



COMMISSION ON TAXATION
AN COIMISIÚN UM CHÁNACHAS

PART 7

SUPPORTING ECONOMIC ACTIVITY



Part 7:

Supporting Economic Activity — *consider how best the tax system can support economic activity and promote increased employment and prosperity*

Section 1 is an introduction and includes the context within which our deliberations were made.

Section 2 provides an overview of the importance of the corporate tax rate in supporting economic activity.

Section 3 provides key information on employment, labour and the tax wedge.

Section 4 focuses on tax measures to support overall economic activity.

Section 5 covers specific activities and sectors.

Appendices 1 and 2 contain supplementary information.

Our recommendations in this Part are as follows:

Corporation tax

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

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

Supporting business

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| 7.6 | The 'corporation tax holiday' for new business should be extended to companies starting out in 2010 or 2011, and a similar scheme should be introduced for the non-corporate sector (see Recommendation 8.65). |
| 7.7 | An optional arrangement should be made available to new non-corporate businesses to allow them to spread their tax payments over the first three years. |
| 7.8 | Stamp duty on all share transactions should be reduced to zero. |
| 7.9 | The tax rate on dividends received by Irish residents should be reduced to the rate applying to deposit interest: <ul style="list-style-type: none"> • The measure should apply to ordinary shares. • Safeguards should be included to ensure that the provision operates as intended. |
| 7.10 | Corporation tax payable on gains on disposal of assets used for trading purposes should be at the rate applicable to trading profits |
| 7.11 | All companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax. |
| 7.12 | The recommendation that all companies should be allowed to adopt a previous year option in relation to the payment of preliminary tax should be implemented having regard to the cash flow costs involved in such a move. In this regard, options might include: <ul style="list-style-type: none"> • Gradually increasing the small company threshold over a number of years, until all companies are covered. • Allowing large companies the option of using a fixed multiple – say 105% – of the previous year's figure. |

7.13	The close company surcharge on professional service companies should be removed.
7.14	The close company surcharge on investment and estate income of companies should be retained. However, the <i>de minimis</i> amount before the provisions come into play should be substantially increased in order to ease the regulatory burden for companies in such cases.
7.15	The Revenue Commissioners should closely monitor the new regime to ensure that it operates as intended.
7.16	The remaining close company surcharge provisions should be examined by the Department of Finance and the Revenue Commissioners to ensure their effectiveness.
7.17	A review should be undertaken by Government to assess the effects of the air travel tax on business in general and tourism in particular. This review should be set in the context of the pending inclusion of air travel in the EU Emissions Trading Scheme (EU ETS) from 2012.
7.18	<p>Taxable income should be computed for business income (Schedule D, Case I and II) based on the accounting profits of a business, with normal statutory disallowances. In particular, we propose that accounts depreciation for tax purposes should replace the capital allowances regime used in business.</p> <ul style="list-style-type: none"> • In the case of buildings, the new provision should only apply where the buildings qualify for capital allowances under the existing rules (but see Recommendation 7.19). • Businesses should be permitted to change to the new regime at any time in a five-year transitional period. • Existing special regimes should continue.
7.19	The list of buildings that qualify for deductibility for tax purposes should be extended.
Supporting sectors and activities	
7.20	Companies should, at their option, be permitted to offset their R&D tax credit against their employer PRSI costs.
7.21	Unilateral credit relief for foreign withholding tax on royalty payments should be extended to all trading companies.
7.22	An overall foreign pooling system for foreign withholding tax on royalty payments should be introduced.
7.23	Persons who are made unemployed should be entitled to offset the retraining costs they incur on certified training courses against income for the previous six years.
7.24	The partial reintroduction of the remittance basis in the Finance (No. 2) Act 2008 should be discontinued.
7.25	A carefully targeted tax incentive, along the lines indicated in Box 7.13, should be introduced to attract skilled persons into Ireland to meet short-term skills gaps.

Section 1:

Introduction

1.1 The supporting economic activity remit

We were invited, in the context of maintaining an equitable incidence of taxation and a strong economy, to consider the structure of the tax system and specifically to ... *"consider how best the tax system can support economic activity and promote increased employment and prosperity..."* We were asked to do this against a backdrop of providing the resources necessary to meet the cost of public services and other Government outlays in the medium and longer term.

We were also asked to have regard to particular commitments in the Programme for Government. Commitments of special relevance to the "supporting economic activity" remit include maintaining the 12.5% corporation tax rate, enhancing the rewards of work and ensuring a flexible, proportionate and modern regulatory framework.

1.2 Broad context of the supporting economic activity remit

The previous Commission on Taxation addressed the role of incentives in economic development in its second report, in March 1984. It placed such incentives in the context of broader economic policy stating that:

"the level and pattern of economic activity is affected much more by the general economic policy of the government than by any set of specific measures labelled incentives."

It espoused a narrow role for taxation incentives, stating that they *"are justified only on very limited grounds"*. These grounds were identified as cases of market failure, competitive concerns with regard to internationally mobile capital investment, and as second-best solutions required to offset shortcomings in other policy areas. This philosophy accords with our recommendations in Part 8, that tax expenditures should only be put in place when one of the following three criteria is met:

1. Correcting market failure
2. Attracting mobile investment, or
3. Offsetting shortcomings in other areas of public policy

This perspective has gained ground among policymakers at home and abroad in the decades since the previous Commission's report. Indeed it is aligned with the terms of reference given to us which focus on how taxation can 'support' economic activity. A well-designed tax system is essential to a well functioning economy, because it ensures that incentives to work, to buy, to invest, and to do business are not unduly distorted by the tax code and rates of taxation.

Tax policies which aim to 'stimulate' or 'drive' certain aspects of economic activity take a different approach by seeking to create incentives in selected sectors/areas, as opposed to minimising the disincentive effect that inevitably comes with taxation.

We affirm this general perspective as appropriate. In particular:

- Firstly, we believe that the best way to achieve low effective tax rates is to broaden the tax base so that tax rates can be kept low. Returning to the previous Commission again: *“if one activity is relieved of its share of taxation then other sectors must bear a correspondingly higher share”* to ensure that the overall level of tax revenue is to be maintained
- Secondly, this perspective highlights a trade-off between supporting overall economic activity and supporting specific economic sectors and activities. We believe that primacy should go to supporting overall economic activity and that tax rates are centrally important in this regard
- Thirdly, we accept that incentives are needed in limited cases. Examples include market failure, attracting mobile investment and offsetting public policy shortcomings as mentioned above. The targeted policy tools that may be appropriate in this regard include:
 - tax reductions (for example, R&D credits)
 - changes in the timing of tax payments, and
 - incentives for investors (for example, BES)
- The fourth issue of importance – which also relates to supporting overall economic activity – concerns the specifics of the tax code. It needs to be internationally competitive – how the Irish tax code compares with those of other jurisdictions has additional consequences for a small open economy with large levels of mobile investment

In deciding “how best the tax system can support economic activity” we considered the key areas of direct tax rates, amendment of the tax code for business, and specific tax incentives to correct market failure and attract mobile investment.

Section 2: Corporation tax

2.1 Introduction

Profits derived by companies from economic activity are primarily subject to corporation tax. This tax yields a significant amount of revenue for the Exchequer, at €5 billion in 2008, down from a peak of €6.7 billion in 2006. The corporation tax rate of 12.5% is a central aspect of Government economic policy. As noted in Section 1, our terms of reference direct us to have regard to the commitments on economic competitiveness and on taxation contained in the Programme for Government, including *“... the guarantee that the 12.5% rate of corporation tax will remain.”* We also note in Part 4 that the 12.5% corporation tax rate is a strong brand for Ireland’s domestic economic activity and inward investment – see section 3.8 of that Part.

In this Section we wish, within our medium to long-term remit, to affirm our own commitment to a low and stable corporate tax rate. We focus on the economic competitiveness issues associated with the corporate tax rate. We begin by looking at international evidence on corporation tax (section 2.2) before turning to the specific circumstances of Ireland (section 2.3). A fuller version of the Section, which contains further analysis of the issues, is presented in Appendix 1.

2.2 International theory and evidence

Overview

Corporation tax influences economic growth by affecting both capital formation and productivity. Corporation tax can have a negative effect on investment (capital formation) by reducing its after-tax return. OECD evidence confirms this at both the firm and industry levels. We focus particularly on mobile investment in the following paragraphs, because Ireland is a small open economy.

Research by the OECD on the relationship between tax and economic growth has highlighted the overall economic impact of corporation tax. It found that, relative to other taxes, “*corporate income taxes appear to have a particularly negative impact on GDP per capita*”.¹ The analysis is part of the rationale for our ranking of tax instruments with respect to their relationship to economic growth presented in Part 4; corporation tax is the least growth-friendly tax in this ranking. We also recognise, of course, that striking the appropriate balance between different tax instruments obviously has important implications beyond supporting economic activity.

Mobile investment

There are many factors that have an impact on mobile investment. These include corporate taxes. Economic evidence suggests that taxes on corporations are a major influence on where mobile investment locates. A literature review by Mooij and Ederveen (2005)² concluded that most of these economic studies find a negative relationship between taxation and foreign direct investment (FDI). There exists a range of estimates of the sensitivity of FDI to tax, the size or elasticity of this relationship, with the average value being -3.72; this is the estimated percentage reduction in FDI in response to a one percentage point increase in the tax rate.

Incidence

It is important from a distributional viewpoint to note that the economic effects of corporation tax are far broader than just the impact on company profits. The concept of tax incidence says that the person who pays a tax does not necessarily bear the economic burden of the tax. The burden of corporation tax falls on the shareholders, the customers and suppliers, or the employees, because all tax burdens are ultimately traced back to individuals.

Recent attempts to measure corporation tax incidence find that a significant part of the effective incidence of the tax falls on wages. To illustrate the scale of this, we note that one study, which uses data on the foreign activities of U.S. multinational firms in more than 50 countries between 1989 and 2004, finds that between 45% and 75% of the burden of corporate taxes is borne by labour, with the balance borne by capital.³

2.3 Irish evidence

Foreign direct investment in Ireland

This international evidence on mobile investment is very relevant to Ireland, given the significant role played by FDI in the Irish economy. A key measure in this regard is the stock of inward

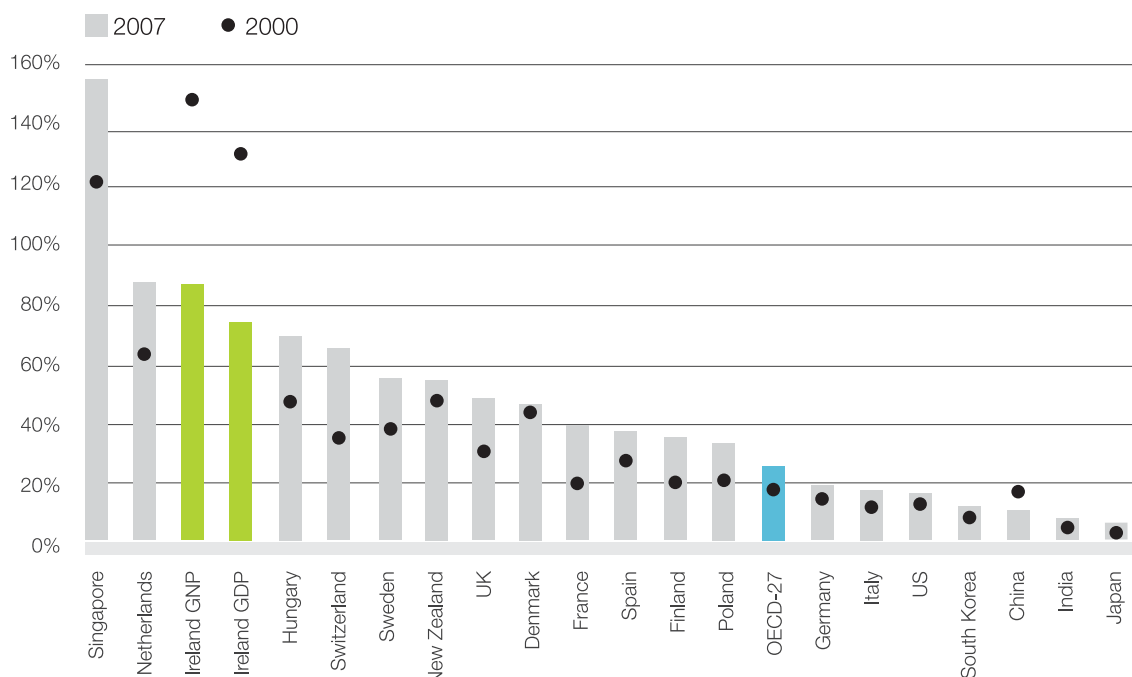
1 ‘Tax and Economic Growth’, OECD Economics Department Working Paper No. 620, July 2008.

2 See ‘Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis’, OECD Tax Policy Studies No. 17, 2007.

3 ‘Labor and Capital Shares of the Corporate Tax Burden: International Evidence’, M.A. Desai, C. F. Foley, J.R. Hines Jr, presented at the International Tax Policy Forum and Urban-Brookings Tax Policy Center conference on *Who Pays the Corporate Tax in an Open Economy?*, 18 December 2007.

investment in Ireland, or the accumulated flow of FDI projects over time. While Ireland's FDI stock, as a percentage of GDP, has declined since 2000, its inward investment levels remain among the highest in the OECD. As shown in Figure 7.1, Ireland ranked third out of 27 OECD countries in 2007 for its stock of inward investment as a percentage of GDP.

Fig 7.1: Stock of inward direct investment (FDI, as a % of GDP), 2007



Source: National Competitiveness Council, 2008.

This large amount of FDI is a significant contributor to the economy. Foreign-owned firms are key drivers of exports, directly employ a significant number of people, have higher rates of R&D, and have a positive impact on the Irish economy through their expenditure.

- Foreign-owned firms assisted by IDA Ireland accounted for 63% of total Irish exports in 2007
- Foreign-owned firms assisted by IDA Ireland employed 153,510 employees in 2007
- R&D expenditure by foreign-owned firms was €1.16 billion in 2007⁴ or 72.4% of total business R&D expenditure in Ireland
- Total expenditure by foreign firms in the Irish economy amounted to €18.1 billion in 2007

The academic literature also stresses the role of FDI in generating technology and knowledge spillovers that can boost the productivity of domestic firms.

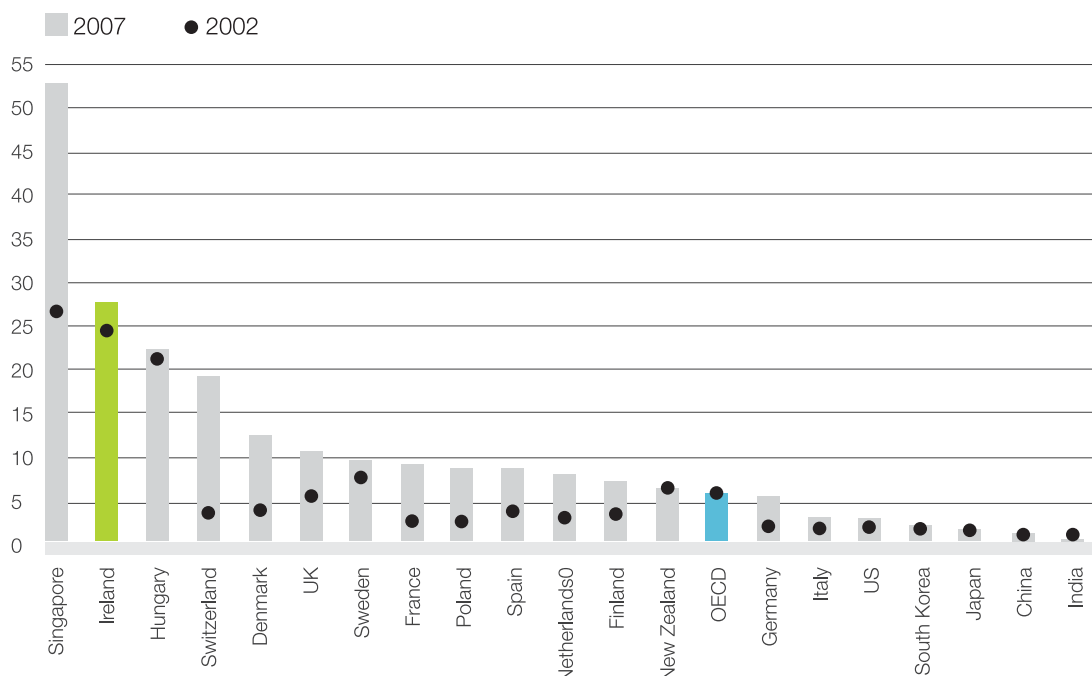
The present situation

The present international trend in tax policy is towards decreasing the rate of corporation tax. The differential between Ireland's rate and that of other countries has narrowed as the average top rate of corporation tax in the EU-15 and EU-27 has declined. Despite this international trend, Ireland still has the lowest corporation tax rate in the EU-15 and the third lowest rate in the EU-27.

International comparisons suggest that Ireland continues to attract a large number of greenfield investment projects relative to its size – see Figure 7.2. We believe that a low corporation tax rate

that is competitive in relation to those of other countries is, and should remain, a core aspect of Irish tax policy.

Fig 7.2: Number of greenfield projects by destination (per million of population), 2007



Source: National Competitiveness Council, 2008.

The attractiveness of Ireland’s corporate tax regime will be increased by the implementation of our recommendations in support of economic activity, which are explored in the other sections of this Part.

Recommendation 7.1

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

Section 3: Taxes on labour

3.1 Introduction

Our terms of reference refer to employment issues twice. In our work we are to have regard to the commitment in the Programme for Government to “keep the overall tax burden low and implement further changes to enhance the rewards of work while increasing the fairness of the tax system”, and to “consider how best the tax system can support economic activity and promote increased employment and prosperity”.

This Section focuses on taxes on labour. We outline, in turn, the incentive effects of income taxes on labour demand and employment (section 3.2), labour supply (section 3.3) and other aspects of economic activity (section 3.4). We also briefly consider the impact of income taxes on different groups and under different conditions (section 3.5). A fuller version of the Section, which contains further analysis of the issues, is presented in Appendix 2.

3.2 Low taxes on labour and labour demand

Taxes on labour should be kept low to support employment. This crucial link is supported by economic theory and empirical economic evidence, both international and Irish.

The economic theory of the incidence of taxation holds that the person who pays a tax, in an accounting sense, does not necessarily bear the economic burden of the tax. In standard economic models the direct impact of a labour tax is borne by either the employee or the employer depending on how the wage level changes. The tax wedge on labour is useful in illustrating this effect: It is defined by the OECD as:

“the gap between the labour costs the employer pays and the corresponding net take home pay the employee receives”.

Raising labour tax increases the tax wedge resulting in two main effects: (1) an increase in before-tax wages, increasing the cost of employing labour and thus reducing demand for labour and employment; and (2) a decrease in after-tax wages of employees reducing their real take home pay. Thus a key effect of increasing taxes on labour, in theory, is that they reduce the demand for labour and thus levels of employment. Research by the OECD (2006) found that, in 12 out of 17 studies, there was evidence that a higher labour tax wedge increases unemployment.

In the Irish context, there is a need to examine how the supply of labour responds to changes in the wage rate, as this is the key factor determining how the tax burden is shared between the employer and the employee (i.e. where the incidence of the tax falls). In the past Ireland’s supply of labour was strongly influenced by emigration (to the UK in particular), such that our labour supply was highly elastic. When labour supply is sensitive to wages, most of the incidence of labour taxes is borne by employers because a decrease in after-tax wage rates (i.e. the alternative where employees bear the burden) could result in an outflow of labour. Academic research confirms that the tax wedge has had a long-run effect on before-tax wages in Ireland, thus increasing labour costs and reducing demand for labour.⁵

It is likely that low taxes on labour have a greater effect on employment in Ireland, than in other countries, because of the nature of Ireland’s labour supply explored above. One economic study finds that taxes on labour income are particularly important, relative to other possible economic causes, in explaining Ireland’s recent economic history.⁶ Ireland’s economic performance between 1973 and 2002 in terms of output and employment is well explained by Ireland’s labour tax wedge. Furthermore, the economic importance of the tax wedge in Ireland has increased since Ireland adopted the euro. As a member of a common currency Ireland can no longer devalue its own currency to regain competitiveness when necessary. Instead, any adjustment has to fall on national prices including wages, and we have seen that labour taxes affect wages.

The present situation

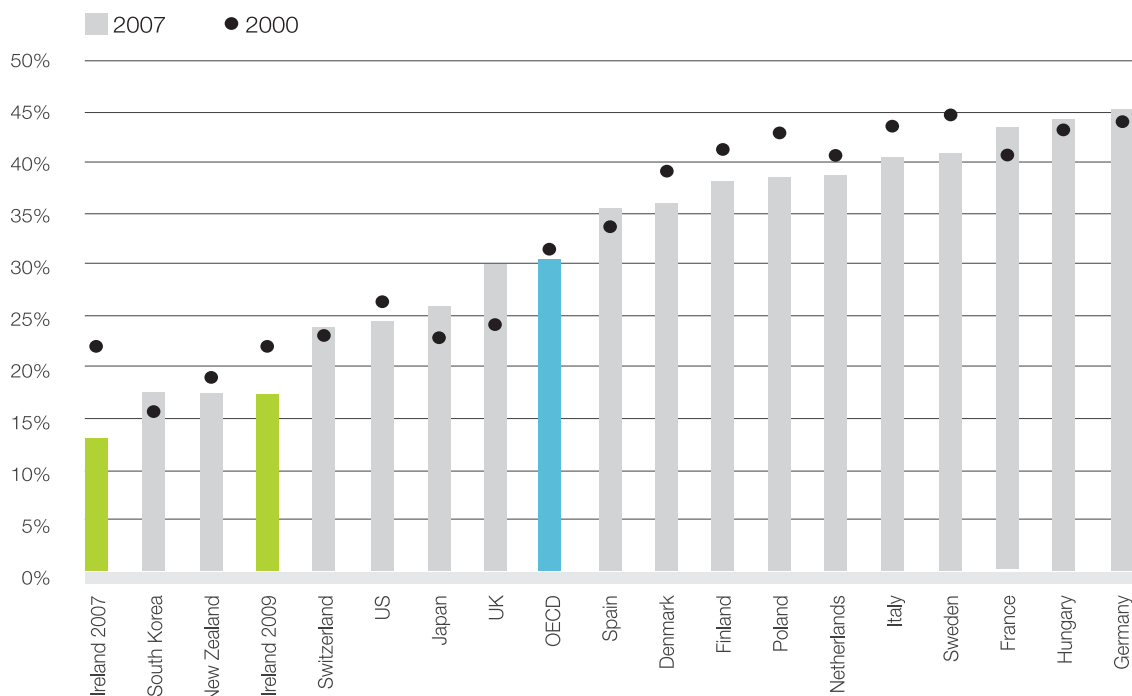
As recently as 2007 Ireland had the smallest tax wedge in the OECD at less than half the OECD average, as illustrated in Figure 7.3. This position has changed in the last two years, and in particular since the April 2009 budget, as Ireland’s tax wedge has now increased to approximately 17.4%. This represents a significant 36% increase in the tax wedge in only two years. It reverses the

⁵ ‘Wage Determination in Economies in Transition: Ireland, Spain and Portugal’, J. Fitz Gerald and J. Hore, ESRI Working Paper No. 147, August 2002.

⁶ ‘Ireland’s Great Depression’, A. Ahearne, F. Kydland, and M.A. Wynne, *The Economic and Social Review*, Vol. 37, No. 2, 2006.

trend where the value of Ireland's tax wedge had fallen significantly in the last decade, from 25.6% in 1998 to 12.8% in 2007, and at a faster rate than the average OECD tax wedge.

Fig 7.3: Total tax wedge on labour (as a % of average earnings), 2007



Source: National Competitiveness Council, 2008; Ireland 2009 Commission Secretariat's own calculations.

The nature of the Irish labour market changed during the last decade and the effect of the tax wedge may be different in 2009. Recent evidence suggests that the supply of labour is not infinitely elastic in Ireland. It is, however, still more sensitive to wage levels than most international countries. Therefore the impact of income taxes and the tax wedge on demand for labour and employment levels continues to be more significant in Ireland than it is in other countries.⁷ Thus policymakers should aim to keep the labour tax wedge low, in absolute terms and relative to other countries.

Recommendation 7.2

A core principle of taxation policy into the medium term should be to keep taxes on labour income, and the labour tax wedge, low in order to reduce the cost of employment and to sustain and stimulate demand for labour.

In the economic environment that Ireland faces in the short-term, a process has already started where tax revenue is being increased to correct the public finances. With specific regard to the Exchequer contribution made by labour taxes, it has been well documented that the share of overall tax revenues accounted for by labour tax has fallen significantly over the last decade. This does not, however, suggest that further policy changes are needed to increase the share of labour tax. This increase is already happening due to recent tax increases (including levies) and also because of the present economic downturn, where the revenue from labour taxes is decreasing at a slower rate than that of other taxes.

The total tax wedge on labour is composed of income tax and social security contributions from

7 ESRI 'Medium-Term Review 2008-2015', J. Fitz Gerald et al., May 2008.

both employees and employers. Employers' social security contributions (employer PRSI) are paid directly by the employer. This direct payment refers to the imposition of the tax but in the short run the effective economic incidence of a change in employer PRSI will also fall primarily on the employer, as it takes time for nominal wages, the price mechanism in labour markets, to adjust. Therefore, a temporary reduction in employer PRSI could be a suitable tax-related policy tool to decrease the cost of employment and sustain demand for labour in a weak economic environment.

3.3 Low taxes on labour and labour supply

When the incidence of taxation falls on the employee (see section 3.2 above) it is after-tax wages that are affected. This has an incentive effect on the supply of labour. Higher taxes decrease the return to employment in the form of after-tax wages which then can affect the decision to enter the labour force (participation) and the decision of how many hours to work. Policymakers have a particular interest in the effect of labour tax increases on incentives to participate in the labour market, because not only does non-participation mean a decrease in income earned but it can also mean an increase in government expenditure on social welfare.

Empirical evidence of a labour supply effect in Ireland predicts that a general increase in wages of 1% would see preferred hours at work rise by 0.18% for men and by 0.48% for women.⁸

Labour force participation levels involve those who switch labour force (migration), as well as those who drop out of the labour force. The issue of migration has grown in importance for labour tax policy as labour mobility has increased with globalisation and the advent of the single European labour market. In this regard, Irish tax policy needs to observe closely the tax wedge differentials between Ireland and other countries, particularly the UK. It should also be noted that multinational companies attach importance to the overall tax package of a country, including labour tax because of its implications for attracting skilled labour. Preliminary research shows that FDI is less likely to be located in countries where average labour taxes or their progression are relatively high, because of the need for skilled workers and managers.⁹

3.4 Low taxes on labour and other aspects of economic activity

Taxes on labour also affect other aspects of economic activity, including entrepreneurship and human capital.

Entrepreneurship

Entrepreneurship is an important factor in generating employment and economic growth. The case for government support of entrepreneurship depends on a positive externality argument, that the benefits flowing from entrepreneurship are not necessarily captured by the entrepreneurs themselves and thus not enough entrepreneurship is carried out. High taxes discourage entrepreneurs by reducing the return from the undertaking of risky entrepreneurial projects and thus impact negatively on job creation and growth.

The progressivity of labour taxes is an important consideration here. Progressive taxes reduce the post-tax income differential between the cases where an entrepreneur is successful and the alternative case of a business failure. Gentry and Hubbard (2000)¹⁰ find that the probability of

8 'Tax Cuts, Tax Reform and Labour Supply Responses', Tim Callan, Arthur Van Soest, and John R Walsh, ESRI Budget Perspectives 2004, October 2003.

9 'Labour Taxation and Foreign Direct Investment', P. Egger and D. M. Radulescu, CESIFO Working Paper No. 2309, May 2008.

10 'Tax Policy and Entrepreneurial Entry', W.M. Gentry and R.G. Hubbard, American Economic Review, May 2000.

entry into self-employment increases as tax rates become less progressive. OECD research also finds that a greater progressivity of personal taxes on labour seems to be associated with lower long-run GDP per capita.¹¹ Progressivity is of course an important consideration with regard to the equity of a tax system; here we note that progressivity also has economic effects which must be taken into account, and that these are prominent when it comes to the progressivity of labour taxes in particular.

Human capital

Taxes on labour affect the decision to pursue education or training because taxation affects the extra returns to work that are earned by this higher human capital. A recent paper on the policy determinants of investment in tertiary education finds that, in particular, lower marginal tax rates on labour earnings have a positive effect on returns to education.¹² The development of human capital is important because levels of education and skill are important determinants of economic growth.

Our recommendations in relation to taxes on labour, labour supply, entrepreneurship and other aspects of economic activity are as follows:

Recommendation 7.3

Taxes on labour should be kept low to support economic activity.

Recommendation 7.4

The degree of progressivity of taxes on labour should take into account the potential economic effects, particularly on job creation and entrepreneurship, as well as equity considerations.

3.5 The impact of taxes on labour is not uniform

The economic impact of taxes on labour is not the same for different demographic groups and for different conditions in the labour market. In other words, the effects of labour taxes are not uniform.

Demographics

The international evidence on labour supply responses to tax changes includes the following findings:¹³

- Married women and lone mothers respond more strongly than men in terms of hours worked to financial incentives created by tax changes
- Taxation and welfare benefits affect the decision whether or not to take paid work at all - this applies to women more than men, and to mothers in particular
- Male participation decisions for those with low or medium levels of education can be responsive to tax changes, but this is to do with a combination of tax and welfare benefits
- The participation decision for men with high levels of education is very unresponsive to tax changes

Irish evidence already cited above predicts that a general increase in after-tax wages of approximately 1% would see labour supply, in terms of preferred hours at work, rise by 0.18%

¹¹ 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', Jens Arnold, OECD Economics Department Working Paper No. 643, October 2008.

¹² 'The Policy Determinants of Investment in Tertiary Education', OECD Economics Department Working Paper No. 576, J. O. Martins et al., September 2007.

¹³ 'Labour Supply and Taxes', C. Meghir and D. Philips, March 2008. Paper prepared for The Mirrlees Review, "Reforming the Tax System for the 21st Century".

for men and by 0.48% for women. The labour supply of married women is significantly more responsive to an increase in their wage rate than men (with respect to the male wage rate).

Income distribution and the poverty trap

An important factor affecting the participation in the labour force of those on low income is the minimum wage. Research indicates that higher taxes on labour income appear to have the most detrimental effects on employment when wages do not fall because of the minimum wage. Bassanini and Duval (2006)¹⁴ find that increases in the tax wedge have a greater impact in raising unemployment the higher the minimum wage is set relative to average wages.

A second factor is the interaction of the tax system with social welfare benefits. Those on lower incomes make the decision to enter the workforce based on a combination of the social welfare benefits they may lose and increased tax payments they will have to pay. ESRI research shows that the highest effective tax rates tend to arise from the withdrawal of welfare benefits, including withdrawal of such benefits from a spouse or partner.¹⁵ This can create a poverty trap where financial incentives exist to remain outside of the labour force.

We conclude that the economic impact of labour taxes is not uniform, across the income distribution and other demographics.

The present situation

The tax wedge in Ireland and internationally for different earners and family situations is shown in Table 7.1. A feature of the Table is that the tax wedge is higher for higher income earners. This is the progressive nature of the Irish labour income tax system. However it is a factor in regard to highly skilled internationally mobile workers: while it is still below the average it is close to the corresponding figures for competitor countries like Switzerland, the UK and the USA for single workers (column 3).

The tax wedge continues to increase in Ireland for salaries above the level of these OECD comparisons. For a single earner with no children earning five times the average wage the tax wedge is 49.2%, after the April 2009 budget, and the marginal tax rate, including levies, on additional income is 50%. The economic effects of the tax wedge at this level of income are broader than just the effect on the individuals themselves. Top earners include the highly skilled workers necessary to attract mobile investment and entrepreneurs who help create wealth and employment.

(We recommend the introduction of a carefully targeted incentive to attract highly-skilled employees in Section 5 of this Part.)

14 'Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions', A. Bassanini and R. Duval, OECD Economics Department Working Paper No. 486, 2006.

15 'Work Incentives, Poverty and Welfare in Ireland', T. Callan, J. Walsh, K. Coleman, ESRI Policy Research Series, No. 60, December 2006.

Table 7.1: Income tax and PRSI less cash benefits, as % of labour costs

Family-type	S	S	S	S	M	M	M	M
No. of children	0	0	0	2	2	2	2	0
Wage (as % of average wage; for 1st & 2nd earner)	67	100	167	67	100-0	100-33	100-67	100-33
Ireland	15	22.3	33.1	-35.8	-1.1	7.4	12.8	15.6
Germany	47.4	52.2	53.1	34.5	36.4	41.5	45.3	47.3
Switzerland	26.8	29.6	33.9	12.8	18.3	20.8	23.8	27.4
UK	30.8	34.1	37.9	15.5	28.3	26.4	29.9	30.8
USA	27.8	30	35.3	7.6	18.1	22.2	24.5	27.8
OECD	33.8	37.7	42.1	18.2	27.3	29.5	32.4	34.5
EU-15	38	42.5	47.7	21.7	31.9	33.4	36.6	38.5

Source: 'Taxing Wages 2006 – 2007', OECD (2007). The shorthand of the table is best explained through an example: the last column presents the tax wedge for a married couple [M] with no children [0] where the two earners earn the average wage and one-third of the average wage respectively [100-33].

Recommendation 7.5

Policymakers should take into account the fact that the economic impact of labour taxes is not uniform across the income distribution range and by reference to other demographics.

Section 4: Supporting business

4.1 Introduction

This Section focuses on overall tax measures to support business. Our premise is that a tax system that supports economic activity generally will also help specific sectors. In the first instance, we draw a distinction between businesses that are starting up and those already established. Fostering business growth is a key factor in the support of economic activity and the promotion of employment. We examine tax measures that help businesses to start up and to grow in section 4.2.

Any proposed business decision will take account of the tax consequences. A tax system which supports economic activity is one in which tax provisions do not act as a barrier to business activities. In section 4.3, we examine tax rules which we believe could hinder businesses in their operations and which we recommend be changed.

In section 4.4, which deals with the tax base on business income, we explore the case for aligning the tax treatment of capital expenditure on business assets with the accounting treatment.

Section 4.5 looks at international tax issues. This is of importance to growing Irish businesses that are looking outwards beyond the domestic market. It is also important in the context of mobile investment. The international tax issues examined in this section are also relevant to companies in the specific activities covered in Section 5.

4.2 Helping businesses in the early stages

There are a number of measures in the tax code that are designed to assist enterprise in the start-up and early stages. Some of these – such as the EU-approved Business Expansion Scheme (BES) and Seed Capital Scheme (SCS) are also analysed in Part 8 of our Report, which covers tax expenditures.

BES and SCS give tax incentives to individuals to invest in companies, and also help the companies concerned by providing finance in the start-up stages. Other measures, such as the corporation tax holiday introduced in Finance (No. 2) Act 2008, give tax incentives directly to new, small companies to assist them in the early years.

Existing tax measures to help new business specifically are summarised in Box 7.1. There are, of course, a number of other tax measures which will help such businesses and which are dealt with elsewhere in this Report. These include tax incentives for purchasing energy-efficient plant and machinery (Part 9) and R&D tax credits (Section 5 of this Part). In addition, small companies (defined as those with annual corporation tax liabilities of up to €200,000) have easier rules for paying preliminary tax.

Box 7.1: Existing tax measures to help new business

- **Start-up costs may be tax deductible:** Pre-trading organisational and start-up costs incurred up to three years before the start of a business are deductible as an expense, provided they would have been deductible if the business were trading.
- **New small companies get a corporation tax holiday:** Companies taxable at 12.5% that begin to trade during 2009 do not pay corporation tax (CT), where the CT liability does not exceed €40,000 annually. This applies for each of the first three years of operation. New companies with a CT liability of up to €60,000 pay reduced tax.
- **Some new businesses do not pay preliminary tax in the first year:** New companies which do not expect their CT liability to exceed €200,000 in their first year do not have to pay preliminary tax. Startup non-corporate trades also get a deferral of preliminary tax in their first year.
- **Tax incentives can help new companies to access finance:** Companies can raise up to €2 million (€1.5 million in any one year) under the Business Expansion Scheme (BES), with income tax relief available to investors (who may each invest up to €150,000) at their marginal rate. Individuals can get tax refunds on amounts up to €100,000 per annum which they invest in their own new companies under the Seed Capital Scheme (SCS).

We considered a number of possibilities to improve the position of start-up businesses. On the whole, we found that new businesses were provided with a comprehensive range of supports and incentives through the tax system.

- Tax deductibility for pre-trading expenses follows OECD norms. This measure is available to all new businesses, both inside and outside the corporate sectors of the economy
- The recent introduction of a three-year corporation tax holiday for small businesses starting

out removes a significant tax barrier to new business at a critical period in their development. New businesses can make profits of €320,000 per annum before paying tax, with marginal relief in respect of profits up to €480,000 annually

- Many of the proposals in relation to BES/SCS that were proposed by the Small Business Forum (2006) have been implemented. In particular, the tax relief limits have been substantially increased. BES/SCS are state aids, approved by the EU up to end-2013. Our recommendations on the schemes are contained in Part 8 of our Report; we recommend *inter alia* that any extensions beyond 2013 should be subject to an evaluation as to whether market failure exists, and that the administrative burden placed on BES-assisted companies should be reviewed

Recommendations for start up businesses

We examined the three-year corporation tax holiday for start-up small businesses in some detail in our review of tax expenditures. We concluded that companies starting up in 2010 and 2011 should also be eligible for exemption (for two years or one year respectively), and also that a similar scheme should be made available to new non-corporate businesses¹⁶. A further additional measure is appropriate to support self-employed (non-corporate) taxpayers in start-up situations. The existing arrangements regarding the payment of preliminary tax, and the nature of the associated problem, are outlined in Box 7.2.

Box 7.2: Preliminary tax payment rules for self-employed (non-corporate) taxpayers in start-up situations

- Self-employed persons pay income tax on income arising in Ireland in a calendar year
- They must pay preliminary tax for a year by 31 October. This is based on either 100% of their prior year income tax liability or 90% of their current year income tax liability
- In a new business, self-employed people can get a preliminary tax deferral, because the calculation rules allow them to base their preliminary tax on the previous year's liability, which is zero
- However, the newly self-employed person has to find tax for two years before the end of the second year. For example:
 - A new business starts on 1 January 2007 and has regular monthly cash income. It puts money aside every month, to cover its tax obligations
 - It does not pay any tax in 2007
 - When it comes to 31 October 2008, the self-employed person must pay his/her full liability for 2007, plus preliminary tax for 2008 (100% of previous year or 90% of current year)
 - The self-employed person may not have enough set aside to pay the tax, even if he or she was setting aside regular amounts each month. For a new business working on invoices (rather than cash receipts), there may be even less savings on hand at 31 October 2008

A situation where individuals have to borrow to pay tax is unsatisfactory and, in particular, is difficult in a tight credit market. We considered an arrangement under which taxpayers might pay a proportion of their first year tax in the first year and, after that, gradually build up payments over three years. They would have a more established track record after three years that would facilitate easier access to funding to pay the tax.

16 Details are given in section 12.20 of Part 8.

The proportions we suggest are:

- 1/3 of first year tax in year one
- The rest (2/3) of first year tax in year two, plus 2/3 of second year tax
- The rest (1/3) of second year tax in year three, plus preliminary tax for the third year. As for year two in the existing system, there may not be enough savings to fully cover the preliminary tax payment, but by now the taxpayer has nearly completed three years of self-employment

A potential difficulty with the proposed arrangement is that it asks new businesses to pay tax in their first year, in cases where they may not do so under the current system. As this is part of a package to ease the regulatory burden on business, we recommend that the scheme be made optional.

We suggest that our proposed arrangement should be made available to new unincorporated businesses that do not qualify for the three-year tax holiday proposed by us. If our tax holiday recommendation is not implemented, then this proposal should apply to all unincorporated businesses.

We conclude that there should not be tax barriers to new business formation, in the context of supporting economic activity. We recommend two additional measures for new businesses as follows:

Recommendation 7.6

The 'corporation tax holiday' for new business should be extended to companies starting out in 2010 or 2011, and a similar scheme should be introduced for the non-corporate sector (see Recommendation 8.65).

Recommendation 7.7

An optional arrangement should be made available to new non-corporate businesses to allow them to spread their tax payments over the first three years.

Costings

Recommendation 7.6: The total cost of extending the corporation tax holiday scheme to companies starting out in 2010 or 2011 has been estimated at €30 million. No cost is available for the introduction of a similar scheme for the non-corporate sector.

Recommendation 7.7: No costs are available. However, there could be some cash flow effects on the Exchequer.

4.3 Removing tax barriers

4.3.1 Introduction

This subsection examines tax barriers to the effective functioning of business across six specific areas:

- Stamp duty on securities transactions
- Tax rate on dividends
- Business assets disposed of by companies
- Preliminary tax payment arrangements for large companies

- Close company surcharges, and
- Air travel tax

In each case, we examine the existing tax arrangements, to assess whether they mitigate against the proper functioning of business. We propose some amendments to the rules.

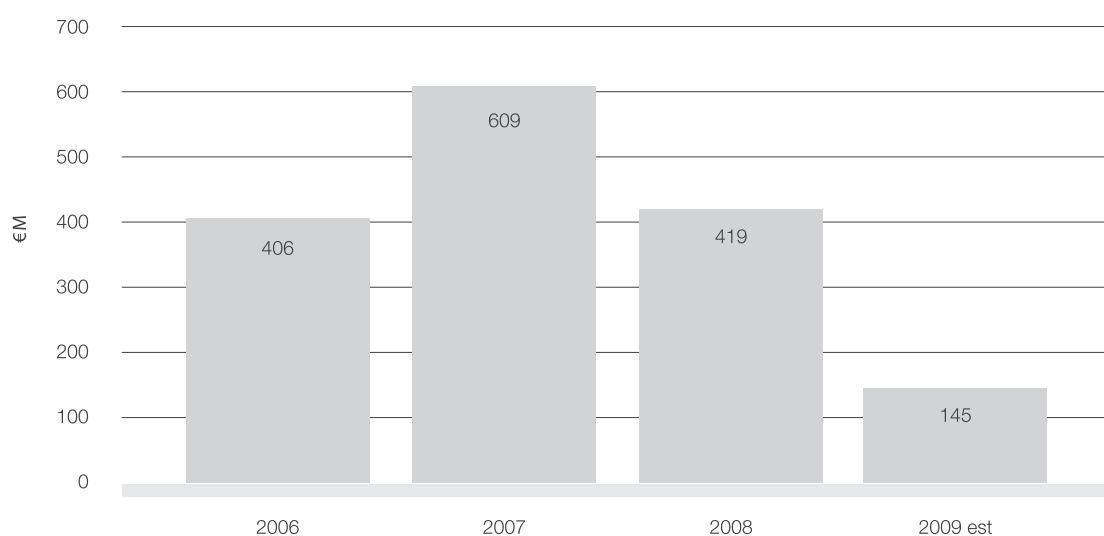
Our recommendations on reducing tax barriers caused by regulatory burdens for enterprise are in Part 5

4.3.2 Stamp duty on securities transactions

Stamp duty of 1% applies to share transfers. The duty applies to transfers of shares in Irish incorporated companies, whether the transfer takes place through the Irish Stock Exchange or through a foreign exchange (typically, London). Stamp duty also applies to transactions in non-quoted shares of Irish incorporated companies – these transfers account for about 12% of total stamp duty yield on shares. Transfers of shares in non-Irish incorporated companies are generally exempt from stamp duty.

The yield from stamp duty on shares has been significant in recent years. However, the expected yield for 2009 is considerably lower than earlier years. Figures range from €406 million (2006) to €145 million (2009 estimate). Summary details are provided in Figure 7.4.

Fig. 7.4: Stamp duty yield from shares 2006-2009



Source: Revenue Commissioners (2009)

A number of bodies requested the removal and/or substantial reform of the stamp duty on securities transactions. The arguments presented to us included the fact that the tax increased the cost of capital for Irish companies and had a detrimental effect on competitiveness and economic activity. Most jurisdictions outside Ireland and the UK apply no (or in some cases, very low) tax on securities transactions. France, Germany, Italy, the Netherlands and Luxembourg have abolished stamp duty on shares in recent years.

A 2007 study commissioned by the Association of British Insurers (ABI), the City of London Corporation, the Investment Managers Association and the London Stock Exchange concluded (*inter alia*) that the UK rate of 0.5% reduced the value of savings and investments, made the markets less competitive,

encouraged the development of alternative trading mechanisms and damaged transparency.

We were also mindful of the work of the European Commission's Clearing and Settlement Fiscal Compliance expert group (FISCO). FISCO advises on the removal of fiscal compliance barriers to the clearing and settlement of cross-border securities transactions within the EU. One of the key issues considered by the Group relates to barriers on transaction tax procedures.

We considered investment in securities which do not attract stamp duty as part of our analysis. This included:

- Shares purchased to hedge a Contract For Difference (CFD), which have been specifically exempted from stamp duty since the introduction of intermediary relief in Finance Act 2007 and
- American Depository Receipts (ADRs), which are certificates representing a shareholding in an Irish company that is listed on a recognised stock exchange in North America. An exemption from stamp duty was introduced for ADRs in 1992, to facilitate Irish businesses raising capital in the US and Canada. Depository receipts structures – collectively known as Global Depository Receipts (GDRs) – are also used in European and global markets (other than London); investors in Irish companies that raise capital by GDRs do not pay stamp duty on their certificates, by practice of the Revenue Commissioners

Irish-resident companies incorporated outside Ireland are also exempt from Irish stamp duty on share transfers. We have concerns about any trend towards incorporation outside Ireland, because it removes the company from Irish company law and corporate governance provisions.

The case for removing stamp duty on share transactions is compelling on the grounds of supporting economic activity and sustaining a capital market in Ireland. Stamp duty on shares increases the cost of raising capital on the Irish market and in London, relative to other markets and other forms of finance. Removing stamp duty encourages companies to incorporate in Ireland.

We considered recommending that the stamp duty rate on share transfers might be reduced (to say, 0.5% to match the UK), with a view to its eventual abolition some time in the future. We are not in favour of this course of action, for the following reasons:

- Current market conditions make this the ideal time for removal of the duty, as the cost of the change is relatively low
- A reduction in the rate of duty on share transactions leaves unanswered the question of the possible taxation of securities that do not currently attract stamp duty
- Removal of the duty is a very positive measure to encourage internationally mobile capital to locate (and incorporate) in Ireland; lowering the rate to 0.5% would not have the same effect

In framing our recommendation we propose that the charge to stamp duty should be removed by reducing the rate to zero, rather than by abolishing the tax. This leaves open the policy option of reintroducing the charge at some level in the future should circumstances warrant such a policy change.

Recommendation 7.8

Stamp duty on all share transactions should be reduced to zero.

Costings

Using estimated figures for 2009, the cost to the Exchequer of reducing the duty to 0% would be approximately €145 million. About 12% of this total (€17.4 million) is accounted for by transfers of unquoted shares. Continuing to apply stamp duty to such transfers is an option, as the case for its removal on the grounds of supporting economic activity is less relevant.

4.3.3 Tax rate on dividends

The tax treatment of savings and investment income of Irish-resident individuals is noted in Part 3 of our Report. In general:

- An individual investing in funds (i.e. 'collective investments' where he or she does not have any control over the selection of the assets/property) will pay exit tax of 25% or 28% in respect of monies received; tax is also paid every eight years¹⁷
- If he or she puts the money on deposit in a financial institution, deposit interest retention tax of 25% is payable on the interest received
- If the individual invests in property, he or she will pay tax at the marginal rate on the rental income¹⁸
- An individual who buys shares in a company will pay tax at the marginal rate on the dividends received

In the context of supporting economic activity, we consider that it is not appropriate that the tax rate on dividends should be higher than the rate on deposit interest. Equalising the tax rate on dividend income and deposit interest would encourage investment in the productive sectors of the economy which could support economic growth and lead to job creation.

We concluded that the rate should be the same as the funds and deposit interest rate and that a similar rate should apply to capital gains on the sale of shares by individuals¹⁹. In our view, this is a rational and coherent approach to the taxation of equity capital (dividends and capital gains). In addition, it rebalances the tax preference given under the current system for interest income on bank deposits.

The measure should apply to dividends on ordinary shares in trading companies (trading income is taxable at the 12.5% corporation tax rate) and in investment companies (investment income is taxable at the 25% corporation tax rate). The inclusion of all companies is in accordance with our rationale that there should be parity of treatment for different forms of savings and investment income. It also avoids significant complexities and compliance burdens that would result if the measure was confined to trading income.

The impact of our proposals on distributed trading income is that such income will suffer a tax rate of 34.375% (before PRSI and levies) by comparison with the maximum income tax rate of 41%. Under our proposal, distributed investment income will suffer a tax rate of 43.75% (before PRSI and levies). Non-distributed investment income will suffer a tax rate (while still in the company) of 40%²⁰. This means that the close company surcharge fulfils its original purpose of bringing the rate

17 This is an anti-avoidance measure to counteract the continual rolling over of investments without a charge to tax arising.

18 The tax deduction on interest on funds borrowed to purchase rental residential property is restricted by 25%

19 See section 4.3.4 of this Part, where we propose a lower rate of CGT for disposals of business assets in certain circumstances.

20 The percentage tax rates of 43.75% and 40% are calculated as follows: €100 x 25% = €25 corporation tax. Balance of €75 x 25% = €18.75 dividend tax at the new rate. Total tax = €43.75 per €100. In the second case, €100 x 25% = €25 corporation tax as before. Applying a 20% surcharge to the balance (ignoring the discount available in a trading company), €75 x 20% = €15. Total tax = €40 per €100.

of tax on distributed and undistributed profits closer together.

The proposed measure would apply to dividends received by Irish resident individuals from ordinary shares in Irish companies. In order to comply with our EU Treaty obligations it would also apply, at a minimum, to dividends from companies outside Ireland in the EU or the European Economic Area. Safeguards would be required to ensure that the provision was not manipulated (for example, by shareholder employees taking income as dividends rather than as salary from a company).

We conclude that dividend income should be taxed at a lower rate in order to encourage enterprise. We recommend that the tax rate on dividends should be reduced to the rate applying to deposit interest. As a general principle, and as part of a rational and coherent approach to the taxation of capital, we also conclude that the tax rate on deposit interest, on funds, on capital gains and on dividends received by individuals should be the same.

Recommendation 7.9

The tax rate on dividends received by Irish residents should be reduced to the rate applying to deposit interest.

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

Costings

It is estimated that recommendation 7.9 would cost in the region of €53 million.

4.3.4 Capital gains tax on disposals by companies of trading assets

The tax system should not discourage companies to invest in their businesses for future growth. In general, companies have two possible sources of internal funds for reinvestment – after-tax trading profits and the proceeds of disposal of capital assets. We believe that it is inappropriate that these two sources of funds for reinvestment should bear very different tax rates – 12.5% in the case of trading profits and 25% in the case of profits on the sale of capital assets. Accordingly, we propose that capital gains on disposal of trading assets by companies should be taxed at the applicable corporation tax rate (rather than the capital gains tax rate)²¹. This will equalise the tax treatment of reinvested retained earnings and reinvested asset disposals.

The proposed rule means that, where a company that is subject to corporation tax at 12.5% disposes of a trading asset and makes a capital gain, the gain would be taxed at 12.5% rather than at the CGT rate (currently 25%). Thus, there would be more money available to the company to reinvest (for example, in other trading assets) or to build up reserves. Should the company choose instead to distribute the proceeds of the asset disposal to its shareholders (for example, by paying a dividend), then the shareholders would, of course, be subject to income tax on the distribution.

Recommendation 7.10

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

21 Specifically, the companies covered would be those taxable under Case I (trading) or II (professional) of Schedule D.

Costings

It is estimated that this measure would cost approximately €75 million.

4.3.5 Preliminary corporation tax payment rules for large companies

Broadly, all non-start up companies pay 'preliminary tax' before the end of their accounting period, and the balance of corporation tax after the end of the year.

For the purposes of payment, the tax code distinguishes between 'small companies', defined as those enterprises with a corporation tax liability of €200,000 or less in the preceding year, and companies above that threshold ('large companies'). Small companies have the option of basing their preliminary tax on the amount of tax that was due for the previous year. Large companies do not have this option.

The regulatory burden on large companies, which must compute their preliminary tax before the end of their accounting period and before the profits are known, is considerable. New instalment arrangements introduced in the Finance (No. 2) Act 2008, that oblige large companies to pay a proportion of tax some five months earlier than before, have added to the burden. The new rules are as follows:

- A first instalment of preliminary tax is paid six months before the end of the accounting period (50% of the previous year's liability or 45% of the current year's liability)
- A second instalment of preliminary tax is paid one month before the end of the accounting period, to bring the total preliminary tax up to 90% of the current year's liability, and
- The balance of tax is paid with the tax return, nine months after the end of the accounting period

Because interest is payable on underpayments of tax²², the tendency for large companies has been to 'overpay' the 90% preliminary tax figure, increasing the burden even further.

Our general conclusion is that the preliminary tax rules for large companies impose a disproportionate compliance burden and cause significant uncertainty to business. This was reflected by a number of bodies during the consultation process. Approximately 2,500 companies would benefit if the rule were abolished and all companies were entitled to avail of the 'small companies' option.

Allowing large companies to base their preliminary tax on 100% of the previous year's figure rather than 90% of the current year's figure means that tax, expected in one tax year, is moved forward into the following tax year. This is the cash flow cost to the Exchequer of making such a change. Figures produced by the Revenue Commissioners suggest it would be in the order of €460 million. This estimate assumes that the new first instalment arrangements introduced in the Finance (No. 2) Act 2008 continue to apply; we do not recommend any changes to the first instalment rules.

The current economic climate makes now the ideal time to implement this change, in terms of minimising cash flow costs to the Exchequer. If the costs of doing so are considered to be excessive (in view of other measures being proposed), we suggest that there is some scope for a gradual move toward full implementation, as indicated in the following recommendations.

22 Although in certain cases, interest can be reduced for large companies in the same group.

Recommendation 7.11

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

Recommendation 7.12

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

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

Costings

Recommendation 7.11: Allowing large companies to base their preliminary tax on 100% of the previous year's figure rather than 90% of the current year's figure would result in a cash flow cost to the Exchequer of some €460 million based on the instalment arrangements introduced in Finance (No. 2) Act 2008.

Recommendation 7.12: Examples of cash flow costs are as follows:

- Increasing the small company threshold to €500,000
(cash-flow cost €50 million (1,330 companies still classed as 'large'))
- Increasing the small company threshold to €1,000,000
(cash-flow cost €90 million (750 companies still classed as 'large'))
- Allowing large companies the option of paying 105% of the previous year's figure
(cash-flow cost €410 million)

4.3.6 Close company surcharges

Many Irish companies are 'close companies', controlled by five or fewer participators (persons having an interest in the income or capital of the company) or by any number of participators who are directors.

- A surcharge of 20% is payable on the investment (non-trading) income of a close company that is not distributed to shareholders (for example, by the payment of a dividend) within 18 months of the end of the accounting period
- Close companies supplying professional services are separately liable to a surcharge of 15% on one-half of their undistributed after-tax trading income

The close company surcharges were introduced as an anti-avoidance measure in 1976. Their purpose was to deter individuals from holding or earning income in a company in order to avail of lower tax rates. Corporation tax at the time was 50% and the top rate of income tax was 77% – a difference of 27%. There is still an issue today, given the difference between corporation tax and income tax when PRSI and levies are taken to account. While the current differential does not justify complete abolition, the case for abolition of the surcharge provisions for companies supplying professional services is

strong on equity grounds, and we recommend this step is taken. We also suggest that the *de minimis* provision for the surcharge on passive income should be substantially increased.

The example in Table 7.2 illustrates how the operation of the professional services surcharge increases the effective rate of corporation tax for such companies from 12.5% to over 19%.

Table 7.2: Professional services company - surcharge provisions

Pre-tax profits (professional income)	€100.00
Corporation tax at 12.5%	€12.50
After-tax income before surcharge	€87.50
Amount subject to surcharge = 50% of income = €43.75	
Surcharge, if no distribution = €43.75 x 15%	€6.56
Effective corporation tax rate, including surcharge (12.5 + 6.56)	19.06%

The close company surcharge provisions featured strongly during the consultation process. It was put to us that the surcharges were an obstacle to business, something that belonged to a different age and that they had outlived their usefulness. Arguments made against the surcharges include the following:

- Private owner-managed companies are established for commercial, not tax avoidance, reasons: For example, professionals (such as architects or engineers) may operate through a corporate structure for limited liability reasons, or because it is part of the practice in the industry, or for insurance/professional indemnity reasons
- The regime for companies is very different nowadays, compared with the tax regime that operated when the provisions were introduced. The introduction of dividend withholding tax and of self-assessment for companies, in addition to the bringing forward of preliminary corporation tax payments, have achieved the acceleration of payment of tax on the profits of companies generally

It is also the case that the surcharge provisions can limit the ability of companies to reinvest. Analysis done in the EU suggests that retained earnings are often an important source of financing for growth and investment for Small and Medium Enterprises (SMEs)²³.

They help survival during economic downturns, when it is harder for businesses to make structural changes or to obtain credit.

Surcharge on professional services companies

Our investigation of ways to support economic activity and grow employment is based on a pro-business ethos. The close company surcharge on professional services companies inhibits such companies from re-investing their trading income. Similar restrictions do not apply to other trading companies. We cannot see an objective rationale for distinguishing between professional services companies and other trading companies and we therefore recommend the abolition of the surcharge for professional services companies.

23 See, for example: http://ec.europa.eu/enterprise/entrepreneurship/action_plan/index.htm

Surcharge on passive income of close companies

The case for removal of the surcharge on investment and estate income is less robust. Equity issues do not arise, and we are not convinced by an argument that the passive income surcharge inhibits the growth of Irish business.

However, we recommend a change to improve the position of SMEs. The rules currently allow for a *de minimis* amount of €635 of investment or estate income to be retained in the close company before the surcharge provisions come into operation. We suggest that this amount should be increased substantially. Operating the surcharge provisions imposes a regulatory burden on companies - particularly small companies - including: calculating the amount that must be paid to ensure that the surcharge does not apply, paying dividends, making dividend withholding tax returns and meeting deadlines.

It was also brought to our attention during the consultation process that the surcharge provisions may not always operate as intended, and that the legislation can be circumvented to avoid the charge on passive income. We recommend that the provisions should be reviewed by the Department of Finance and the Revenue Commissioners to ensure their effectiveness.

Recommendation 7.13

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

Recommendation 7.14

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

Recommendation 7.15

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

Recommendation 7.16

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

Costings

Corporation tax liability from all close company surcharges was about €19 million in 2007. It is difficult to predict the losses to the income tax system that might result if the surcharge on professional services companies is removed. Distributions that are currently made to avoid the surcharges would be eliminated. Available data do not distinguish between the various types of surcharge. The tax impact of any behaviour change on the part of professional services businesses (not currently incorporated) is also not clear.

To give indicative examples of the impact of the *de minimis* recommendation, an increase in the amount from €635 to €5,000 would cost approximately €1 million and remove some 2,000 close companies from the surcharge provisions. An increase in the *de minimis* amount to €10,000 would cost some €1.3 million and remove approximately 3,550 close companies from the surcharge provisions.

4.3.7 Air travel tax

Another potential barrier to growth is the air travel tax introduced in the October 2008 Budget. A broad outline of the measure is given in Box 7.3.

Box 7.3: Air travel tax – main features

- This is an excise duty, which applies from 30 March 2009 to passengers on planes departing from Irish airports. There are two rates:
 - €2 where the flight is to a destination within 300 kilometres of Dublin Airport (this covers all flights within Ireland and flights to Cardiff, Glasgow, Prestwick, Liverpool, Manchester, Blackpool, Isle of Man)
 - €10 for the rest of the UK and any other destination
- The tax is payable by the airline operator in respect of passengers departing on its planes
- There are various exemptions – for example, for transit passengers, for disabled persons and their helpers and for non-fare paying passengers (crew, children under two years of age). There are also exemptions for small planes (less than 20 passengers) and small airports (passengers less than 50,000 in the previous year)

We considered whether the tax was supportive of economic activity, given the possible damage to inbound tourism and damage to business – for example, businesses with high numbers of employees regularly travelling between Dublin and London. The fact that we are an island nation, and the fact that air travel tends to be very sensitive to price, are important factors in this regard. Submissions to us also pointed to the economically detrimental nature of the tax.

The investigation of fiscal measures to protect and enhance the environment is also part of our remit. We recognise that the air travel tax has merit from an environmental perspective (although its effectiveness in this regard would be enhanced if the charge were calibrated to reflect greenhouse gas emissions). In this context, we note that the airline sector will be brought into the EU Emissions Trading Scheme from 2012; it may be appropriate to review the air travel tax once a pan-European price for carbon emissions from air travel is in place.

Details on the EU Emissions Trading Scheme are in Part 9.

Recommendation 7.17

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

4.4 The tax base on business income

4.4.1 Introduction

Expenditure is deductible as a business expense for tax purposes when it is incurred wholly and exclusively for the purpose of the trade, and is revenue (not capital) in nature. Expenditure of a capital (as opposed to revenue) nature is not deductible for tax purposes. However, capital allowances may be available on some capital expenditure. Capital allowances are a form of

depreciation for tax purposes. In general, expenditure on plant and machinery, on motor vehicles and on industrial buildings attracts capital allowances, subject to conditions. A brief overview is given in Box 7.4.

Box 7.4: Overview of capital allowances tax regime

- An allowance is given for wear and tear of plant, machinery and motor vehicles in use for the purposes of a trade at the end of an accounting period
- It is calculated by reference to the cost of the item (less any grants received and less any recoverable value-added tax) and the allowable expenditure may be written down at the rate of 12.5% on a straight line basis
- Capital allowances are also available in respect of expenditure on transmission capacity rights, computer software, energy efficient equipment (including electric and alternative fuel vehicles), and some buildings. The rate at which the expenditure may be written down varies according to the type of expenditure incurred
- On the disposal of an asset that has qualified for capital allowances, the sale proceeds are compared with the tax written down value and any resultant profit or loss (up to the original amount qualifying for capital allowances), known as a balancing charge or balancing allowance, is taxable or tax deductible accordingly

4.4.2 Aligning tax treatment with accounting treatment

Our proposal is that taxable income should be the accounting profits of the business (subject to statutory disallowances such as entertainment expenses). In particular, we consider that the existing tax treatment of capital expenditure for business purposes does not meet the needs of a modern economy. In our view, there is a strong case for aligning the tax treatment with the accounting treatment. Currently, the depreciation of capital assets as computed for accounting purposes is not an allowable business expense against income for tax purposes.

An accounts depreciation regime makes sense from the point of view of a modern, up to date tax system that is capable of adapting to change. For example, the 'tools of the trade' have changed in business over the years and will change again. Rather than make piecemeal additions to the capital allowances regime (for instance, the rules for transmission capacity rights came into operation in March 2003), a closer alignment between the tax treatment and the accounting treatment is appropriate.

As a company is required to prepare its accounts in accordance with standard accounting rules – Irish Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) – an objective method of allowing for deductibility would be available if such a system were implemented.

Income as computed for GAAP or IFRS purposes should also form the basis of business taxation in the non-corporate sector (sole traders and partnerships). It does not make sense that two systems – GAAP/IFRS accounts depreciation for companies and capital allowances for others – should be used. We suggest that the Revenue Commissioners publish ranges of acceptable depreciation rates for various asset classes for small businesses to simplify compliance obligations.

4.4.3 How the proposed change would benefit business – an example

The capital allowances regime for computer software usefully illustrates our proposal on the most appropriate way to give a tax deduction to trading companies for capital expenditure. Under existing tax provisions, expenditure on software is covered by capital allowances rules. The details are summarised in Box 7.5. A key difficulty with the capital allowances regime is that it generally does not apply allowances to a time period which fits with the economic life of the business asset.

Box 7.5: Existing tax regime for expenditure on software

- Software used for business purposes is written off over 8 years at 12.5% on a straight line basis (i.e. equal annual instalments)
- The tax provision deems the software to be plant and machinery and applies the capital allowances wear and tear rules to it
- Balancing allowances and balancing charges rules also apply in the event of a disposal of software

GAAP or IFRS depreciation charged should be deductible for software. It was put to us during the consultation process that the eight year writing-down period of the capital allowances regime is generally too long for software, which may have a life of two to three years – for example, if it is software for a game.

A problem with capital allowances is that the writing-down period ('tax life') may not reflect the actual life ('economic life'). By adopting a regime where a tax deduction would be given for the depreciation figure in the accounts of the business, issues that may arise in relation to the setting of appropriate time periods are addressed. This is more flexible than a capital allowances regime, as different amortisation periods – depending on the economic life of the asset – are used. Other advantages were noted earlier - new 'tools of the trade' which will emerge as business develops can be accommodated more easily, and the system is objective and certain. This is particularly likely for assets related to 'green' technology that may develop in the future and for assets such as carbon credits which do not qualify for capital allowances.

We conclude, in the light of the above, that taxable income should be computed for business income (Schedule D, Case I and II) based on the accounting profits of a business, with normal statutory disallowances. In particular, we propose that accounts depreciation for tax purposes should replace the capital allowances regime used in business for assets other than buildings.

4.4.4 Special issues in relation to buildings

As well as contributing to certainty and being more responsive to the realities of modern business, a tax base for capital expenditure that is aligned with accounting treatment could also mean that expenditure, which is not deductible for tax purposes under the existing regime, would become eligible for relief. The impact of this on the tax regime for buildings raises particular issues; the existing capital allowances rules for buildings are outlined in Box 7.6.

Box 7.6: Existing tax regime for expenditure on buildings

- The general rule is that an annual allowance of 4% straight line is available in respect of industrial buildings (factories and mills)
- Property-related accelerated capital allowance schemes, under which capital allowances are calculated at the rate of 1.5% per annum for six years and 10% in the seventh year, have been available for property in various regions or relating to particular asset types. See Part 8 for details on these
- Tax incentives for research facilities are also available:
 - 100% of capital expenditure incurred on buildings and plant used for the purpose of scientific research is available upfront.
 - Tax credits of 25% are also available for capital expenditure on R&D building facilities
- There are two schemes of capital allowances for farm buildings
 - Under the first scheme, expenditure on the net cost of farm buildings is claimed as an expense against income over seven years, at the rate of 1.5% for the first six years and 10% in the final year
 - Under the second scheme, expenditure on buildings necessary for the control of pollution is deductible over three years, when certain conditions are met. See Part 8 for details
- Capital allowances are not available for shops and offices

Because capital allowances are not allowed on many buildings, permitting a deduction for depreciation (for the office and retail sector, for example) would significantly reduce the tax base on business income. For pragmatic reasons, therefore, we recommend that accounts depreciation should replace capital allowances for buildings that qualify for capital allowances under the existing regime, but should not be deductible for other buildings.

The tax system should be responsive to the realities of modern business. Call centres for example, which have been described as the 'modern industrial buildings' do not currently qualify for capital allowances and we believe that there is a strong case for allowing them to qualify. There may be other categories of buildings with an equally strong case. We recommend that consideration should be given to extending the classes of buildings that qualify for an accounting depreciation deduction, as the existing capital allowances regime is not reflective of modern business.

4.4.5 Impact of special tax rules for capital expenditure

There are a number of areas in the capital allowances tax code where special regimes have been introduced. Box 7.6 indicates for example, that there are special rules for capital expenditure on buildings used for R&D and for farm buildings. While a tax base for capital expenditure that is aligned with accounting treatment is in our view appropriate, we propose that existing "special" regimes should continue²⁴.

4.4.6 Conclusions on tax base for business

Our general conclusion is that business income for tax purposes should be determined on the basis

²⁴ For example, the accelerated capital allowances scheme for expenditure on energy-efficient equipment for business is evaluated in Part 8 of our Report, where we recommend that it be continued for its current term, and then evaluated in accordance with the criteria we developed for tax expenditures. There are also businesses that currently have an asset base which benefits from a capital allowance regime which is shorter than the economic life of those assets. It is not the intention of our proposals to interfere with these regimes.

of accounting profits for both companies and non-corporate bodies. This would lower compliance costs on business, contribute to certainty for business, be more responsive to the realities of the business environment and be more capable of adapting to change.

As part of our proposal, we recommend that a provision would be available to allow businesses to elect to cross over to the new rules at any time in a transitional period of five years, with safeguards to ensure that a tax deduction would not be given more than once for any expenditure item. We do not propose that the new rules should apply in cases where deductions for buildings are not available, nor do we propose that special provisions should be superseded by the new rules on deductibility. We do, however, propose that the deductibility regime for buildings should be extended, as we consider that the existing deductions do not adequately reflect modern business needs.

Recommendation 7.18

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

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

Recommendation 7.19

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

Costings

Recommendation 7.18 could be implemented at no cost to the Exchequer

No costs are available for recommendation 7.19.

4.5 International issues

4.5.1 Introduction

Fiscal incentives to assist new businesses and employment (section 4.2), the removal of tax provisions that act as barriers to business (section 4.3) and a more appropriate tax base for business income (section 4.4) will go some way to improving the tax system in order to support economic activity and promote increased employment.

This section looks at international issues in connection with supporting economic activity. The international dimension is important for both the indigenous business looking outwards and the mobile foreign investor looking to Ireland as a possible location of choice.

The EU, OECD and wider international dimension to our deliberations are particularly important in the context of supporting economic activity. Two international tax issues are considered in this section. These are (i) the taxation of dividend income received from abroad, and (ii) withholding

taxes on interest and royalty streams from Irish companies to companies that are located abroad. We conclude the section with an endorsement of the policy focus on the continued expansion of Ireland's tax treaty network.

4.5.2 International tax issue (i) – taxation of dividend income received from abroad

Participation exemption for dividends means that dividends received by a holding company from its subsidiaries are exempt from tax. The proposal that dividends received by an Irish-resident holding company from its foreign subsidiaries should be exempt from tax featured strongly during the consultation process. The point was made that such an exemption on dividends – along with the exemption on capital gains in respect of disposals of shares in subsidiaries that is already available – would be seen as a major part of a holding company regime.

The current tax treatment of dividends received by an Irish resident company is summarised in Box 7.7.

Box 7.7: Tax treatment of dividends received by Irish companies - main features

- The tax treatment depends on where the dividends come from:
 - From Irish subsidiary, exempt
 - From EU or tax treaty country:
 - If paid out of trading income, taxable at 12.5%
 - If paid out of non-trading income, taxable at 25% (but see note*)
 - From elsewhere, taxable at 25%
 - Trading profits may be traced up through a chain of companies to the top Irish company
 - Credit is given for foreign tax paid. Unused credits can be pooled. There are two pools, one for 12.5% credits and one for 25% credits
- * *Dividends from EU and tax treaty countries that are received by portfolio investor companies are taxed at 12.5%, whether or not they come out of trading profits. (These are companies with less than 5% of the share capital of the foreign company.)*

Under the current system, there is a charge to tax with a credit for foreign tax, which may result in no net liability to Irish tax. The rules place a compliance burden on Irish recipient companies. Participation exemption could be simpler from a regulatory burden point of view.

An examination of the taxation system for dividends in several countries reveals that there is some international trend towards participation exemption for foreign dividends. While participation exemption schemes already exist in many countries, virtually no country had full participation exemption, without complex rules.²⁵ We concluded that each participation exemption regime came with its own different level of intricacies and therefore we are not recommending any change at this time.

4.5.3 International tax issue (ii) – outbound payments of interest or of royalties

Interest payments to non-residents must be paid under deduction of tax at the standard rate of income tax. Also, Irish resident companies (and Irish branches of non-resident companies) must withhold tax on patent royalty payments or on other annual payments.²⁶ Payments outside of these categories are generally not subject to withholding tax.

²⁵ The United Kingdom, for example, is amending its dividend taxation rules in 2009. The UK, however, also has Controlled Foreign Companies (CFC) legislation, under which foreign income is, in certain circumstances, taxed on the UK parent company as it arises, without it being received in the UK.

²⁶ Under case law, these are payments that the recipient earns without incurring any expenses in so doing – i.e. what is known as “pure income profit” in the hands of the recipient.

Exemptions from the requirement to withhold tax on these outbound payments may be available under double tax treaties, under the EU Interest and Royalties Directive, or under provisions in the Irish tax code. The rules are broadly summarised in Box 7.8.

Box 7.8: Payments of interest or royalties from Ireland to other countries - main features

- Withholding taxes on royalties paid out of Ireland can be reduced or eliminated under the provisions of double tax agreements; prior approval from the Revenue Commissioners is currently required
- Under the EU Interest & Royalties Directive, payments of interest and royalties to companies in other EU countries are exempt from Irish withholding tax if:
 - the Irish company directly controls at least 25% of the voting power of the other EU company (or *vice versa*), or
 - a third EU company directly controls at least 25% of the voting power of each of the other two companies
 This can be applied on a self-assessment basis
- Exemptions from the withholding tax requirement also apply (on a self-assessment basis) for:
 - Interest paid by companies in the course of a trade to companies in the EU or in territories with which Ireland has a double tax agreement
 - Interest paid by securitisation companies to persons resident in the EU/tax treaty countries, and
 - Interest on financial instruments such as quoted Eurobonds and wholesale debt securities

Reductions or exemptions from withholding tax are not always available (for example, where the payments are made to non-treaty countries outside the EU) and in these cases, the Irish company must withhold tax at 20% on the payment. The question of removing the withholding tax requirement for such outbound payments was raised with us during the consultation process. Having regard to the policy focus on the continued expansion of Ireland's tax treaty network (see section 4.5.4 following) we do not consider that any changes to the current system of withholding tax on outbound payments are warranted at this time.

4.5.4 Tax treaty network

We received a number of submissions calling for Ireland's tax treaty network to be extended. Ireland has 46 treaties and there are plans to add significantly to this number. We endorse this policy focus on the expansion of Ireland's tax treaty network. We also note that the Finance (No. 2) Act 2008 provides that it is no longer necessary for both jurisdictions to have ratified a treaty in order to avail of some of the domestic tax provisions which require treaty residence, and that this was widely welcomed.

Section 5: Supporting sectors and activities

5.1 Introduction

Section 4 covered fiscal measures to support economic activity generally. This Section examines possible fiscal measures and incentives in relation to specific sectors and activities. It considers how tax policy might be used to help foster the knowledge-based economy and an innovation-friendly business environment.

We focus initially on research and development (section 5.2) and some issues in relation to royalties (section 5.3). Upskilling the domestic labour force, as well as encouraging highly skilled workers to locate in Ireland, are important components of the overall package and are considered in section 5.4.

The environmental agenda also creates businesses opportunities for Ireland. The fiscal measures we propose in Section 4 to assist business generally, as well as the incentives that we discuss in this Section, have a role to play in this. Issues in relation to the “Green Economy” are considered in Part 9 of our Report.

5.2 Research and development

The definition of research and development (R&D) in the tax code requires a systematic, investigative or experimental approach to be taken in a field of science or technology. The definition is based on that in the OECD Frascati Manual and accords with international norms. It covers the full range of R&D activities from basic research to applied research to experimental development.

The market on its own will fail to generate the optimum level of R&D because it is difficult, and typically impossible, for investors to capture the full benefits of their investment; others free ride on the fruits of their efforts. The market failure problem is compounded because of the great uncertainties that apply in terms of securing a commercially viable payoff²⁷.

Two tests are applied to determine if an activity is R&D:

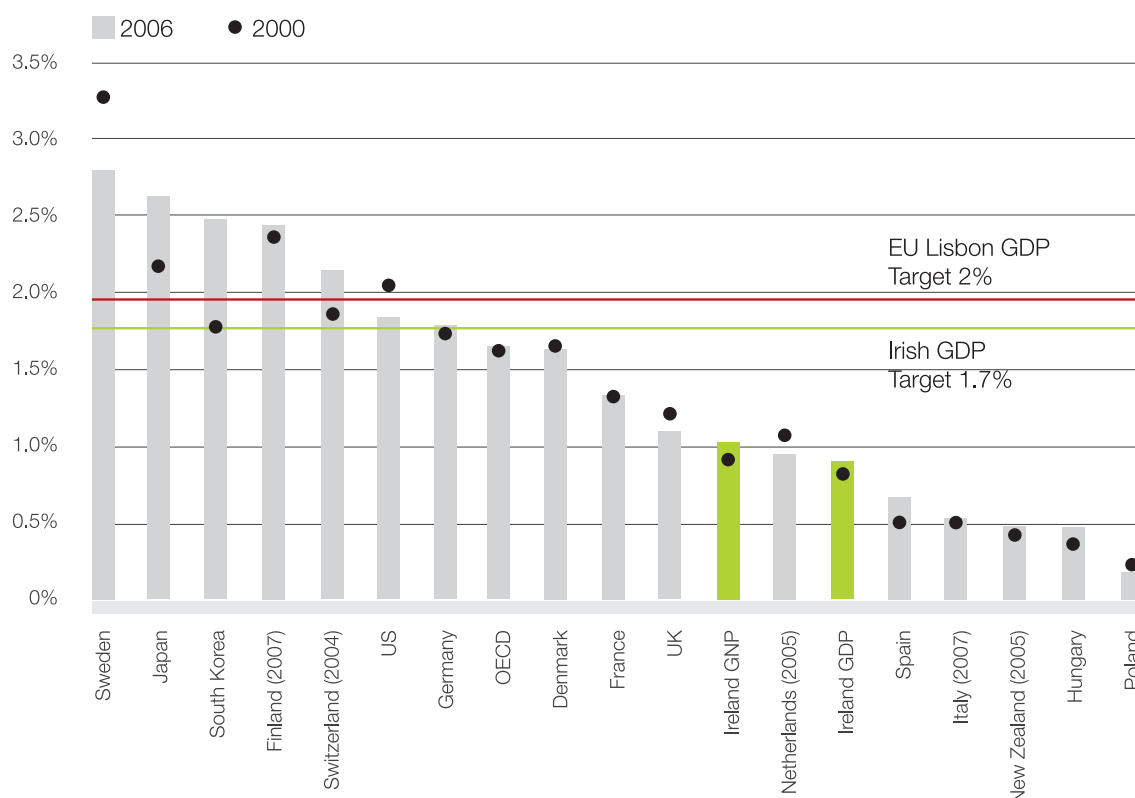
- It must seek to achieve scientific or technological advancement
- It must involve the resolution of scientific or technological uncertainty

In terms of economic structure, Ireland’s industrial policy places a high value on research and development, innovation and commercialisation. The report of the Enterprise Strategy Group highlighted as one of its two key policy issues the need to build “*technological and applied research and development (R&D) capability, to support the development of high-value products and services*”. The Irish Strategy for Science, Technology and Innovation has set a target of €3 billion for business expenditure on R&D by 2013, double the level of 2006. A related issue here is Ireland’s sectoral structure, with modern manufacturing and internationally traded services increasingly prominent. In 2007 modern manufacturing accounted for 58% of industrial value-added and 14% of total national gross value-added.

Ireland’s performance in relation to business expenditure on R&D is shown in Figure 7.5.

27 In this context, we note the recent appointment of an Innovation Taskforce to advise the Government on strategy for positioning Ireland as an International Innovation Hub as part of the Smart Economy.

Figure 7.5: Business Expenditure on R&D as a % of GDP, 2006



Source: National Competitiveness Council, 2008.

Ireland operates an R&D tax credit system under which credits against corporation tax are available on buildings used for R&D and for incremental expenditure (relative to a base year of 2003) incurred by a company on R&D. Key features are outlined in Box 7.9.

Box 7.9: Main features of Ireland’s existing R&D tax credit schemes

- tax credit of 25% of incremental expenditure (relative to a base year of 2003) incurred by a company on R&D is provided
- The credit is initially available for offset against corporation tax payable by companies in the same group
- Unused credits can be carried forward. They may also be carried back and offset against corporation tax paid in the previous year. Any unused credits can be refunded over a three year period
- Tax credits are also available on a volume basis for expenditure on buildings used for R&D
- The R&D must be carried out by a company in the European Economic Area; spending is not eligible to the extent that it is grant-aided
- Simple example of company availing of scheme:

Expenditure on R&D in 2003	€100.00
Expenditure on R&D in 2004	€120.00
Incremental spend 2004/2003	€20.00
Tax credit* = €20 x 20%	€4.00
Expenditure on R&D in 2009:	€140.00
Incremental expenditure 2009/2003	€40.00
Tax credit** = €40 x 25%	€10.00

*Tax credit available for offset against CT liability, or carried forward or surrendered to a group company.

** Credit refundable since Finance (No. 2) Act 2008 and rate increased to 25%.

A competitive system for attracting R&D is an integral part of the development of the knowledge-based economy. International comparisons (OECD 2006)²⁸ that there is aggressive competition between countries for R&D based investments. Incentive schemes were operated in 19 of the 27 countries surveyed. Over 40% of Foreign Direct Investment in Ireland is now in high-value R&D.

Ireland's R&D tax credit schemes have been enhanced on a number of occasions since their introduction with effect from 1 January 2004. Proposals in relation to research and development featured in several submissions to us, and some amendments – such as refunds of unused credits – were introduced in the Finance (No. 2) Act 2008 while we were in session.

We considered whether further enhancements to the R&D tax regime are warranted. We examined the offsetting provisions, the case for changing to a volume basis, and definitions of R&D for the purposes of the reliefs.

5.2.1 Utilisation of R&D credit

Under the current rules, the R&D tax credit is available for offset against corporation tax payable by the company. During the consultation process, the argument was made that making the credit available for offset against employer PRSI would be of more benefit to some companies. The kind of companies affected are typically members of an international group, where investment decisions are made on a plant by plant basis and are based on pre-tax comparisons between investment locations in different jurisdictions. In such a scenario, the Irish R&D tax credit, which affects the after-tax position of a company, is not considered in weighing up location decisions.

The argument has merit²⁹. In the context of supporting economic activity, we recommend that companies should have the option of offsetting their R&D tax credits against employer PRSI.

- Any change should be implemented at no cost to the Exchequer
- The measure should be optional (because many businesses prefer the current arrangements)
- An option made should be binding on the company or group concerned for a fixed period

(The possibility of allowing for offset of R&D tax credits against payroll costs or taxes other than employer PRSI was considered but is not recommended, because of the fiduciary nature of such taxes.)

5.2.2 Changing from an incremental to a volume basis

As shown in the example in Box 7.9, the current incremental regime allows for expenditure on R&D that is in excess of that undertaken in the base year of 2003 to qualify for the credit. A volume-based approach would mean that the full expenditure in any given year would qualify for the credit – using the figures shown in Box 7.9, for instance, the R&D spending of €140 in 2009 would be eligible for relief.

International trends with R&D tax credits have shown a move from an incremental to a volume basis, which is a simpler system. However, we do not propose any change in this area. In particular:

28 'Tax treatment of business investments in intellectual assets: an international comparison', OECD Science, Technology and Industry (STI) working paper 2006/4.

29 The accounting treatment of the R&D tax credit under IFRS (International Financial Reporting Standards) and Irish GAAP (Generally Accepted Accounting Principles) became topical since we began our deliberations. We note that the Revenue Commissioners have acknowledged [eBrief No. 36/09 (29/5/09)] that some companies may account for the R&D tax credit through the profit and loss account or income statement in arriving at the pre-tax profit or loss rather than recognising it as a reduction to their tax charge.

- The incremental approach provides an incentive to companies to increase their levels of R&D spending and it reduces deadweight costs (i.e. R&D activities that would happen in any event without any incentive)
- The incremental approach also minimises Exchequer costs, and
- The credit on buildings is, in any event, volume based

The establishment of 2003 as a permanent base year in the Finance (No. 2) Act 2008 means that all companies that began operations after 2003 (or other companies with zero spending on R&D in 2003) effectively have a volume-based scheme.

5.2.3 Definitions of R&D

Calls to broaden the definition of R&D (for example, in relation to the eligibility of software tools and clinical trials) were made during the consultation process. The definition of qualifying R&D that is contained in the corporation tax code and that follows international best practice – see introduction to section 5.2 above – is supplemented by regulations made by the Minister for Enterprise, Trade and Employment (in consultation with the Minister for Finance) which provide that certain categories of activities are, and certain categories are not, R&D activities. As the current definition accords with international norms, no change is recommended.

5.2.4 Conclusions on R&D

To conclude, we recommend one change to the R&D tax credit system, as indicated below.

Recommendation 7.20

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

Costings

This change is cost neutral to the Exchequer. It is recognised that some form of Exchequer crediting system will be required to compensate the Social Insurance Fund if offsets against employer PRSI are introduced.

5.3 Foreign tax credit on royalties

5.3.1 Tax treatment of royalties payable to Irish businesses from abroad

This section covers the tax treatment of royalties payable to Irish-based businesses in respect of intellectual property that is used abroad. Typically, the issue relates to software that is licensed from Ireland to businesses located outside Ireland – foreign withholding taxes imposed on income in respect of the software may not be fully relieved under Irish tax rules. The withholding tax rules are summarised in Box 7.10.

Box 7.10: Withholding tax rules for royalty payments into Ireland

- The imposition of foreign withholding tax on royalties paid into Ireland depends in the first instance on the tax rules in the paying company's jurisdiction
- Foreign withholding tax can be imposed at whatever rate applies under the law of the jurisdiction from which the royalties are paid
- Foreign withholding tax may be reduced under the terms of the tax treaty between the paying country and the country of residence of the recipient
- Where withholding tax is imposed, credit relief may be available under the terms of the EU Interest and Royalties Directive, or under the terms of a double tax agreement between the paying country and Ireland
- There are two provisions under Irish tax law in respect of royalty payments from non-treaty countries that have been subject to withholding tax:
 - Companies subject to corporation tax at the 10% rate may avail of unilateral relief, under which the foreign withholding tax may be credited in Ireland against Irish tax;
 - Other companies may deduct the withholding tax as a trading expense. This is a significantly less generous form of relief than a credit system.

To illustrate the operation of the rules, Table 7.2 gives an example of an Irish company that licences software to a foreign company and receives a royalty payment (subject to withholding tax) for it:

Table 7.2: Foreign withholding tax on royalty payments to an Irish company

Royalty income from abroad	€100.00
Expenses incurred	€80.00
Taxable profits in Ireland (net royalty income)	€20.00
Irish tax before credit = €20 × 12.5%	€2.50
Withholding tax paid abroad @ 20% (on the gross royalty)	€20.00

The foreign tax of €20 may be treated as follows:

- If the royalty comes from a country with which Ireland has a double taxation agreement, the foreign tax will be credited against the Irish tax on the royalty. Because the amount of credit is limited to the Irish tax referable to the income (which is €2.50 in the example), this will reduce the Irish tax borne to zero. (Company pays €20.00 total)
- If the royalty comes from a non-treaty country
 - If the recipient is a company availing of the 10% manufacturing rate of tax, then under the unilateral credit relief provisions, foreign credit of €2.00 will be available³⁰. (Company pays €20.00 total)
 - Otherwise, the €20 is allowed as a deduction against the taxable profits. The Irish profits are reduced to nil, and no further tax is payable. (Company pays €20 total tax, despite having no profits)

In our view, all trading companies should be able to avail of unilateral credit relief. Currently, such relief is available, but only to manufacturing companies that are subject to the 10% corporation

30 In this case, the Irish tax is €20 × 10% = €2.00

tax rate, which will expire at the end of 2010. Our proposal means that foreign withholding tax would be credited in Ireland against Irish tax, in cases where the payment comes from a country with which Ireland does not have a tax treaty. Such relief would improve the position of Irish companies expanding into foreign markets.

However, unilateral credit relief with a separate limit for each country is not, in our view, sufficient. In summary:

- The foreign withholding tax is imposed on the gross royalty (€100 in the example above)
- The Irish tax is imposed on the profit margin (net royalty income) (€20 in the example)
- The amount that can be credited is limited to the relevant Irish tax (€2.50 in the example)
- So the only time that the company in the example above will get full relief and be able to credit all the foreign withholding tax is where no expenses are incurred

Pooling of foreign tax credits on royalties should be permitted with an overall foreign pool. Royalty pooling in this way would allow the foreign withholding tax to be absorbed against all foreign royalty income and would reduce the effective rate of tax for companies paying foreign tax. In the example above, the company has €17.50 'unused' credit under the double tax treaty or unilateral credit system. Pooling allows this to be utilised for offset against Irish tax on other foreign royalty income. Table 7.3 adds two new columns to Table 7.2, to show a second royalty.

Table 7.3: Foreign withholding tax on royalty payments to Ireland - pooling

Royalty income from country A	€100.00	Royalty No 2 from country B	€100
Expenses incurred	€80.00	Expenses incurred	€10
Taxable profits in Ireland	€20.00	Taxable profits in Ireland	€90
Irish tax before credit = €20 x 12.5%	€2.50	Irish tax before credit = €90 x 12.5%	€11.25
Withholding tax paid abroad @ 20% (on the gross royalty)	€20.00	There is no withholding tax in country B	

In the absence of pooling:

- With the first royalty, the €20 foreign credit is available; the company pays no Irish tax
- With the second royalty, the company pays tax of €11.25
- The company's total tax is €20.00 (foreign) plus €11.25 (Irish) – an effective tax rate of 28.49% on its profits - and it has "excess" foreign tax credits of €17.50

Under a pooling arrangement, the 'excess credit' from the first royalty would be used to reduce the tax borne by a further €11.25, thereby reducing the Irish tax to zero. The company's total tax liability would thus be the foreign tax of €20.00 (its effective tax rate is reduced to 18% and would eventually reach 12.5% if it had more income in country B).

Pooling arrangements for foreign tax paid on profits of overseas branches and on interest and dividend payments coming into Ireland are already in place. The introduction of pooling for royalties seems entirely appropriate and we recommend it.

Recommendation 7.21

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

Recommendation 7.22

An overall foreign pooling system for foreign withholding tax on royalty payments should be introduced.

Costings

Recommendation 7.21: This measure would cost approximately €6 million.

Recommendation 7.22: Estimated cost in the region of €50 million³¹.

5.4 Skills and training

The skills profile of the labour force is a key component in the creation of an environment that supports economic activity and promotes increased employment. Skills and training featured significantly in the submissions. Our work in this area was also informed by the National Skills Strategy set down by the Expert Group on Future Skills Needs (2008). Skills shortages were brought to our attention during the consultation process. Our analysis focussed on two issues:

Skills shortages were brought to our attention during the consultation process. Our analysis focussed on two issues:

- The need to develop the domestic skills base by upskilling the Irish labour force, and
- The need to bring skilled people to Ireland in the short run, to meet immediate demands for experienced personnel

5.4.1 Upskilling the Irish labour force

Existing tax treatment of expenditure on education and training is summarised in Box 7.11. A cross-country comparison on the tax treatment of expenditure on training/education by employers (OECD 2006)³² indicated that full deductibility of training expenses in the year incurred was the main method of tax treatment. This is also the case in Ireland. Further details on training-related tax breaks for employees are given in Part 8, where we recommend that these tax incentives should be continued.

Box 7.11: Summary of tax treatment of training and education costs

- Costs incurred by employers on employee training and education (such as course fees and membership subscriptions for professional bodies) are normally tax deductible as a revenue expense
- Pre-trading expenditure on training incurred by a business before trading starts may be written off over a three-year period
- Tax credits (at the standard rate) are allowed to individuals for fees paid for third-level education; tax credits are also available for expenditure on FÁS-approved language or information technology courses
- There is an income tax exemption for employees in respect of retraining costs incurred by their employers as part of a redundancy package, up to a limit

31 Based on information from Forfás and the development agencies, who point out that it does not factor in any behavioural change.

32 STI working paper 2006/4, op cit.

Our consideration of whether extensions to the tax reliefs would be desirable was informed by the following considerations:

- State funding on education and training is considerable - apart from expenditure on the educational institutions, grants and services to employers to provide education and training are available through FÁS and the development agencies, among others
- Training is needed by both unemployed and employed persons; using tax as a policy instrument is not appropriate for persons outside the tax net
- The deadweight costs associated with tax incentives for upskilling are considerable

We concluded that, by and large the current system caters adequately for relevant courses; the deadweight costs associated with tax incentives for upskilling/training staff suggests that other policy instruments may be more effective. However, there is one area where amendments to the current tax provisions are warranted.

Tax relief is currently available where an employee who is made redundant retrains, and the cost of the course is borne by the employer (see Box 7.11). We propose a further incentive for unemployed persons who incur their own retraining/upskilling costs, under which tax refunds (up to an annual limit) would be made available for offset against income for the previous six years. This mirrors the seed capital scheme, which provides tax refunds to unemployed individuals who set up their own companies. (There is further detail about the seed capital scheme in Part 8 of our Report.)

Recommendation 7.23

Persons who are made unemployed should be entitled to offset the retraining costs they incur on certified training courses against income for the previous six years.

Costings

No cost estimate is available for this measure.

5.4.2 Attracting key skills into Ireland

The remittance basis of taxation, and the measure for foreign domiciled individuals introduced in Finance (No. 2) Act 2008, are briefly summarised in Box 7.12.

Box 7.12: Summary of tax measures geared towards foreign nationals working in Ireland

- Prior to 2006, the remittance basis applied under which foreign nationals coming to reside in Ireland could confine their Irish income tax liability on foreign income to the income they brought into Ireland
- The Finance Act 2006 abolished the remittance basis in respect of employment income derived from employments exercised in Ireland. Foreign nationals were brought into the PAYE net, and Irish income tax was deductible from earnings relating to employment duties in Ireland
- The Finance (No. 2) Act 2008 introduced a new regime for foreign employees coming to work in Ireland from non-EEA countries with which Ireland has a double tax treaty. The employer must operate Irish PAYE on the employment income and the relief applies by way of repayment of Irish tax on up to 50% of remitted earnings in excess of €100,000 per annum

The remittance basis of taxation is considered in Part 5 of our Report. A targeted tax incentive to allow Ireland to compete in world markets for mobile employees who are in demand internationally was an issue we considered in some detail. We examined, in the first instance, the provision introduced by the Finance (No. 2) Act 2008, which applies to a limited category of employments exercised in Ireland. Broadly, the measure only applies

- To persons earning in excess of €100,000 per annum
- To individuals who are not Irish domiciled and who, before they came to Ireland, were living and working in a country:
 - that is not in the European Economic Area, but
 - that has a tax treaty with Ireland
- Where the individual is sent by his or her foreign employer to work in Ireland for that employer or for an associated company of that employer and continues to be paid from abroad

Individuals availing of the provision may reduce their income to the greater of:

- €100,000 plus 50% of the employment income over that amount, or
- The income from that employment remitted to Ireland

We concluded that the measure introduced in Finance (No. 2) Act 2008 has limited value as a measure to encourage key workers with required skills to locate in Ireland, because it is confined to employees from non-EEA countries and is not based on skills that are in demand in this country. On the one hand, it is too narrow (certain territories) while on the other hand, it is too broad (all skills covered). We recommend that it should be discontinued.

We favour a targeted scheme based on skills rather than nationality. The skills we are focusing on are ones that are strategically important to the development of defined sub-sectors of the economy, and which are simply not available in Ireland. Our proposal is presented in Box 7.13.

Box 7.13: Attracting key skills into Ireland – a carefully targeted incentive

- A targeted scheme, based on specific skills, rather than salary criterion, would be more effective in meeting identified needs
- The Department of Enterprise, Trade and Employment (DETE) would be advised by the Expert Group on Future Skills in developing a ‘critical skills list’
- The burden of proof would be on the employer, to show that the necessary skills could not be met domestically – this would be done on a company by company basis; employers would apply to DETE and would be given evidence of their qualification for the incentive, which could be provided to the Revenue Commissioners
- Relief would be given by way of deduction from a person’s taxable income; there would be a limit on the amount of relief that would be given, so that:
 - There would be a cap on the relief set at 25% of total income, and
 - This would be subject to an income ceiling of €250,000
 This means that the maximum reduction available to an individual would be €62,500 (€250K x 25%)
- Relief would be time-limited: An individual could claim relief under the scheme for a maximum of three years.
- The scheme would cover critical skills only, and these would also be time-limited
- Focus would be on skills, not nationality
- The inclusion of a skill on the list would only be allowed if it was considered to be the best way for Ireland to fill the gap. In other words, skills which are strategically important for the development of defined sub-sectors of the economy

Such a scheme would address the need to bring key employees to Ireland to meet immediate, short-run demands for experienced personnel. We consider that the benefits that flow from the location here of these mobile workers could be considerable. This is due to the positive externalities, including the development of those sectors of the economy that have been identified as being of strategic importance - development which will not happen in the absence of a targeted incentive, as the skills are not available domestically.

Recommendation 7.24

The partial reintroduction of the remittance basis in the Finance (No. 2) Act 2008 should be discontinued.

Recommendation 7.25

A carefully targeted tax incentive, along the lines indicated in Box 7.13, should be introduced to attract skilled persons into Ireland to meet short-term skills gaps.

Costings

No cost estimates are available for these measures.

Appendix 1

Supplementary information on Section 2 - the economics of corporation tax

International theory and evidence

Overview

Corporation tax influences economic growth through affecting both capital formation and productivity. Corporation tax can have a negative effect on investment (capital formation) by reducing its after-tax return. OECD evidence confirms this at both the firm and industry level. This section focuses particularly on mobile investment because Ireland is a small open economy. The impact of corporate taxation on productivity can occur through several channels. First, corporation tax can result in a re-allocation of resources towards possibly less productive sectors by distorting relative factor prices. Second, corporation tax, when complex, can impose high compliance administrative costs. Third, the effect of corporation tax on investment may have knock-on effects on innovation. Fourth, the effect of corporation tax on mobile investment may hinder technology transfers and knowledge spillovers

Recent empirical research by the OECD on the relationship between tax and economic growth has highlighted the overall economic impact of corporation tax, finding that relative to other taxes, "corporate income taxes appear to have a particularly negative impact on GDP per capita."³³ This analysis ranks tax instruments with respect to their relationship to economic growth. Property taxes are the most growth-friendly, followed by consumption taxes, then personal income taxes, and finally corporate income taxes.³⁴ The OECD paper estimates the effect on GDP per capita of changing the tax mix while keeping the overall tax-to-GDP ratio constant: a shift of 1% of tax revenues from income taxes to consumption and property taxes would increase GDP per capita by between a quarter of a percentage point and one percentage point in the long run. This is because direct taxes like corporation tax are more distortionary as they have a greater effect on economic incentives. Economic theory suggests that this effect is likely to be greater in a small open economy where capital is more mobile.

Mobile investment

One of the key results in the optimal tax setting literature is that, in the absence of location-specific rents, a government in a small open economy should not levy any (source-based) taxes on capital.³⁵ This is because a small open economy faces a perfectly elastic supply of capital from abroad. In formal economic models, a rise in the tax on the return to capital located in an open economy will raise the required pre-tax rate of return on capital in that economy, inducing an outflow of capital.

Griffith, Hines and Sørensen (2008) list a number of caveats to this result. First, if by investing in a particular location, firms can earn location-specific rents, which are immobile as opposed to mobile firm specific rents, the government of that jurisdiction may impose some amount of source tax without deterring investors. This relates to the new economic geography perspective which emphasises the role of 'agglomeration economies' and the business concentration benefits of a particular country. A further

33 'Tax and Economic Growth', OECD Economics Department Working Paper No. 620, July 2008.

34 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', Jens Arnold, OECD Economics Department Working Paper No. 643.

35 'International Capital Taxation', Rachel Griffith, James Hines, and Peter Birch Sørensen, March 2008, Paper prepared for The Mirrlees Review, "Reforming the Tax System for the 21st Century".

example is the issue of market access with firms choosing to locate production in large markets even if they maintain relatively high tax rates. Second, capital may not be perfectly mobile. Third, a corporate income tax may be a necessary ‘backstop’ to the personal income tax. Fourth, even though it may be inefficient to tax capital income at source, a source-based corporation tax may be a political necessity. Only the first two caveats are based on economic efficiency grounds specific to corporation tax. The first caveat is an empirical issue to which we will return below. On the second issue, capital is more mobile in a small open economy.

Turning to the empirical work in this area, most of the research concentrates on foreign direct investment (FDI). A literature review carried out for the OECD by Mooij and Ederveen (2005) finds that most studies report a negative relationship between taxation and FDI, but with a wide range of estimates of the tax elasticity of FDI.³⁶ The average elasticity value is -3.72; this is the estimated percentage change in FDI in response to a one percentage point change in the tax rate. Distribution analysis finds that a majority of the estimated elasticities occur in the range of -5 to 0. Within these general findings it is noteworthy that the share of FDI that comprises real investment in physical capital is more responsive to taxes than other components of FDI. Also, it seems that FDI is becoming more responsive to taxation over time, as studies using more recent data are found to produce larger elasticities.

A more recent survey of the academic research concludes that “it is clear from this accumulated evidence that taxation does play a role in affecting the choices made by multinational companies”.³⁷ In particular, average tax rates tend to play a significant role in discrete location choices, and hence in the overall allocation of capital. Devereux and Griffith (1998), for example, presented evidence that the discrete location decisions of US multinationals within Europe were affected by average tax rates rather than marginal tax rates.³⁸ This is as predicted by economic theory, with marginal tax rates more relevant for the level of investment.

Incidence

It is important from a distributional viewpoint to note that these economic effects of corporation tax are far broader than just the impact on company profits. The concept of tax incidence says that the person who pays a tax doesn’t necessarily bear the economic burden of the tax. The cardinal rule of tax incidence analysis is that only individuals can bear the burden of taxation and that all tax burdens should be traced back to individuals.³⁹ Thus, the burden of corporation tax ultimately falls on the shareholders, the customers/suppliers, or the employees. This can be illustrated by examining capital formation, the key channel identified in the literature. Lower company profits decrease the incentive to invest and thus decrease the capital stock, which in turn reduces the marginal productivity of labour, and thus wages.

Recent attempts to measure corporate tax incidence find that a significant part of the effective incidence of the tax falls on wages. One study using data on 23,000 companies located in 10 countries over the period 1993-2003 estimates that approximately 54% of any additional tax is passed on in lower wages.⁴⁰

36 ‘Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis’, OECD Tax Policy Studies No. 17, 2007.

37 ‘The Impact of Taxation on the Location of Capital, Firms and Profit: A Survey of Empirical Evidence’, Michael P. Devereux, Oxford University Centre for Business Taxation, WP 07/02

38 ‘Taxing Corporate Income’, Alan J. Auerbach, Michael P. Devereux, and Helen Simpson, March 2008, Paper prepared for The Mirrlees Review, “Reforming the Tax System for the 21st Century”.

39 ‘Who Bears the Corporate Tax? A review of What We Know’, Alan J. Auerbach, National Bureau of Economic Research Working Paper Series, No. 11686, 2005.

40 ‘The direct incidence of corporate income tax on wages’, Wiji Arulampalam, Michael P. Devereux and Giorgia Maffini, Oxford University Centre for Business Taxation, WP 07/07.

Another report using data on the foreign activities of US multinational firms in more than 50 countries between 1989 and 2004 finds that between 45% and 75% of the burden of corporate taxes is borne by labour with the balance borne by capital.⁴¹ In smaller countries the domestic labour force is likely to bear more of the burden of the tax because capital is more mobile in a small open economy.⁴²

Irish evidence

Foreign direct investment in Ireland

This international evidence on mobile investment is very relevant to Ireland as the importance of FDI to the Irish economy is well known. A key measure in this regard is the stock of inward investment in Ireland which is the accumulated flow of FDI projects over time. While Ireland's FDI stock, as a percentage of GDP, has declined since 2000, its inward investment levels remain among the highest in the OECD. In 2007, Ireland ranked third out of 27 OECD countries for its stock of inward investment as a % of GDP.⁴³

This large amount of FDI is a significant contributor to many key economic aggregates. Foreign owned firms are key drivers of exports, directly employ a significant number of people, have higher rates of R&D, and impact the Irish economy through their expenditure.⁴⁴

- Foreign-owned firms assisted by IDA Ireland accounted for 63% of total Irish exports in 2007. Over various time periods, the growth rate of exports by these foreign-owned firms (as well as the level) exceeds the growth rate of exports by agency-assisted indigenous enterprise: the respective rates for these two groups are 11.5%, 21.8% and 5.8% for foreign-owned firms versus 6%, 8% and 3.8% for indigenous firms, for the time periods 1990-1994, 1995-1999, and 2000-2007
- Foreign-owned firms assisted by IDA Ireland employed 153,510 employees in 2007
- R&D expenditure by foreign-owned firms was €1.16 billion in 2007 or 72.4% of total business R&D expenditure in Ireland. Thus foreign-owned firms are playing a significant role in Ireland's attempt to move up the value chain as it tries to match competitor countries in its level of R&D intensity
- Total expenditure by foreign firms in the Irish economy amounted to €18.1 billion in 2007. This comprises €7.2 billion on services purchased in Ireland, €3.3 billion on materials produced in Ireland, and €7.6 billion on payroll costs. Measuring this expenditure relative to GNP we get a figure of 11.3%, a decline from 19.7% in 2000
- The academic literature also stresses the role of FDI in generating technology and knowledge spillovers that can boost the productivity of domestic firms.

Empirical evidence.

A recent paper estimates the economic impact of the rate of corporation tax in Ireland by examining a natural experiment, the extension in the early 1990s of the low tax regime to the non-manufacturing economy, in particular to the business and financial services sector.⁴⁵ The rate of corporation tax in the market services sector fell gradually from 40% in 1994 to 32% in 1998 and finally to 12.5% by 2003.

41 'Labor and Capital Shares of the Corporate Tax Burden: International Evidence', Mihir A. Desai, C. Fritz Foley, James R. Hines Jr, presented at the International Tax Policy Forum and Urban-Brookings Tax Policy Center conference on Who Pays the Corporate Tax in an Open Economy?, 18 December 2007.

42 'The direct incidence of corporate income tax on wages', Wiji Arulampalam, Michael P. Devereux and Giorgia Maffini, Oxford University Centre for Business Taxation, WP 07/07.

43 The ranking does not change when GNP is used as the denominator.

44 Much of this data is from 'Annual Business Survey of Economic Impact 2007', Forfás.

45 'The Macroeconomic Impact of Changing the Rate of Corporation Tax', Thomas Conefrey and John Fitz Gerald, ESRI Working Paper No. 273, January 2009.

This paper finds that the fall in the tax rate had a significant positive long-run impact on the sector in the form of a substantially higher level of exports and output. The reduction in the corporate tax rate from 40% to 12.5% accounted for an increase in exports of services of over 60%.

The overall macroeconomic effects of the change in the tax rate, allowing for multiplier and competitiveness effects, are then estimated. To isolate the impact of the tax change from other economic factors, two simulations of the *HERMES* macroeconomic model are undertaken: one simulation with the corporation tax rate held at 40% and one where it is cut to 12.5%. The reduction in corporation tax rates for non-manufacturing sectors is estimated to have increased the level of GNP in 2005 by over 3.7%. The paper concludes that the increase in output arising from the change in the corporation tax regime applying to the business and financial services sector was significant, but that it was not the main factor driving increased output in Ireland as the level of GNP in Ireland rose by 87% over the period 1995-2005.

An earlier paper uses a cross-country approach to examine the effect of corporation tax rates on FDI, with a particular focus on Ireland. It finds that 10% higher statutory corporate tax rates are associated with 44% less foreign investment from the United States, controlling for income, population, and European location.⁴⁶ This simple model accounts for the Irish experience very well.⁴⁷

The present situation

The present international trend in tax policy is towards decreasing the rate of corporation tax. Thus, the differential between Ireland's rate and that of other countries has narrowed as the average top rate of corporation tax in the EU-15 and EU-27 has declined. There is, however, a danger in just comparing the headline rates of tax because when the exact tax base is taken into account the effective tax rate applicable to companies will be different from the headline rate.

Despite this international trend Ireland still has the lowest corporation tax rate in the EU-15 and the third lowest rate in the EU-27.⁴⁸ Ireland continues to attract a large number of greenfield investment projects, relative to its size. In 2007, only Singapore attracted more greenfield projects per capita [see Figure 7.2 in Section 2].

Appendix 2

Supplementary information on Section 3: The economics of labour-related taxes and employment

Low taxes on labour are important for supporting demand for labour

Taxes on labour income should be kept low to support demand for labour and employment levels. This crucial link is supported by economic theory and empirical economic evidence, both international and Irish.

The economic theory of the incidence of taxation highlights that the person who pays a tax, in an accounting sense, does not necessarily bear the economic burden of a tax; instead this burden can be shifted to others as other economic variables change in response to the tax change. In standard economic models, the direct impact of a labour tax is borne by either the employee or the employer depending on how the wage level changes. The tax wedge on labour is useful in illustrating this effect; it is defined by

46 'Sensible Tax Policies in Open Economies', James R. Hines Jr., *Journal of the Statistical and Social Inquiry Society of Ireland*, Vol. XXXIII, 2004.

47 This last issue is examined by analysing the change in the Irish residuals from the cross-country regressions.

48 'Annual Competitiveness Report 2008 volume 1', National Competitiveness Council.

the OECD as the gap between the labour costs the employer pays and the corresponding net take home pay the employee receives.⁴⁹ An increase in labour tax will increase the tax wedge resulting in two main effects: an increase in before-tax wages, increasing the cost of employing labour and thus reducing demand for labour and employment; and in a decrease in after-tax wages of employees reducing their real take home pay. Thus a key effect of taxes on labour, in theory, is that they reduce the demand for labour and thus levels of employment.

International empirical evidence shows that labour taxes influence employment, supporting this demand for labour channel. The OECD's 2006 reassessment of its jobs strategy surveyed the econometric evidence of the impact of the tax wedge and a majority of the studies, 12 out of 17, found evidence that a higher labour tax wedge increases unemployment.⁵⁰ The OECD's own research found an economically large effect with baseline estimates implying that a "historically typical" reform of the tax wedge by 2.8 percentage points would increase the employment rate by 1.1 percentage points in the average OECD country.

An earlier survey of the economic evidence found that a 10 percentage point rise in the tax wedge reduces labour input by somewhere between 1% and 3% of the working age population. It concluded that tax rates are a significant factor, though not the main factor, in explaining differences in the amount of market work undertaken by the working age population in different countries.⁵¹

In turning to the Irish evidence, we must examine how the supply of labour responds to changes in the wage rate (the elasticity of labour supply), as this is the key factor determining how the tax burden is shared between the employer and the employee (i.e. where the incidence of the tax falls). In the past Ireland's supply of labour was strongly influenced by emigration to the UK, in particular, such that our labour supply was highly elastic.⁵² When labour supply is elastic, most of the incidence of labour taxes is borne by employers as a decrease in after-tax wage rates (i.e. the alternative where employees bear the burden) would result in an outflow of labour. Thus when labour taxes were decreased in Ireland (e.g. in the first partnership agreement of 1987) most of the incidence fell to employers, decreasing the upward pressure on before-tax wages, increasing competitiveness and ultimately employment. Academic research confirms this analysis that the tax wedge has had a long-run effect on before-tax wage formation in Ireland.⁵³ Fitz Gerald and Hore (2002) find almost full pass through of taxes to wages in the long run in Ireland over the period 1960-1999. In the short run a 1% increase in the Irish tax wedge increased wage rates by 0.75%. Thus the tax wedge in Ireland has raised labour costs and decreased the demand for labour, decreasing employment.

The relative importance of this labour tax effect in Ireland's recent economic history is highlighted in a recent paper which conducts a business-cycle accounting exercise on Ireland's economic performance between 1973 and 2002.⁵⁴ This paper attempts to isolate the different impacts of total factor productivity, government spending and taxes on labour income and investment. The estimate used for Ireland's labour tax wedge is driven primarily by movements in explicit tax rates and it is this measure and the productivity measure that are found to be the key factors, such that "the labour wedge acting in isolation would have generated a severe downturn in economic activity in the 1970s and 1980s." Turning to unemployment

49 'Taxing Wages 2006 / 2007', OECD, 2007. The OECD tax wedge is an average tax rate measure.

50 'OECD Employment Outlook: Boosting Jobs and Incomes', OECD 2006.

51 'Employment and Taxes', Stephen Nickell, CEP Discussion Paper No 634, London School of Economics, May 2004.

52 ESRI 'Medium-Term Review 2008-2015', J. Fitz Gerald et al., May 2008. Empirical studies show that this phenomenon explained the behaviour of Irish wage rates up to the mid-1990s

53 'Wage Determination in Economies in Transition: Ireland, Spain and Portugal', John Fitz Gerald and Jonathan Hore, ESRI Working Paper No. 147, August 2002. This confirms earlier research by Anderton & Barrell (1995) and Bradley et al (1993).

54 'Ireland's Great Depression', A. Ahearne, F. Kydland, and M.A. Wynne, *The Economic and Social Review*, Vol. 37, No. 2, 2006.

specifically, a second result is that “only the labour wedge generates a decline in the labour input”. Thus taxes on labour income are particularly important in explaining Ireland’s recent economic history.

The economic importance of the tax wedge in Ireland has increased alongside the growing importance of price and wage competitiveness since Ireland adopted the euro. As a member of a common currency, Ireland can no longer devalue its own currency to regain competitiveness when necessary, thus the adjustment has to fall on national prices, including wages. Our recent history in this regard is that Ireland has experienced a 32% loss in international price competitiveness between January 2000 and September 2008, with approximately one-third of the loss due to higher price inflation in Ireland.⁵⁵

The present situation

As recently as 2007 Ireland had the smallest tax wedge in the OECD at less than half the OECD average (see Fig 7.3 in Section 3). This position has changed in the last two years, since the April 2009 budget, as Ireland’s tax wedge has now increased to approximately 17.4%. This represents a significant 36% increase in the tax wedge in only two years. This reverses the trend where the value of Ireland’s tax wedge had fallen significantly in the last decade, from 25.6% in 1998 to 12.8% in 2007, and at a faster rate than the average OECD tax wedge.⁵⁶

The effect of the tax wedge may be different now because recent evidence suggests that the supply of labour is not always infinitely elastic in Ireland because the nature of the Irish labour market changed during the last decade.⁵⁷ Thus part of the recent reductions in labour taxation accrued to employees in the form of higher wages, with the positive impact on competitiveness and employment less than in earlier times.

However, despite this recent decrease, a recent estimate suggests that labour supply is still quite elastic by international standards.⁵⁸ Therefore the impact of income taxes and the tax wedge on demand for labour and employment levels is still greater in Ireland than it is in other countries. Thus policymakers should aim to keep the labour tax wedge low, in absolute terms and relative to other countries.

In relation to the economic environment the country faces in the short-term, a process has already started where tax revenue is being increased to correct the public finances. With specific regard to the Exchequer contribution of taxes on labour, it has been well documented that the share of labour tax in overall tax revenues has fallen significantly over the last decade. From a peak of 36.6% in 1997 the income tax share fell to a trough of 27.2% in 2006, a fall closely mirrored by a corresponding rise in the share of asset-related tax revenues.⁵⁹ This does not, however, suggest that further policy changes are needed to increase the share of labour tax in overall tax revenues. This increase is already happening due to recent tax increases (including levies) and also because of the present economic downturn, where the revenue from labour taxes is decreasing at a slower rate than that of other taxes. By 2008, the income tax share had already risen back to 32.3%.

The total tax wedge on labour is composed of income tax and social security contributions from both employees and employers. Employers’ social security contributions (employer PRSI) are paid directly

55 ‘Annual Competitiveness Report 2008 volume 2’, National Competitiveness Council.

56 The total tax wedge is based on a two-earner family with two children with wage levels of 100% and 67% of the average wage for the two earners; ‘100-67%’ in the OECD shorthand (OECD, ‘Taxing Wages’, various years).

57 The ESRI note two specific changes that affect the labour supply curve through migration: the nature of the migration has changed and is no longer primarily between Ireland and the UK, and large inflows of migration result in rising costs of living in the short run when the stock of infrastructure is fixed.

58 ESRI ‘Medium-Term Review 2008-2015’, J. Fitz Gerald et al., May 2008. By comparison the “consensus estimate” is that labour supply is “very inelastic” according to recent surveys of the literature; these studies primarily use American data (‘Labour Economics’, G.J. Borjas, 2005).

59 Source: Central Budget Office, Department of Finance. These data are income tax revenue as a percentage of total tax revenue, not including social insurance contributions.

by the employer. This direct payment refers to the imposition of the tax but in the short run the effective economic incidence of a change in employer PRSI will also fall primarily on the employer, as it takes time for nominal wages, the price mechanism in labour markets, to adjust. Therefore, a temporary reduction in employer PRSI could be a suitable tax-related policy tool to decrease the cost of employment and sustain demand for labour in a weak economic environment.

Low taxes on labour are important for supporting labour supply

When the incidence of taxation falls on the employee it is after-tax wages which are affected which then has an incentive effect on the supply of labour. Higher taxes decrease the return to employment in the form of after-tax wages which then can affect the decision to enter the labour force (participation) and the decision of how many hours to work. Policymakers have a particular interest in the effect of labour tax increases on incentives to participate in the labour market because not only does non-participation mean a decrease in income earned but it can also mean an increase in government expenditure on social welfare.

Empirical evidence of a labour supply effect in Ireland predicts that a general increase in wages of 1% would see preferred hours at work rise by 0.18% for men and by 0.48% for women.⁶⁰ Specific results of further interest are that increased participation accounts for the major part of the response, with increases in hours of work playing a lesser role, for both men and women; and that the labour supply response to different forms of a tax cut is rather similar in terms of the overall change in participation (male and female combined) and in the rise in average desired hours.

These results are important for the policy balance between targeting the average or the marginal rate of tax. Increased participation accounts for the major part of the labour supply response and participation is a binary decision to enter the labour force or not driven by average tax rates; whereas increases in hours of work is a relative decision more influenced by marginal tax rates. Thus, on this evidence average tax rates are of greater economic importance. This is confirmed by the result that the labour supply response in terms of the rise in average desired hours is rather similar for different forms of a tax cut: if marginal rates were more important than average rates, then cuts in tax rates should be more important than changes to the bands or credits.

Targeting average tax rates and labour force participation involves those who switch labour force, i.e. migration, as well as those who drop out of the labour force. The issue of migration has grown in importance for labour tax policy as labour mobility has increased with globalisation and the advent of the single European labour market. In this regard, Irish tax policy needs to observe closely the tax wedge differentials between Ireland and other countries, particularly the UK. It should also be noted that multinational companies consider the overall tax package of a country, including labour tax, because of its implications for attracting skilled labour. Preliminary research shows that FDI is less likely to be located in countries where average labour taxes or their progression (because of the need for skilled workers and managers) are relatively high.⁶¹

Tax evasion is also relevant here as higher taxes on labour increase the incentive to evade tax through not reporting all the labour that is supplied. The shadow economy comprises all economic activities that would generally be taxable were they reported to the tax authorities. As such it includes not only illegal activities but also unreported income from the production of legal goods and services. Several macroeconomic and

60 'Tax Cuts, Tax Reform and Labour Supply Responses', Tim Callan, Arthur Van Soest, and John R Walsh, ESRI Budget Perspectives 2004, October 2003.

61 'Labour Taxation and Foreign Direct Investment', P. Egger and D. M. Radulescu, CESIFO Working Paper No. 2309, May 2008.

microeconomic studies based on data for several countries suggest that a major driving force behind the size and growth of the shadow economy are an increasing burden of tax and social security payments.⁶² As one example of this, the labour supply of men with high levels of education is very unresponsive to tax changes but the amount of taxable income they earn does seem responsive; Meghir and Phillips (2008) believe it is likely that this is due to income shifting.

Low taxes on labour support other aspects of economic activity

Labour taxes also affect other aspects of economic activity, including entrepreneurship and human capital. Entrepreneurship is an important factor in generating employment and economic growth. The case for government support of entrepreneurship depends on a positive externality argument, that the benefits flowing from entrepreneurship are not necessarily captured by the entrepreneurs themselves and thus not enough entrepreneurship is carried out. High taxes discourage entrepreneurs by reducing the return from undertaking risky entrepreneurial projects.

Many empirical studies, however, have found a positive relationship between income taxes and entrepreneurship.⁶³ This incongruity is thought to be due to the use of data from the USA where the tax law allows the self-employed to deduct losses against highly-taxed labour income. In this scenario an increase in labour tax can encourage self-employment as it makes loss-offsetting more valuable while not affecting net gains as the profits are taxed as corporate income.⁶⁴ A recent study uses Sweden to focus on the negative relationship between taxes and entrepreneurship because Swedish tax law provides less generous loss-offsetting.⁶⁵ This study finds that average and marginal taxes negatively influence the propensity to become self-employed in Sweden. Turning to the ongoing decisions of existing entrepreneurs, Carroll *et al.* find that higher tax rates reduce investment, hiring, and small business income growth.⁶⁶

The progressivity of taxes on labour is also important here as progressive taxes reduce the post-tax income differential between the cases where an entrepreneur is successful and the alternative case of a business failure. OECD research finds that a stronger progressivity of personal labour taxes seems to be associated with lower long-run GDP per capita.⁶⁷ This is interpreted to partly reflect higher entrepreneurship and risk-taking, as well as the responsiveness of labour supply.⁶⁸ In related research, Gentry and Hubbard (2000) found that the probability of entry into self-employment increased as tax rates became less progressive.⁶⁹

Progressivity is of course an important consideration with regard to the equity of a tax system; here we note that progressivity also has economic effects which must be taken into account, and that these are prominent when it comes to the progressivity of labour taxes in particular.

Turning to human capital, its development is important because levels of education and skill are important determinants of economic growth. Taxes on labour affect the decision to pursue education or training because taxation affects the extra returns to work that are earned by this higher human capital. A recent

62 'Hiding in the Shadows: The Growth of the Underground Economy', F. Schneider and D. Enste, International Monetary Fund, 2002.

63 'Entrepreneurship and the Policy Environment', Y. Georgellis and H. J. Wall, Federal Reserve Bank of St. Louis Review, March/April 2006.

64 See 'Taxes and Entrepreneurial Activity: Theory and Evidence for the US', J. B. Cullen & R.H. Gordon, NBER Working Paper, No 9015, 2002.

65 'Income taxes and the probability to become self-employed: The case of Sweden', A. Hansson, Ratio Working Paper No 122, 2008.

66 This research is in a series of papers of which the latest is 'Personal Income Taxes and the Growth of Small Firms', R. Carroll, D. Holtz-Eakin, M. Rider, and H.S. Rosen, in J.M. Poterba (ed.) *Tax Policy and the Economy*, Volume 15, 2001.

67 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', Jens Arnold, OECD Economics Department Working Paper No. 643, October 2008.

68 Human capital is already controlled for in the statistical analysis.

69 'Tax Policy and Entrepreneurial Entry', W.M. Gentry and R.G. Hubbard, American Economic Review, May 2000.

OECD paper on the policy determinants of investment in tertiary education includes tax reforms in its analysis although acknowledging that they are rarely motivated with reference to their effects on incentives for investment in higher education.⁷⁰ This paper finds that, in particular, lower marginal tax rates on labour earnings have a positive effect on returns to education.

The effects of taxes on labour are not uniform

The economic impact of labour taxes is not the same for different demographic groups and for different conditions in the labour market.

Demographics

Meghir and Phillips (2008) survey the international evidence on labour supply responses to tax changes and find different elasticities for different demographic groups. They conclude “that hours of work do not respond particularly strongly to the financial incentives created by tax changes for men, but they are a little more responsive for married women and lone mothers. On the other hand, the decision whether or not to take paid work at all is quite sensitive to taxation and benefits for women and mothers in particular.” The consensus in the literature is that participation elasticities for married women are quite high and is perhaps more important than weekly hours of work. A “strong consensus” is that the participation elasticity for lone mothers is among the highest of all demographic groups.

The same authors find a very low hours worked adjustment to changes in marginal wages for men and conclude that it “can almost be ignored for welfare purposes”. This is influenced by a key characteristic of male labour supply that men work primarily full time. Male participation decisions for those with low or medium levels of education can be responsive, but this is to do with a combination of tax and welfare benefits. The work decision is very unresponsive to tax changes for men with high levels of education.

Irish evidence already cited in Section 3 predicts that a general increase in after-tax wages of approximately 1% would see preferred hours at work rise by 0.18% for men but by 0.48% for women. The labour supply of married women is significantly more responsive to an increase in their wage rate than men (with respect to the male wage rate).

This study also found that the gender distribution of the labour supply response to a tax cut varied for different tax cutting options. A cut in the top rate of tax, or a widening of the standard rate band, prompts a greater increase in female participation and average desired hours and much less in male participation. A cut in the standard rate of tax, or an increase in personal allowances, leads to similar increases in participation rates for both genders.

Income distribution

An important factor for those towards the bottom of the income distribution is the minimum wage. Research indicates that higher taxes on labour income appear to have the most detrimental effects on employment when wages do not fall because of the minimum wage.⁷¹ Minimum wages can impede employers from shifting all or part of the incidence of pay-roll taxes onto low-productivity workers by lowering wages, increasing the negative effect of the tax wedge on the demand for labour. Bassanini and Duval (2006) find that increases in the tax wedge have a greater impact in raising unemployment the higher the

70 ‘The Policy Determinants of Investment in Tertiary Education’, OECD Economics Department Working Paper No. 576, J. O. Martins et al., September 2007.

71 ‘Boosting Jobs and Incomes: Policy Lessons from Reassessing the OECD Jobs Strategy’, OECD 2006.

minimum wage is set relative to average wages.⁷² OECD research estimates that an increase in the ratio of minimum to median wages by 10 percentage points would increase the impact of the tax wedge on unemployment by about 50% in the 'average' OECD country.

A second factor is the interaction of the tax system with social welfare benefits. The participation decision to enter the labour force, for those towards the bottom of the income distribution, is affected by a combination of withdrawn social welfare benefits and increased tax payments. ESRI research shows that the highest effective tax rates tend to arise from the withdrawal of welfare benefits, including withdrawal of such benefits from a spouse or partner.⁷³ The replacement rate is an important measure of this dynamic and much international evidence finds a statistical link between the replacement rate and the unemployment rate.⁷⁴ In Ireland "there is a great deal of co-movement in the replacement rate and unemployment rate series" from 1975 up to the turn of the century, with this relationship seeming to break down from 2001 onwards.⁷⁵

The present situation

The tax wedge in Ireland and internationally for different earners and family situations is shown in Table 7.1 in Section 3.

A feature of the Table is that the tax wedge is higher for higher income earners. This is the progressive nature of the Irish labour income tax system. However it is a factor in regard to attracting highly skilled internationally mobile workers: while it is still below the average it is close to the corresponding figures for competitor countries like Switzerland, the UK and the USA for single workers (column 3). The tax wedge continues to increase in Ireland for salaries above the level of these OECD comparisons. A single earner with no children earning five times the average wage faces a total tax wedge of 49.2%, after the April 2009 budget, and the marginal tax rate, including levies, on additional income is 50%.⁷⁶ The tax wedge at this level of income is important as the economic effects are broader than the effects on the individuals themselves, because such earners include highly-skilled workers necessary to attract mobile investment and entrepreneurs who create wealth and employment.

72 'Employment Patterns in OECD Countries: Reassessing the Role of Policies and Institutions', A. Bassanini and R. Duval, OECD Economics Department Working Paper No. 486, 2006.

73 'Work Incentives, Poverty and Welfare in Ireland', T. Callan, J. Walsh, K. Coleman, ESRI Policy Research Series, No. 60, December 2006.

74 For example see 'Unemployment in the OECD since the 1960s: what do we know?' S. Nickell, L. Nunziata and W. Ochel, Economic Journal, 2005. The replacement rate can be defined as the ratio of 'out of work' family disposable income to 'in work' family disposable income.

75 'Replacement Rates and Unemployment: from Bust to Boom', T. Callan, K. Coleman, J.R. Walsh, in the 'The Irish Labour Market Review 2006: A FAS Review of Irish Labour Market Trends and Policies, 2006.

76 This example is for 'S, 0, 500' in the shorthand of the table. The tax wedge includes tax, levies, PRSI and employers PRSI, for a wage of €170,000; the 50% effective marginal tax rate consists of a 41% income tax rate, a 5% health levy and a 4% income levy with employer's PRSI omitted.

