Tax in Society Fantasy Budget Project - Team 11

Tax in Society	**Group 11**
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Introduction

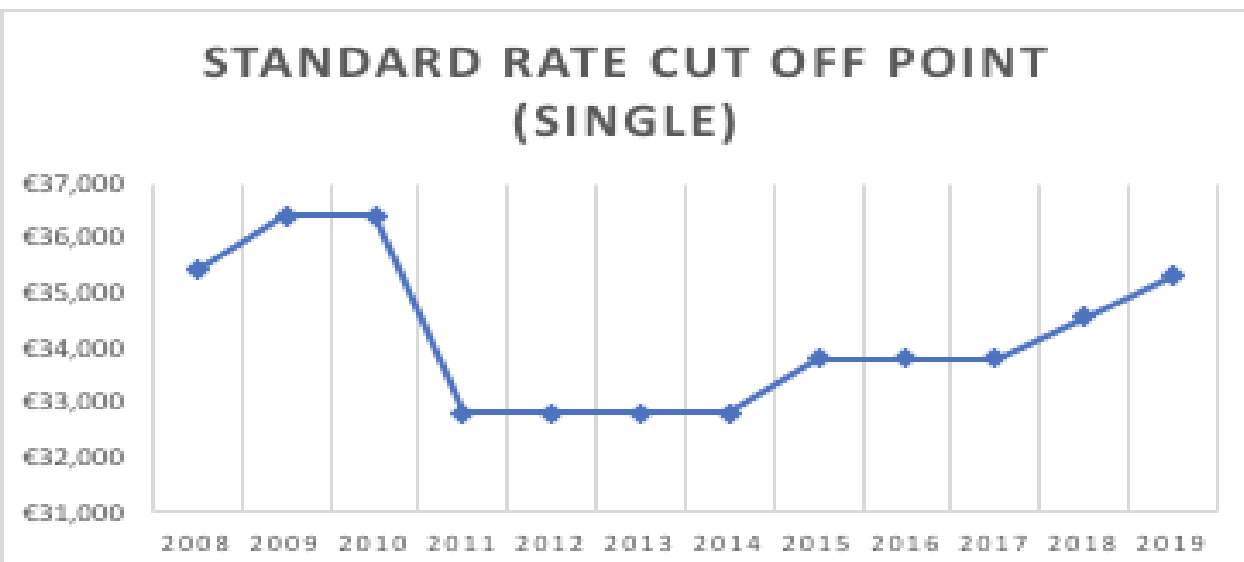
Our report investigates the impact of three key measures brought in by Paschal Donohue, Minister for Finance, in Budget 2019; the increase in the standard rate cut-off point, the abolition of the 9% VAT rate on tourism activities and the introduction of a 12.5% Exit Tax. Following that, we have briefly outlined a measure that we believe the government should have introduced, which is our proposed method to reform the current local property tax system.

One key measure that impacted the individual/family

A key measure that has impacted individuals/families is the increase in the standard rate cut-off point for income tax from €34,550 to €35,300. While this may seem like a relatively small increase, the importance of it is clear in that 40% of 2017 tax receipts came from income tax. This is one of several tax cuts that will cost the exchequer up to €350m, which is largely because the portion of the population paying tax at the higher rate will be reduced in 2019 (Reddan, 2018).

The increase means that a single person will pay tax at the lower rate of 20% on €750 more a year. Had Minister Paschal Donohue not broadened the lower band, it is believed that a further 65,000 units - single individuals and married couples - would have fallen into the higher tax rate of 40% (Reddan, 2018). With a higher cost of living and subsequent wage growth, this is a welcome change for those in the 'squeezed middle' earning between €36,000 and €54,000 a year, who could now make savings of up to €150 a year from income tax alone. However, net incomes are still down from the 2008 highs, a decade on from the financial crisis, says Ursula Matthews, senior manager at PWC (2018).

The chart below summarizes the changes in the Standard Rate Cut-Off Point for a Single Individual throughout the last decade:



The standard rate cut-off point has been rising gradually since it dropped from €36,400 in 2010 to €32,800 in 2011. The standard rate cut-off was also increased by €750 in Budget 2018, which is reflective of the higher 'living wage' and the increase in minimum wage by 50c in just two years. This year's widening is implemented in an effort to diminish the effect that salary inflation, which is currently 3.3%, will have on those in the squeezed middle according to Joe Tynan - Tax Partner with PWC (2018). This is confirmed in the CIPD/IRN Private sector pay survey which found that 56% of 350 organisations surveyed will increase basic pay this year by an average of 2.8% (CIPD Survey, 2018).

Although the increase in the tax band is moving Ireland towards a more competitive position in the EU, our personal taxes are still relatively high when compared to other European countries such as The Netherlands and Germany. With Brexit looming, it is essential that Ireland remains an attractive place to work and that the personal tax rates are low enough to attract overseas talent to Ireland (Connaughton, 2018).

One key measure that impacted indigenous Irish business

A key measure that has impacted indigenous Irish businesses in Budget 2019 is the announcement from Paschal Donohue that the VAT rate currently applied to tourism activities will increase from 9% to 13.5%, effective from 1 January 2019.

This comes after the Tax Strategy Group (TSG) recommended in their July 2018 report that the 9% rate should be abolished (2018). The reduced rate was brought in during the recession to try to stimulate demand in the tourism industry and with the economy experiencing significant growth, the TSG demonstrated in their report that the 9% rate for the tourism industry has served its purpose and should be reverted to 13.5%. The TSG also revealed that while the employment levels in most of the service industry returned to pre-recession levels in 2016, the accommodation/food services sector saw employment grow at the second highest rate since 2011, returning to its pre-recession level in 2014. This growth be seen in Table 3 below;

Table 3: Growth in Employment in Individual 9% Rate Activities

9% Sector	Growth in employment (jobs) over 2011-2016
Restaurants	41%
Hairdressing & beauty	25%
Accommodation	29%
Sport	5%
Publishing	-13%
Amusement parks	74%
Cinemas	-19%
Raising of equines	19%
Museum activities	14%
Operation of historical sites	155%
Total 9% Rate Sectors	**36%**

In line with Adam Smith's canon of efficiency, Minister Donohue believes that demand in the industry will not be affected by the increase in VAT and if this is indeed the case, it is estimated to generate an extra €466m in 2019 and €560m annually thereafter for the exchequer (O'Dea, 2018).

While the TSG supports this measure, many who operate in the industry are firmly against it. David Marshall (hairdresser) believes it will be "crippling" and that he will be unable to retire until his mid-70s as a result. As businesses in the highly competitive market already grapple with wafer thin profit margins, they feel unable to pass on any price increases to customers (Comer, 2018).

Aiden Murphy, adviser to the hotel industry, outlines that smaller hotels outside of Dublin will be hit much harder and furthermore, he believes that it will derail much of the investment and expansion planned in the regional hotel sector for some years (Paul & Kelly, 2018).

We are then left with the issue of what the effective incidence of the increase will be. As we know, the formal incidence of VAT is that consumers should bear the burden, however in January, individual retailers will have to decide what to do with their prices; to increase them, to accept a reduction in their profits, or some combination of the two (Paul, 2018).

While there is plenty of evidence in the TSG report to show that the industry has largely recovered since the economic crisis, much of this growth has been seen in the accommodation sector in Dublin. While there have been many negative reviews from other sectors in the tourism industry on Donohue's decision to abolish the 9% rate, it was always intended to be temporary and it is now time to revert to the original 13.5% rate.

One key measure that impacted foreign investment into Ireland

In relation to FDI, this budget is about remaining competitive and maintaining the transparency of our corporate tax structure. As a result of the EU Anti-Tax Avoidance Directive, we will see the introduction of a 12.5% Exit Tax from budget day. The tax has been established to prevent companies from moving assets that have unrealised capital gains out of the state (Roche, 2018).

The key to understanding the exit tax is the idea of a permanent establishment ("PE"). It can differ slightly between countries depending on their local PE regulation and any double tax treaties they have. We think the best explanation of a PE is *"a significant and continuous economic presence"* (Mazars, 2018).

As of 9 October 2018, unrealised gains will be taxed in the following three situations:

- Where a company resident in an EU country transfers assets from it's PE in Ireland to a PE in another country;
- Where a company resident in another EU country transfers the business carried on by PE in Ireland to another country; or
- Where a company transfers its tax residence from Ireland to another country.

No liability arises where assets are transferred relating to the financing of securities, as the asset is due to revert to Ireland within twelve months (Gulliver, 2018).

The key decision the government faced was what rate to apply. After industry consultation, the 12.5% rate was chosen because the gain is unrealised, so should be in line with the trading income rate. There is a sense of relief in the industry that it is not closer to the CGT rate of 33%.

In assessing the exit tax, we looked at Smith's canons of taxation. It's equitable because it was introduced as an anti–avoidance measure, and its function is to create a tax liability in the country where the gain arose. It satisfies the concept of horizontal equity because it's a flat tax with a

12.5% rate, so companies with equal liability pay equal amounts. Inter-nation equity is satisfied as it stops capital flight to other countries because liability arises when residence is transferred to another country. It is an efficient measure as it won't unintentionally distort economic decisions, because it has been introduced to deter certain behaviours. The exit tax will be administratively efficient because it will be on a self-assessment basis and will be disclosed in the corporation tax return**.** The measure satisfies the canon of certainty as the exit tax states clearly the situations where a liability will arise, and where it won't. The 12.5% rate makes the liability simple to calculate.

This exit tax is not designed to generate revenue, it is to prevent companies from moving their residence to low tax jurisdictions to dispose of assets. We think it is an effective measure that is in line with our current FDI policy and may deter large multinationals from moving assets owned by Irish subsidiaries to the US to take advantage of the low rate of 13.125% on foreign derived intangible income that was introduced last year.

A measure that the government should have introduced

We propose to redesign the Local Property Tax system by introducing a formula that calculates a different rate of LPT for each city/county council. The aim of this proposal is to:

1) Safeguard the current €500 million Local Property Tax intake.
2) Avoid large hikes in LPT through 'regional smoothing' (Kelly 2018).

<u>Current Local Property Tax</u>

In 2015, the amount of LPT owed by homeowners annually was frozen until 2019, meaning that people still pay the same amount of LPT that they have since the original LPT valuation in 2013, despite any increase in the value of their property. With house prices due to be revalued next year, politicians are concerned that the high levels of house price inflation since 2013 will cause severe increases in the LPT. Michael Brennan (2018) outlines the government's plan to reform the LPT, giving homeowners varying rates depending on which city/county council they live in. This plan is in line with recommendations made by Dr. Don Thornhill (2015) in his review of the Local Property Tax in 2015.

The main issue with this proposal is that it gives each local council the power to determine the rate through negotiation and deliberation every time there is a revaluation. This concept has come under heavy criticism for its lack of consistency on a national level. Evaluating this proposal using Smith's canons of taxation, we have established that this method lacks administrative equity.

<u>Reforming the Local Property Tax</u>

Our proposal is to introduce a Local Property Tax rate for each city/county council. The formula we will use to determine each rate is easily calculated by dividing the national rate of LPT by the cumulative effect of house price inflation in that area.

$$\text{Local Rate} = \frac{0.18\%}{\text{Cumulative House Price Inflation}}$$

Benefits of the Proposed LPT Model

According to the OECD's Hierarchy of Taxes, property tax should be the least harmful tax to economic growth. To avoid a tax being harmful, it must be stable. Using our model, as the rate of house price inflation changes, so too does the local rate in order to keep the amount of LPT payable constant. This mechanism safeguards the current €500 million LPT intake and means that homeowners who live in areas of high house price inflation will not be subject to steep hikes, defusing the highly anticipated 'LPT ticking time bomb'.

The table below outlines an example of an individual property valued at €1 million in 2013.

National Rate = 0.18%					
Year	**House Price Inflation**	**Cum Inflation (Indexation)**	**Market Value (€)**	**Local Rate After Indexation**	**Tax Payable**
2013	0%	1.00	€1,000,000	0.180%	€1,800
2014	2%	1.02	€1,020,000	0.176%	€1,800
2015	4%	1.06	€1,060,800	0.170%	€1,800
2016	6%	1.12	€1,124,448	0.160%	€1,800
2017	7%	1.20	€1,203,159	0.150%	€1,800
2018	9%	1.31	€1,311,444	0.137%	€1,800
2019	7%	1.40	€1,403,245	0.128%	€1,800
2020	6%	1.49	€1,487,439	0.121%	€1,800
2021	1%	1.50	€1,502,314	0.120%	€1,800
2022	-3%	1.46	€1,457,244	0.124%	€1,800
2023	-5%	1.38	€1,384,382	0.130%	€1,800
2024	-6%	1.30	€1,301,319	0.138%	€1,800
2025	-6%	1.22	€1,223,240	0.147%	€1,800

Assumptions

- House Price Inflation rates are random.
- The value of the property moves in conjunction with HPI in that area.
- Local rate = 0.18% / Cumulative Inflation
- Tax payable = Market Value of Property X LPT Rate

Yellow = Revaluation

Dr. Thornhill's review was mainly criticised due to the council's power to determine their own rate of LPT. Our proposal improves Dr. Thornhill's suggestion by removing the human element to apply an appropriate rate. This method also ensures that the tax policy will be consistent nationwide.

Both the current LPT and Dr. Thornhills's proposed LPT are inferior to our model in terms of flexibility. As the national rate of 0.18% is used in our formula for calculating the local rate, any future budgetary changes to the 0.18% will change each local council's rate proportionally. This controlling feature has never been achievable before due to the volatility in house prices.

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