Irish Tax Institute

Budget 2013 Submission

Supporting employment and staying competitive internationally

October 2012

Budget 2013 Submission

Table of Contents

Page

Executive Summary

Budget 2013 will be the third delivered under the EU/IMF/ECB recovery programme. The target of raising €1.25 billion in additional tax for 2013 is extremely challenging, given the adjustments that have already been made over the life of the programme.

In this context, there are three key principles which underline the approach the Institute has taken in this Budget 2013 submission:

1. Employment is a key priority and income tax, the universal social charge (USC) and PRSI are taxes on labour. Increasing headline rates for income tax, the USC or PRSI will increase the cost of employment and could damage output and put jobs at risk. Domestic and international evidence-based research supports this position[1]. Headline rates of income tax, USC and PRSI should not be increased.

2. If some level of income tax increase is unavoidable, then base broadening measures are generally less damaging to economic recovery than rate increases. Our submission considers some base broadening possibilities that government could consider.

3. Irish businesses need support and investment right now. In this submission we consider the range of tax supports and initiatives that currently exist and are well summarised in the Action Plan for Jobs 2012[2]. Within this framework, we suggest some modifications that should enhance their attractiveness to investors and increase their take-up.

However, the immediate Budget 2013 arithmetic is not the only challenge we face. Ireland should emerge from its current programme at the end of 2015 and, in meeting current revenue targets, we cannot allow ourselves to lose ground on international competitiveness.

We have an excellent track record for attracting international investment and for being an easy place to do business. However, this is becoming an increasingly crowded space and our neighbours in the UK, in particular, are making great efforts to gain ground in winning FDI projects. The Institute and many other bodies have highlighted certain challenges with our key strategic offerings which, if addressed, could better equip us to meet these competitive threats. In particular, these challenges include

- Our Intellectual Property regime – the scope and rate of relief,
- Our offering for attracting mobile talent – the rate of the relief and its application to newly hired employees, and
- The complexity of our tax credit and debt relief rules.

[1] Research dating back as far as 1987 (*The marginal social cost of taxation in Ireland* – Honohan, 1987 – still regarded by many as being relevant and authoritative today) and from as recently as this year (*What are the best instruments for fiscal consolidation* – OECD, 2012)
[2] *Financial Support for Irish Business* – Department of Jobs, Enterprise and Innovation

These issues cannot all be dealt with in Budget 2013, but now is a good time to begin focussed discussions about them. We need to benchmark ourselves against what our competitors are offering in each of these categories and, crucially, what they are planning to roll out over the next 5 years. Based on this information, we can have an informed debate with all stakeholders about what choices we want to make to meet the competition we are unquestionably facing.

Irish Tax Institute Recommendations for Budget 2013

1. Income tax

1. High marginal income tax rates reduce economic output, raise the cost of employment and impede job creation efforts. The USC and PRSI are equally regarded by the public as forms of taxation and therefore an increase in USC or PRSI rates would have the same behavioural impact as an increase in income tax rates. Between Budget 2008 and Supplementary Budget 2009, marginal income tax rates for PAYE workers increased from 43.5% to 52% and for the self-employed, from 46.5% to 55%. The severity of these increases in a short time frame of about 18 months has had a dramatic impact on taxpayers and on competitiveness. We consider that there is no scope for any further increases in income tax or USC/PRSI rates in Budget 2013.
2. The income tax yield in 2011 exceeded that for 2007, despite the dramatically reduced number of people in employment. The revenue from income tax (including USC) in 2012 is projected to be the highest ever (€15.3 billion) despite the ongoing high unemployment levels. We have become increasingly reliant on income taxes to raise revenue in the past 4 years, so that the expected Exchequer yield from income tax in 2012 will be 42% of total tax yield. The Institute is not in favour of further increasing this dependency. However, if any revenue raising measures on income tax are simply unavoidable, then it is less damaging for jobs if the income tax base is broadened.
3. The reform strategy put forward by the IMF[3] (see also page 8) suggests more focused broadening of the tax base and targeting of "special" income tax reliefs through implementing a package of measures.
4. It is vital that the Government upholds its commitment in the Programme for Government to keep the standard rate of employer PRSI at 10.75%. Any increase in the rate of employer PRSI would add further to the cost of employment and could be harmful to job creation and retention.

2. Property tax

5. Media reports suggest that any new property tax will be introduced as a self-assessment tax. It is estimated that 1.6 million households will be liable for this property tax. However, only 600,000 taxpayers currently pay income tax by self-assessment. Therefore a large population of taxpayers will be brought into an unfamiliar self-assessment regime for the first time.
6. Significant investment will be required by Revenue to ensure there is clear communication and assistance for taxpayers to maximise understanding and compliance. Resourcing this campaign adequately will be an important factor in the successful introduction of the tax.

[3] IMF Country Report No. 12/265 – September 2012

7. It must be easy for taxpayers to actually pay this tax. A range of payment options should be provided to taxpayers, in terms of both timing and payment method.
8. Ability to pay and fairness are an important component in the new property tax. Whilst it may somewhat complicate the tax initially, the Institute believes that previous property-related taxes such as stamp duty should be taken into account for a time bound period, to prevent undue hardship.
9. To avoid unnecessary complexity with base calculations, payment dates etc, the NPPR charge should be merged into the new property tax.
10. A robust appeals system will be an essential component of the tax.

3. Small businesses

11. We have seen little evidence of take-up for the corporation tax start-up exemption. It would appear that the key limiting factor is the condition that only start-up companies which hire 8 employees can avail of the full exemption. We believe that some consideration should be given to reducing this requirement to 2 / 3 employees, which is more a realistic employment number for businesses in the start-up phase.
12. The experience from many quarters is that the take-up for the Employment and Investment Incentive Scheme (EIIS) has also been low to date. We believe that three key modifications might improve its attractiveness, and these are detailed at page 14 below.
13. To assist small businesses with cash flow difficulties, we recommend that the threshold for the cash receipts basis of accounting for VAT be increased to €2 million. Again, this could be introduced for a limited period of time.
14. In our Budget 2012 submission, the Institute focussed on Irish indigenous business exporting to new markets. Building on the assistance provided by Government in Budget 2012, we would welcome some further broadening of the countries included in the Foreign Earnings Deduction scheme.
15. To help stimulate activity in the construction sector and address shadow economy concerns, a specific income tax credit could be made available to taxpayers carrying out home improvement works using suppliers who can provide evidence of tax clearance.
16. A tax relief for individuals making loan capital investments would encourage lending from the private sector into SME businesses. This is an idea which was previously put forward by the Institute as part of its Jobs Initiative submission and is outlined more fully at 3.6 below.
17. The Institute supports the feasibility study currently being carried out by Government into a Single Business Tax for micro enterprises. The UK have consulted on a similar model and are proposing to introduce a voluntary simplified cash basis for income tax and simplified arrangements for certain expenses for small unincorporated businesses with receipts up to £150,000 per annum. The Exchequer impact is estimated to be negligible.
18. Access to credit is clearly a major obstacle to growth for SMEs. In order to attract additional wealth from abroad and to encourage Irish investors to inject capital into Irish businesses, we recommend consideration of private investment

incentives in the nature of the UK's "Entrepreneurs' Relief" and "Business Investment Relief".

4. International competitiveness

19. In light of international competitive challenges from the UK, amongst others, a broad-ranging benchmarking study of Ireland's competitive position, in terms of both tax and non-tax considerations, should be undertaken, and immediate discussions should begin on a medium to long term competitiveness plan. In particular:
    - Proposals should be gathered for further improvements to the Special Assignee Relief Programme – dealing in particular with the rate of relief and the application to new hires.
    - An assessment should be carried out on the potential for introducing a Patent Box incentive, in light of UK advancements in that area.
    - Opportunities for simplification of our tax credit and debt relief rules should be explored.

5. Pensions

20. Over 10 separate changes have been made to the tax treatment of private pensions since Budget 2011, and uncertainty about future Government plans is curtailing taxpayer investment in pensions, as evidenced by a number of recent studies. A clear roadmap for tax and pensions policy is needed in Budget 2013.
21. Pension payments are subject to marginal rate taxes when paid out on retirement and therefore any marginal tax relief for contributions made is simply a timing difference. Marginal rate tax relief needs to be retained to ensure that pension contributions are not eroded further, leading to significant problems for future generations. Feedback from our members tells us that a blended rate of relief is not going to attract taxpayers to invest in pensions and it will also be difficult and costly for the State to administer.
22. Clarity is needed that the temporary Pension Levy will end in 2014, as scheduled.
23. Some consideration should be given to allowing funds in excess of the Standard Fund Threshold to be drawn down at marginal tax rates.
24. Ways should be examined of achieving fairness by introducing a measure for public sector pensions that would have a similar effect to the Standard Fund Threshold.

6. VAT

27. If some VAT base-broadening measures are to be considered, particular care will need to be taken in evaluating the options in light of the position of VAT as a tax governed by a European Directive.

1. Income tax

Institute recommendations on income tax

- High marginal income tax rates reduce economic output, raise the cost of employment and impede job creation efforts. The USC and PRSI are equally regarded by the public as forms of taxation and therefore an increase in USC or PRSI rates would have the same behavioural impact as an increase in income tax rates. Between Budget 2008 and Supplementary Budget 2009, marginal income tax rates for PAYE workers increased from 43.5% to 52% and for the self-employed, from 46.5% to 55%. The severity of these increases in a short time frame of about 18 months has had a dramatic impact on taxpayers and on competitiveness. We consider that there is no scope for any further increases in income tax or USC/PRSI rates in Budget 2013.
- The income tax yield in 2011 exceeded that for 2007, despite the dramatically reduced number of people in employment. The revenue from income tax (including USC) in 2012 is projected to be the highest ever (€15.3 billion) despite the ongoing high unemployment levels. We have become increasingly reliant on income taxes to raise revenue in the past 4 years, so that the expected Exchequer yield from income tax in 2012 will be 42% of total tax yield. The Institute is not in favour of further increasing this dependency. However, if any revenue raising measures on income tax are simply unavoidable, then it is less damaging for jobs if the income tax base is broadened.
- The reform strategy put forward by the IMF[4] suggests more focused broadening of the tax base and targeting of "special" income tax reliefs through implementing a package of measures.
- It is vital that the Government upholds its commitment in the Programme for Government to keep the standard rate of employer PRSI at 10.75%. Any increase in the rate of employer PRSI would add further to the cost of employment and could be harmful to job creation and retention.

Rates and base

There is evidence to suggest that the optimal system of income tax for stimulating economic growth would be characterised by a broad base and low rates. The 2009 report of the Commission on Taxation presents evidence from OECD studies which indicate that *"if economic growth is the main policy aim to be pursued, then a flatter income tax structure is a more appropriate instrument than one that leans towards greater progressivity, as the latter is likely to act as a disincentive to further effort"*.

During the 1980s, the Irish income tax system was noteworthy for its high rates and the narrowness of its base. A 1987 study[5] noted that this resulted in deadweight costs, arising

[4] IMF Country Report No. 12/265 – September 2012
[5] *The marginal social cost of taxation in Ireland* – Honohan, 1987

from the distortion of individuals' behaviour and the resulting reduction in economic output. A suggested solution to this was an extension of the tax base.

The income tax base also narrowed quite considerably during the first decade of this century and the IMF recently noted[6] that, relative to other OECD economies, Ireland currently has a combination of high personal and indirect tax rates and relatively narrow bases. Some steps have been taken towards addressing this, with the reduction in bands and credits, the introduction of the Universal Social Charge (USC) and the planned extension of PRSI to unearned income of PAYE workers.

The withdrawal of a range of tax expenditures in recent years has also contributed to base-broadening: the patent royalty exemption was withdrawn, property-related reliefs have been curtailed, a ceiling was applied to the artists' exemption and various restrictions to tax reliefs on private pensions were introduced – see Appendix III for details.

Marginal rates

It is recognised internationally that high marginal income tax rates inhibit economic output and result in deadweight losses to the economy[7]. The higher the marginal rate becomes, the weaker the incentive to take up employment and the more adverse the impact on economic growth.

Between 2008 and 2009, marginal income tax rates for PAYE workers increased from 43.5% to their current rate of 52%. The rate for the self-employed increased from 46.5% to 55%. Ireland now has the most progressive income tax system in the EU and the third most progressive system in the OECD[8]. The point at which Irish taxpayers become subject to the top rate of income tax (currently €32,800) is also comparatively low by international standards. As a small open economy, with a highly-mobile workforce, Ireland is particularly vulnerable to the impact of high marginal income tax rates. The 2009 Commission on Taxation cites an OECD paper which notes the *"possibility that high top marginal rates will increase the average tax rates paid by high-skilled and high-income earners so much that they will migrate to countries with lower rates resulting in a 'brain drain' which may lower innovative activity and productivity"*.

Workforce participation

The withdrawal of benefits and other factors also influence workforce participation by lower-paid workers. A study[9] carried out by the Nevin Economic Research Institute, and published in May 2012, found that Irish households who take up work or increase their participation in the labour market face additional costs. An example is given of a two-adult two-child household where the children are in pre-school and primary school. In

---

[6] IMF Country Report No. 12/265 – September 2012
[7] *Preparing Fiscal Consolidation* - OECD
[8] *Progressivity of Irish Income Tax System* – PublicPolicy.ie – September 2012
[9] *The cost of work: insights from minimum income standards research for Ireland* – NERI, May 2012

this example, the transition from where both adults are unemployed to one taking up work on a full-time basis imposes an additional weekly cost of €20.41 on the household. If the other adult also commences work on a part-time basis, the household faces additional weekly costs of a further €96.52, mainly explained by further increases in housing costs (rent), additional personal costs (such as union subscriptions) and childcare.

The OECD[10] notes that *"effective tax burdens on low-income workers are often very high due to the combined impact of taxation and benefit withdrawal on entering employment, or on increasing hours worked once in employment. Furthermore, empirical evidence highlights the high responsiveness of low-income workers to these disincentives, particularly at the participation margin."* The possible options suggested by the OECD for improving work incentives include reducing income tax and social security burdens on low-income workers and introducing in-work tax credits.

Cost of employment

Another obstacle to employment generation is the employer PRSI burden. We believe that it is vital that the Government upholds its commitment in the Programme for Government to keep the standard rate of employer PRSI at 10.75%. The effect of any increase in the standard rate of employer PRSI would be widespread; 96% of the total employer PRSI yield is derived from employments in respect of which the higher rate of employer PRSI is payable[11].

Any increase in the rate of employer PRSI could be harmful to job creation and retention. This is particularly relevant for scarce higher-paid highly-skilled workers, as there is no cap on the salary level which is subject to PRSI. The burden of this cost of employment should not be measured in isolation but should be taken together with all of the other costs of doing business in Ireland. According to the National Competitiveness Council[12], "*Ireland remains a high cost location*".

When the lower rate of employer PRSI was reduced as part of the Jobs Initiative, the Government noted that "*one way to help job creation and improve our labour cost competitiveness is to ease the costs on employers of taking on new employees."* This analysis remains valid, and has added significance in light of increasing unemployment levels. Last year, the OECD[13] advised that this rate cut should not be withdrawn at the end of 2013, as scheduled, and in fact recommended addressing the sharp increase in the rate which currently arises once the employee's earnings go above €356 per week.

Summary

In summary, the Institute believes that there is little scope for any further income tax, USC or PRSI increases. OECD studies have consistently found that taxes on labour are

---

[10] *Taxation and Employment* – OECD, 2011
[11] Response to Parliamentary Question 18 July 2012
[12] *Ireland's Competitiveness Scorecard 2012* – National Competitiveness Council, July 2012
[13] *Economic Survey of Ireland* – OECD, October 2011

the most damaging to growth. In our submissions over the past four years, we have consistently recommended that marginal rates cannot increase further if Ireland is to remain competitive. Ireland is already highly reliant on receipts from income tax; revenue from income tax and USC is projected to account for 42% of the overall tax take for 2012. The income tax yield in 2011 exceeded that for 2007, despite the drastically reduced number of people in employment. The revenue from income tax (including USC) in 2012 is projected to be the highest ever (€15.3 billion) despite the ongoing unemployment crisis.

The evidence is that base-broadening is less harmful to growth, and we believe that this is the route which should be pursued in light of our current economic circumstances. PRSI is equally regarded by the public as taxation and an increase in PRSI rates would have the same behavioural impact as an increase in income tax rates.

However, if it is intended that income tax measures will form part of the Budget 2013 adjustment, a package of base-broadening measures such as that recommended in September 2012 by the IMF[14] could be considered as an alternative to raising income tax / PRSI rates – these proposals are set out in more detail at Appendix I. "Incentive to work" issues at the lower end of the pay scale could also be reviewed as part of any package of measures.

[14] *Ireland: Selected Issues* – IMF Country Report No. 12/265, September 2012

2. Property tax

A key move towards base-broadening in Budget 2013 will be the introduction of the full property tax. In a comprehensive submission made on 16 March 2012 to the Inter-Departmental Group on Property Tax, the Institute set out its recommendations for the structure and operation of the tax. They are summarised briefly below.

Institute recommendations on property tax

- Media reports suggest that any new property tax will be introduced as a self-assessment tax. It is estimated that 1.6 million households will be liable for this property tax. However, only 600,000 taxpayers currently pay income tax by self-assessment. Therefore a large population of taxpayers will be brought into an unfamiliar self-assessment regime for the first time.
- Significant investment will be required by Revenue to ensure there is clear communication and assistance for taxpayers to maximise understanding and compliance. Resourcing this campaign adequately will be an important factor in the successful introduction of the tax.
- It must be easy for taxpayers to actually pay this tax. A range of payment options should be provided to taxpayers, in terms of both timing and payment method.
- Ability to pay and fairness are an important component in the new property tax. Whilst it may somewhat complicate the tax initially, the Institute believes that previous property-related taxes such as stamp duty should be taken into account for a time bound period, to prevent undue hardship.
- To avoid unnecessary complexity with base calculations, payment dates etc, the NPPR charge should be merged into the new property tax.
- A robust appeals system will be an essential component of the tax.

3. Small businesses

Institute recommendations on small businesses

- We have seen little evidence of take-up for the corporation tax start-up exemption. It would appear that the key limiting factor is the condition that only start-up companies which hire 8 employees can avail of the full exemption. We believe that some consideration should be given to reducing this requirement to 2 / 3 employees, which is more a realistic employment number for businesses in the start-up phase.
- The experience from many quarters is that the take-up for the Employment and Investment Incentive Scheme (EIIS) has also been low to date. We believe that three key modifications might improve its attractiveness, and these are detailed at page 14 below.
- To assist small businesses with cash flow difficulties, we recommend that the threshold for the cash receipts basis of accounting for VAT be increased to €2 million. Again, this could be introduced for a limited period of time.
- In our Budget 2012 submission, the Institute focussed on Irish indigenous business exporting to new markets. Building on the assistance provided by Government in Budget 2012, we would welcome some further broadening of the countries included in the Foreign Earnings Deduction scheme.
- To help stimulate activity in the construction sector and address shadow economy concerns, a specific income tax credit could be made available to taxpayers carrying out home improvement works using suppliers who can provide evidence of tax clearance.
- A tax relief for individuals making loan capital investments would encourage lending from the private sector into SME businesses. This is an idea which was previously put forward by the Institute as part of its Jobs Initiative submission and is outlined more fully at 3.6 below.
- The Institute supports the feasibility study currently being carried out by Government into a Single Business Tax for micro enterprises. The UK have consulted on a similar model and are proposing to introduce a voluntary simplified cash basis for income tax and simplified arrangements for certain expenses for small unincorporated businesses with receipts up to £150,000 per annum. The Exchequer impact is estimated to be negligible.
- Access to credit is clearly a major obstacle to growth for SMEs. In order to attract additional wealth from abroad and to encourage Irish investors to inject capital into Irish businesses, we recommend consideration of private investment incentives in the nature of the UK's "Entrepreneurs' Relief" and "Business Investment Relief".

A strong indigenous base of small companies is the backbone of successful economies worldwide. This was a key theme of our Budget 2012 submission, and we believe that a particular policy focus should be placed on small businesses in Budget 2013.

3.1 Corporation tax start-up relief

When the corporation tax relief for start-up companies was introduced, it was done so "*in recognition of the particular challenges faced by new and start-up companies in these challenging economic times*"[15]. Our members who advise small businesses have reported a number of issues associated with the relief, which are limiting its take-up by businesses. The major difficulty is the fact that the relief is now linked to the amount of employer PRSI payable by the company. A company now effectively needs to be employing at least 8 employees in order to benefit from the full extent of the relief available. Our feedback is that it is quite rare for a start-up company to attain this level of employees in its first 3 years of trading. Therefore, we would recommend that some consideration be given to relaxing this requirement to provide that companies engaging 2 or 3 employees could avail of the full amount of the relief.

3.2 Cash basis of accounting for VAT

The cash basis of accounting for VAT is currently an option for traders whose annual turnover does not exceed €1million or whose supplies are almost exclusively made to non-registered customers. Feedback from our members who advise small businesses suggests that some increase in this limit would be welcome and would ease the administrative burden and cashflow difficulties being experienced by those businesses. We would suggest that a limit of €2 million could be given some consideration.

3.3 Support for exporters

In order to assist Irish companies in their efforts to internationalise their operations and realise their export potential we would welcome some consideration being given to a targeted extension of the scope of the Foreign Earnings Deduction beyond the BRICS countries.

3.4 Employment and Investment Incentive Scheme

We believe that some key modifications to the Employment and Investment Incentive Scheme (EIIS) could boost interest in the scheme, which we understand has been limited to date. Amendments could be made from the points of view of both the investor and the investee company.

Investor

Feedback from our members indicates that the inclusion of relief under the EIIS in the list of "specified reliefs" for the High Earners' Restriction may be counter-productive.

While the High Earners' Restriction may be effective in achieving increased effective tax rates, it may not be appropriate when it comes to reliefs to support job creation. It is important to note that relief available to investors under the EIIS is already capped at

[15] Budget Speech, October 2008

€150,000 but the impact of the High Earners' Restriction is that the cap is actually €80,000 unless the investor has a significantly high level of "adjusted income". The relief is curtailed further where the investor is availing of other "specified reliefs".

The UK has decided not to include business reliefs in their new cap on income tax reliefs, on the basis that business reliefs are already capped and further limitations simply prevent investors from taking business risks. We believe that it would be worth undertaking a cost-benefit analysis to review the merits of a similar approach here.

Investee company

Other factors which we understand account for the limited take-up of the EIIS to date relate to the conditions to be fulfilled by the investee company.

1. The 3-year investment timeframe is proving quite restrictive and it is quite difficult for companies to invest funds received through the EIIS and generate a return sufficient to pay back the investment within a 3-year period. Numerous companies have cited this to our members as a drawback of the scheme and a reason for not using the EIIS as a source of finance.

2. Although the scope of companies which can avail of funding under the EIIS has been widened, the legislation remains quite restrictive for companies which operate group structures. Subsidiary companies must satisfy certain criteria in order for the holding company/group to qualify. This is preventing some groups from availing of the scheme – we can provide further details if this would be helpful. The restrictions surrounding companies in group structures require review to enable more groups to qualify. The relief could still be subject to the condition that the funds be used by the qualifying company and not used by any non-qualifying companies in the group.

3.5 Tax relief on home improvement costs

We believe that some stimulation could be given to employment in the construction sector by allowing home-owners to claim tax relief on home improvement costs. This is a stimulus measure which has previously been suggested by the Institute and others including IBEC and the Construction Industry Federation.

This could involve offering home-owners an income tax credit on costs related to energy retro-fitting and other home improvement works, where such services are provided by suppliers who can provide evidence of tax clearance. The homeowner would be required to obtain a VAT invoice and Revenue could check this on a risk-assessment basis. This policy could also have a multiplier effect in terms of addressing shadow economy issues, increasing employer PRSI revenues for the State and incentivising VAT compliance by service providers.

3.6 Loan investment

The Institute, in its submission to the Minister for Finance in advance of the Jobs Initiative in 2011, made a suggestion which would help to stimulate the provision of loan finance by private individuals to viable SMEs. We recognise that 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.
- In order to diversify risk for individual investors, a facility for investing in pooled funds could be made available.
- 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 could be subject to income tax at DIRT rates.
- The administrative burden must be kept to a minimum to avoid some of the difficulties that arose under the Business Expansion Scheme (BES).
- If we are to introduce a meaningful incentive for investment, then it must be excluded from the High Earners’ Restriction.

3.7 Film relief

Investment by private investors is also vital to the sustainability of Ireland’s film industry. International evidence would suggest that such investment would not occur without a tax incentive such as our section 481 TCA 1997, which is currently the subject of an economic impact assessment by the Department of Finance. In a separate response to the Government’s recent consultation on film relief, the Institute has urged that the relief be retained as it encourages investment in a productive sector of our economy, creates jobs and has a beneficial multiplier effect.

3.8 Tax simplification for small businesses

For some time, the Institute has been strongly supportive of the simplification of the tax regime applicable to small businesses. A RedC survey conducted in 2010 on behalf of the Institute found that the top tax issue which is of concern when starting a new business in Ireland is the worry that tax administrative procedures can be complex and daunting. The study found that VAT and Payroll Taxes are the top 2 taxes which are perceived as imposing an unnecessarily high administrative burden on small businesses.

One possible element of simplification could be the introduction of a "micro-tax" for the smallest enterprises. The Institute welcomed the commitment in the Programme for Government to *"direct the Revenue Commissioners to examine the feasibility of introducing – on a revenue neutral basis – a Single Business Tax for micro enterprises (with a turnover of less than €75,000 per annum) to replace all the existing taxes on sole traders and small businesses to cut compliance costs and make starting a business much less daunting."* The review of the Programme for Government, published in March 2012, stated that "*Analysis carried out to date indicates that the measure cannot be delivered in the form described. Work is ongoing with the Revenue Commissioners to develop alternatives."*

We would strongly encourage perseverance with this initiative and the Institute, through its extensive network of members, is willing to offer all possible assistance with the development of the proposal.

UK developments on a micro tax

It is instructive to review recent research carried out in the UK and developments in that country in relation to simplifying the manner in which small businesses interact with the tax system.

The Office of Tax Simplification (OTS) in the UK published a discussion paper on *"A simpler income tax for the smallest businesses"* in July 2011 and the final report was issued in February 2012[16].

The research carried out by the OTS indicated that "cash accounts" are widely used by the very smallest unincorporated businesses, which demonstrates that businesses find this method easier and less time-consuming to use. The study also showed that claiming for certain business expenses, such as use of the taxpayer's home, can be disproportionately burdensome for such businesses, particularly in light of the small sums involved. The OTS therefore recommended some simplification, noting that this could deliver benefits to HMRC in terms of its management of the tax system and that *"an alternative system could make a contribution by helping some businesses move out of the informal economy and so help HMRC's work on the "tax gap"*.

[16] Small business tax review: Final report - Simpler income tax for the smallest businesses – OTS, February 2012

Arising from that, HMRC conducted a public consultation which ran until 22 June 2012[17]. Their proposal is to introduce a voluntary simplified cash basis for income tax and simplified arrangements for certain expenses for small unincorporated businesses with receipts up to £150,000 per annum. The proposed cash basis is expected to have a negligible impact on the Exchequer beyond 2016. The simplification of expenses is expected to actually increase receipts by approximately £20m per annum.

3.9 Other business investment incentives to consider

We have rightly been very focused in Ireland on attracting international talent and we must continue to be – see section 4 below. However, our Irish businesses are suffering from lack of funding, as well as this resourcing issue, and therefore it is worth considering steps that could be taken to attract foreign capital investment. Two examples are set out below.

Entrepreneurs' Relief

The UK currently offers an Entrepreneurs' Relief, which allows individuals to avail of a reduced rate of capital gains tax on the disposal of their business. A similar incentive could be considered in order to incentivise investment in small businesses. The relief could be offered in respect of investments made in advance of a particular date – say, 31 December 2014. Such investments would qualify for a reduced rate of capital gains tax upon exit. The relief could be subject to appropriate investment conditions, holding periods etc. This would be an incentive for business investment similar to that offered for investment in property in Budget 2012. However, in that case, the feedback from our members indicates that the holding period of 7 years associated with the property incentive is perceived as excessive and limits the value of the relief. Many investors hold property for a period of 3-4 years, so that a holding period of 7 years is not commercially viable.

Relief for investment of foreign income / gains

A relief to encourage wealthy investors to remit their foreign income and gains for investment in Irish businesses would be worthy of consideration. In Budget 2012, the UK Government introduced a "business investment relief" in order to incentivise this kind of investment in UK companies. In light of the difficult borrowing environment facing small businesses here, we believe that consideration should be given to introducing a measure which achieves a similar objective here. The relief could be made subject to appropriate investment criteria and safeguards.

[17] *Simpler Income Tax for the Simplest Small Businesses* – HMRC consultation, 27 March 2012

4. International competitiveness

Institute recommendations on international competitiveness

- In light of international competitive challenges from the UK, amongst others, a broad-ranging benchmarking study of Ireland's competitive position, in terms of both tax and non-tax considerations, should be undertaken, and immediate discussions should begin on a medium to long term competitiveness plan. In particular:
  - Proposals should be gathered for further improvements to the Special Assignee Relief Programme – dealing in particular with the rate of relief and the application to new hires.
  - An assessment should be carried out on the potential for introducing a Patent Box incentive, in light of UK advancements in that area.
  - Opportunities for simplification of our tax credit and debt relief rules should be explored.

As an economy which derives a significant benefit from Foreign Direct Investment (FDI), it is vital that we keep our competitive position under constant review.

We believe that a medium to long term plan should be put in place for building on and improving Ireland's competitive position in the period beyond our emergence from the EU/IMF Programme.

The plan should be informed by a benchmarking exercise, comparing our FDI offering to those of our closest competitors, on which work should commence without delay. A timeline could then be produced, with targets for the achievement of actions on the key components of our offering: a regime for attracting mobile international talent, an attractive environment in which to develop and exploit intellectual property, a clear system of relief for interest costs, and a competitive incentive for engaging in productive research and development activity.

The UK provides a good example of a clearly defined and well marketed FDI strategy in recent times. The UK Government has set itself the target of creating the most competitive tax system in the G20 and is taking decisive action towards achieving that goal. Over the past two years, the UK's tax competitiveness has improved the most among 14 major economies examined in a recent study conducted by KPMG International[18]. Further details on the UK strategy are provided in Appendix II.

Attracting wealth and talent

The attraction of highly-mobile international talent and wealth is critical to the continued success of Ireland's FDI strategy. It is interesting to note that this is something which has also been recognised as essential by the UK. The focus of the UK's ongoing consultation

[18] *Competitive Alternatives 2012, Special Report: Focus on Tax* – KPMG, September 2012

in respect of its rules on tax residence is the encouragement of wealthy international investors to spend more time and money and create more jobs in the UK economy. The aims of the proposed reform are to:

> *"…provide a significant new incentive for non-domiciles to invest in the UK and simplify the rules to reduce administrative burdens. The current rules discourage non-domiciles from bringing their income or capital gains to the UK, creating barriers to potential investment in the UK economy. The Government's aim is to remove these barriers so that non-domiciles are encouraged to invest in UK business, contributing to its priority of generating growth and rebuilding the economy."*

The simplicity of Ireland's rules on residence means that we have not experienced the same issues which have arisen in the UK. However, the consultation on our residence rules is causing uncertainty and there is a concern that any added complexity would be detrimental to our competitive position.

Another key component of Ireland's FDI offering is the Special Assignee Relief Programme (SARP). We suggested a number of key modifications to this incentive as part of our post Finance Bill 2012 submission and we would reiterate again the importance of reviewing this relief, particularly in terms of how it pertains to newly hired staff and the competitiveness of the effective rate of tax payable under the scheme,

Driving innovation

In our submission in advance of Budget 2012, the Institute highlighted a number of issues for consideration as Ireland strives to drive our export capabilities through innovation and invention. The key elements of our strategy in this area are the R&D tax credit and our Intellectual Property (IP) incentives. We put forward a number of recommendations for improvements in these areas in that submission and in previous submissions such as introducing a full volume basis for the R&D tax credit on new projects, streamlining the claims process for the credit, considering the introduction of a Patent Box for IP or, as an alternative, removing the 10-year clawback period.

In light of the imminent commencement of the Patent Box in the UK, which will apply from April 2013, we would recommend that an assessment should be carried out on the feasibility of introducing a similar incentive here in the medium term.

5. Pensions

Institute recommendations on pensions

- Over 10 separate changes have been made to the tax treatment of private pensions since Budget 2011, and uncertainty about future Government plans is curtailing taxpayer investment in pensions, as evidenced by a number of recent studies. A clear roadmap for tax and pensions policy is needed in Budget 2013.
- Pension payments are subject to marginal rate taxes when paid out on retirement and therefore any marginal tax relief for contributions made is simply a timing difference. Marginal rate tax relief needs to be retained to ensure that pension contributions are not eroded further, leading to significant problems for future generations. Feedback from our members tells us that a blended rate of relief is not going to attract taxpayers to invest in pensions and it will also be difficult and costly for the State to administer.
- Clarity is needed that the temporary Pension Levy will end in 2014, as scheduled.
- Some consideration should be given to allowing funds in excess of the Standard Fund Threshold to be drawn down at marginal tax rates.
- Ways should be examined of achieving fairness by introducing a measure for public sector pensions that would have a similar effect to the Standard Fund Threshold.

Measures taken by Government in dealing with the current budgetary difficulties have already included a number of significant changes to Irish pensions policy (refer to Appendix III for a summary).

The cumulative impact of these changes and the prospect of further changes to come have created significant uncertainty among taxpayers and a marked decline in public support for making provision for retirement through pension planning. Recent findings bear this out. The Pensions Board, in its Annual Report for 2011, recorded that the total number of active members in occupational pension schemes at April 2012 was 771,878, a decline of over 38,000 members compared to 2010 levels.

The OECD[19] gives a figure of 41.3% for pension coverage in Ireland (figures based on 2009). This compares with the following rates elsewhere:

[19] OECD Pensions Outlook 2012 (page 109)

Country	Coverage rate of private pension plans (as % of total labour force or total employment)
Ireland	41.3%
Germany	51.6%
United Kingdom	53.0%
United States	56.7%
Netherlands[20]	93.4%

Furthermore, pension funds have experienced severe losses in recent years. The Pensions Board, in its Annual Report for 2011, estimated that about 70% of defined benefit schemes are in deficit.

Many say that the 0.6% temporary Pension Levy, introduced to fund the Jobs Initiative, has exacerbated these difficulties. The levy has reduced the value of the funds to which workers have contributed throughout their working lives and has decreased the pension income of retirees. The OECD Pensions Outlook 2012 notes that *"the retroactive tax levy introduced on Irish pension funds has also raised eyebrows in the international pension policy community"*.

The Institute is of the view that any further reform of the tax treatment of pension contributions should be carefully thought through so as not to further exacerbate the problem of inadequate pension coverage. While we appreciate the short to medium term budgetary imperatives facing the Government, the long-term sustainability of our pensions infrastructure is vital. Accelerating tax revenues to the current year could result in a much increased burden on the State in future years.

5.1 Addressing inequalities in pensions taxation

Reform of pensions policy since the crisis began has also built up inequalities among taxpayers, depending on their employment status. There is significant disparity in the pensions benefits available to, and tax treatment of, private sector PAYE workers, the self-employed, public sector incumbents and public sector new entrants.

This disparity is partly due to the investment losses experienced by pension funds in recent years, but can also be attributed to a combination of the following factors:

- **Changes to tax treatment of private sector pensions:** While tax policy towards pensions should be supportive of savings activity up to an adequate level, some might argue that the policy direction in recent times has had the opposite effect.

[20] In the Netherlands, occupational pension plans are quasi-mandatory (OECD Pensions Outlook 2012)

The reduction in earnings limits, the application of USC and PRSI to contributions, the reduction in the Standard Fund Threshold and the introduction of the temporary Pension Levy have all combined to make it less tax-efficient for private sector workers to save for retirement through pension planning.

- **Differing treatment of incumbents and new entrants:** The Public Service Pensions (Single Scheme) and Remuneration Bill 2011 proposes amendments to public sector pensions arrangements for new entrants, but the Bill has yet to be enacted. It is notable that incumbents will not be affected by the changes proposed in the Bill. This contrasts with the position in respect of amendments to the private sector pensions framework, which have an immediate impact on incumbents.

- **Valuation of defined benefit schemes:** Defined benefit pension funds are valued using a capitalisation factor of 20:1. However, in reality, public sector pensions may provide added benefits such as an early retirement age, spousal protection or escalation entitlements. It is suggested by some that a ratio upwards of 30:1 may be considered more accurate for such funds.

  The capitalisation factor of 20:1 also implies an annuity rate of 5% upon retirement. Our feedback is that annuity rates are now much lower. This means that participants in defined contribution schemes are required to have much larger funds (in excess of the Standard Fund Threshold) to fund pension income equivalent to that available from public sector funds which may be valued at the Standard Fund Threshold. Defined contribution pensioners are then subject to penal rates of taxation on funds in excess of the Standard Fund Threshold.

It is vital that pensions policy moves towards attaining a position of equality among private sector PAYE workers, the self-employed and public sector employees. As private sector employees get closer to retirement, the standard fund threshold makes it more difficult for them to attain a fund close to what is attainable in the public sector.

5.2 The approach for Budget 2013

At the outset, we would make the important point that pension contributions are not a means of avoiding tax but are merely a way of allowing workers to defer a tax liability, as an incentive to save for their retirement. Indeed, there is already a mismatch between the relief available on contributions and the tax suffered on draw-down, i.e. income tax relief (only) at the marginal rate is available on contributions, while draw-downs are subject to income tax at the marginal rate and also USC.

In formulating an approach to pensions taxation for Budget 2013, the Government will have regard to the cost of the tax expenditure associated with pension provision. The Tax Strategy Group papers for Budget 2011 estimated that the net cost of tax, PRSI and health levy relief on private pension provision ranges between €2.5 to €3 billion per annum.

However, those estimates were based on figures for 2007, and the intervening period has seen significant behavioural change in relation to pension planning. We have outlined above the falling levels of pensions coverage in Ireland. Far fewer individuals are now employed, and a smaller proportion of those who are employed are investing in a pension plan. Those who are continuing to make pension contributions are doing so to a lesser extent, and are not making sufficient contributions to fund an adequate pension. This behavioural change among income earners has already significantly eroded the cost of the tax expenditure associated with pensions.

In addition, a figure of €1bn is estimated as the cost of tax foregone on fund growth. This is based on a notional growth of 6% when, in practice, pension funds are below their 2008 levels. The figures also include a BIK cost for private sector employer contributions but not for the increase in liabilities by public sector employees.

We believe that the priority at the moment should be restoring public confidence in retirement saving by taking the following actions:

1. Maintaining marginal rate tax relief for pension contributions. In light of all of other recent changes to pensions taxation, any reduction in the level of tax relief for contributions could have very serious consequences for taxpayer involvement in pension planning. The prospect of the tax rate upon draw-down further exceeding the rate at which relief is available for contributions would likely prove a significant deterrent to pension investment.

2. Introducing a measure of certainty by confirming that the Pension Levy is a temporary measure and will end, as scheduled, in 2014.

3. Allowing funds in excess of the Standard Fund Threshold to be drawn down to help stimulate demand. The draw-down should be subject to taxation at marginal tax rates rather than the current penal rates of up to 69% which apply to funds in excess of the Standard Fund Threshold. The draw-down could be done on a phased basis. The proposal would not affect the adequacy of future pension provision, as only the excess over the Standard Fund Threshold would be permitted to be accessed in this manner.

   Finance Act 2012 offered a precedent for this, as it contained a provision allowing individuals who have both private and public sector pension entitlements to "cash in" their private sector entitlement at their marginal rate of income tax on a once-off basis.

4. Ways should be examined of achieving fairness by introducing a measure for public sector pensions that would have a similar effect to the Standard Fund Threshold.

6. VAT

Institute recommendations on VAT

- If some VAT base-broadening measures are to be considered, particular care will need to be taken in evaluating the options in light of the position of VAT as a tax governed by a European Directive.

As part of its Seventh Review of the Programme of Financial Support for Ireland[21], the IMF noted that scope exists here for VAT base-broadening. The Institute is not in a position to comment on the economic impact which would result from an increase in rate applicable to one of the categories of rates or the removal of individual supplies from one rate and their placement in another. However, it is our view that particular care must be taken in evaluating these options because of the peculiar position of VAT as a tax governed by a European Directive.

The VAT Directive[22] provides for the application of various rates by member states. For instance the standard rate of VAT may not be less than 15% and a member state may apply a maximum of two reduced rates which may not be below 5%. The Directive also sets down rules relating to exemption with or without credit and it provides for limited derogations from the foregoing rules which apply where certain rates were in use prior to particular, specified, dates. In light of the complexity of each of these provisions and the multiplicity of supplies which are liable at different rates, it is not possible to make any specific comments but the Institute believes that a few general comments are warranted.

The Institute does not believe that the introduction of a third reduced rate is possible. Furthermore, many of the items which are taxable at the zero rate and to which exemption is applied have been "grand-fathered in" under the derogations in the Directive. The Institute would be concerned that if such a supply is removed from exemption or zero-rating it may not be legally permissible to return this item to the exempt or zero rate in the future; such decisions are likely to be permanent.

[21] *Ireland: Selected Issues* – IMF Country Report No. 12/265, September 2012
[22] Title VIII of Directive 2006/112/EC

Appendices

Appendix I

IMF proposals on income tax base-broadening[23]

"A reform strategy could seek to raise average PIT [Personal Income Tax] *rates for taxpayers earning above 67 percent of average wage (or €21,708); increase the income level at which the top marginal rate kicks in; ensure better targeting of special income tax reliefs (including for USC); and smoothen out kinks in the tax schedule. The following is one way to achieve this:*

(a) Phase out the annual PAYE tax credit of €1650 between the minimum wage (€17,508) and the average wage (€32,400). This will increase the average and marginal income tax rates for persons earning between the minimum and average wage; raise the average tax for those earning above the average wage; and improve the targeting of special income tax reliefs.

(b) The savings from (a) – which could be substantial – may be partly used to lower the income tax rate in the first bracket, or split it into two (e.g. 15 and 25 percent) so as to ensure that tax burdens do not rise for those earning below 67 percent of the average wage.

(c) The income ceiling at which the top marginal rate kicks in could be increased somewhat to partly compensate those earning around the average wage, taking due regard of the scope that exists to ensure more equitable tax treatment of married couples vs. individual payers.

(d) In addition, the PRSI could be better aligned with the income tax by (i) reducing the PRSI exemption threshold which, at €18,304 is 11 percent above the income tax entry point of €16,500; and (ii) phasing out the universal entitlement to an allowance on first €6,604 of income between the minimum wage and average wage, similar to what is proposed for the PAYE tax credit.

(e) Finally, the interaction of the USC, income tax and PRSI could be reviewed to iron out large kinks in the average tax schedule at the USC and PRSI exemption thresholds."

---

[23] IMF Country Report No. 12/265 – September 2012 (page 40-41)

Appendix II

The competitiveness strategy adopted in the UK

The UK Government has set itself the target of creating the most competitive tax system in the G20 and has communicated its plan of action towards achieving this goal well in advance. In its March 2011 document, *The Plan for Growth,* HM Treasury identified 3 key benchmarks against which they intend to measure their progress:

(a) The lowest corporate tax rate in the G7 and among the lowest in the G20
(b) The best location for corporate headquarters in Europe
(c) A simpler, more certain tax system

The actions to be taken towards achieving the aim of creating the most competitive tax system in the G20 were identified as follows:

- Reducing the main rate of corporation tax
- Reforming the UK's Controlled Foreign Company (CFC) rules
- Introducing a new 10% rate of corporation tax on income from patents
- Reforms to the regime for taxing foreign branches
- Simplification of the tax system

Significant steps towards achieving these goals have been taken to date, and a progress report was provided with Budget 2012:

Figure 1.1: Implementation timeline for the Government's economic reforms

	COMMITMENTS ANNOUNCED	PROGRESS ALREADY ACHIEVED	FORTHCOMING IMPLEMENTATION
	BUDGET 2011 AND AUTUMN STATEMENT 2011	BUDGET 2012	BY BUDGET 2013 AND BEYOND
COMPETITIVE TAX SYSTEM	■ Reduce main corporation tax rate from 28 per cent to 23 per cent by 2014 ■ Introduce Foreign Branch Exemption, Patent Box and reformed Controlled Foreign Companies (CFC) rules ■ Commitments to raise SME rate of R&D tax credit and introduce an 'above the line' credit ■ Office of Tax Simplification review of small businesses taxation launched	■ Main corporation tax rate cut to 26 per cent in April 2011 and 24 per cent from April 2012 ■ Foreign Branch Exemption introduced in 2011 ■ Consultation on Patent Box and CFC rules completed ■ SME rate of R&D tax credit increased to 225 per cent from April 2012 ■ Consultation on simpler small business tax published at end of March 2012	■ By 2014 the main corporation tax rate will be cut even further to 22 per cent ■ Patent Box and modernised CFC rules will be enacted in 2012 ■ Above the line R&D tax credit in place from April 2013 ■ Measures to simplify income tax for up to three million small businesses in place from April 2013

As noted in the Budget 2012 documents, these reforms are building on the UK's already strong competitive position, having the highest number of double tax treaties in the G20, no withholding tax on dividends and a full dividend exemption.

The key measures announced in Budget 2012 were as follows:

- From 2013, higher rate of income tax to fall from 50p to 45p.
- Corporation tax rate to fall to 24% from 2012, eventually to fall to 22% by April 2014. This will be the lowest headline CT rate in the G7.
- Launch of a consultation on the integration of income tax and National Insurance Contributions.
- Introduction in April 2013 of a new cash basis for calculating tax for small unincorporated businesses.

HM Treasury in the UK has been to the fore in marketing the tax efficiencies which make the UK an attractive place in which to do business, one example being the manner in which tax incentives for the creative industry have been marketed[24,25].

---

[24] *UK to get world-class creative tax breaks* – HM Treasury, 18 June 2012 http://www.hm-treasury.gov.uk/press_48_12.htm

[25] HMRC Patent Box and CFC roadshow: http://www.hmrc.gov.uk/ct/forms-rates/claims/patent-box-roadshows.htm

Appendix III

Recent changes to Irish pensions policy

Measures taken by Government in dealing with the current budgetary difficulties have already included a number of significant changes to Irish pensions policy. It is useful to review the amendments over the past number of years and their impact, in order to inform the future policy direction.

The October 2008 Budget began the process, with the following adjustments to private sector pensions:

- Reduction in the annual earnings limit for tax-relievable contributions to €150,000
- No indexation of the Standard Fund Threshold

The public sector pension-related deduction was subsequently introduced with effect from 1 March 2009, and it resulted in an average deduction of 7.5% from the salaries of public servants. Further changes to public and private sector pension arrangements were made in the last 2 Budgets and in the Jobs Initiative, and these are detailed in the following table:

Instrument	Changes affecting Private Sector	Changes affecting Public Sector
Budget 2011	• Employee pension contributions subjected to employee PRSI and USC • Employer PRSI for employee contributions cut by 50% • Annual earnings limit for tax-relievable contributions further reduced from €150,000 to €115,000 • Overall life-time limit of €200,000 introduced on the amount of tax-free retirement lump sum • Standard fund threshold reduced from €5.4m to €2.3m • Annual imputed distribution on Approved Retirement Funds increased from 3% to 5%	• 6%-12% reductions for all pensions over €12,000 per annum • Extension of the period under which pensions are calculated by reference to the pre-cut rates of pay from the end of December 2011 to the end of February 2012 • New pension scheme for new entrants (announced in Budget 2010) to come into effect in 2011 – pensions to be based on career-average earnings rather than final salary • Public sector pension levy to be subject to employee PRSI and USC
Jobs Initiative (May 2011)	• Introduction of annual Pension Levy of 0.6% on the market value of assets under management in Revenue-approved pension funds for the years 2011-2014	
Budget 2012	• Employer PRSI relief on employee contributions to occupational pension schemes abolished from 1 Jan 2012 • Annual imputed distribution on Approved Retirement Funds increased from 5% to 6% for asset values in excess of €2m • PRSAs also subject to the ARF deemed distribution rules • Changes to tax treatment applicable on the death of an ARF holder • Amendments to the tax treatment of funds in excess of the standard fund threshold • Encashment option for individuals with both private and public sector pension entitlements	• Encashment option for individuals with both private and public sector pension entitlements