Irish Tax Institute

Jobs Initiative Submission

April 2011

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Part A Tax initiatives in the Programme for Government – Thoughts and Proposals for Implementation

The Irish Tax Institute fully appreciates that the Government and the Minister have a major focus on jobs in the "Programme for Government" and in the forthcoming Jobs Initiative.

This is demonstrated by a number of proposed key tax initiatives in the Programme for Government:

1. Cutting the 13.5% rate of VAT to 12% up to end 2013;
2. Halving the lower 8.5% rate of employer PRSI up to end 2013 on jobs paying up to €356 per week;
3. Amending the R&D tax credit regime to make it more attractive and accessible to smaller businesses by:
   – moving to the volume basis for companies with R&D expenditures of under €100,000, subject to a cost benefit analysis,
   – offsetting the R&D credit against employers' PRSI, and
   – introducing steps to cut red tape in the applications process;
4. Introducing a Single Business Tax for micro enterprises;
5. Maintaining the corporate tax rate at 12.5%;
6. Establishing a Tax and Social Welfare Commission to examine entitlements of self-employed and the elimination of disincentives to employment.

We note from the Minister's Written Answers in the Dáil on 13 April 2011 that the Jobs Initiative will put into effect the Government's jobs and growth strategy set out in the Programme for Government. On that basis, we understand the Jobs Initiative will include some of the measures outlined above.

Reducing the lower rate of VAT

We welcome the Government's proposal to reduce the lower rate of VAT to assist Irish labour intensive businesses become more cost competitive. To ensure that these objectives are met, we have set out some practical issues to consider in implementing the change:

- We believe the lower rate should only be introduced from the beginning of a VAT period. Rate changes in the middle of a VAT period cause great administrative complexity.
- There should ideally be a short lead in time for the reduction, to avoid the deferral of purchase decisions especially in the case of high value items e.g. buying a house, entering a building contract, etc.
- Early engagement with software providers and provision of information to retailers is essential, to allow for a smooth changeover.

- Guidance will be required on practical issues e.g. changing business stationery, signage, arrangements for businesses operating at midnight on changeover date such as pubs, clubs etc.

As you aware, a standard rate VAT reduction initiative was introduced as a temporary measure in the UK between 1 December 2008 and 31 December 2009.Some of their experience with this initiative is worth noting.

- While a short lead in time is recommended as above, the one-week lead in time for the UK VAT rate change caused certain problems, arising as it did during the peak pre-Christmas business activity. The change was announced on 24 November to be effective from 1 December 2008.
- The majority of retail outlets (both physical shops and online stores) that used an advertised gross price, faced the dilemma of whether to pass the VAT reduction on to customers or not. The logistics of global price changing, re-labelling, or mass price changes on a large retail website veered some businesses towards keeping prices constant, at least in the short term. This simplified the task for business but reduced the benefit to consumers.

Reducing employer PRSI for the lower paid

As part of the Jobs Initiative, it has been announced that the Government are proposing to amend the employer PRSI rate in respect of those earning the minimum wage to 4.25% (from 8.5%).

This will no doubt provide a welcome reduction in employment costs on lower paid staff. We understand that it will not be limited to new employees thereby reducing complexity and helping maintain existing employment as well as creating new employment.

To ensure the smooth implementation of this change, some lead time will need to be allowed for the re-write of payroll software. For example, PRSI is calculated on a weekly basis. In certain circumstances, wages for a particular week could fall below the minimum wage weekly amount, where the individuals concerned are not actually on the minimum wage e.g. part time workers or those leaving/joining in a particular week.

The R&D regime

The Institute welcomes the steps proposed in the Programme for Government on R&D. Allowing companies the option to offset R&D tax credits against employer PRSI was a recommendation of the Commission on Taxation and would enable companies to account for the R&D credit through the profit and loss account. In a recent KPMG report[1] almost 1 in 4 large companies expressed the view that having the R&D tax credit against the accounting cost line would help them further increase investment in Ireland.

[1] Take a Closer Look – A Survey of Business Attitudes to Research and Development in Ireland in 2009/2010

As regards the move to a volume basis, the Institute welcomes the proposal of a cost/benefit analysis for smaller companies. However we would urge the Minister to consider extending this cost/benefit analysis to all companies to determine whether it would result in an increase in R&D spending across the board. Many competing jurisdictions such as Australia, Canada, France, the Netherlands and the UK now offer a volume based approach and it essential that we remain attractive as a location for R&D in order to protect and grow high value jobs in this sector.

The Institute has highlighted on a number of occasions, the administrative difficulties that currently exist for taxpayers trying to make R&D claims. Any steps that could be taken to streamline the process and ensure that Government departments actively promote the benefits of the credit, particularly amongst small business, would be very welcome. HMRC in Northern Ireland have made particularly good progress with this education and support role.[2]

Single business tax

The Institute highlighted the possibility of a single business tax for micro-enterprises with the Joint Oireachtas Committee on Economic and Regulatory Affairs last year. This formed part of a package of recommendations we made on reducing the burden of red tape for SMEs who are trying to comply with their tax obligations. We believe that a feasibility study into a single business tax would be worthwhile and we would be happy to participate in any such study.

Part B Achieving Fiscal Neutrality with the Jobs Initiative

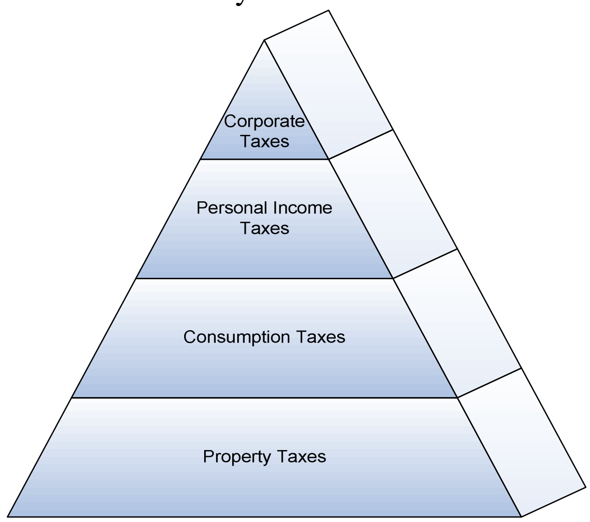
We note the Minister's comments on the requirement for fiscal neutrality in the Jobs Initiative.[3] When asked about possible increases in taxation to pay for jobs initiatives, the Minister stated that if the comprehensive spending review process is successful it will eliminate the need for tax increases.

If tax increases are required, we would ask the Minister to bear in mind the guidance of the OECD. Their research[4] confirms that corporate taxes are found to be most harmful for growth, followed by personal income taxes and then consumption taxes. Recurrent taxes on immovable property appear to have the least impact. A revenue neutral growth-oriented tax reform would, therefore, be to shift part of the revenue base from income taxes to less distortive taxes such as recurrent taxes on immovable property or consumption (in this regard, we note the commitment in the Programme for Government to limit the top rate of VAT to 23%).

The funding for initiatives in the medium to longer term could be generated from a combination of water charges and a property tax/site valuation tax. With regard to water charges, we note the Programme for Government proposes the installation of water

[2] Your Research Our Support, Research and Development Tax Relief in Northern Ireland - HMRC
[3] Press Conference, 15 April 2011
[4] Tax and Economic Growth – Economics Department Working Paper No. 620

meters in individual households and the introduction of water charges based on usage above a free allowance. We further note the Minister for the Environment, Heritage and Local Government' statement that the installation of meters will commence in 2012 and his understanding that it could take three years in total to install water meters in every household. To the extent that there is any move to a property tax in the future, we would urge that this process is opened to full consultation in order to achieve consensus on the most workable model for the Irish economy.



As regards further increases in income tax rates, the Programme for Government contains a commitment to "maintain the current rates of income tax together with bands and credits". We welcome this commitment. However, it is not simply the headline income tax rate that is important but rather the marginal rate (including PRSI and the Universal Social Contribution (USC)). The aggregate marginal rate of tax/PRSI and USC is now 52% or 55% depending on whether one is employed or self-employed. The distinction in rates between the employed and self employed represents a 3% surcharge on the USC for the self-employed, introduced at Committee Stage of the Finance Act 2011. Those with self employed or unearned income are now paying tax at a higher rate than those with employment income which clearly will do little to incentivise the entrepreneurial economy.

The Institute believes that, at these levels, the taxation of income now exceeds the "tipping point" beyond which there is no economic benefit to Government in raising the top rates any higher.[5] Any increase in income tax, PRSI or USC will increase the marginal rate even higher than the current levels and could have a damaging impact on business competitiveness and our ability to sustain and create new jobs.

We can see the impact of raising income tax rates to unsustainably high levels in the UK. In their Budget 2009, the income tax rate was increased to 50% (from 40%) on incomes

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[5] Can More Revenue be Raised by Increasing Income Tax Rates for the Very Rich? – Institute for Fiscal Studies Briefing Note BN84, 2009

of over £150k, which resulted in a marginal rate of 52% including national insurance. At the time of the introduction of the 50% rate it was reported that HM Treasury expected to collect just 30% of the tax due from the 50% rate.

"The past two years have seen almost 1,000 hedge-fund employees move to the Swiss cantons – ostensibly all thanks to rises in the top rate of UK income tax, currently 50p in the pound – casting into doubt London's future as the dominant centre for the world's $1,900bn hedge-fund industry outside the US."[6]

As recently as last month, the current Chancellor Mr Osborne said that high personal tax rates "crush enterprise, undermine aspiration and often undermine tax revenues as people avoid them" In his Budget 2011 announcement and since he entered the Treasury as Chancellor, Osborne has made clear that he sees the 50p rate as temporary and he will try to do everything to reverse it when the conditions allow.

PART C Job creation proposals from the Irish Tax Institute

Irish businesses continue to find it difficult to obtain bank finance. To compound matters, Ireland has historically lagged behind other EU countries in respect of private equity investment, in particular to the SME sector[7]. Unless these businesses receive the necessary finance, whether from bank lending or private capital funding, they will not be in a position to recruit additional staff and many risk closure. A targeted approach is required to "unlock" private sector capital and direct it into active Irish business. The Institute has a number of suggestions that might assist in this regard:

(i) Investment from Irish Pension Funds

This proposal offers an alternative funding mechanism for established unquoted medium and large Irish corporates (the "target group"). Under this proposal, Irish pension funds would be enabled (and possibly even required), to invest a minimum of their asset allocation in the target group. Investment by Irish pension funds in our own indigenous business is currently minimal and this proposal aims to increase investment levels. Additional funds raised in this way could be used to enable the target group to continue or expand their operations. It is proposed that a pension fund structure be established with the following characteristics:

1. Companies in the target group that wish to participate and apply for funding would be pooled together.
2. Expertise in identifying and managing the pool would be drawn from existing experts in private equity fund management.
3. The pension fund would be required to invest 5% of its resources in either unquoted Irish shares (ordinary or preference shares, as appropriate) or secure corporate bonds. Allocating 5% of pension fund assets in this way (say 1% p.a.

[6] Financial Times, October 2010
[7] At 0.155% of GDP in 2008 the level of private equity investment in Ireland lagged well behind the EU average- *Forfas/NCC Annual Competitiveness Report 2010.*

for 5 years) would result in a total investment of approximately €3.6bn in shares or secure corporate debts. If the investment policy was restricted to defined contribution schemes, the total investment over 5 years would be €1.3bn.
4. The pension fund would receive its investment return in the form of dividend and/or redemption of its investment.
5. The structure of these loans and share investments would be standardised for efficiency of operation. The same documentation should be used as far as possible.
6. The assumptions are that the fund would operate within the existing framework of regulations applicable to Life Assurance and Pensions (e.g. disclosure, accounting and reporting requirements). New and different obligations introduce cost to the administration and will undermine the viability of the venture.
7. The "prudent investor" principle would currently be a barrier to this proposal and would need to be amended to ensure that investments in the target group do not offend the principle.
8. This proposal could be introduced at no Exchequer cost. However, it would be important to maintain the marginal tax relief currently available to individual investors rather than the proposed gradual reduction of the rate to 20% by 2014[8], to ensure there is sufficient incentive for taxpayers to invest.

(ii) Encouraging investment by individuals in active Irish business

Many businesses, and in particular family businesses, may be reluctant to dilute share ownership but still have a pressing need to access capital for growth. Loan investment can meet this need for capital and can also provide more flexible options on exit, thereby offering a more attractive option for potential investors with cash. A tax relief for individuals making loan capital investments would encourage lending from the private sector into SME businesses. The necessary cost/benefit exercise would be required before making any final decisions, but the proposed relief could have the following characteristics:

- The relief could be limited to investment in SMEs which are active trading companies and where the potential for job creation is demonstrated.
- There could be a minimum investment period of 3 to 5 years.
- To provide additional security for investors, the loan investment could be based on convertible loan stock, with conversion into share capital occurring only in the event of default.
- The relief could be based on a deduction for individuals from their total income and could be limited to the standard rate of income tax.
- To compete with other forms of investment, any interest return on these loan investments would be subject to income tax at DIRT rates.
- The administrative burden must be kept to a minimum to avoid some of the difficulties that have arisen under the current Business Expansion Scheme (BES).

[8] 'The National Recovery Plan 2011-2014' published on 24 November 2010.

- If we are to introduce a meaningful incentive for investment, then it must be excluded from the High Earner's Restriction under Chapter 2A, Part 15, Taxes Consolidation Act 1997.

(iii) Welfare sharing

The Institute proposes that Government introduce a form of social welfare assistance for employers to encourage the recruitment of staff from the Live Register. If the employer recruits a person who has been on the Live Register for at least six months, then the employer can claim 50% of that employee's basic social welfare payment to defray the cost of salary for a period of 12 months. The job would be a new full time position. The 50% allocation could be spread evenly over the year, or could be front loaded for the employer. The cost of this proposal would be approximately €5,200 per successful applicant but this cost would be more than outweighed by the social welfare and supplementary benefits savings achieved.

(iv) Employment and Investment Incentive (EII)

Subject to EU approval, the EII relief is intended to replace the current BES regime. While much of the reform is welcome, the Institute has a number of concerns in respect of these new provisions:

- The reduction of the upfront relief from 41% to 30% could significantly impact on the ability to source investors.
- The necessity to claim the additional relief of 11% at the end of the investment period will place an administrative burden on investors. Investors will have to ascertain if the conditions have been met by the company and then will have to claim the additional relief. This would appear to contradict one of the aims of the EII of reducing administrative burden.
- While the reduction in the investment period from 5 to 3 years offers greater flexibility, in most instances where a BES investment is sought, the company would not be in a position to repay the capital after 3 years. Most companies are in start-up or growth phases and the reality therefore is that longer investment periods would still by necessity apply.
- EII should be removed from the list of specified reliefs coming within the 'high earners restriction'. The fact that it remains a specified relief significantly restricts the potential pool of investors.

PART D Fundamental Tax Policies for a Better Ireland

We fully appreciate that the immediate focus for the Government is to introduce speedy initiatives aimed at early increased employment and this is very welcome. We also believe it is important to lay the foundations now for clear and well signalled tax policies for the future and we would like to work together towards a cohesive longer term tax strategy for growth and jobs. Business, investors and consumers alike need fiscal certainty especially in the current climate. The Institute believes that this can best be achieved through consultation and discussion on other specific initiatives following on from the announcement of the Jobs Initiative.

HM Treasury and HM Revenue & Customs in the UK have recently published a Tax Consultation Framework[9] which identifies the five stages to the development and implementation of best practice tax policy:

Stage 1: Setting out objectives and identifying options.

Stage 2: Determining the best option and developing a framework for implementation including detailed policy design.

Stage 3: Drafting legislation to effect the proposed change.

Stage 4: Implementing and monitoring the change.

Stage 5: Reviewing and evaluating the change.

In terms of areas for review and reform in the Irish tax system, we would suggest that this UK model be applied to the following policy priorities:

1. A strategic review of our overall FDI offering. Whilst the 12 ½% rate is a key brand for Ireland and the steps the Government has taken to preserve it are very welcome, it would be useful to take a critical look at our current competitive FDI offerings in light of recent developments in other countries, such as the UK, France, Singapore etc.
2. The tax system for entrepreneurs and job creators. This has, to some extent been examined recently in the UK by the Office of Tax Simplification.[10]
3. Full review of the PRSI system. This was a project commenced by the previous Government and which is urgently in need of full reform.
4. Final decision on property incentives so that taxpayers can plan for their unwinding.
5. Review of the tax appeals system so that all taxpayers can have full access to a transparent and cost effective system.

[9] Published jointly by HM Treasury and HMRC in March 2011
[10] Small Business Tax Review, March 2011