in 2007, an increase of 54%. It is projected that the annual increase in the current costs of water services will be in the order of 14% to 15% over the next number of years. The total projected capital cost for water services over the lifetime of the current National Development Plan (2007 – 2013) is estimated at €4.7 billion. The income for 2007 from water services for the non-domestic sector was €169 million, whereas expenditure on this sector was €227 million: a recovery rate of 74%.

7.2.2 Unaccounted for water (UFW)

The level of reported unaccounted for water in the 34 local authorities varied in both 2007 and 2008, from 18% to 65%. The average level of UFW was 45% in 2007 and 44% in 2008. This contrasts to UFW rates which varied from 16% to 82% in a 2000 National Water Study. By unaccounted for water we mean the amount of treated water entering the distribution system that cannot be accounted for by legitimate use. It can be comprised of water mains and reservoir losses, distribution network losses and user supply pipe leakage, as well as water taken illegally and water used for such operational purposes as system flushing and fire-fighting.

Local authorities have set themselves medium-term and long-term targets for unaccounted for water (see Appendix 1 for more on this). In order to achieve these targets the majority are now implementing water conservation programmes funded by the Department of the Environment, Heritage and Local Government. However, given the slow progress with the conservation programmes, there has been little improvement in recent years in the level of UFW. We note with concern that of the €298 million made available since 2003 for water conservation programmes, only €115 million (39%) had been drawn down by local authorities by May 2009. We understand from DoEHLG that activity under this expenditure programme is expanding and it expects this trend to continue over the next number of years as local authorities gear up their water conservation operations.

11 Survey by N.U.S. Consulting for Forfás

We consider that the reduction of unaccounted for water must continue to be aggressively pursued. Water gains that accrue from reducing unaccounted for water to acceptable limits will help provide for a more cost-efficient delivery of water services to consumers in the future.

7.2.3 The capital cost of water infrastructure

We consider that capital investment in water infrastructure in Ireland should have as its primary focus a demonstrable improvement in environmental performance. The principal outcome of this should be a sustainable and cost-effective water supply. Future capital investment must seek to meet or exceed international best practice, and to deliver optimum value for money. This would allow local authorities to:

- Meet the consumption needs of a growing population
- Achieve water quality standards
- Minimise water leakage, and
- Achieve the highest standards of environmental protections and compliance

In order to ensure a long-lasting and sustainable water supply, capital investment programmes at both local and national levels must place a higher priority on expanding infrastructural water conservation activity. This should be done particularly by rehabilitation and reinforcement of existing water networks, and by sharing water networks to achieve efficiencies and economies of scale. To meet this objective, local authorities should maximise efficiencies that can accrue from sharing infrastructure where feasible.

7.3 Contribution of commercial sector under the current water charges regime

The Government's water pricing policy requires local authorities to recover the cost of water services from users, except from households using the service for domestic purposes. The policy provides for full cost recovery without profit, with charges based on actual metered consumption. This policy should mean that no subsidisation should occur between the non-domestic and domestic sectors. The fact is that full cost recovery from the non-domestic sector is not being achieved. The cost of providing water services to the non-domestic sector will have to be met in full by 2010 to comply with the EU Water Framework Directive. At present the cost recovery ratio from the non-domestic sector is 73% resulting in a shortfall of about €58 million in 2008. We consider that this shortfall should be addressed immediately.

Despite the intended policy to recover the full cost of water services from commercial users, it is clear that the full capital cost of providing water services to commercial users is not applied to their water charges. According to the DoEHLG, only the marginal cost of the capital services is applied to commercial water charges¹². The application of the proportionate capital costs to the commercial sector would result in water charges that would more closely approximate the EU average.

The DoEHLG also pointed out that the lack of any deterrent to excessive use of water by the domestic sector supports the contention that a greater-than-normal proportion of water services costs in Ireland are attributable to that sector. The indications are that excessive volumes of water are being used by a population that largely perceives water to be a free and limitless resource.

12 We understand that what the DoEHLG means by marginal cost in this instance is: "the cost over and above the cost that would apply to a domestic service".

In the non-domestic sector in contrast, as the metering programme has progressed and customers have been forced to switch from flat charges to volumetric bills, local authorities report that large levels of leakage within non-domestic premises have come to light and been addressed.

Excessive usage leads to shortage of supply, resulting in higher demand for additional water services infrastructure, and increased local authority expenditure on the provision of water services (totalling an estimated €680 million in 2007). There are also positive lessons to be learned from metering that already exists in group water schemes which provide water services to 170,000 or more domestic users.

Recommendation 11.13

Measures should be put in place immediately to ensure that the costs of water services provided are fully recovered from the non-domestic sector.

7.4 Contribution of domestic sector

Some submissions to us have suggested a more universal application of water charges to ensure a proportionate contribution from all sectors, domestic and non-domestic, to the costs of providing water services.

The Green Paper on Local Government points out that Government policy to date has been to prohibit the charging for water to domestic homes on the basis that this is 'a core public service'. However, we note that this is in contrast to a charging regime that was in place in many areas between 1983 and 1997. In 1996, almost all local authorities imposed annual flat rate charges for water services to domestic properties. Charges were usually fixed across an authority, and ranged from €65 to €184 per household at that stage. Approximately €63 million was collected in domestic water charges in 1996.

Absence of a conservation mindset

The difficulty with the current policy approach is that it does not give the appropriate signal to homeowners that water is a resource which is costly to treat for drinking, and even more costly to treat as waste water, before it can be released back into the environment. These costs have risen in recent years, as Ireland puts in place the expensive infrastructure required to meet the discharge quality standards which are now required. Ireland is almost unique in Europe in not charging the domestic user for these costs.

The absence of a 'conservation' mindset in relation to water actually costs the taxpayer significantly more, as additional capacity has to be built, maintained and operated, to provide the additional drinking water and waste water treatment.

We believe that the unsustainable nature of this approach in the long term must be addressed and that charging domestic users for water services on the basis of use should form part of a revised approach. The fact is that a domestic water user in Ireland may install a swimming pool and access a free water supply to maintain that pool all year round at no cost. In our view, this is hardly a core public service¹³.

13 Section 56 of the Water Services Act 2007 (which commenced with effect from 15 December 2007) gives local authorities powers to issue notices ordering corrective action to be taken to prevent wastage or excessive consumption of water. In the absence of metering, establishing whether water is being used excessively is difficult.

The user/polluter pays principle

Public acceptance of charges for local authority services can be difficult to secure, as was evident from the introduction of waste charges. The Green Paper points out that there is a conflict between the principle that the taxation system should pay for certain essential public services delivered by local authorities in Ireland, and the principle of the 'polluter pays' which underpins the charging regimes for water services in most EU Member States. The 'polluter pays' principle recognises that much human activity has an environmental cost – which, if paid for in a visible way, encourages corrective behaviour. We consider that the polluter pays principle, which underpins the EU Water Framework Directive, should also underpin the policy approach to providing water for domestic users in Ireland.

Recommendation 11.14

Domestic water charges should be introduced as a sustainable approach to realising an acceptable conservation culture.

Water charging and metering

The major focus of our consideration was the following: what financing base for water services is the most appropriate and sustainable approach in the medium-term and long-term? We took the view that, at the very least, a sustainable medium- or long-term vision should involve the measurement of water consumption across all sectors, including the domestic sector. A metering system measures consumption and encourages better behaviour in the use of a valuable resource through the provision of a means for householders to see what they are consuming. Importantly, it would provide for a transparent charging mechanism.

In order to provide a transition to a transparent basis for water charges, water meters should be provided for all domestic and non-domestic users. We understand from discussions with the DoEHLG that a meter installation programme will cost in the region of €400/€450 million (in 2008 terms) over a period of five years or more. This should be seen in the context of the multi-billion euro investment programme for water services currently underway. It should also be noted that the full cost should not be borne up-front by the State, and can be passed on to the consumer. Incentivising consumers to purchase water meters is an essential step which must accompany the introduction of water charges.

Users should be incentivised to install meters by a reduction in or exemption from water charges in the year in which a user installs a water meter and for a period thereafter, as necessary. Local authorities should also be incentivised or encouraged to prioritise investment to reduce water leakage during the window where National Development Plan funding for water infrastructure is available. Failure by a local authority to achieve acceptable leakage rates will leave them in the unsatisfactory position of having to explain water charges based on full economic recovery whilst leakage rates are at an unacceptable standard.

Where metering is in place, jurisdictions that take water conservation seriously impose a sliding scale where the charge increases – typically very sharply – from a very low rate for the first units of consumption per month to a high rate. We note that with modern metering technology, there is no problem with implementing such a sliding scale.

A free quota?

We considered the possibility of providing a free quota of water to every household. Agreeing on an appropriate quota is fraught with difficulty. Setting a relatively generous quota would do little or nothing to encourage water conservation; setting a low quota, or giving a number of units per member of the household, would present huge administrative difficulties. We concluded that it is preferable to have no quota in place and that those on low incomes could be dealt with through a waiver system.

Waiver

Our approach to the provision of a waiver system for water and waste charges is set out at section 8.5 below. In the context of the provision of water to domestic users, we suggest that a number of free units of water should be provided, for each billing period where the household income is below a certain threshold similar to other free household benefit schemes operated by the Department of Social and Family Affairs. We do not intend to be prescriptive on what that income threshold should be, and recommend that the waiver system should have regard to the ability-to-pay criteria similar to the application of free units of electricity for those whose income is below a certain threshold.

In the period before metering is provided, during which our proposed flat charge is in place, the waiver should be based on setting aside an appropriate portion of the flat charge.

We consider that the cost of providing free units to consumers who qualify for a waiver should be met by local authorities and not centrally.

7.5 Phasing-in of water charges for the domestic sector

It will take some time for a metering system to be put in place on which water charges can be based. However, the re-introduction of water charges should in our view commence without undue delay. Pending the rolling out of meters to all domestic users, we consider that water charges should be phased in, to commence the recovery of the economic cost of water services to domestic users.

With regard to the phasing in period, we make the following observations:

- Water charges for domestic users should be phased in over a period of time. By the end of the period full economic costs of delivering water services should be recovered from users and be consistent with the objectives of the EU Water Framework Directive. The exception for full economic recovery should be for 'free scheme' recipients who should be exempt or partially exempt from water charges initially and receive a defined amount of free units once meters are installed
- The phasing-in period should coincide with the timeframe for the NDP capital investment programme, and exclude the recovery of capital costs for domestic users for that period
- During that period every effort should be made by local authorities to provide metering for all domestic housing units (and the non-domestic users that are not metered). The charging system should provide an incentive for users to install meters at as early a stage as is practicable. This could be provided through exempting, or part-exempting, users from a water charge for the year in which they install a meter, or offsetting the cost of the meter installation against the water charge
- Initially, water charges should be set at a low flat basic rate and be increased on a graduated basis over the phasing in period so that the basic flat charge equates, on an overall basis, to

full economic cost recovery at the end of the phasing in period. Users who convert to meters should be charged by reference to metered use (if this is lower than the basic charge). They should receive a discount on their volumetric bills if higher (measured against the basic flat charge) for a period, say one or two years, after the installation of the meter;

- It should be compulsory that water meters are installed in all new housing units.

7.6 Public information

For the re-introduction of water charges for domestic users to gain public acceptance it will be necessary for local authorities, and for central government, to make it clear to all water consumers through public information campaigns, the need for a water conservation mindset and what is being charged for and why it is necessary to charge. This campaign will need to set out how it is proposed to introduce a graduated system for water charges over a set period of time.

Recommendation 11.15

There should be some level of incentivisation to ensure that consumers are encouraged to install meters.

Recommendation 11.16

Charges should be phased in over a period of time.

Recommendation 11.17

The charging should commence with a flat rate charge and change to volumetric billing for consumers once meters are put in place.

Recommendation 11.18

A waiver scheme should be provided for low-income householders.

Recommendation 11.19

Water meters should be installed in all new housing units.

Recommendation 11.20

A public information campaign should clearly outline the rationale for water charges and the way in which they will be implemented.

7.7 Pricing

The cost of providing water services is subject to a range of local variable factors, such as the number of sources of water supply and the number of treatment plants and pumping stations required. Local authorities are currently required, when pricing water services for non-domestic customers, to recover the costs of providing the service to those customers. We believe that water pricing should be introduced for all water consumers by local authorities based on a consistent methodology and applying the principle of full cost recovery.

Recommendation 11.21

Water pricing should be introduced for all water consumers by local authorities based on a consistent methodology and applying the principle of full cost recovery.

Section 8:

Waste charges

8.1 Overview of waste collection services

Local authorities raise revenues in respect of waste management services by putting in place charges on consumers (domestic and commercial) for the collection and disposal of waste, where the local authority itself is the waste collector. Where waste collection is undertaken by a licensed waste management operator, the revenue and expenditure accrue to the private operator, with no involvement by the local authority.

Local authorities also raise revenues from gate charges at their own landfill sites. The revenue from the landfill levy does not accrue to local authority funds; it is directed to a central Environment Fund which is utilised for a range of purposes to improve the quality of our environment.

Encouraging change

Waste management activity by local authorities is financed by the charges imposed on occupiers of domestic and commercial premises, and the gate charges at landfills. We believe that cost recovery should not be the sine qua non of imposing waste charges. Encouraging behavioural change to ensure that all consumers manage waste in a more efficient manner, and that waste reduction is achieved in line with the principle of 'reduce, re-use and recycle' should – along with landfill minimisation targets – be a primary focus of waste charge rates.

The 1998 Policy Statement on Waste Management¹⁴ recognised that:

"Ireland's waste management infrastructure has been consistently under-resourced, and that significant capital investment will be necessary to achieve the radical improvements which are required".

The policy statement also pointed out that waste collection and disposal services provided by local authorities do not reflect the full economic costs of these services:

"Many households face relatively low waste charges, or no charges at all, while waste charges levied on commercial interests are often well below the true economic cost of managing their waste. Local authorities must move rapidly towards full cost recoupment for the waste services they provide."

Since 1998 the position has changed significantly. Indecon economic consultants estimated that cost recovery for waste collection services in Ireland is in the region of 80%, which is due to the introduction of waste charges. This is 'laudable' per the OECD, which points out that cost recovery is significantly lower in other OECD countries.

Waste charges are now in place in all local authority areas, with pay-by-use and pay-by-weight being the dominant forms of charging. We support continued efforts to secure further cost recovery to ensure that all consumers pay for their own waste.

14 A policy Statement on Capital Waste Management, Changing our Ways, Minister for the Environment, September 1998

Recommendation 11.22

The polluter pays principle should continue to underpin waste charges to ensure that all consumers pay for their own waste.

8.2 Levies and final disposal

While cost recovery for waste collection in Ireland is 'laudable', our efforts at recycling and diverting waste away from final disposal require serious attention and concerted action. In order to meet our obligations under the 1999 EU Landfill Directive, the target for bio-degradable waste (paper, food waste and garden waste) that must be diverted from landfill by 2013 is 1.7 million tonnes. The Comptroller and Auditor General in his 2005 Annual Report has raised the concern that, based on our performance to date, there is a significant risk that we will fail to meet the targets set by the Landfill Directive. If this is the case, financial penalties will apply. The latest National Waste Report from the Environmental Protection Agency (EPA) has further highlighted these concerns and has indicated that a degree of urgency is required if penalties are to be avoided.

In regard to the cost of final disposal, we note that there are cost recovery (capital and operating) and environmental costs associated also with incineration (and probably some of the other final disposal technologies being considered).

8.3 Conclusion

The landfill levy is one mechanism which can be utilised to encourage behaviour to divert waste away from landfill and meet our obligations under EU law. It should be increased so as to further encourage this behaviour. In the interests of economic efficiency final disposal charges should not favour any particular type of disposal and should be based on the sum of capital, operating and environmental costs imposed.

Recommendation 11.23

The landfill levy should be increased to encourage behaviour to divert waste away from landfill and meet our obligations under EU law and a similar mechanism should be considered for other forms of final disposal.

8.4 Privatisation of waste management services

The contracting out of waste collection services to the private sector has implications for local government financing, particularly in the provision of waivers for consumers on limited incomes. In general, waivers are not provided in local authority areas where the waste collection services are provided by the private sector. There are very few exceptions.

We are concerned about an approach that limits waivers to areas where waste is collected only by local authorities, as it breaches one of our guiding principles of equity. We note the formal investigation of complaints on this issue by the Ombudsman which found that:

"where somebody lives or who collects their rubbish should not determine whether they can get a waiver or how much of the charge is set aside".

The Ombudsman recommended that the appropriate legislation should be amended to provide for an

obligation on operators to provide waivers. We consider that waste collection charges, whether supplied by a private operator, or directly by a local authority, should factor in the cost of waiver provision.

The principle of an equitable incidence of taxation and a person's ability to pay are clearly challenged by the absence of waivers for people in certain areas. We take the view that nobody who should be entitled to a waiver on inability-to-pay criteria ought to be excluded on the basis of a lacuna in legislation. The relevant legislation should be amended immediately.

As part of its review of the Irish Public Service during 2007/2008¹⁵, the OECD carried out a case study, which reviewed the regulation and provision of municipal waste management services in Ireland. It identified that the shift from public service provision to an increased involvement of private enterprises in the waste management market raises concerns about the selective servicing of the most lucrative markets, and the delivery of environmental and social public goods¹⁶.

In the last decade or so, local authorities have increasingly ceded waste collection to the private sector, especially outside of the Dublin region. The OECD point out that the entry of the private sector into the waste collection area has been enabled, firstly, by the ability to charge user fees; and secondly, by a rise in quality standards driven by the EU, which has increased costs. This increase created an opportunity for the private sector to move where local authorities were either unwilling, or unable, to collect waste, particularly in non-urban areas.

We consider that where a public service obligation exists, then there should be no unequal treatment of citizens. The relevant legislation should be amended to ensure that all waste collection operators are obliged to provide waivers where appropriate.

The OECD case study on local waste management in the local government sector also pointed out that local authorities are incentivised to achieve returns on the landfills they own, by utilising existing landfill capacity as much as possible, regardless of national efficiency concerns or environmental targets such as waste minimisation or waste recycling.

Recommendation 11.24

Waivers should be available from all service providers in all local authority areas to all clients who lack an ability to pay.

8.5 A waiver system for water and waste charges

Some of the submissions from local authorities have asked us to consider the introduction of a national waiver scheme to fund the cost of waivers, where consumers are exempted from paying service charges if their income is below a certain threshold.

We consider that a waiver system should be put in place for service users. It should be based on ability-to-pay criteria, similar to – for example – the application of free units of electricity for those whose income is below a basic income threshold.

We looked at the question of whether or not a national waiver scheme should be introduced to

¹⁵ See OECD Public Management Reviews, Ireland: Towards an Integrated Public Service

¹⁶ It is estimated by the Irish Waste Management Association that annual revenues are now in the region of €1.5 billion. In recent years there has been significant consolidation in the private waste market with companies now offering services throughout the various stages of the waste chain (collection, disposal, recycling etc.). Rising fees coupled with the small geographically spread-out nature of the consumer base has encouraged the horizontal integration as larger operators acquire the businesses of smaller private operators. This process of consolidation is likely to continue. The potential for monopolies to develop within the waste sector may ultimately lead to higher charges and loss of choice for the consumer.

cover the cost to local authorities of providing waivers.

We believe that the management of revenue streams, including overseeing and funding waivers – whether they are from local services charges such as for waste and water services, or from taxation measures such as a local property tax – should remain fully within the ambit of each local authority. To dilute that responsibility by devolving it to a third party – such as the Department of Social and Family Affairs, as has been suggested – would weaken a local authority's control over the management of, and responsibility for, the revenue stream from each of these services.

For that reason the pricing framework for waste and water services should include a proportion which will fund the cost of providing services to consumers who qualify for a waiver. A central set of guidelines should be developed. We consider that a local authority should not find its cost recovery pricing framework disadvantaged because a large number of low income households are in its area. Within the guidelines which should be developed we propose that some element of equalisation funding should be available to compensate for a waiver provision in local authority areas with a high incidence of low income households.

Recommendation 11.25

We do not support the establishment of a national waiver scheme. The pricing of waste and water services should be designed to fund the cost of providing services to consumers who qualify for a waiver.

8.6 Tax relief on service charges

Tax relief is available for local service charges that are paid in full and on time, either by the person liable for them, or by another person who resides in the premises to which the service relates. It is provided whether the service fee is paid to a local authority or independent contractors.

The relief is given at the standard rate of tax for any service charges paid, including bin tags, in the previous year¹⁷. The cost of the relief will be considerable if water charges are introduced in line with our recommendations. The overall revenue from water and waste charges by the end of the transition phase for introducing water charges is likely to be more than €750 million. The tax expenditure, based on relief at the standard rate, would be €150 million per annum.

The relief was originally introduced in the Finance Act 1995 and gave effect to one of the undertakings in the then Government's policy agreement, "A Government of Renewal". We noted the speaking note provided for the then Minister for Finance for the Committee stage of the debate:

"As acknowledged in ["A Government of Renewal"] there is a strong feeling of inequity about service charges by many people. The allowance being provided for ... is envisaged as a short term measure until the question of the overall funding of local government can be resolved. It is also being granted in recognition of the fact that local charges are regarded by some persons as constituting double taxation."

¹⁷ The total tax relief that can be claimed for both fixed charge payments (including lift charges and pay-by-weight) and bin tags is subject to an overall limit of €400. 20% of this amount is allowed as a tax credit.

Recommendation 11.26

Tax relief on service charges should be abolished.

We consider that this short-term measure should now be brought to an end. The polluter pays principle should underpin the charging process for local authority services and should not be diluted by the provision of tax relief. If this was the case, there would also be a rationale for tax relief on other utility bills.

Section 9: Other means of financing local government

9.1 Planning fees

Planning fees charged by local authorities are set centrally by the Department of the Environment, Heritage and Local Government (DoEHLG). Local authorities have no discretion in the matter¹⁸.

The Indecon review of local government financing highlighted the chasm that exists between the cost of running the planning system and the revenue received in planning fees. The Department of the Environment, Heritage and Local Government estimates that when the full costs of the planning functions provided by local authorities are included, the average cost of processing an application for planning permission exceeds the average fee income by more than €1,500¹⁹.

In 2006 the estimated funding gap was just under €40 million, approximately 50% of the overall cost of the planning service²⁰. There is no relationship between planning costs and other related costs in the construction industry. The shortfall in funding is met from the general resources of local authorities.

A number of submissions raised this funding shortfall as an issue for us. The Green Paper also suggests that there is potential to recover more costs in this area.

The DoEHLG published a consultation paper, *Resourcing the Planning System*, which concludes that:

“Application fees charged in Ireland fall well short of those charged by our nearest neighbouring jurisdictions and significant shortfalls exist between fees charged and costs to planning authorities.”

By far the majority of planning fees come from the residential development area, specifically the construction of houses or domestic extensions. The consultation paper points out that during 2006, over 70,000 planning applications were made under this category. The current fee payable for an application for permission to build a new house is €65 (compared to €470 in the UK), while the fee for material alterations to a house is €34. As the consultation paper states:

“Such low charges mean that in a period of significant house price inflation and rising construction costs, the fee for delivery of the service which constitutes a critical stage in the construction of a house is barely equal to the cost of a few litres of paint.”

18 Section 246 of the Planning and Development Act 2000 sets out the powers of the Minister (of the DoEHLG) to set fees.

19 *Resourcing the Planning System – Consultation Paper*, May 2008, DoEHLG.

20 Per the Indecon Review of Local Government Financing.

The average cost of processing an application for a one-off house is estimated to be €489. We consider that this gap needs to be reduced through increased user charges.

We note that for very large developments a maximum fee of €38,000 is set for application fees with, in practice, developments of up to 10,550 square metres charged on a floor area basis, with fees for anything greater than this area capped at €38,000. We consider that large developments should not receive the benefit of such a cap.

The consultation paper proposed that some classes of planning fees be increased to a level that more adequately reflects the cost of providing the service. A minimum fee is also proposed for some classes of planning application.

The consultation paper proposed that fees should be increased, but not to a level which would allow for full economic cost recovery at this time – on the grounds that the widening gap between the cost of providing the planning service and the revenue received in application fees needs to be addressed. It recognised that to address the gap fully would require very significant increases (up to 750% in some cases), which could have major consequences for customers of the planning system.

An analysis of the planning income and expenditure for a selection of local authorities²¹ indicates that expenditure is greater than revenue for most of the councils reviewed, and that there is significant variation in the ratio of costs to income per planning application across the sector. This supports the proposal in the Consultation Paper that the widening gap between the cost of providing the planning service and the revenue received in application fees needs to be addressed.

We consider that an efficiency review of the cost of planning services is the appropriate way forward before consideration can be given to devolving the setting of planning fees from the Minister to local authorities.

However, we take the view that any future charging regime should have regard to wider issues including access to the appeals process on planning decisions, and the interaction of planning costs for developers and other charges that result from planning decisions, such as development levies.

- We have reservations about moving to full economic cost recovery for a number of reasons: Firstly, some of the fixed costs borne by local authority planning units provide general planning advice and services for which planning applicants should not be asked to bear the cost
- Secondly, there may be a significant impact on the costs to the construction and development sector which require further detailed examination
- Thirdly, further consideration needs to be given to what is an appropriate charging matrix for planning appeals, and whether it is equitable that planning applicants should be asked to fund some or all of the costs of appeals, particularly where some third party appeals may be technical, or have a public or common good interest, or are simply vexatious

Notwithstanding these reservations we consider that the funding gap outlined above needs to be considerably reduced and that this process should begin immediately. Setting an implementation period for the recovery of a higher proportion of planning costs would allow users of the planning service time to prepare for higher charges, and ensure the least possible impact on development patterns across Ireland and on competitiveness.

21 As set out in the Indecon Review of Local Government Financing.

Recommendation 11.27

Following an efficiency review:

- The Department of the Environment, Heritage and Local Government should develop a charging system in conjunction with local authorities to ensure a higher proportion of planning costs are recouped from planning applicants.
- Consideration should be given to devolving responsibility for setting planning fees from the Minister to local authorities subject to central guidelines being developed.

9.2 Housing rents

Rental income provides the main source of funding for the management and maintenance of the local authority housing stock. However, this revenue does not provide an income stream for local authorities to re-invest more money in the provision of more social housing, or for refurbishing or regenerating existing social housing stocks as the revenues from housing rents do not meet the cost of housing provision by local authorities.

Rental income from local authority housing is not linked to the market value of the property; it is linked to a tenant's ability to pay through a differential rent system. Since 1986 the power to determine rent levels was devolved to local authorities. However, the determination of the rent levels is still controlled to some extent by central government, through guidelines issued by DoEHLG. These require that rent levels should continue to reflect a tenant's ability to pay. However, there is considerable variation of the income per housing unit across local authorities.

The Housing (Miscellaneous Provisions) Act 2009 provides for more up-to-date guidance for local authorities in determining rent levels. It aims, according to the DoEHLG, to "eliminate some irrationality that has developed".

Our analysis was informed by the National Economic and Social Council (NESC) review of housing policy in Ireland, which identified a number of issues regarding public rental policy for further analysis and debate²²:

- The current differential rental scheme for Irish social housing results in a continuing shortfall between rents collected, and the costs of maintenance and management.
- Adjusting rents to tenants' ability to pay has a major social value when, as is the case with local authority housing, tenants are concentrated at the lowest end of the income spectrum.
- The operation of the current differential rental scheme has a number of unintended drawbacks:
 - It constitutes a continuing drain on local authority resources rather than a financial asset. The stock is unable to generate a surplus for further investment (e.g. refurbishment and regeneration is dependent on securing separate funding) and a continuing dependence is created on central funding and decision-making.
 - The existence of maximum rent levels reduces the overall efficiency of the scheme, as higher income tenants benefit disproportionately.
 - Other possible inequities arise from the capping of rent contributions by subsidiary earners in a household, which makes it possible for multi-earner households to pay a much lower proportion of their income in rent than single earner households.

22 Housing in Ireland: Performance and Policy, NESC Report No 112, November 2004.

- The failure to reflect the quality of, or demand for, particular dwellings in the calculation of rents leads to horizontal inequities; tenants with identical incomes and family circumstances can find themselves paying the same rent for dwellings whose locations or quality give a wholly different value.
- Inefficient pricing can arise as the age of houses largely determines maximum rent variations, while age is often poorly correlated with the overall quality of dwellings and the supply of, and demand for, different dwellings and locations.
- Finally, people in similar circumstances can also be treated very differently because of the county or borough in which they are renting. There is considerable variety in all aspects of rent calculation across local authorities, in the treatment of dependants and subsidiary earners, maximum rent limits and income banding.

NESC concluded that it is important, in the interests of both equity and efficiency, that rental policies across the range of long-term accommodation for social tenants are consistent. They should impose a fair rent, while reflecting the ability to pay. For all these reasons, NESC recommended that a review of the current differential rents policy be carried out to improve the sustainability and effectiveness of the current scheme. We note that the suggested review has not been undertaken to date.

The report by the NESC also indicated that local authority housing rents in Ireland receive a larger subsidy than public housing in other European countries. We recognise that ability to pay and the differential rent scheme is an important tool in improving social inclusion.

We also recognise that there may be sound reasons in some local authority areas why the income per housing unit is lower than an average:

- Where there is a high vacancy rate due to difficult social conditions
- Where a local authority has significant numbers of disadvantaged, and low income, households which give rise to much lower rent charges

However, given the significant capital investment being made in social housing, we believe that concerted action is needed to ensure that the disparities in income per unit across local authorities are reduced. These issues should be examined as part of the on-going review of housing policy.

We consider that there must be no deviation from the policy of basing housing rents on a tenant's ability to pay. The situations where higher income tenants and households which have subsidiary earners benefit from the existence of maximum rent levels needs to be reviewed to ensure that they do not benefit disproportionately.

The gap between rents collected and the cost of maintenance of houses and management of estates is an issue which, from a local government financing perspective, merits detailed examination - particularly in view of the unintended drawbacks identified in the NESC review.

Recommendation 11.28

There should be no deviation from the policy that housing rents are based on a person's ability to pay. Maximum rent levels should be removed to ensure that some tenants and households do not benefit disproportionately.

Recommendation 11.29

A review of the current differential rents scheme should be carried out to improve the sustainability and effectiveness of the scheme, as previously recommended by NESC.

Recommendation 11.30

The significant disparity across local authorities between rents collected on an income per housing unit basis should be addressed without delay with a view to elimination.

Section 10:

The balance of local government financing and the equalisation of funding

10.1 Introduction

The Green Paper on Local Government has as a central theme the idea that local government can deliver more if equipped to do so. The paper identifies autonomy in fundraising as one way in which local authority discretion and accountability can be increased. However, the Green Paper also points out that there is little consensus on how such autonomy should be achieved. This goes to the heart of whether, and how, the balance of funding should be changed to reflect the ideals of the Green Paper that local government can deliver more if equipped to do so.

This Section of our Report sets out the existing position and how, in broad terms, our recommendations will change the balance of funding.

10.2 The present balance of current funding

The balance between nationally provided and locally collected sources of income for local government current financing was broadly as follows in 2008:

Table 11.3: Local government sources of financing

	2007	2008
Commercial rates	€1.344	27%
Receipts for own goods and services	€1.403	28%
Local government fund	€0.999	20%
Government grants and subsidies ²³	€1.272	25%
Total	€5.018	100%

In general, local authorities' source around 55% of their overall current income from their own generated resources such as: commercial rates, housing rents and receipts for goods and services, such as waste charges and also water charges from the commercial sector. The share of local authority budgeted income provided directly by the State amounted to just over €2 billion – or 45% of total current income.

However, overall figures mask considerable variation between local authorities as to their sources of income. The following table indicates that city and town councils are far less reliant than most

23 Of which approximately €180 million relates to higher education grants funded by the Department of Education and Science and paid out by local authorities to grant recipients. This funding cannot be used by local authorities for any other purposes.

county councils on revenue generated from the central government. This reflects the fact that large city councils, such as Dublin and Cork have very strong economic bases from which healthy commercial rates revenue streams can be generated.

Table 11.4: Breakdown by local authority type

2007	County Councils %	City Councils %	Borough Councils %	Town Councils %	Total %
Commercial rates	22.0	35.8	37.0	40.1	26.8
Receipts for own goods and services	26.1	30.8	35.3	30.6	27.7
Local government fund	22.4	13.5	17.7	21.1	20.0
Government grants and subsidies	29.5	19.9	10.0	8.3	25.5
	100	100	100	100	100

10.3 Commercial rates

Commercial rates – which are a form of taxation on property – are a local source of income, over which local authorities have a considerable measure of control. Rates are levied annually by county, city, borough and certain town councils. Each of these authorities has exclusive rating jurisdiction within its own area.

If accepted, our recommendations on the broadening of the rates base will mean, on an overall basis, that local government funding from this source will increase in the order of €80 – €90 million.

This is broken down as follows:

Table 11.5: Additional own resources from broadening the commercial rates base

	Estimated Revenues
Rating State properties	€50 million +
Rating vacant properties	€20 million
Rating offshore structures	€ minimal
Rating B&B, guesthouses and self-catering	€3 million *
Farm buildings owned by corporates	€ minimal
Part-rate third level and professional educational institutions	€10 million
Part-rating of community halls	€ minimal

* Tentatively estimated at €3 million plus

Note: If our recommendations are accepted future revenues from some of the base broadening measures above will be minimal. Factors other than revenue raising underpinned those recommendations. For example, rating offshore structures such as wind-farms puts them in the same rating position as onshore wind farms. Part-rating community halls puts them in same rating position as local businesses carrying on similar commercial activity.

10.4 Receipts for own goods and services

Local authorities charge for the services they provide, for example: commercial water charges; housing rents, waste charges, parking charges and planning application fees. In most cases the

charge or fee is set locally. However, certain charges or fees, such as planning fees, are fixed at national level²⁴.

Our focus on increasing own resources from user charges, particularly water charges, will mean a very significant increase in income under this heading. This will impact on the overall balance of local government financing. We estimate the potential increased resources in this area to be in the order of €500 million at the end of our suggested transition period for the provision of full water charges – see Table 11.6. Subject to the outcome of the proposed review of the housing rents scheme, the charges involved should be decided on at local level, bearing in mind the principle that they should be based on the recovery of full economic costs and having regard to the development of a framework for water pricing.

Table 11.6: Additional own resource income from increasing user and service charges

	€million
Full water charges on all domestic users	€450 million
Full cost recovery for water services to non-domestic sector	€58 million
Full economic cost recovery of waste charges*	
Planning fees	up to €40 million
Housing rents	subject to further review

* We are not giving an estimate for additional income from this source as any estimate may change if, as has been the case, local authorities continue to cede waste collection to the private sector.

10.5 Local government fund

The Local Government Fund (LGF) for general purpose grants was established in 1993 and is funded from the following sources:

- An Exchequer contribution
- The full proceeds of motor tax, and
- Bank interest

The general purpose grants are the Government's contribution towards the cost to local authorities of providing their day-to-day services.

For 2009, it is envisaged that the LGF will comprise a €520 million contribution from the Exchequer; €1.085 billion from motor taxation receipts, with a small balance of €4 million accruing from interest on LGF funding invested with the National Treasury Management Agency. In addition, Budget 2009 provided for a new revenue stream to accrue to the LGF from an annual €200 charge on non-principal private residences. It will be levied and collected by local authorities, and used to contribute to Exchequer funding to local authorities for operational costs. The Budget 2009 estimate of revenue from this source was €40 million in a full year.

24 We mention in Part 3 of our Report that, in a Judgement delivered on 16 July 2009, the European Court of Justice ruled that Ireland was in contravention of Council Directive 2006/112/EC (Case C-554/07) in not having a general requirement that public authorities be subject to VAT where they were engaged otherwise than in their capacity as a public authority. We note that this ruling has implications for a wide range of services provided by local authorities, such as waste collection, car parking and recreation and amenity services.

For 2008 the Local Government Fund income was distributed as follows:

Table 11.7: Distribution of local government fund income 2008

	€million
General purpose grants	€999 million
Non-national roads payments	€565 million
Other miscellaneous payments	€80 million

Our focus on increasing own resources from user charges and on broadening the rates base will mean that there should be less reliance on the Local Government Fund as a source of financing for local government.

10.6 An annual property tax as a source of local government financing

Our recommendation that all of the revenues from an annual property tax (APT) - once it becomes established as a nationally administered tax by the Revenue Commissioners – should be used for the future financing of local government, will bring about a structural change in the financing of the local government sector. In conjunction with our other recommendations on local government financing it will provide the potential for local government to be financed primarily from own resource income – see Table 11.8.

We conclude that the taxation of motor vehicles, and the national environmental policy underpinning that tax base (reducing carbon emissions), is more appropriate to a national taxation system, the revenues from which should be directed to central government and that the proposed APT should become a source of local government financing.

By way of illustration, the impact of our proposed changes to the 2008 local government financing (annual property tax should it yield approximately €1 billion per annum, water charges for domestic users and increased revenues from water charges from the non-domestic sector, other increased user charges and a broader commercial rates base) funding base will mean a significant restructuring of the funding base when all the financing options we recommend are implemented – which should be by no later than the end of 2014 in our view.

Table 11.8 – The financing mix of local government financing in 2008 and after our recommendations are implemented in 2014 using 2008 as a base year.

		€billion 2008	%	€billion 2014	%
1	Commercial Rates	€1.344	27%	1.427	28%
2	Receipts for Own Goods and Services	€1.403	28%	1.951	39%
3	Local Government Fund – General purpose grants – <i>from APT</i>	€0.999	20%	1.0	20%
4	Government Grants and Subsidies (including €550m from D/Transport for local and regional roads, c€170 million for higher education grants <i>and an amount for an equalisation fund which could be transferred from the LGF line above</i>)	€1.272	25%	0.64	13%
	TOTAL	€5.018	100	€5.018	100

Note 1: The first three categories could then be classified as own resource income as all are derived from user charges or local property taxation in its two forms: commercial rates and annual property tax. Local property taxation has the potential to contribute almost half of local government financing, with user charges contributing almost 40%. There may be no need for a LGF classification going forward.

Note 2: The question arises as to how central government stamp duty revenues would be replaced if all of APT revenues are used for local government financing? We propose that APT revenues (should they have a projected yield of €1 billion or more) could replace motor taxation revenues as a source of local government financing. This would still leave a 'gap' of about €500 million. This gap arises from the loss of the previous stamp duty yield (other than the 'windfall gains' that arose from stamp duty in the 2003 – 2007 period in particular). In effect the possible yield from water charges – about €500 million – reduces the reliance, by that amount, on the central Exchequer for direct government grants and subsidies and effectively fills the 'gap'.

Our recommendations mean:

- **Water charges** – at present there is an unidentified water services allocation on the general purpose grants allocation which would not be required once full water charges are in place at the end of the five-year transition period recommended by us.
- **Rating State-occupied properties** – the contribution in lieu of rates, estimated at €35 million, would no longer be required from this source of funding. (However, if State properties are to be subject to full rates charges, as recommended by us, some additional funding from Exchequer resources may be required to enable the public body occupying the State property to meet the rates charge.)
- **Planning fees** – the funding gap of €40 million that arises from the relatively low planning fees that are in place, is met from the general resources of local authorities. These resources are funded in part from the general purposes grant provided for by the LGF. This can also be reduced.

10.7 Government grants and subsidies

Government grants and subsidies to local authorities are paid by a number of Government departments, including the DoEHLG. The most significant are:

- **Grants for road works:** these are categorised into national and non-national roads. For national roads, funding is provided by the Department of Transport to the National Roads Authority, which then determines the allocations to local authorities for improvement and maintenance work on roads.
- **Grants for water supply and sewage schemes:** These grants cover the approved costs of major water supply and waste water schemes undertaken under the Water and Sewage Investment Programmes. Some of this funding is provided by the Department of Community, Rural and Gaeltacht Affairs.
- **Grants for housing:** the major grants are for local authority housing construction, remedial works, voluntary housing and traveller accommodation.
- **Higher education grants** – for which funding of approximately €180 million is provided by the Department of Education and Science.
- **Civil defence** – for which funding is provided by the Department of Defence.

Our recommendations will have little or no impact on this source of central government local authority funding.

10.8 The equalisation of funding and the needs and resources model

The Department of the Environment, Heritage and Local Government developed a Needs and Resources Model in 2000 to ensure that the allocation of general purpose grants to local authorities from the LGF is done on an equitable and transparent basis. A number of submissions to us from local authorities have suggested changes to this funding model.

It is appropriate that central government should have a role in ensuring that local authorities with weaker economic bases have access to a pool of funding which helps to equalise their funding position vis-à-vis local authorities with stronger economic bases. Similar equalisation procedures are also found in other jurisdictions.

The aim of the model is to bring about equalisation between local authorities over time, so that each will have sufficient resources from a combination of central grants and local income, to provide an acceptable level of services to their customers. The Lyons Review of local government finance in the UK²⁵ put it well: “it is important to ensure that communities with high levels of socio-economic need and low tax raising abilities are not left behind”.

Amendments and refinements are made to the model each year following consultations with local authorities to ensure that the unit costs and unit incomes in the model reasonably reflect local authority cost bases.

We understand from DoEHLG that the model was independently evaluated to verify its approach and to guide its further development. The findings of this evaluation confirmed that the principles of the model are sound and reasonable.

A further review of the model is underway to reflect the differences in the cost bases of individual local authorities, using the improved financial reporting systems that are now in place. Ongoing periodic review and evaluation of the model is appropriate. Local authorities themselves should be part of that review and evaluation process. A more comprehensive review of the model will be

25 Lyons Inquiry into Local Government – Final report, March 2007, HMSO.

required if our recommendation that the revenues from an annual property tax be used as a source of local government financing is accepted and implemented.

Recommendation 11.31

The Needs and Resource Model should be periodically reviewed and evaluated to ensure that the difference in the costs bases of local authorities are reflected in relevant decisions by central government on equalisation funding. The reviews should be undertaken in partnership with local authorities.

10.9 Efficiencies and shared services

The recent OECD review of the Irish public service²⁶ pointed out that:

“Local Government seems to provide a good example of using shared services in the Irish public service. This is mainly because the Local Government Computer Services Board, a separate and independent organisation, provides a centre of competence with aggregated buying power and represents a critical mass for standardisation. The rest of the Irish public service, however, has been slow to catch on.”

The OECD went on to point out that the Local Government Computer Services Board is very progressive in information, communications and technology (ICT) and the development and provision of shared services and works closely with a range of central government bodies.

The social partnership agreement, Towards 2016, also commented on the “marked progress” throughout the local government sector in implementing change and modernisation programmes in areas that include enhanced customer service and the adaptation of technology and flexible working arrangements. The agreement pointed out that: “there is a growing ease of personal and technological access to ongoing developments in areas such as environment, planning and registration processes”.

The Indecon review of local government financing made a number of recommendations which focused on efficiency improvements in local authority expenditure programmes, which were combined with reforms in the methods of funding of local authorities - particularly through more effective charging and additional local funding sources.

We consider that the introduction of water charges to the domestic sector (and non-domestic users not currently charged) provides a huge incentive for local authorities to more quickly address water leakage rates, which are at an unacceptable level. Efficiency gains have been achieved where metering has been provided both through the identification of leaks and damaged pipes, and more economic water usage. We also believe that the provision of charges based on recovering further economic costs in the planning area has the potential to secure further efficiencies in that service. It may also be an area where shared services between local authority areas could be more actively explored.

As Indecon also pointed out, the revenue collection activities of local authorities should be examined in order to ascertain whether the sharing of resources between local authorities could achieve more efficiency gains.

26 OECD Public Management Reviews, Ireland – Towards an Integrated Public Service, 2008

We support the approach taken in the Report of the Taskforce on the Public Service²⁷ that the use of shared approaches, whether in-sourced, outsourced or co-sourced, should be prioritised for areas such as:

- Data centre facilities.
- Services for civil and public service bodies.
- Shared payroll systems.
- The administration of performance management systems.
- Training, upskilling and certification of personnel in the civil and public service.

The Taskforce identified the use of shared services in HR, Finance, Procurement and ICT as a way to achieve potential benefits to achieve such outcomes as:

- Economies of scale
- Tangible service improvements
- The enhancement of reporting and accountability
- The standardisation of processes and reporting across the Public Service.

We consider that the approach set out by the Taskforce should be wholeheartedly endorsed by the local authority sector and guided, where appropriate, by the sector working with the Department of the Environment, Heritage and Local Government.

We are conscious that local authorities are continually exploring ways to achieve further efficiency gains and cost-saving measures and that they are committed to realising the potential for shared services, as outlined in Towards 2016, in areas identified by the Taskforce and in areas such as, waste management, water treatment plants, procurement and data capture.

Recommendation 11.32

The initiatives being undertaken to improve efficiencies in local authority expenditure programmes should continue to receive a priority focus at local authority level and from central government. That priority will be assisted by the new standardised costing system which provides for greater benchmarking of local authority performance.

Appendix 1

Unaccounted for Water (UFW)				
Local Authority	2007 UFW %	2008 UFW %	Medium Term Target %	Long Term Target%
Carlow	49	49	37	25
Cavan	54	42	30	22
Clare	48	48	36	27
Cork City	55	55	49	30
Cork County	50	50	27	27
Donegal	50	50	45	40
Dublin City	37	37	30	22
Dun Laoghaire/Rathdown County	20	24	20	20
Fingal	23	23	20	15
Galway City	54	52	40	20
Galway County	64	64	45	30
Kerry	54	53	48	43
Kildare	26	26	24	22
Kilkenny	60	60	35	25
Laois	53	53	38	25
Leitrim	37	37	–	–
Limerick City	42	42	40	20
Limerick County	38	22	–	–
Longford	44	42	40	20
Louth	47	47	30	30
Mayo	45	45	30	25
Meath	48	44	40	30
Monaghan	46	43	30	25
North Tipperary	50	50	40	30
Offaly	53	51	45	30
Roscommon	64	60	50	35
Sligo	55	50	45	35

Unaccounted for Water (UFW)				
Local Authority	2007 UFW %	2008 UFW %	Medium Term Target %	Long Term Target%
South Dublin	17	18	18	16
South Tipperary	65	65	50	35
Waterford City	46	41	37	34
Waterford County	41	41	35	25
Westmeath	41	39	33	23
Wexford	39	39	35	25
Wicklow	26	26	26	22
Average	45	44		

Source: Local Authorities



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

ANNEXES



Annex 1	Terms of Reference.
Annex 2	Letter to the Chairman from Brendan Hayes.
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Annex 7	Band individualisation examples and 2009 income tax thresholds.
Annex 8	Income tax, PRSI and levies: differences in bases and definitions.
Annex 9	Tax treatment of social welfare payments.
Annex 10	Annex III of the VAT Directive.
Annex 11	Summary of conditions determining residence in other countries.
Annex 12	Recommendations of the Revenue Powers Group and recommendations of the Law Reform Commission on the Revenue appeals system.
Annex 13	Relevant international pension tax reform.

Annex 1:

Terms of Reference

The terms of reference for the Commission are:

Having regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government, in particular, the commitments:

- To keep the overall tax burden low and implement further changes to enhance the rewards of work while increasing the fairness of the tax system
- To ensure that our regulatory framework remains flexible, proportionate and up to date
- To introduce measures to further lower carbon emissions and to phase in on a revenue neutral basis appropriate fiscal measures including a carbon levy over the lifetime of the Government, and
- The guarantee that the 12.5% rate of corporation tax will remain

The Commission is invited, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the taxation system and specifically to:

- Consider how best the tax system can support economic activity and promote increased employment and prosperity while providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term
- Consider how best the tax system can encourage long term savings to meet the needs of retirement
- Examine the balance achieved between taxes collected on income, capital and spending
- Review all tax expenditures with a view to assessing the economic and social benefits they deliver and to recommend the discontinuation of those that are unjustifiable on cost/benefit grounds
- Consider options for the future financing of local government, and
- Investigate fiscal measures to protect and enhance the environment including the introduction of a carbon tax

As the introduction of a carbon tax requires a completely new tax charge and structure, the Commission is asked to commence work in this area immediately. The Commission is requested to report on the results of its examination and consideration and to make such recommendations as, and when, it thinks fit to the Minister for Finance but not later than 30th September 2009.

Annex 2:

Letter to the Chairman from Brendan Hayes

Mr. Frank Daly

Chair

The Commission on Taxation

Le Pole House,

Ship Street Great,

Dublin 8,

Ireland

10th August 2009

Re:-The Report of the Commission on Taxation

Dear Mr Daly,

When I accepted the then Minister for Finance's invitation to serve on the Commission on Taxation I was aware that the Terms of Reference circumscribed its remit in a manner that would present difficulties for me. Nevertheless I was of the view that it was possible to make substantial progress on developing a fairer, more progressive and economically sustainable system of taxation.

In my experience, the Commission took its task very seriously, went about its work in a conscientious manner and arrived at its conclusion with honesty and integrity.

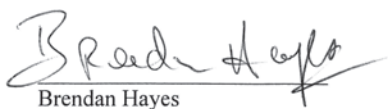
In addition, I want to acknowledge the work ethic, professionalism and expertise in, challenging, varied and complex areas of taxation against impossible deadlines, displayed by yourself as Chair and the Secretariat in facilitating the Commission discharge its mandate and deliver its report.

Whilst I recognise that progress has been made by the Commission, to which I contributed, that will broaden the tax base, ensure a more sustainable revenue flow to the state, eliminate many of the more serious inequities in the tax system, introduce some progressive amendments and extensions to the system, and reduce the scope for tax avoidance, nevertheless, on balance, I cannot support the Commission's Report for the following reasons,

- The Commission's Recommendations reinforce a low tax model of the economy and of society that I do not support
- The Commission's Recommendations are not optimised to generate the revenues necessary to create a social infrastructure capable of supporting a cohesive and equitable society and a sustainably productive and growing economy.
- The manner in which the low tax policy, is applied to the economy and informs the Commission's findings is fundamentally flawed and is inhibiting economic growth, exacerbating social and economic inequality and inequitably distributing the tax burden.
- That social and economic model gives rise to structural pressures that increase income and wealth disparities that the Commission's Recommendations will not correct. Those disparities, together with the current national economic and social policy framework, have made ours a profoundly unequal society. The tax and social security systems, strategic state involvement and well financed public services are normally deployed, in advanced European countries, to moderate such inequalities to achieve social cohesion and promote economic growth. However where the state adopts a low tax policy, in the manner in which this state has, the result is an underfinanced set of public services, including health, education and local government, and an inadequate social security infrastructure which further exacerbates inequality, reduces social cohesion and retards economic growth.. The Commission was required by its terms of reference to uphold the current low tax policy and its recommendations reflect this. Consequently the Commission's Report will neither fairly distribute the burden of taxation nor generate, in a progressive manner, sufficient revenue for the state, to ameliorate those disparities or enhance social provision and cohesion whilst supporting economic growth.
- Based on its terms of Reference, the prevailing economic and social policy framework and a firm view on the most appropriate taxation structure for Ireland at this time, the Commission has made some recommendations that I cannot support and that I believe will undermine social cohesion and or economic growth.
- Finally in a number of areas I believe the Commission has struck the wrong balance between fairness and efficiency in its recommendations.

For these reasons I have severe reservations on the Report of the Commission and respectfully decline to sign it.

Yours Sincerely


Brendan Hayes

10 August 2009

Annex 3:

List of submissions

Alcohol Beverage Federation of Ireland	Department of Health and Children
American Chamber of Commerce	Department of Social and Family Affairs
Arkins Kenny & Co.	Department of Transport
Association of Chartered Certified Accountants	Devlin, Jim
Association of County and City Councils	Dillon, John
Association of Higher Civil and Public Servants	Donegal County Council
Ballinvalley, Margaret	Dowling, Charles
Bank of Ireland Private Banking	Drinks Industry Group of Ireland
Barry, Michael	Dublin City Council
Beggan, Celine	Dundalk Chamber
Boylan, Frank, Bank of Ireland Third World Fund	EarthRoute
Brady, Dr. Hugh, President University College Dublin	Economic and Social Research Institute
Brett, Ivo	Ennis Chamber
Browne, Maria	Environmental Protection Agency
Byrne, John Paul	Ernst & Young
Callan, Professor Tim	Fáilte Ireland
Carson, Douglas	Feasta – Foundation for the Economics of Sustainability
Chambers Ireland	Feighery, Paul
Chambers, M.	Financial Taxation and Trustee Services Ltd.
Children's Rights Alliance	Foley, James, ESB Electric Aid
Citizens Information Board	Foley, Mary
Coghlan, James	Gallico Developments
Combat Poverty Agency	Galway County Council
Comhar - Sustainable Development Council	Gay and Lesbian Equality Network
Community Foundation for Ireland	Genworth Financial
Construction Industry Federation	Giblin, Sean
Consultative Committee of Accountancy Bodies - Ireland	Gibney, Cormac
CORI Justice	Glynn, Joseph
County and City Managers Association	Gray, Alan, Indecon Economic Consultants
Crilly, Kieran	Green Party
Cúram	Hanrahan, John
Dawnay, Hugh	Havok
Deloitte & Touche	Hayden, Eamonn
Department of Arts, Sport and Tourism	Heatley, Freddy
Department of Community, Rural and Gaeltacht Affairs	Heery, Tony
Department of Enterprise, Trade and Employment	Hurley, Mark
Department of the Environment, Heritage and Local Government	IFA Aquaculture
Department of Finance	Institute of International and European Affairs
	Institutes of Technology - Secretary/Financial Controllers Group
	Irish Association of Investment Managers
	Irish Association of Pension Funds
	Irish Banking Federation
	Irish Business and Employers Confederation

Irish Charities Tax Reform Group	Moore, Daragh
Irish Congress of Trade Unions	Murphy, Denis, Blackwater Motors
Irish Exporters Association	Murphy, Diarmuid
Irish Farmers Association	Musgrave Group
Irish Funds Industry Association	National Centre for Liturgy
Irish Heritage Trust	National Competitiveness Council
Irish Hotels Federation	National Disability Authority
Irish Insurance Federation	National Tourism Development Authority
Irish Landmark Trust	Newman, John
Irish Life Assurance	Nolan, Mark
Irish National Organisation of the Unemployed	Nugent, Chris
Irish Nurses Organisation	O'Connell, Des
Irish Petroleum Industry Association	Office of the Ombudsman
Irish Pharmacy Union	O'Regan, Noel
Irish ProShare Association	O'Sullivan, Pat
Irish Rugby Football Union	Philanthropy Ireland
Irish Rugby Union Players Association	Power, Michael
Irish Rural Link Ltd.	Professional Footballers' Association of Ireland
Irish Stock Exchange	Quigley, John R.
Irish Taxation Institute	Quigley, Mary
Irish Tobacco Manufacturers Advisory Committee	RGDATA
Irish Tourism Industry Confederation	Roche, Thomas
Irish Universities Association	Roscommon County Council
Kelly, Glenn	Ryan, Joe
Kelly, Suzanne	Ryan, Sean
Kerry County Council	Shannon Development Ltd.
King, Timothy	Sheedy, Tom
Law, Jonathan	Small Firms Association
Law Society of Ireland	Society of Actuaries in Ireland
Limerick Institute of Technology	Society of St Vincent de Paul
Loftus, John	Society of the Irish Motor Industry
Longford County Council	Spicer, Richard
Lynch, Conor	Standard Life
Lynch, Damian	Stewart, Jim
MacDonncha, Aodán	The Community Foundation for Ireland
MacThomáis, Uinseann	The Iona Institute
Martin, Tom	The Ireland Funds
Mayo County Council	The Pensions Board
Mercer	The Revenue Commissioners
McGauran, Vincent	The Wheel
McKeown, John	Thornes, Peter
McKenna, Justin	Tierney, John, Dublin City Manager
McKevitt, Tom	Twomey, Conor
Midlands Gateway Chamber	Údarás na Gaeltachta
Monaghan County Council	Urban Forum

Annex 4:

Oral hearings

American Chamber of Commerce	Irish Congress of Trade Unions
Callan, Professor Tim	Irish Exporters Association
Conference of Religious of Ireland, Justice Office	Irish Farmers Association
Consultative Committee of Accountancy Bodies - Ireland	Irish Hotels Federation
Irish Banking Federation	Irish Tourism Industry Confederation
Irish Business and Employers Confederation	National Competitiveness Council

The Commission also met with the following:

Children's Rights Alliance	Ordnance Survey Ireland
County and City Managers Association	Pensions Ombudsman
Coillte	Small Firms Association
Combat Poverty Agency	Society of the Irish Motor Industry
Comhar - the Sustainable Development Council	Sustainable Energy Ireland
Department of Communications, Energy and Natural Resources	The Pensions Board
Department of Enterprise, Trade and Employment	The Revenue Commissioners
Department of the Environment, Heritage and Local Government	Tierney, John, Dublin City Manager
Department of Finance	
Department of Social and Family Affairs	
Department of Transport	
Donnelly, Dympna	
Ecology Foundation - Ireland	
Economic and Social Research Institute	
Enterprise Ireland	
Environmental Pillar	
Environmental Protection Agency	
Forfás	
Foundation for the Economics of Sustainability	
Friends of the Earth	
IDA Ireland	
Irish Association of Pension Funds	
Irish Business and Employers Confederation	
Irish Charities Tax Reform Group	
Irish Taxation Institute	
Irish Tobacco Manufacturers Advisory Committee	
McCarthy, Colm	
McHugh, Neil	
National Women's Council	

Annex 5:

Acknowledgements

The members of the Commission, along with the Secretariat, wish to particularly acknowledge the assistance received from the following.

Economic and Social Research Institute - Director Frances Ruane and her colleagues Tim Callan, John FitzGerald, Richard Tol and Sue Scott

Enterprise Ireland

Environmental Protection Agency

Forfás

Foundation for Fiscal Studies

Heady, Professor Chris, University of Kent

IDA Ireland

Matthews, Professor Alan, Trinity College Dublin

Other Government Departments and Offices

The Department of Finance

The Geary Institute (UCD)

The Revenue Commissioners

Valuation Office

The Commission is also very grateful for the assistance provided by Paul Bolger, Department of Communications, Energy and Natural Resources

Annex 6:

Taxation of couples [Part 5]

1. Overview

Husbands and wives married to each other may elect to be assessed to income tax under either:

- Joint assessment (also known as aggregation)
- Separate assessment (which gives the same aggregate tax payable as joint assessment)
- Assessment as a single person (also known as separate treatment)

In contrast, heterosexual unmarried couples, same sex couples and siblings living together are all assessed to income tax as single persons and cannot elect to be assessed to tax under joint assessment (aggregation) or separate assessment.

2. Joint assessment (aggregation)

Joint assessment (aggregation) is an option for husbands and wives married to each other. Under joint assessment, allowances, tax credits and income tax bands can be allocated between spouses to suit their circumstances. For example:

- If only one spouse has taxable income, all allowances, tax credits and the benefit of the full amount of the lower rate of income tax will be given to him or her
- If both spouses have taxable income, they can decide which spouse is to be the assessable spouse and request the tax office to allocate the tax credits and the income tax rate bands between them in whatever way they wish. The employer tax credits, relief for long-term unemployed, the seafarer's allowance, employment expenses and the 'extended' band of the lower rate of income tax (for joint assessment couples with two incomes) are non-transferable
- In the absence of an election, the spouse with the highest income will be deemed to be the assessable person

3. Separate assessment

Separate assessment is an option only for husbands and wives married to each other. Under separate assessment, each spouse's tax affairs are independent of the other. The following tax credits are divided equally:

- Married person's tax credit
- Age tax credit
- Blind person's tax credit
- Incapacitated child tax credit

The balance of the tax credits is given to each in proportion to the cost borne. The employee tax credit and employment expenses, if any, are allocated to the appropriate spouse. However, any allowances and tax credits which are unused by one spouse may be claimed by the other spouse. The employee tax credit relief for long-term unemployed, the seafarer's allowance, relief for long-term unemployed, employment expenses and the 'extended' band of the lower rate of income tax (for joint assessment couples with two incomes) are non-transferable.

4. Assessment as a single person

Assessment as a single person (also referred to as separate treatment)

- Is an option for husbands and wives married to each other
- Is the only option for other couples

Under assessment as a single person, each spouse or partner is treated as a single person for tax purposes and both spouses/partners:

- Are taxed on their own income
- Receive allowances, tax credits and income tax bands due to them as a single person
- Pay their own tax
- Complete their own return of income form and claim their own tax credits

In addition, one spouse or partner cannot claim relief for payments made by the other and there is no right to transfer of tax credits, allowances or income tax bands.

5. Main differences between joint assessment and non-joint assessment cases for income tax purposes

5.1 Tax credits

The following tax credits can be transferred between husband and wife but cannot be transferred between two cohabiting single persons¹:

- Age tax credit
- Blind person's tax credit
- Incapacitated child tax credit
- Dependent relative tax credit
- Employed persons taking care of an incapacitated individual tax credit

It should be noted that the home carer tax credit is available only to husbands and wives who opt for joint assessment.

5.2 Reliefs

The following reliefs can be transferred between husband and wife but cannot be transferred between two cohabiting single persons:

- Interest paid
- Premiums on insurance against expenses of illness
- Premiums under long-term care policies
- Rent paid
- Fees paid for third-level
- Fees paid for training courses
- Service charges relief
- Certain gifts
- Loss relief

¹

Arising from the change in the Finance Act 2007, health expenses relief (section 469 TCA 1997) may be claimed by a taxpayer in respect of any other individual and is not confined to a spouse or dependants as was the case prior to 2007.

5.3 Exemptions

Where either spouse is aged 65 or over, the age exemption income threshold for a husband and wife married to each other of €40,000 (for 2009) – and increased where there are qualifying children by €575 in respect of the first and second child and €830 for each additional child – can be used against the aggregate of their income. However, individuals not entitled to joint assessment have an age exemption threshold of €20,000 and two persons who are not husband and wife married to each other may not aggregate their income for the purposes of utilising a joint threshold of €40,000.

5.4 Bereavement issues

The widowed person's tax credit is available only to the bereaved husband or wife of a married couple. The married person's tax credit is available also to the surviving spouse, in the year of death only, from date of death of the other spouse.

5.5 Separation

When a husband and wife married to each other separate and one spouse is mainly or wholly maintained by the other by voluntary maintenance, the payer is entitled to married tax credit and the recipient is entitled to single tax credit. In addition, if both husband and wife so elect, they may elect for joint assessment as if the separation never took place.

6 Treatment of married couples for capital taxes and stamp duty purposes

6.1 Capital acquisitions tax

Gifts and inheritances from one spouse to the other spouse are exempt from CAT.

6.2 Capital gains tax

- Assets can be transferred from one spouse to the other spouse at original cost for tax purposes – i.e. there is no taxable gain on the transfer. This also applies where the transfer takes place between former spouses under the terms of their divorce settlement
- The unused capital losses of one spouse can be set off against capital gains of the other spouse so long as they are living together, and
- The period of ownership of an asset by one spouse is treated as the period of ownership of the asset by the other spouse for the purposes of certain reliefs e.g. principal private residence relief and retirement relief

6.3 Stamp duty

Transfers of property between spouses generally are exempt from stamp duty.

Transfers of property from one spouse to the other where those spouses have divorced and the transfer is made on foot of a relief order within the meaning of section 23 of the Family Law Act 1995, an order under Part III of the Family Law (Divorce) Act 1996 or a foreign court order made under or in consequence of the dissolution of a marriage where the dissolution is entitled to be recognised in Ireland, are also exempt from stamp duty.

A person whose marriage is the subject of a decree of judicial separation, a decree of divorce, a decree of nullity or a deed of separation may benefit from first-time purchaser relief once and only once where that person buys another house to live in provided, at the date of execution of the instrument giving effect to the new purchase, the person no longer has an interest in the former marital home and the other spouse continues to occupy, since the date of the decree or the date of execution of the deed of separation, the former marital home as his or her only or main residence, which was occupied by both of them as their main residence prior to the decree or the date of execution of the deed of separation.

Annex 7:

Band individualisation examples and 2009 income tax thresholds [Part 5]

Note: These examples are intended to show the effect of band individualisation alone. As such, calculations relating to employee PRSI and the income and health contribution levies which would also influence net take home pay are excluded.

Example 1					
Married one-earner PAYE couple with 1 child		Married two-earner PAYE couple with 1 child Joint assessment (assume 65:35 income split)			
Income:	€45,400	€29,510	+	€15,890	
	€	€		€	€
Gross tax @ 20% =	9,080	5,902	+	3,178	= 9,080
<i>Less credits</i>		<i>Less credits</i>			
Married	3,660	1,830		1,830	
PAYE	1,830	1,830		1,830	
Home carer	900				
	6,390 (6,390)	3,660	+	3,660	= (7,320)
Net tax	€2,690	Net tax			€1,760
Difference in net tax liability:	930				
Difference due to bands:	Nil				
Difference due to credits:	930				

Example 2

Married one-earner PAYE couple with 1 child

Income: €46,400

€

45,400 @ 20% = 9,080

1000 @ 41% = 410

Gross tax: 9,490

Less credits

Married 3,660

PAYE 1,830

Home carer 900

6,390 (6,390)

Net tax €3,100

Difference in net tax liability: 1,140

Difference due to bands: 210

Difference due to credits: 930

Married two-earner PAYE couple with 1 child
Joint assessment (assume 65:35 income split)

€30,160 + €16,240

€

€

€

6,032 + 3,248 = 9,280

Less credits

1,830 1,830

1,830 1,830

3,660 + 3,660 = (7,320)

Net tax €1,960**Example 3**

Married one-earner PAYE couple with 1 child

Income: €72,800

€

45,400 @ 20% = 9,080

27,400 @ 41% = 11,234

Gross tax: 20,314

Less credits

Married 3,660

PAYE 1,830

Home carer 900

6,390 (6,390)

Net tax €13,924

Difference in net tax liability: 6,684

Difference due to bands: 9,534

Difference due to credits: 930

Married two-earner PAYE couple with 1 child
Joint assessment (income split as shown)

€45,400 + €27,400

€

€

€

7,280 (36,400 @ 20%) 5,480 (27,400 @ 20%)

1,800 (9,000 @ 20%)

9,080 (band of €9,000 transferred between spouses) + 5,480 14,560

Less credits

1,830 1,830

1,830 1,830

3,660 + 3,660 = (7,320)

Net tax €10,840

Example 4

Married one-earner PAYE couple with 1 child

Income: €73,000

	€
45,400 @ 20% =	9,080
27,600 @ 41% =	<u>11,316</u>
Gross tax:	20,396

Less credits

Married	3,660	
PAYE	1,830	
Home carer	900	
	6,390	(6,390)

Net tax €14,006

Difference in net tax liability:	6,684
Difference due to bands:	5,754
Difference due to credits:	930

Married two-earner PAYE couple with 1 child
Joint assessment (income split 50:50)

€36,500 + €36,500

€		€	€
7,280	(36,400 @ 20%)	7,280	(36,400 @ 20%)
<u>41</u>	(100 @ 41%)	<u>41</u>	(100 @ 41%)
7,321		+ 7,321	14,642

Less credits

1,830		1,830	
1,830		1,830	
3,660	+	3,660	= (7,320)

Net tax €7,322**Example 5 (Bands individualised at the level of the married one-earner band)**

Married one-earner PAYE couple with 1 child

Income: €90,800

	€
45,400 @ 20% =	9,080
27,600 @ 41% =	<u>18,614</u>
Gross tax:	27,694

Less credits

Married	3,660	
PAYE	1,830	
Home carer	900	
	6,390	(6,390)

Net tax €21,304

Difference in net tax liability:	10,464
Difference due to bands:	5,754
Difference due to credits:	930

Married two-earner PAYE couple with 1 child
Joint assessment (income split 50:50)

€45,400 + €45,400

€		€	€
9,080	(45,400 @ 20%)	9,080	(45,400 @ 20%)
9,080		9,080	
	+		18,160

Less credits

1,830		1,830	
1,830		1,830	
3,660	+	3,660	= (7,320)

Net tax €7,322

Income tax thresholds 2009			
PAYE sector earners		Self-employed sector earners	
Single		Single	
Credits:		Credits:	
Personal:	€1,830	Personal:	€1,830
Employee:	€1,830		
Entry point to tax net:	€18,300 per annum (€351.92 per week)	Entry point to tax net:	€9,150 per annum (€175.96 per week)
Married one-earner (no children)		Married one-earner (no children)	
Credits:		Credits:	
Personal credit (married):	€3,660	Personal credit (married)	€3,660
Employee:	€1,830		
Entry point to tax net:	€27,450 per annum (€527.88 per week)	Entry point to tax net:	€18,300 per annum (€351.92 per week)
Married one-earner (with children)		Married one-earner (with children)	
Credits:		Credits:	
Personal credit (married):	€3,660	Personal credit (married)	€3,660
Employee:	€1,830	Home carer:	€900
Home carer:	€900		
Entry point to tax net:	€31,950 per annum (€614.42 per week)	Entry point to tax net:	€22,800 per annum (€438.46 per week)
Married two-earner		Married two-earner (both self-employed)	
Credits:		Credits:	
Personal credit (married):	€3,660	Personal credit (married)	€3,660
Employee x2:	€3,660		
Entry point to tax net:	€36,600 per annum (€703.85 per week)	Entry point to tax net:	€18,300 per annum (€351.92 per week)
Lone parent		Lone parent	
Credits:		Credits:	
Personal credit:	€1,830	Personal credit:	€1,830
Employee:	€1,830	One parent family:	€1,830
One parent family:	€1,830		
Entry point to tax net:	€27,450 per annum (€527.88 per week)	Entry point to tax net:	€18,300 per annum (€351.92 per week)

Annex 8:

Income tax, PRSI and levies: Differences in bases and definitions [Part 5]

1. Income tax base

Income tax is charged on income under various Cases and Schedules and different rules apply in the calculation of different categories of income. Such calculations take account of trade losses, expenses, allowances, reliefs and personal tax credits reflecting an individual's marital and parental status and age.

2. PRSI base

In general insured persons aged 16 years or over and less than 66 years are required to pay social insurance contributions based on their level of income. These contributions provide entitlement to benefits under the various social insurance schemes. An individual can be insured for social insurance purposes in three ways:

- a) An employed contributor
- b) A self employed contributor
- c) A voluntary contributor²

Employed contributor

Employment contributions are paid by employed contributors and their employers in respect of any payment made for the benefit of the employee the first instance to pay both the employer's and the employee's contribution and to recover the employee's contribution from the employee.

Reckonable earnings for social insurance purposes means income assessable to income tax under schedule E (income from employments and pensions) including non-pecuniary income such as certain benefits-in-kind and reduced by payments to approved pension schemes under the net pay arrangement. Reckonable earnings are generally reduced by additional voluntary contributions to pension schemes.

Reckonable emoluments for social insurance purposes are defined as emoluments which do not arise from an insurable employment but which are subject to PAYE such as director's fees paid to a non-executive director. Superannuation payments under the net pay arrangement are deductible in arriving at the reckonable income. Additional voluntary contributions to pension schemes are generally deductible.

Legally enforceable maintenance payments which are deductible for income tax purposes may also be deductible for PRSI purposes.

Certain employments are 'excepted' employments which mean that they are non-insurable. Part 2 of the First Schedule to the Social Welfare (Consolidation) Act 1993 lists certain excepted employments as follows:

- Employment in the service of the individual's spouse

2

A person who ceases to be an employed contributor or a self employed contributor other than by reaching pensionable age may be entitled to make voluntary contributions.

- Employment of a casual nature
- Employment by a prescribed relative of the employed person being either employment in the common home of the employer and the employed person or employment specified in regulations as corresponding to employment in the common home of the employer and the employed person
- Employment specified in regulations as being of a casual nature that is ordinarily adopted as subsidiary employment only and not as the principal means of livelihood
- Employment specified in regulations as being of inconsiderable extent (€38 per week)
- Employment under a scheme administered by FAS Community Employment scheme, which commenced before 6 April 1996

Self employed contributor

Reckonable income for social insurance purposes is income chargeable to income tax under Schedule D (income from a trade or profession and investment and rental income) and Schedule F (dividends and distributions received from Irish resident companies). It includes certain income which is exempt from income tax such as the artist's exemption, profits from woodlands and income from the provision of childcare services in a qualifying premises. Legally enforceable maintenance payments are deductible for PRSI purposes. Trading losses, retirement annuities and payments made under deeds of covenant (which would normally be deductible for income tax purposes) are not deductible in the case of self-employed contributors.

PRSI ceiling and classes

There are 11 different classes of PRSI, most of which are subdivided into different subclasses. A weekly PRSI free allowance of €127 (€6,604 per annum) applies for employees at PRSI classes A and H where weekly earnings are in excess of €352 per week (€18,304 per annum). A reduced weekly PRSI free allowance of €26 (€1,352 per annum) applies for all employees at PRSI classes B, C and D. An annual contribution ceiling applies in the case of employee PRSI (€75,036) but no ceiling applies in respect of employer PRSI. Self-employed contributors pay PRSI at a reduced rate of 3% where annual income is €3,174 and over. There is no PRSI free allowance and no contribution ceiling.

3. National training levy base

The national training levy of 0.7% forms part of the employer PRSI contribution in respect of contribution classes A and H. The levy is incorporated in the employer's share of PRSI. Approximately 76% of employees are in these classes. The base for the national training levy is the same as applies for PRSI.

4. Health contribution base

The Health Contribution Act 1979 places an obligation in respect of each individual who is aged 16 or over and under age 70 to pay health contributions towards the cost of provision of services under the Health Acts. The health contribution levy, at a rate of 4%, is payable by employees and the self-employed. Individuals pay the 4% contribution where annual income is in excess of €26,000. An additional 1% health contribution levy applies to earnings exceeding €75,036. Recipients of the social welfare widow's or widower's pension, deserted wives benefit or allowance, the one

parent family payment and corresponding pensions from an EU Member State are exempt from payment of the health contribution levy. All medical card holders are also exempt.

Payments made under a legally enforceable maintenance agreement are exempt from the health contribution levy. In the case of a married couple, liability to health contribution levy applies separately to each spouse.

The definitions of reckonable earnings, reckonable emoluments and reckonable income for health contribution levy purposes are contained in the Health Contribution Regulations 1979.

- **Reckonable earnings**
Reckonable earnings are defined as emoluments derived from insurable employment which is charged to tax under Schedule E. The emoluments are reduced by any allowable contributions to an approved pension scheme. Apart from contributions to an approved pension scheme or a permanent health insurance scheme, no expenses, reliefs or allowances are deductible in computing reckonable earnings. Additional voluntary contributions which may qualify for income tax relief are not exempt from the health contribution unless deducted through a payroll system.
- **Reckonable emoluments**
This includes earnings from a non-insurable office (e.g. directors fees or emoluments received by a person who is over 66 years of age and therefore not insurable).
- **Reckonable income**
The definition of reckonable income for the purposes of the health contribution levy differs from the definition of reckonable income for self-employment PRSI contributions. Tax-exempt profits under the artist's exemption, tax-exempt profits from woodlands and tax-exempt income from the provision of childcare services in the home are exempt from the health contribution levy but are liable to the self-employment PRSI contribution. Other sources of income which are exempt from income tax, such as patent royalties, are also exempt from the health contribution levy.

5. Income levy base

The income levy is a levy payable on gross income, including notional pay. The levy is a separate charge to income tax and there are no deductions or credits available against it. It is collected from gross income at progressive rates.

All individuals are liable to pay the income levy where gross annual income exceeds the threshold of €15,028 (€289 per week). For individuals aged 65 years or over, there is an increased annual income exemption threshold of €20,000. Where income exceeds the relevant threshold, the income levy is chargeable on the full amount of the income.

The income levy is chargeable at 2% on annual earnings up to €75,036, 4% on earnings from €75,037 to €174,980 and at a rate of 6% on earnings over €174,980.

Exempt individuals

- Individuals whose total annual income is less than €15,028

- Individuals aged 65 years of over whose gross annual income is less than €20,000
- Individuals holding a full medical card

Exempt income includes

- Social welfare payments
- Payments made in lieu of social welfare payments such as Community Employment Schemes paid by the Department of Enterprise, Trade and Employment or Back to Work Allowance paid by the Department of Education
- Income subject to deposit interest retention tax
- Legally enforceable maintenance payments

Further information is available at www.revenue.ie/en/practitioner/law/income-levy.pdf

The table below sets out in tabular form the main differences in the bases for income tax, PRSI, the health contribution levy and the income levy.

	Income tax	PRSI – Class A (employee)	PRSI – Class S	Health contribution levy	Income levy
Full exemption for individuals					
Medical card holders	No	No	No	Yes	Yes
Individuals in receipt of Widow/widowers, one parent family payment	No	No	No	Yes	No
Age under 16	No	Yes	Yes	Yes	No
Exempt income sources					
Social welfare payments	No	Yes	Yes	Yes	Yes
Income subject to DIRT	No ³	Yes	No	No	Yes
Income subject to exit tax	No ⁴	Yes	No	No	Yes
Dividends from patent royalties	Yes	n/a	Yes	Yes	No
Dividends from woodlands	Yes	n/a	No	Yes	No
Other investment income	No	Yes	No	No	No
Benefit-in-kind	No	No	No	No	No
Remuneration paid in shares	No	Yes	Yes	Yes	No
Approved share schemes	Yes	Yes	Yes	Yes	Yes
Occupational pensions	No	Yes	Yes	No	No
Exempt income: Artists and woodlands	Yes	n/a	No	Yes	No
Exempt income: patent royalties	Yes	n/a	Yes	Yes	No
Income from leasing of farm land	Yes	n/a	No	No	No
Childcare services relief (income less than €15,000 per annum)	Yes	n/a	No ⁵	Yes ⁶	Yes
Deductible items					
Pension contributions – employee	Yes	Yes	Yes	Yes	No
Pension contributions – self employed	Yes	n/a	No	No	No
Pension contributions - AVCs	Yes	Yes	n/a	Yes	No
Maintenance payments for spouse under a legal agreement	Yes	Yes	Yes	Yes	Yes
Maintenance payments for children	No	No	No	No	No
Capital allowances	Yes	Yes	Yes	Yes	No
Losses	Yes	n/a	No	No	No
Allowance (per week)		€127	-		
Low income exclusions					
Exclusion if income below (per week)	n/a	€352		€500	€289
Exclusion if income below (per year)	n/a	n/a	€3,174	€26,000	€15,028
Exclusion for person aged 65 and over – income below (per year)	€20,000	n/a	n/a	n/a	€20,000
Exclusion for married persons aged 65 and over– aggregate income below (per year)	€40,000	n/a	n/a	n/a	€40,000
Unit of taxation	Married couple	Individual	Individual	Individual	Individual

3 Liability confined to standard rate

4 Liability confined to exit tax rate

5 Flat rate of €253 payable

6 Under €26,000 limit

Annex 9:

Tax treatment of social welfare payments [Part 5]

This Annex sets out the tax status of the main social welfare payments. A number of other schemes exist in addition to those listed below but are no longer open to new claimants. Examples of these include deserted wife's benefit and allowance and the pre-retirement allowance.

Payments which are subject to income tax are designated with the symbol (T) below while payments that are not subject to tax are designated (NT).

In the case of those payments which are subject to income tax:

- a) the child dependant amounts which are payable with most of the payments are also taxable with the exception of those payable with jobseeker's benefit, illness benefit, and injury benefit (i.e. the child dependant amounts payable with these three benefits are exempt from tax);
- b) as regards jobseeker's benefit, the first €13 per week is exempt from tax;
- c) the first 6 weeks of illness benefit and injury benefit in any tax year are exempt from tax.

In the case of those which are not subject to tax, the non-application of taxation may be due to the character of the payment (as in the case of maternity benefit or adoptive benefit), or to a specific statutory exemption (as in the case of child benefit or jobseeker's benefit paid to systematic short-time workers) or to long standing practice (as in the case of jobseeker's allowance).

Taxable Payments	Rate of payment (2009)
State Pension (contributory) (T) <i>(formerly Old Age Contributory Pension)</i> Paid to people aged 66 and over who have paid social insurance contributions in Ireland and satisfy a number of qualifying conditions. (A pro-rata pension may alternatively be paid based on a combination of reckonable contributions in Ireland and EU or Bilateral Agreement countries). It is not means-tested. In general, a person must have been an employee and paying full-rate social insurance contributions. In addition, persons can also qualify based on paid self-employed contributions.	(Personal rates only are shown for illustrative purposes) €230.30 per week (under 80).
State Pension (non-contributory) (T) <i>(formerly Old Age Non-Contributory Pension)</i> The State Pension (Non-Contributory) is a means-tested payment for people resident in Ireland aged 66 or over who do not qualify for a State Pension (Contributory) based on their social insurance record.	€219.00 per week (under 80).
State Pension (transition) (T) <i>(formerly Retirement Pension)</i> Paid to people aged 65 who have retired from work and who have enough social insurance contributions. To be deemed to have retired a person's earnings from employment must be less than €38 per week/€3174 per year. It is not means-tested. At age 66, the person will transfer to the State Pension (Contributory).	€230.30 per week.

Widow's and Widower's Pension (contributory) (T) A weekly payment to the husband or wife of a deceased person. Either the recipient or their deceased spouse must have enough social insurance contributions. The pension is payable regardless of other income.	€209.80 per week if under age of 66 €230.30 per week if over the age of 66 but under 80
Widow's and Widower's Pension (non-contributory) (T) Means-tested payment payable to a widow or widower who does not qualify for a contributory widow's/widower's payment and who does not have dependent children. It is only payable to people aged under 66.	€204.30 per week.
One-Parent Family Payment (T) A payment for men and women who are bringing children up without the support of a partner. For example, it is payable to an unmarried person, a widowed person, prisoner's spouse, a separated or divorced person, or one whose marriage has been annulled. Person must meet certain conditions and must satisfy a means test. If divorced or unmarried, the recipient must also have attempted to get maintenance from the child's other parent (father or mother).	€204.30 per week.
Guardian's Payment (contributory or non-contributory) (T) (formerly <i>Orphan's Allowance</i>) May be made to a person taking care of an orphan or a child where one parent is dead or unknown or has abandoned and failed to provide for the child and the other parent is unknown or has abandoned and failed to provide for the child. It is not necessary to be a legally appointed guardian. The payment must benefit the child. If the child is attending a full-time education course, is aged between 18 and 22 years of age and is not living with or in the care of a guardian, the payment can be paid directly to the child. The payment can be contributory (based on PRSI payments paid by the parent) or non-contributory (based on a means-test). It is not possible to get a guardian payment and a foster care allowance. Guardian's payments are regarded as the beneficial property of the children and are taxed accordingly.	€176.50 per week
Illness benefit (T) (first 6 weeks tax free in any tax year) (formerly <i>Disability Benefit</i>) A person may get this payment if they cannot work because of illness. They must be under 66 years of age and covered by social insurance (PRSI).	€204.30 per week.

Invalidity Pension (T) This is a weekly payment to people who cannot work because of a long-term illness or disability and are covered by social insurance. Normally, a person must be getting Illness Benefit for at least twelve months before they claim Invalidity Pension. It may be possible to get Invalidity Pension after a shorter period if the person is unlikely to be able to work for the rest of their life because of illness or disability. At age 65, the rate of payment increases to the same rate as State Pension (Transition). At age 66, the person will transfer to State Pension (Contributory). A recipient is entitled to a Free Travel Pass and may also get extra social welfare benefits, for example, the Household Benefits Package.	€209.80 per week.
Carer's Benefit (T) Payment made to insured persons in Ireland who leave the workforce to care for a person(s) in need of full-time care and attention because of age, physical or learning disability or illness, including mental illness. A recipient can get Carer's Benefit for a total period of 104 weeks for each person being cared for. This may be claimed as a single continuous period or in any number of separate periods up to a total of 104 weeks.	€220.50 per week.
Injury Benefit (T) (first 6 weeks tax free in any tax year) Is a weekly payment paid for up to 26 weeks after accident or onset of disease if a person is unfit for work due to: • An accident at work • An accident while travelling (on an unbroken journey) directly to or from work • An occupational disease (a disease contracted in the course of employment or due to the nature of work, for example, from contact with physical or chemical agents)	€204.30 per week

Disablement Benefit (T) May be paid if an insured person suffers a loss of physical or mental faculty because of an accident at work, an accident travelling directly to or from work, or a prescribed disease contracted at work. Payment is made where the level of disablement following the accident or disease is assessed at 1% or more. Where the level of disablement is assessed at 20% or more, the benefit is paid by weekly or 4 weekly pension. However, where the rate is assessed at less than 20%, the benefit is generally paid as a lump sum. (However, where the claim is finalised and the rate of disablement is between 10% and 19% the claimant has the option of lump sum or pension). The size of the lump sum will vary depending on the degree of disablement and how long the person is reasonably expected to be disabled. If a person is getting Disablement Benefit and is unfit for work, they may qualify for Illness Benefit based on their social insurance contributions (PRSI). If they do not qualify for Illness Benefit or another social welfare payment, they may get Incapacity Supplement. The amount of payment depends on the degree of disablement, which is medically assessed. For assessments of 20% disablement upwards, a pension is payable. (normally paid after Injury Benefit finishes). The pension is taxable but the gratuity/lump sum is not.	The amount of payment per week is based on the percentage degree of disability assessed. The rate for 100% incapacity is €235.40 per week.
Incapacity Supplement (T) <i>(formerly Unemployability Supplement)</i> This is an extra supplement with Disablement Benefit. A person may get this payment if they are permanently incapable of work as a result of an occupational accident or disease and do not qualify for another social welfare payment such as Illness Benefit. They may also get an increase in their payment for an adult dependant and child dependants. The claimant earnings cannot exceed €33 while claiming this supplement.	€204.30 per week.
Constant Attendance Allowance (T) This allowance may be paid weekly as an increase to Disablement Benefit if person is so seriously disabled as to need someone (a relative or some other person) to help them daily at home to attend to personal needs for a period of at least 6 months. The person must be getting a Disablement Benefit of 50% or over. Allowance is based on the recommendation of the Department's medical advisor. The allowance is not paid for any period during which the person is in a hospital or similar institution. Respite Care Grant is payable to the carer.	€221.20 per week.
Death Benefits Pension (T) The death benefit pension is an occupational injuries benefit, paid to spouses of individuals who have died in workplace accidents or where the person was getting a Disablement pension assessed at 50% or greater at the time of death. It is not contribution-based and operates in the same way as the widow(ers) contributory pension.	€234.70 per week

Blind Pension (T) Meanstested payment to blind and visually impaired people normally living in Ireland. To qualify for the pension, a person will be required to have an eye test by an ophthalmic surgeon (paid for by the Department) to verify visual impairment and certain people with low vision may qualify. A person in receipt of this payment may also qualify for the Blind Welfare Allowance. They will automatically get a Free Travel Pass and a Companion Free Travel Pass. (A Free Travel Pass allows a person to travel on State public transport in Ireland for free. A Companion Free Travel Pass allows a companion aged 16 or over to also travel for free).	€204.30 per week.
Jobseeker's Benefit (T) <i>(formerly Unemployment Benefit)</i> Weekly payment made to people who are out of work and covered by social insurance (PRSI). Jobseeker's benefit paid to systematic shorttime workers is statutorily exempt from tax under Section 126 of the Taxes Consolidation Act 1997.	€204.30 per week.
Payments not subject to taxation	
Child Benefit (NT) Universal payment to the parents or guardians of children under 16 years of age, or under 19 years of age if the child is in full-time education, FÁS Youthreach training or has a disability. With effect from 2010, the payment is being discontinued in respect of children aged 18 years. In 2009, only half the payment is available in respect of such children.	1st and 2nd Child: €166 per month 3rd and subsequent children: €203 per month
Systematic Short-Time Benefit (NT) Where an employee's normal working week is reduced, the person may receive Jobseeker's Benefit for the days they do not work. The total number of days at work and on JB combined cannot be more than 5 in a week.	Depends on short- time arrangement
Maternity Benefit (NT) Maternity Benefit is a payment made to women who are on maternity leave from work and covered by social insurance (PRSI). The amount of money paid each week depends on the person's earnings. It is paid directly on a weekly basis for a maximum of 26 weeks. Some employers will continue to pay an employee, in full, while she is on maternity leave and require her to have any Maternity Benefit paid to them. For an employee, the weekly rate of Maternity Benefit is calculated by dividing the gross income in the relevant tax year* by the number of weeks actually worked in that year. Eighty percent (80%) of this amount is payable weekly, subject to a minimum payment and a maximum payment. For a self-employed person, the weekly rate of Maternity Benefit is calculated by dividing the gross income in the relevant tax year by 52 weeks - 80% of this amount is payable weekly, subject to a minimum payment and a maximum payment. * "Relevant tax year" is the second last complete income tax year before the year in which the payment starts.	Maximum payment: €280.00 per week Minimum payment: €230.30 per week

Adoptive Benefit (NT) Adoptive Benefit is a payment to an adopting mother or a single male who adopts a child. It is available to both employees and self-employed people. The person must meet certain social insurance (PRSI) contribution conditions on their own insurance record. Adoptive Benefit is paid for a continuous period of 24 weeks from the date of placement of the child.	Maximum payment: €280.00 per week Minimum payment: €230.30 per week																
Health and Safety Benefit (NT) Is a weekly payment for employed women who are pregnant or breastfeeding, and who are granted health and safety leave by their employer. The right to health and safety leave from employment in Ireland is set out under Section 18 of the Maternity Protection Act 1994. A woman is granted health and safety leave from employment in Ireland if her employer cannot remove a risk to her health while she is pregnant, or breastfeeding, or assign her alternative "risk-free" duties. To qualify for Health and Safety Benefit, a woman must meet certain criteria and social insurance (PRSI) contribution conditions. The employer pays the first 21 days of health and safety leave, and the Department of Social and Family Affairs pays the remainder.	Maximum payment: €204.30 per week.																
Jobseeker's Allowance (NT) Means-tested weekly payment for persons aged 18 or over who are unemployed.	€204.30 per week.																
Family Income Supplement (NT) Weekly tax-free payment available to married or unmarried employees with children. It gives extra financial support to people on low pay. To qualify for FIS, net average weekly family income must be below a certain amount for the family size. FIS is 60% of the difference between net family income and the income limit for that size of family. 2009 Income Limits: <i>Family income must be less than:</i> <table> <tr> <td>One child:</td><td>€500</td></tr> <tr> <td>Two children:</td><td>€590</td></tr> <tr> <td>Three children:</td><td>€685</td></tr> <tr> <td>Four children:</td><td>€800</td></tr> <tr> <td>Five children:</td><td>€920</td></tr> <tr> <td>Six children:</td><td>€1,030</td></tr> <tr> <td>Seven children:</td><td>€1,160</td></tr> <tr> <td>Eight children:</td><td>€1,250</td></tr> </table> Qualification guarantees a minimum payment of €20 each week.	One child:	€500	Two children:	€590	Three children:	€685	Four children:	€800	Five children:	€920	Six children:	€1,030	Seven children:	€1,160	Eight children:	€1,250	Depends on net family income.
One child:	€500																
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Four children:	€800																
Five children:	€920																
Six children:	€1,030																
Seven children:	€1,160																
Eight children:	€1,250																
Farm Assist (NT) Means-tested income support scheme for farmers in Ireland. It is similar to Jobseeker's Allowance but has a more generous means test. In addition, recipient does not need to be available for work in order to qualify for Farm Assist.	€204.30 per week.																

Supplementary Welfare Allowance (NT) Provides a basic weekly allowance to eligible people who have little or no income. People with low incomes may also qualify for a weekly supplement payment under the Supplementary Welfare Allowance Scheme to meet certain special needs, for example, help with rent/mortgage interest payments or for urgent or exceptional needs. Operated by Community Welfare Officers in the HSE.	€204.30 per week.
Disability Allowance (NT) Means-tested weekly allowance paid to people with a disability who are between 16 and 65 years of age. Person must: - Have an injury, disease or physical or mental disability that has continued or may be expected to continue for at least one year - As a result of this disability be substantially restricted in undertaking work that would otherwise be suitable for a person of that age, experience and qualifications - Be aged between 16 and 65 - Satisfy a means test - Satisfy the Habitual Residence Condition	Maximum rate: €204.30 per week.
Respite Care Grant (NT) Annual payment made to carers in Ireland. It is paid in respect of each person being cared for on the first Thursday of June. Carers can use the grant in whatever way they wish. It is paid automatically to those getting Carer's Allowance, Carer's Benefit, Constant Attendance Allowance or Prescribed Relative's Allowance. It can also be claimed for separately by those who do not qualify for one of those payments. It is not means tested.	€1,700 per year (paid in June).
Domiciliary Care Allowance (NT) This is a monthly payment made to the carer of a child (aged under 16) with a severe disability who lives at home. The disability must be likely to last for at least one year, and the child must need constant care and supervision that is substantially more than that normally needed by a child of the same age. The payment is not means-tested on either the child's means or the carer's means and a payment may be received in respect of each eligible child. Up to end-March 2009, the Domiciliary Care Allowance scheme was operated by the Health Service Executive.	€309.50 per month.

Annex 10:

Annex III of the VAT Directive⁷ [Part 5]

List of supplies of goods and services to which the reduced rates referred to in Article 98 may be applied

- (1) Foodstuffs (including beverages but excluding alcoholic beverages) for human and animal consumption; live animals, seeds, plants and ingredients normally intended for use in the preparation of foodstuffs; products normally used to supplement foodstuffs or as a substitute for foodstuffs
- (2) Supply of water
- (3) Pharmaceutical products of a kind normally used for health care, prevention of illnesses and as treatment for medical and veterinary purposes, including products used for contraception and sanitary protection
- (4) Medical equipment, aids and other appliances normally intended to alleviate or treat disability, for the exclusive personal use of the disabled, including the repair of such goods, and supply of children's car seats
- (5) Transport of passengers and their accompanying luggage
- (6) Supply, including on loan by libraries, of books on all physical means of support (including brochures, leaflets and similar printed matter, children's picture, drawing or colouring books, music printed or in manuscript form, maps and hydrographic or similar charts), newspapers and periodicals, other than material wholly or predominantly devoted to advertising
- (7) Admission to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities
- (8) Reception of radio and television broadcasting services
- (9) Supply of services by writers, composers and performing artists, or of the royalties due to them
- (10) Provision, construction, renovation and alteration of housing, as part of a social policy
 - (a) Renovation and repairing of private dwellings, excluding materials which cannot account for a significant part of the value of the service supplied
 - (b) Window-cleaning and cleaning in private households
- (11) Supply of goods and services of a kind normally intended for use in agricultural production but excluding capital goods such as machinery or buildings;
- (12) Accommodation provided in hotels and similar establishments, including the provision of holiday accommodation and the letting of places on camping or caravan sites
 - (a) Restaurant and catering services, it being possible to exclude the supply of (alcoholic and/or non-alcoholic) beverages
- (13) Admission to sporting events
- (14) Use of sporting facilities
- (15) Supply of goods and services by organisations recognised as being devoted to social wellbeing by Member States and engaged in welfare or social security work, in so far as those transactions are not exempt pursuant to Articles 132, 135 and 136
- (16) Supply of services by undertakers and cremation services, and the supply of goods related thereto

⁷ Amended by Council Directive 2009/47/EC effective from 1 June 2009

- (17) Provision of medical and dental care and thermal treatment in so far as those services are not exempt pursuant to points (b) to (e) of Article 132(1)
- (18) Supply of services provided in connection with street cleaning, refuse collection and waste treatment, other than the supply of such services by bodies referred to in Article 13
- (19) Minor repairs of bicycles, shoes and leather goods, clothing and household linen (including mending and alteration)
- (20) Domestic care services such as home help and care of young, elderly, sick or disabled
- (21) Hairdressing

Annex 11:

Summary of conditions determining residence in other countries⁸ [Part 5]

	183 day rule	6 month presence	Main abode	Centre of economic interests	Centre of personal interests	Emigration/immigration rules	Citizen/national	Domicile	Other
Austria		continuous ⁹	Y					Y	
Australia	Y		Y			Y		Y	Y ¹⁰
Bulgaria	Y		Y	Y	Y				Y ¹¹
Denmark		continuous	Y						Y ¹²
Finland		continuous	Y						Y ¹³
France	Y ¹⁴		Y ¹⁵	Y					Y ¹⁶
Germany		continuous	Y					Y	
Hungary	Y		Y	Y	Y		Y		Y ¹⁷
Ireland	Y								Y ¹⁸
Italy		Y	Y	Y	Y			Y	Y ¹⁹
Luxembourg		Y	Y		Y ²⁰				
Netherlands			Y	Y	Y				Y ²¹
New Zealand	Y		Y						
Norway	Y					Y			Y ²²
Poland	Y			Y	Y				
Romania	Y			Y	Y			Y	
Slovak Republic	Y		Y						
Spain	Y			Y					Y ²³
Sweden		continuous	Y ²⁴						Y ²⁵
United Kingdom	Y								Y ²⁶

8 One or more of the conditions must be met depending on the country.

9 Periods of temporary residence will be added together if there is an obvious intention to return to and continue the stay in Austria.

10 Primary test: resident in the ordinary meaning of the word. Statutory tests: domicile, 183 days and superannuation.

11 Seconded abroad by a Bulgarian institution or company.

12 Resident more than 180 days within a 12 month period

13 Three-year rule

14 May be less than 183 days if principal place of residence is in France.

15 Main test

16 Centre of professional interests

17 Hungarian residence permit required generally. Different rules apply for certain EU/EEA countries.

18 280 days in aggregate in that tax year and the preceding year

19 Individuals who are registered in the Civil Registry for the greater part of the tax period

20 Presence of the family is a major criterion

21 No definition of residence in Netherlands tax law. Residence is determined according to the circumstances

22 270 days over a 36 month period

23 If spouse and minor dependent children qualify as residents.

24 Place of abode normally means the individual is continuously present for a period of more than six months

25 Maintenance of essential ties if not continuously present. Individuals who have been resident in Sweden for at least 10 years are presumed to have maintained essential ties with Sweden and are deemed residents in the five years following their departure (5 year rule).

26 Habitual visits over four consecutive tax years averaging 91 days or more in a tax year.

Annex 12:

Recommendations of the Revenue Powers Group and recommendations of the Law Reform Commission on the Revenue Appeals System [Part 5]

Recommendations of the Revenue Powers Group (summarised by this Commission)

The jurisdiction of the Appeal Commissioners should be extended to include appeals regarding:

- The categorisation of penalties
- The application of interest rates in certain defined situations
- The facts defining a voluntary disclosure, and
- Breach of proposed time limits regarding length of audits to protect against unjustified disruption to a taxpayer's business

The Appeal Commissioners should be empowered to adjudicate in a "Monday morning" type session:

- Whether the Revenue Commissioners have a right in law to seek particular information
- Breach of proposed statutory time limits on audit and/or a request to stay in audit
- Unreasonable disruption to business from the removal of current records, and
- Any dispute as to whether a disclosure is voluntary or otherwise

Subject to the provisos that:

- These arrangements being practicable in terms of resources available to the Appeal Commissioners; and
- The taxpayer being required in all cases to pay the tax which is not in dispute.

Recommendations of the Law Reform Commission (summarised by this Commission)

- The independence of the Appeal Commissioners should be expressly stated in legislation.
- The establishment of an open and formal selection and appointment process for future Appeal Commissioners should be put in place.
- Appointment as an Appeal Commissioner should require a professional legal qualification for a specified period in any of the fields of legal practice, accounting or taxation and also that the candidate is otherwise well qualified. When a vacancy arises such qualifications should be specified irrespective of the qualifications of the remaining Commissioners.
- The appointment of Appeal Commissioners should be put on a statutory footing.
- Responsibility for listing appeals from the Revenue Commissioners to the Appeal Commissioners should lie with the Appeal Commissioners.
- The Appeal Commissioners should specify that, in appropriate and defined circumstances, an Appeal Commissioner may administer an oath to any witness including a taxpayer or an Inspector of Taxes.
- The relevant legislation should be amended to provide that the Appeal Commissioners should control the record of their own decisions and make them available to parties as of right.
- The Appeal Commissioners should issue a concise reasoned determination in appropriate cases within a short period (ideally three months) of the determination, including a summary of the facts

and giving reasons for the decisions. Resources should be provided so that an effective system for the reporting of decisions of the Appeal Commissioners may be established and every appropriate decision is published.

- The Appeal Commissioners' power to issue precepts should apply in relation to any party, and, if necessary, appropriate provision should be made in respect of costs.
- In light of the European Convention on Human Rights (now incorporated into Irish Law) an appeal should lie from the Revenue Commissioners to the Appeal Commissioners in respect of the imposition of penalties but should not extend to mitigation of penalties on grounds of hardship.
- In respect of the imposition of penalties, a taxpayer should have a right of appeal from the Appeal Commissioners to the Circuit Court and, with the leave of the Circuit Court, to the High Court and Supreme Court on a point of law by way of case stated.
- The Revenue Commissioners should have the same rights of appeal as a taxpayer from decisions of the Appeal Commissioners.
- It should be expressly provided that an appeal should lie from the Appeal Commissioners to the Circuit Court and not to a Circuit Court judge.
- The listing of taxation appeals before the Circuit Court should be in accordance with standard practice, that is, that the County Registrar and the Courts Service be responsible for the listing of and arrangements for appeals.

Annex 13:

Relevant international pension tax reform [Part 10]

This Annex illustrates briefly how a number of countries have reformed their pension systems in response to the specific challenges they faced.

Mandatory private pensions as a substitute for part of public provision - Sweden

In Sweden the main driver of pension reform was the need to ensure the long term sustainability of State pension provision through a shift to defined contribution schemes combined with a guaranteed minimum State pension.

The Swedish pension system consists of four components – notional retirement pension; individual defined contribution account; guarantee pension and voluntary occupational pensions.

The notional retirement pension is financed by employer contributions representing 16% of an employee's gross annual income and other taxable benefits. This system operates as a pay as you go scheme. The contributions are paid by the employer to the state and notional contributions are made to an individual's account. Retirement benefits are based on total contributions, wage growth and life expectancy calculations. The objective is to make current pension costs sustainable by keeping them in balance with current contribution levels.

The individual defined contribution account is financed by additional contributions from the employer equal to approximately 2.5% of the employee's gross annual income. The employees may choose the level of risk

associated with a fund. If no choice is made, the pension capital is managed by a default fund. Benefits accruing under this part of the system are based on investment performance of the individual accounts.

The above two components have coverage levels in excess of 90%.

Guarantee pension which provides basic security for those individuals who are entitled to pension but have a low income or none at all. Guarantee pension is financed by the national budget.

Voluntary occupational pensions in Sweden are additional to the components set out above. The schemes are regulated by collective agreements between employees and employers. These schemes provide a supplementary income of approximately 10% of final salary.

Mandatory private pensions in addition to public pensions – Australia

The main feature of Australian reform has been the introduction of mandatory pension provision, known as ‘compulsory superannuation’. The Australian pension system consists of three pillars:

The age pension is a means tested benefit by reference to all income and assets. The minimum payment is set at 25% of male average industrial wage.

Compulsory superannuation was introduced in 1992. The aim of the scheme at that time was to ensure that as many as possible have access to superannuation and to provide a higher standard of living in retirement. The current level of mandatory employer contribution is set at 9%. It is planned to gradually raise employer contributions to 12%. Employees may make contributions to their fund but are not required to do so.

Voluntary superannuation contributions are encouraged by the provision of tax concessions to employers and the self employed. Employers can make additional superannuation payments on behalf of their employees if they wish. Employees can make additional contributions if they wish but these are not tax deductible when the contribution is made.

Further reforms have been made to the compulsory superannuation system to enable most employers to claim a tax deduction for the 9% employer contributions to funds for their employees. The self-employed may also be able to claim a tax deduction for their personal superannuation contributions.

Soft-mandatory pensions in addition to public pensions – New Zealand

New Zealand introduced pension reforms to increase supplementary pension provision from what was a traditionally low base. Their soft-mandatory system, known as the Kiwi Saver, utilises auto enrolment of employees to a pension saving scheme and is designed to increase retirement benefits in addition to the state pension provision.

State pensions in New Zealand are known as Superannuation pensions. State pensions are non contributory and not means-tested. The State pension is paid to all residents over 65 and amounts to approximately 32.5% of national gross average earnings.

The Kiwi saver scheme was introduced to encourage the long term savings habit and increase post retirement income. Its long term objective is to assist fiscal sustainability by decreasing the reliance on the working population.

The scheme is voluntary and open to all. Workers are auto-enrolled into a saving scheme upon joining

workforce or changing job. The scheme includes a once-off kick-start payment from the state of \$1,000. Employee contributions can be between 2%-8% of gross salary and can be deducted by the employer.

Employers are required to make contributions of 2% of gross salary. Employees receive a tax credit of up to \$20 per week. Non employees can also participate and also receive a tax credit of up to \$20 per week.

The funds, which are managed by private fund managers, are locked-in until superannuation age. Members can choose a scheme provider and the level of risk associated with a fund; alternatively a default provider is allocated. Contribution breaks are possible in the case of hardship. Pre-retirement access is possible in certain circumstances such as home purchase. However, this excludes access to kick-start or tax credits.

Since its introduction in July 2007 about two-thirds of those who were auto-enrolled have remained in the scheme. The scheme currently has approximately 600,000 members.

Cuts in public pension to leave a greater role for the private sector – Germany

The main element of the German pension system is the state pension which is an earnings-related scheme funded mainly by social contributions paid equally by employees and employers (just under 20% in total). However, the German state pension system is heavily subsidised through general taxation.

In 2001 Germany introduced reforms to the funding of the earnings related scheme outlined above to allow for the introduction of some tax incentives. Under the reforms earnings up to 4% of the 20% contribution ceiling in social pension insurance can be converted into a supplementary pension scheme. The result is to reduce contributions to and payments from the State pension.

Current Pension System – United Kingdom

The United Kingdom (UK) operates a basic state pension and encourages long-term saving for retirement through tax incentives for private pension provision. A range of different private pension products are available including occupational pensions, personal pensions, stakeholder pensions (a type of personal pension) and self-invested personal pensions, with new products in the pipeline.

A **basic state pension** (BSP) payable at a flat rate is a contribution-based benefit that can be claimed once a person has reached State pension age and has sufficient national insurance contribution, or received credits. In addition to the BSP, there is also a **state second pension** (S2P) which is designed to give those on lower earnings, or who may not be able to work full time (e.g. carers), an opportunity to earn a better state pension.

In relation to **private pension** provision, a number of significant reforms were introduced in 2006. In general, tax relief is available for individuals on contributions of up to 100% of UK taxable earnings. While there is no limit on the amount of pension saving that an individual can build up in a pension scheme, two key controls operate to limit the amount of tax relieved savings that can be made. These are:

- **The annual allowance**, set at £245,000 for 2009/2010 operates as a cap to curb excessive annual build-up of pension rights. If the increase in the value of an individual's pension rights or contributions (plus any employer contributions) exceeds the annual allowance, a tax charge at the rate of 40% applies to the excess.
- **The lifetime allowance**, set at £1.75 million for 2009/2010, comes into play when benefits are drawn down from a pension scheme. If an individual's total pension savings exceed the Lifetime

Allowance, any excess is taxed. The tax charge is set at 25% if the excess savings are taken in the form of a pension and 55% if taken as a lump sum.

Both the lifetime and annual allowances have increased each year since their introduction but from 2010/2011 will be fixed at £1.8 million and £255,000 respectively for at least the following five tax years.

Employer contributions do not count against an individual's tax relief. These rules apply to everyone irrespective of the type of pension scheme involved.

In the case of occupational pension schemes, relief is granted through the payroll with basic or higher rate relief being granted automatically. For contributions to personal pensions the pension provider claims tax back from the state at the basic rate of 20%, with higher rate taxpayers claiming the difference through a tax return or claim. Non-taxpayers can make contributions to a personal pension and benefit from basic rate tax relief (20 per cent) on the first £2,880 a year contributed.

Future Reforms

Further reforms to the State and Private Pension regimes are in the pipeline. These include

- Tax relief on pension contributions for individual's with an annual income of £150,000 or more is to be restricted from 2011/2012 with relief being tapered away so that for those earning over £180,000 relief will be worth 20%, the same as to basic rate taxpayers
- From 2012 it is planned that all eligible workers, who are not already in a good quality workplace pension scheme, will be automatically enrolled into either their employer's pension scheme or a proposed new savings vehicle known as a '*personal account scheme*', without any active decision on their part. All eligible workers will have to actively decide not to be in a scheme if they feel it is not a suitable form of personal saving for their circumstances. To encourage participation employees' pension contributions will be supplemented by contributions by employers and tax relief. In that regard, for the first time all employers will be required to contribute a minimum of 3% of qualifying pensionable earnings to an eligible employee's workplace pension scheme. This will supplement the 4% employee contribution and around 1% from the State in the form of tax relief. The employer contributions are to be phased in so that the burden on employers is minimised
- The proposed new personal accounts scheme is intended to be a straightforward opportunity for workers to contribute to a high-quality, low-cost savings vehicle. The accounts are expected to be trust-based defined contribution occupational type pension products aimed at providing people with a simple low-cost way of pension saving. There is likely to be a choice of investment funds, which may include options such as social, environmental and ethical investments as well as branded funds. For those not wishing to make an investment choice, a default fund will be available with members being automatically enrolled into the default fund if no investment choice is made. Those joining personal account schemes will be able to continue to save in their account even after they leave the workplace or move to another employer that does not offer personal accounts.



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

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