



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

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. <ul style="list-style-type: none"> • 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. <ul style="list-style-type: none"> • 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. <ul style="list-style-type: none"> • 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 extramarital 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, IRC, 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:

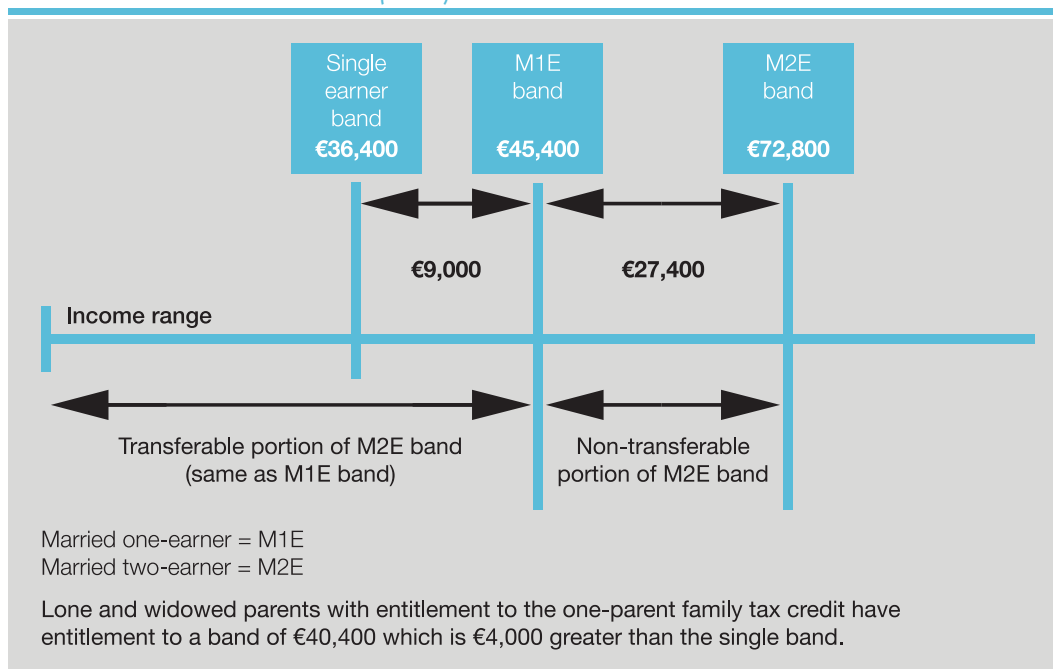
Single	€36,400
Married one-earner	€45,400
Married two-earner	€72,800 maximum*

*€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 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: <ul style="list-style-type: none"> • 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.